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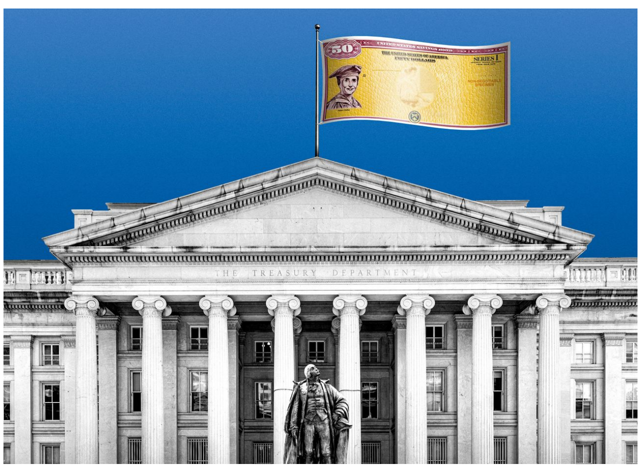
The Tax Advantages of Series I Savings Bonds

Also: Don't miss out on the tax benefits of using qualified charitable distributions



New Series I bonds sold from November 2021 through April 2022 currently earn interest at an annualized rate of 7.12%.

PHOTO: MIKEL JASO

By Tom Herman
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At first glance, a stodgy, government-guaranteed investment may not seem like the most thrilling investment idea. But for many investors that's exactly what U.S. Treasury Series "I" savings bonds are these days.

New I bonds sold by the Treasury from November 2021 through April 2022 earn interest at a mouthwatering annualized rate of 7.12%. (A new rate will be set every six months after that.) And that rate is attracting droves of safety-conscious investors looking for a hedge against inflation, plus a few tax advantages.

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The bonds, which are backed by the full faith and credit of the U.S. government, are sold directly by the Treasury through its TreasuryDirect site. (For answers to many frequently asked questions, check out the Treasury's "Series I Savings Bonds FAQs.") There are no brokerage commissions or fees. The minimum holding period is only one year. But the bonds earn interest for 30 years, or until you decide to redeem them, whichever comes first, the Treasury says. If you redeem them before five years, you lose interest for the previous three months. After five years, you can cash in the bonds without a penalty.

Investors are limited to buying only as much as $10,000 in electronic I bonds per person each year. But you can purchase up to an additional $5,000 per person in paper I bonds using your federal income-tax refund. (Personal disclosure: My wife and I each bought $10,000 of I bonds last year and plan to buy another $10,000 apiece this year, for a total of $40,000.)

While the current rate makes Series I bonds very attractive, there are also some tax advantages—and wrinkles—to consider.

The interest paid on savings bonds is free from all state and local income taxes. That can be an important feature for many upper-income investors who live in high-tax areas, such as New York City, California, New Jersey, Hawaii, Washington, D.C., and Oregon, among others.

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However, the interest income is subject to federal estate and gift taxes as well as state estate or inheritance taxes.

Savings-bond interest also typically is subject to federal income tax—but not always. Under certain circumstances, you may be able to exclude part or all of the interest earned from federal income taxes when the money is used to pay for qualified higher-education expenses for yourself, your spouse or a dependent during that year. The IRS offers an explanation in Publication 970, "Tax Benefits for Education."

Eric Smith, an IRS spokesman, says when filing your taxes you should attach Form 8815, entitled "Exclusion of Interest From Series EE and I U.S. Savings Bonds Issued After 1989 (For Filers With Qualified Higher Education Expenses)." For more details, see IRS Publication 550.

You have a choice on when to report the interest income on your federal income-tax return. Not surprisingly, most people defer reporting the interest income until they file a federal income-tax return for the year in which they receive "what the bond is worth including the interest," the Treasury says. The TreasuryDirect site also points out that when electronic I bonds in a TreasuryDirect account stop earning interest, "they are automatically cashed and the interest earned is reported to the IRS."

But there is another option that many taxpayers should consider. Instead of deferring reporting the interest income, they can choose to report it each year. That could be a smart move for someone with little or no taxable income. For example, consider savings bonds held in a child's name. "The child may be paying taxes at a lower rate than will be true years later when the bond matures," the Treasury says. Once you choose this option, however, "you must continue to do so every year after that for all your savings bonds (or, for example, the child's bonds) and any you acquire (or, the child acquires) in the future."

For more details, go to the TreasuryDirect site.

With tax-filing season under way, some readers have raised questions about qualified charitable distributions, or QCDs. Many older investors prize this technique as a tax-savvy way to donate to charity from a traditional individual retirement account. But, as one reader indicated, it's easy to miss out on this benefit if you don't pay close attention to the details.

Here is a quick review of the basics: If you are 70 1/2 or older, you typically can transfer as much as $100,000 a year from your IRA directly to a qualified charity without having any of that transfer subject to tax. A properly done QCD counts toward your required minimum distribution for the year.

Pay close attention, however, to the words "directly" and "qualified." The transfer really must be made *directly* from the IRA to a qualified charity. And not all types of charities are qualified for a QCD. For example, a reader asked whether a donor-advised fund, or DAF, is a qualified charity for a QCD. The answer is no. Congress specifically excluded DAFs, a popular charitable-giving vehicle, for this provision.

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Do you have a question about taxes or tax planning? Send it to taxquestions@wsj.com.

When you make a qualified charitable distribution, be sure to write yourself a reminder to help you remember it at tax-preparation time so that you don't mistakenly wind up paying tax on the transfer. It's easy to make that error—and it can be very costly.

Lastly, here is an unrelated reminder for donors: If you plan to claim the standard deduction for 2021 (as most taxpayers usually do) and if you made charitable deductions during the year, don't forget about a charitable contribution deduction for non-itemizers. For 2021, singles who don't itemize deductions typically may deduct as much as $300 of their gifts to qualified charities; joint filers can deduct as much as $600. (But donations to donor-advised funds don't count.) On IRS Form 1040, enter the amount on line 12b.

"As with contributions for itemizers, be sure to have a receipt or acknowledgment letter in hand before you file," says Mr. Smith, the IRS spokesman.

Mr. Herman is a writer in California. He was formerly The Wall Street Journal's Tax Report columnist. Send comments and tax questions to taxquestions@wsj.com.

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