Government Savings Bonds

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What is it?

Savings bonds issued by the U.S. government are considered one of the safest investments because they are backed by the full faith and credit of the United States. They offer several advantages, including safety of principal and exemption from state taxes, but there are some disadvantages.

The U.S. government has issued a total of 13 types of savings bonds, but only three series are currently offered: Series EE, Series HH, and Series I bonds.

> **Tip:** U.S. savings bonds differ from other U.S. Treasury bonds because they are nonmarketable.

> **Caution:** Series HH savings bonds will no longer be issued after August 2004.

Series EE bonds

First issued in 1980, Series EE bonds are among the most popular of Treasury securities. The face amount printed on the bond is known as its denomination, which can range from $50 to $10,000. Series EE bonds are sold at a discount equal to one−half of the face value of the bond. In other words, a Series EE bond with a face value of $100 would cost you $50. Instead of paying interest to bondholders, Series EE bonds are a form of zero−coupon bond . This means that the value increases in set increments semiannually and continues to gain in value for as long as you own it or until it matures.

The maturity date of a Series EE bond (i.e., when it reaches its full face value) depends on the interest rate of the bond at the time you purchased it. The maturity period of Series EE bonds is 30 years. You can hold them for up to 30 years or cash them in (redeem them) before that time. The original principal plus accumulated interest is payable upon redemption. You can buy up to $30,000 (face value) of Series EE bonds per person annually.

> **Caution:** You must hold Series EE bonds at least five years before you redeem them in order to avoid a three−month interest penalty.

> **Tip:** To find out what your governments savings bonds are currently worth or whether they're still paying interest, go to TreasuryDirect's website at www.publicdebt.treas.gov/sav/savrdtbl.htm .

> **Tip:** Certain Series EE bonds sold through financial institutions or over the Internet at www.publicdebt.treas.gov/ols/olshome.htm are now called Patriot bonds. The funds

raised by the bonds, while not earmarked for a specific purpose, will contribute to the federal government's overall effort to fight the war on global terrorism.

Series HH bonds

Series HH bonds were first offered in 1980. These bonds pay interest every six months, but they do not rise in value like Series EE bonds. The original maturity date on Series HH bonds is 10 years, after which they can continue to earn interest for another 10 years, for a final maturity of 20 years after the bonds were originally issued. However, the rates change after the first 10 years. Like other government savings bonds, the interest on Series HH bonds is subject to federal income tax, but not to state or local income tax.

> **Caution:** You cannot buy Series HH bonds for cash. They are only available by reinvesting Series H bonds (the series that preceded Series HH) or by exchanging Series E/EE bonds. Series HH bonds are available in denominations of $500 to $10,000.
>
> **Caution:** Series HH savings bonds will no longer be issued after August 2004.

Series I bonds

Series I bonds, an extension of the Treasury's inflation−indexed bonds, became available in September of 1998. They are intended to encourage Americans to save more by offering protection for interest income against future swings in the cost of living. They are available in several denominations from $50 to $10,000.

Series I bonds are sold at face value, and all interest is paid at redemption along with the face value. These bonds increase in value every month, receive compounded interest on a semiannual basis, and can be cashed in any time after six months. The interest is subject to federal income tax but not to state or local income tax. However, Series I bonds allow you to defer federal taxes on the interest for up to 30 years.

> **Caution:** If you cash in a Series I bond before 5 years, you will forfeit three months' worth of interest.

Strengths

Top quality

Government bonds are backed by the full faith and credit of the U.S. government, which collects taxes to pay bond owners. Because of this, there is almost no risk of losing your investment.

Easy to buy and redeem

You can purchase, exchange, or redeem government savings bonds at most banks. Some employers will also let you invest in these securities through automatic payroll deductions. You can also buy savings bonds with an automatic deduction from your bank account through the government's EasySaver program. For information, see www.publicdebt.treas.gov .

Interest is exempt from state and local taxes

The interest you receive from these bonds is exempt from state and local income taxes. However, the interest income is usually subject to federal income tax. This may not be the case, however, for Series EE bonds that are used to pay for college tuition (see below).

> **Caution:** You pay no state gift taxes on the transfer of government savings bonds. However, the bonds are not exempt from state inheritance taxes.

Interest may be exempt from federal income tax

Taxpayers who purchase Series EE bonds, and who meet certain income limits and usage requirements, may be able to claim a federal income tax exemption for the interest they receive on these bonds. To claim the exemption, the proceeds of the bonds must be used to pay for educational expenses.

For more information, see Series EE Bonds for Education Savings .

You can defer taxes on the interest

Series EE bondholders generally report interest they receive when they redeem the bond or when the bond reaches maturity. However, the IRS will let you report the interest in the year that it is actually earned if you make an election to do so. For more information, consult IRS Publication 17.

> **Caution:** If you elect to pay taxes on the interest you receive from Series EE bonds in the year you earn it, you must do so on all of the Series EE bonds you hold. You cannot choose one method for some bonds and another method for other bonds.

> **Tip:** Taxpayers who want to defer taxes on interest earned on their Series EE bonds can exchange them for Series HH bonds. However, this option is available only until August 31, 2004, because Series HH savings bonds will no longer be issued after this date.

Tradeoffs

May be difficult to figure out the interest rate and the rate of return on your investment

Series EE bonds do not come with an explicitly stated interest rate. The interest rate on bonds issued today is pegged to the average yield of other government securities at the time of issue, and bonds issued today pay a different rate than those issued in the past.

In addition, bonds issued prior to 1995 follow a two−tiered rate schedule. One rate schedule follows a government−guaranteed rate of return; the other follows market−based interest rates. The total interest you receive on your bonds is calculated under each schedule. You receive the higher total.

> **Tip:** To find out what your governments savings bonds are currently worth or whether they're still paying interest, log onto www.publicdebt.treas.gov/sav/savrdtbl.htm .

May not protect your investment from inflation

With the exception of Series I bonds, the rate of return on most U.S. savings bonds is pegged to fixed interest rates. If the rate of inflation rises, your investment will have less buying power. For a discussion on the relationship between inflation and risk, see Types of Risk .

On the other hand, Series I bonds are designed to protect you from inflation. You earn a fixed base rate plus a rate that is adjusted semiannually for inflation. The rates are declared twice a year, in May and November. The fixed rate portion remains the same for the life of the bond.

Cannot be sold or used as collateral for a loan

Unlike other U.S. government securities including other types of government bonds, government savings bonds cannot be sold in a secondary market. Moreover, you cannot pledge them as security to obtain a loan.

How to buy government savings bonds

Series EE bonds and Series I bonds

Most U.S. banks offer government savings bonds. You can also purchase bonds from the Federal Reserve and the U.S. Treasury Department or through a payroll deduction plan. Or, you can buy them online at www.savingsbonds.gov/ .

Obtaining Series HH bonds

You cannot buy Series HH bonds. You can acquire them in exchange for Series E bonds (an older issue of government savings bonds), Series EE bonds, and U.S. savings notes that are at least six months old. You can also acquire them by reinvesting Series H bonds that have matured. You need a minimum $500 redemption in order to make the exchange. For the first 10 years, you will receive interest at the fixed rate that prevails at the time of the exchange. If the bond is held longer, the interest rate will change.

> **Caution:** Series HH savings bonds will no longer be issued after August 2004.

Tax considerations

Taxes are generally due in the year the bond is redeemed

If you use the cash method of accounting (as most individual taxpayers do), you generally report the interest on U.S. savings bonds when you receive it. If you use an accrual method of accounting, you must report interest on U.S. savings bonds each year as it accrues. When you cash in a bond, the bank or other payer that redeems it must give you a Form 1099−INT if the interest part of the payment you receive is $10 or more.

If you have Series EE bonds or Series I bonds, you generally pay any income taxes in the year you redeem the bonds or at maturity, whichever comes first. The difference between the purchase price and the redemption value is taxable interest. However, if you elect to do so, the IRS may let you pay income tax on the interest from your bonds in the year the interest is earned. You must use the same method for all Series EE and Series I bonds that you own.

With Series HH bonds, interest is paid twice a year by direct deposit into your bank account. If you are a cash method taxpayer and have Series HH bonds, you must report interest on these bonds as income in the year you receive it.

You can defer taxes on Series EE bonds by converting them to Series HH bonds

If you exchange older bonds for Series HH bonds, you pay no taxes on the transaction, regardless of any interest you have earned on the older bonds. You pay the taxes when the Series HH bonds are redeemed or mature. At that time, you report as interest the difference between their redemption value and your cost. Your cost is the sum of the amount you paid for the traded Series EE or Series E bonds, plus any amount you had to pay at the time of the trade.

> **Tip:** You can choose to treat all of the previously unreported accrued interest on the Series EE or Series E bonds traded for Series HH bonds as income in the year of the trade.
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> **Caution:** Taxpayers who want to defer taxes on interest earned on their Series EE bonds by exchanging them for Series HH bonds have only until August 31, 2004 to do so, because Series HH savings bonds will no longer be issued after this date.

Income taxes are due when bonds change hands

When the ownership of a savings bond changes, it creates a taxable event (or disposition). If you give government savings bonds to a minor child, for example, you are liable for income taxes on all interest earned up to the date of the transfer. Tax liability for any interest that accrues thereafter passes to the child, who is likely to be in a lower tax bracket than you.

A gift of government savings bonds is a taxable disposition

Taxable events occur when the owner of savings bonds has them reissued in the name of a co−owner or a beneficiary, or gives the bonds to another person and reissues the bonds in that person's name. A taxable event also occurs when the owner of the bonds makes an irrevocable transfer to a trust.

Before the transfer, the current owner must pay income taxes on any accrued interest, and he or she may be liable for any gift taxes on the transfer. The transfer value would be the entire value of the bond at the date of the transfer.

> **Tip:** If you have given the recipient $11,000 (figure for 2004) or less in the year of the transfer, the gift may qualify for an exclusion from gift taxes under the federal gift tax rules.

The bonds are not revalued upon the death of the owner

Unlike other investments, government savings bonds are not marked up to fair market value when you die. Estate executors have three options when reporting income from these investments. They can elect to:

- Report any unreported interest on the final income tax return
- Report all the savings bond interest in the estate, or
- Distribute the bonds to the beneficiary

In the third case, the beneficiaries can report the savings bond interest when the investment is redeemed, or they can make an election in any year to report previously unreported interest.

> **Tip:** Your executor should calculate which method generates the most tax savings. The people who ultimately receive the bonds can choose to continue deferring interest or to report the interest annually on the bonds they receive.

A number of other rules apply to bonds, such as how to report taxes when bonds are sold between interest dates. For more information, see IRS Publication 17 and/or consult a financial planning professional.

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