


SAVINGS BONDS

*Charitable and  
Tax-Saving Strategies*

DONOR'S GUIDE



## CHARITABLE AND TAX - SAVING STRATEGIES

*M*any people have accumulated interest on U.S. Savings Bonds that they purchased years ago. Owners of these bonds are often reluctant to cash them in for fear of having to report large amounts of taxable interest income on their income tax returns. Even giving the bonds to a child will trigger taxation of the accumulated interest. Consequently, many people hold the bonds until death, at which time their estates or their beneficiaries must pay income tax on the interest accumulated over their lifetimes.

No matter how large or small the amount, savings bonds can be used as the basis for a charitable gift, either during your lifetime or upon your death. If you want to make a charitable gift during your lifetime, you will first need to redeem the bonds for cash and then donate the cash as a gift—as savings bonds cannot be given directly to a charitable organization. The charitable tax deduction from the cash gift may reduce the income tax burden that occurs from cashing in the bonds. The deduction for cash gifts is limited to 50 percent of your adjusted gross income with a five-year carryover.




If you want to make a charitable bequest, savings bonds will produce more tax benefits than almost any other type of asset. If savings bonds are left to your estate or to your heirs, income tax will need to be paid on all of the accumulated interest. If the bonds are left to a charitable organization or a charitable remainder trust, however, no income tax will be paid when the bonds are redeemed because the organization and trust are both tax-exempt. The charitable remainder trust provides for a tax-free redemption of the bonds and benefits both the bond owner's descendants and his or her charitable intentions.

If your estate exceeds \$2 million, it could be subject to estate tax. Although the highest estate tax rate is 46 percent, the additional income tax assessed upon the redemption of the bond can easily raise the total tax bill on the accumulated interest up to 65 percent! Rather than have 65 percent of the interest paid to the government, you can make a charitable bequest of the bonds so that 100 percent of the value is dedicated to your selected charitable purpose.

### **Lifetime Gifts of Savings Bonds**

Savings bonds that accrue income, such as EE bonds, generally cannot be transferred to anyone during your lifetime without reporting the




accumulated interest on your income tax return. The advantage of redeeming the bonds for cash, and in turn making a cash gift, is that you can claim a charitable income tax deduction, possibly offsetting the additional income tax in the year of the transfer.

### ***Gift to Heir***

**Example:** Charles has, in his name, savings bonds worth \$5,000 that he originally purchased for \$1,000. He gives the bonds to his son by reissuing them in his son's name. Charles must recognize the entire \$4,000 of accumulated interest income on his income tax return in the year that the ownership was changed. He will not be able to claim an income tax deduction for a gift to his son.

### ***Gift to Charitable Organization***

**Example:** Curtis has, in his name, savings bonds worth \$5,000 that he originally purchased for \$1,000. He can make a gift to his favorite charitable organization by redeeming the bonds for cash and giving the cash. He must recognize the entire \$4,000 of accumulated interest income on his income tax return. He will be entitled, however, to an offsetting charitable income tax deduction of \$5,000—the full value of the bonds—up to 50 percent of his




*adjusted gross income, so he may not owe any income tax in the year that he made the gift. In fact, he will have a net income tax deduction of \$1,000 (\$5,000 charitable deduction minus \$4,000 of income).*

### **Charitable Bequests of Savings Bonds**

Savings bonds are a great asset to bequeath to a charitable organization. When the organization redeems the bonds, it will be able to keep the entire value for charitable purposes. The accumulated interest income will never be taxed! If you have the bonds transferred to a charitable remainder trust that will make payments to a relative or friend for life, and then ultimately pay the remainder to a charitable organization, the trust can redeem the bonds without paying income tax because it is also tax-exempt. This will permit larger payments both to your relative or friend and to the charitable organization.

### **Outright Bequests**

*Example: Deborah has savings bonds worth \$12,000 that she purchased for \$2,000 (the untaxed, accumulated interest totals*



*\$10,000). She also owns publicly traded stock worth \$12,000 that she purchased years ago for \$2,000. She is considering a charitable bequest of \$12,000 to her favorite charitable organization. Her estate does not exceed \$2 million, so it will not be subject to estate tax.*

Deborah's children will be better off if she bequeaths the savings bonds, rather than the stock, to the organization. If she gives the children the stock, its cost basis will be "stepped up" to its value on the date of her death (i.e., \$12,000) so that they will have no taxable income if they subsequently sell the stock for \$12,000. By comparison, if she gives the stock to a charitable organization and her children receive the savings bonds, they will have taxable interest income of \$10,000 when they cash in the bonds. After paying as much as \$3,500 of income tax (35 percent tax rate times \$10,000 interest), they will have less cash than if they had received the stock. Whether Deborah bequeaths the stock or the savings bonds, because it is tax-exempt, her favorite organization would have the same \$12,000.



## Charitable Remainder Trusts

A charitable remainder trust is tax-exempt. If your will or living trust provides that your charitable remainder trust will own the savings bonds after your death, then the trust will not pay any income tax when it redeems the bonds. The trustee can reinvest the proceeds in other investments and most likely pay a higher rate of your return to the people who you want to benefit from the trust. When the last beneficiary dies, the proceeds of the trust will be given to further the purposes of your favorite charitable organization.

***Example:** Maddy owns Series EE and HH savings bonds worth \$250,000, of which \$100,000 is untaxed interest. She wants to establish a charitable remainder unitrust in her will with a 7 percent payout for her 60-year-old son. Her estate will not be subject to estate tax because her total wealth does not exceed \$2 million.*

As Maddy considers the assets to fund the trust at her death, she should probably select the savings bonds. Had she given the bonds directly to her son, the son would have had to recognize all \$100,000 as ordinary income and pay income tax on this amount. The original



purchase price of \$150,000, by comparison, would be a tax-free return of capital. After paying as much as \$35,000 of income tax (35 percent of the interest income), the son would have only \$65,000 of the \$100,000 interest earnings along with the \$150,000 original principal left to invest.

If the bonds were instead bequeathed to a charitable remainder trust, the trust, because it is tax-exempt, could redeem the bonds without paying income tax. If the unitrust could only earn 5 percent, the son would receive the 2 percent differential from the trust over his lifetime. The net result is significant income tax deferral because:

1. The entire \$100,000 of interest earnings (along with the \$150,000 principal) could be invested to produce investment income, whereas the son might have had only \$65,000 plus \$150,000, or \$215,000, of after-tax proceeds to invest.
2. Much of the taxable \$100,000 interest earnings would be gradually distributed to the son over his lifetime rather than in one lump sum, which could lessen the tax liability.



## How to Make a Bequest of Savings Bonds

The best way to give savings bonds to a charitable organization is to have a provision in your will that states that your savings bonds shall become the property of the organization after your death. The estate will distribute the bonds to the chosen organization or the charitable remainder trust. Then the institution or charitable remainder trust will report the interest income when it redeems the bonds. Because charitable organizations and charitable remainder trusts are tax exempt, however, no tax will be due when the bonds are redeemed.

See your attorney and financial advisor to structure your charitable gifts in the most advantageous way.

## Types of Savings Bonds and How They Work

**Series EE Bonds (Patriot Bonds).** Series EE savings bonds, the most common type, are usually issued at a discount price of half of the bond's stated maturity value. For example, a savings bond with a stated maturity value of \$100 is usually purchased at a discount price of \$50. Each bond grows in value because of the accumulated interest. It can



be redeemed at the maturity date for the stated value, but often the owner continues to hold the bond, which accumulates interest. The owner needs to pay close attention to the purchase date, as the Series EE bonds stop paying interest 30 years after that date.

The owner is usually not taxed until he or she redeems the bond. The amount of interest income that the owner must eventually report is the difference between the bond's redemption amount and the original purchase price.

**Series HH Bonds.** Series HH savings bonds, issued at the face amount, pay interest twice each year and stop paying interest after 20 years.

A popular strategy, which ended Aug. 31, 2004—when new Series HH bonds were no longer issued—allowed owners of Series EE bonds to swap those bonds in a tax-free exchange for Series HH bonds. This enabled them to receive biannual interest payments based on the full value of the Series EE bonds without having to recognize the accumulated interest from the Series EE bonds. If the Series HH bonds are ever redeemed, the owner will finally be taxed on all of the accumulated interest on the Series EE bonds.



**Series I Bonds.** This newest form of savings bond pays a yield that is a fixed percentage above the rate of inflation. These bonds are issued at their face values, not at discounted values.

### The Most Common Planned Charitable Gifts

**Charitable Remainder Trust.** A charitable remainder trust makes payments to one or more people for life (or for a fixed term of years—maximum 20) and then the remaining proceeds are distributed to one or more charitable organizations. A charitable remainder trust is a separate trust that is established by the donor in which a trustee, who was selected by the donor, manages the trust. A charitable remainder trust that meets all of the requirements under tax law is a tax-exempt trust; it pays no income tax on the income that it accumulates.

The most common type of charitable remainder trust is a unitrust, which pays a set percentage (between 5 percent and 50 percent) of the value of the trust's assets, revalued each year. Another type is an annuity trust, which pays the same dollar amount to the beneficiaries each year until the trust terminates.



*Charitable Gift Annuity.* A charitable gift annuity is a contract between a person and a charitable organization in which the organization pays a fixed dollar amount each year to one or two persons over their lifetimes. A person who acquires a charitable gift annuity can claim a charitable tax deduction for a portion of the amount paid to the charitable organization.

Whereas payments usually begin shortly after the annuity is acquired, it is possible to have a “deferred gift annuity” in which larger payments begin at a later date (e.g., at age 65), resulting in a more sizable charitable deduction. Many, but not all, charitable organizations offer charitable gift annuities and deferred gift annuities.