

S A V I N G S B O N D S

Charitable and Tax-Savings Strategies

a donor's guide

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SAVINGS BONDS

Charitable and Tax-Saving Strategies

Many 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 gifting the bonds—to a child or a charitable organization, for example—will trigger 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 charitable gifts, either during your lifetime or upon your death. If you want to make an *outright charitable gift* of savings bonds during your lifetime, the charitable tax deduction from the gift may reduce the income tax burden that would otherwise occur from cashing in the bonds. The amount you can deduct will vary: the deduction for cash gifts is limited to 50 percent of your adjusted gross income with a five-year carry-over, or 30 percent if the bonds have appreciated in value. By making a *deferred charitable gift* you can get *both* an income tax deduction and a lifetime income stream from the deferred charitable gift.

If you want to make a charitable bequest at death, savings bonds will produce more tax benefits than virtually 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 decedents and charitable intentions.

If your estate exceeds \$1.5 million, it could be subject to estate tax. Although the highest estate tax rate is 48 percent, the additional income tax assessed upon the redemption of the bond can easily raise the total tax bill on the accumulated interest to more than 70 percent! Rather than have 70 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.¹ The advantage of charitably giving the bonds is that you can claim an offsetting charitable income tax deduction, eliminating income tax in the year of the transfer.

¹An exception is a transfer to a revocable trust, in which case no income is recognized.
Rev. Rule.58 2, 1958-1 C.B. 236

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 A CHARITABLE ORGANIZATION

Example: Curtis has, in his name, savings bonds worth \$5,000 that he originally purchased for \$1,000. He can give the bonds to his favorite charitable organization by reissuing the bonds in the name of the organization or by redeeming the bonds for cash and giving the cash. Either way 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—so he will 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 (\$4,000 of income minus \$5,000 charitable deduction).

You can also make a *deferred charitable gift* during your lifetime using savings bonds. This can be a helpful tax savings strategy for people who own bonds that are approaching the final maturity (30 years for Series EE bonds and 20 years for Series HH bonds).

Example: Nancy, 75, has Series HH bonds that are almost 20 years old and are about to stop paying interest of 4 percent. The bonds are worth \$10,000, and their original cost was \$2,000. She will redeem the bonds at their final maturity

date and will have to report \$8,000 of interest income that will be taxed at her highest marginal income tax rate. After paying tax, she will have less money to reinvest and will have less income each year.

As an alternative, Nancy's favorite charitable organization will issue—in exchange for a \$10,000 payment—a charitable gift annuity that will pay her \$710 (a 7.1 percent yield) for the rest of her life. This constitutes better cash flow than she had received from the interest on the bonds. In addition, she can claim a charitable income tax deduction of \$4,296 (43 percent of her payment to acquire the charitable gift annuity) that will offset the \$8,000 of interest income.

Charitable Bequests of Savings Bonds

Savings bonds are a great asset to bequeath to a charitable institution. When an organization redeems the bonds, it will be able to keep the entire value for charitable purposes—*the accumulated interest income will never be taxed!*² 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 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.

²Private Letter Ruling 9845026 (August 11, 1998). A private foundation will, however, have to pay the 2 percent excise tax that all private foundations pay on investment income. Rev. Rul. 80-118, 1980-1 C.B. 254.

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 \$1.5 million, so it will not be subject to estate tax.

Deborah's children will be better off if she donates 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 (e.g., \$12,000) so that they will have no taxable income if they 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 donates 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 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 with \$100,000 of untaxed interest. She wants to establish a testamentary charitable remainder unitrust with a 10 percent payout for her 60-year-old son. Her estate will not be subject to estate tax because her total wealth does not exceed \$1.5 million.

As Maddy considers the assets to put in the trust, she should probably select the savings bonds. Had she transferred the bonds directly to her son, the son would have had to recognize all \$100,000 as ordinary income and pay income tax on the entire amount. The original purchase price, 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 left to invest.

If the bonds were instead transferred 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 on the \$100,000 corpus, the son would receive the 2 percent differential from the corpus over his lifetime. The net

result is significant income tax deferral since:

1. The entire \$100,000 could be invested to produce investment income, whereas the son might have only had the \$65,000 of after-tax proceeds to invest.
2. Much of the taxable \$100,000 amount 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 transfer 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 institution 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, 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.

The information in this publication is not intended as legal advice. For legal advice, please consult an attorney. Figures cited in examples are based on current rates at the time of printing and are subject to change.

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