Taxes on I Bonds

Series I bonds are a popular savings investment that can also help you save on taxes…but the federal income tax consequences can be complex.

As investors seek to insulate their portfolio from rising inflation and the bumpy stock market, many are turning to Series I savings bonds (I bonds). Right now, I bonds are paying an interest rate of 6.89%. But don't just focus on the investment return. I bonds also have important tax advantages for owners. Interest earned on I bonds is exempt from state and local taxation, but owners can also defer federal income tax on the accrued interest for up to 30 years.

Unfortunately, though, the federal tax rules aren't always straightforward. As a result, the tax treatment varies depending on who owns the bonds, whether you gift the bonds to someone else and, in some cases, how they are used. What follows are descriptions of how and when I bond interest is taxed under federal law in nine common situations. Hopefully, if you're dealing in these savings bonds, the information below will help you trim your tax bill.

Buying I Bonds for Yourself

Buyers of I bonds have a choice when they acquire the bonds. They can pay federal income tax each year on the interest earned or defer the tax bill to the end. Most people choose the latter. They report the interest income on their Form 1040 (opens in new tab) for the year the bonds mature or when they're cashed in, whichever comes first.

However, deferring tax on the full amount of accrued interest for up to 30 years may sound like a great idea until you get the tax bill for three decades worth of interest. Also, taking the tax hit all at once can push you into a higher tax bracket, making the bill even more expensive than it needed to be.

Buying I Bonds for Someone Else

Savings bonds make great gifts. But if you buy I bonds for someone else, the interest is reportable by that person, provided the bonds are titled in his or her name.

The recipient can choose to defer paying tax on the interest or report it annually, just like any other holder of I bonds.

I Bonds Issued to Co-Owners

For I bonds issued in the name of co-owners, such as a parent and child or grandparent and grandchild, the interest is generally taxable to the co-owner whose funds were used to buy the bonds. However, that co-owner can choose to defer paying tax on the interest or report it annually. This is true even if the other co-owner redeems the bonds and keeps all the proceeds.

Gifting I Bonds That You Own

Gifting an I bond before maturity will accelerate taxation of the interest income. Giving away bonds you already own to someone else doesn't get you off the hook with Uncle Sam for owing money on previously untaxed interest. If the bonds are reissued in the gift recipient's name, you're still taxed on all that interest in the year of the gift.

Donating I Bonds to Charity

Donating an I bond before it matures to charity while you're alive will also accelerate taxation of the interest income. As with gifts to other people, giving away bonds you already own to your alma mater, favorite museum or other charitable organization doesn't let you avoid the tax on previously untaxed interest. You're still taxed on all that interest in the year the donation is made.

Inheriting I Bonds

If you inherit I bonds that haven't yet matured, who is taxed on the accrued interest that went untaxed because the original owner deferred the interest? It depends. The executor of the decedent's estate can choose to include all pre-death interest earned on the bonds on the decedent's final income tax return. If this is done, the beneficiary reports only post-death interest on Form 1040 when the bonds mature or are redeemed, whichever comes first. If the executor doesn't include the interest income on the deceased owner's final federal income tax return, the beneficiary will owe taxes on all pre- and post-death interest once the bond matures or is redeemed, again whichever is earlier.

Redeeming I Bonds to Pay for Higher Education

One way to avoid paying any federal income tax on accrued I bond interest is to cash in the bonds before the maturity date and use the proceeds to help pay for college or other higher education expenses. But there are lots of rules and hurdles to jump over to be able to take advantage of this additional tax perk. For instance:

- You must have purchased the bonds after 1989 when you were at least 24 years old;
- The bonds must be in your name only;
- The bonds must be redeemed to pay for undergraduate, graduate or vocational school tuition and fees for you, your spouse or your dependent;
- Grandparents can't use this tax break to help pay for their grandchild's college tuition unless the grandparent can, on his or her 1040, claim the grandkid as a dependent;
- Room and board costs aren't eligible for the exclusion; and
- The exclusion is subject to strict income limits (for 2022, the interest exclusion begins to phase out at modified adjusted gross incomes of more than $128,650 for joint filers and $85,800 for others and ends at modified AGIs of $158,650 and $100,800, respectively).

If the proceeds from all savings bonds cashed in during the year exceed the qualified education expenses paid that year, the amount of interest you can exclude is reduced proportionally.

Use IRS Schedule B and Form 8815 to report and calculate any excluded I bond interest used for education.

Buying I Bonds With Your Tax Refund

If you're due a refund with your federal tax return, the IRS makes it easy for you to use all or part of that money to buy an I bond. Just file Form 8888 (opens in new tab) with your Form 1040. You don't need to open an account in advance on Treasury Direct (opens in new tab), the government clearinghouse for buying and redeeming U.S. savings bonds. As long as you complete the Form 8888, the IRS will cause the I bonds to be mailed to you.

You can buy up to $5,000 in I bonds (note they come in increments of $50) with your tax refund. If you decide to go down this route, you'll receive paper I bonds in the mail that are issued in your name (or in the name of you and your spouse if you filed a joint tax return). You can also use your tax refund to buy I bonds in the name of anyone else, such as your child or grandchild. Again, you would elect this on Form 888