Investors Turn to I Bonds Amid Rising Inflation

By Tim Shaw

Low-risk investments offered by the U.S. government such as Series I savings bonds have grown in popularity as a strategy to combat inflation. This is a look at how I bonds are structured and treated for tax purposes.

Background. Series I bonds are provided by the Treasury Department and are nonmarketable, meaning they're not traded on a secondary market. Since the bonds are backed by the government, they can't lose value. While I bonds yield lower returns compared with other types of bonds, they are considered safer investments and have become more attractive in recent months, as I bonds are protected against inflation.

As "zero-coupon bonds," the bondholder earns interest on interest rather than being paid out over time. The bonds can be redeemed after 12 months and grow in value for up to 30 years. However, if redeemed in the first five years, the previous three months of interest is forfeited.

Interest rates. Composite, or "earning," rates for I bonds are calculated by combining two interest rates. A fixed rate determined at the time when the bond is purchased is locked in for the lifetime of the bond and doesn't change. Treasury updates the fixed rate every six months on the first business days of May and November.

The inflation rate, the other component of the composite rate, is tied to changes to the Consumer Price Index, meaning the rates increase with inflation. While the inflation rates are also announced at the same times as fixed rates, inflation rate changes are applied every six months starting with the initial issue date. For example, if a taxpayer purchases an I bond in August, the new inflation rate announced in November will be applied in February.

The current composite rate, in effect through October 31, is 9.62%.

Tax and reporting. Earned interest from I bonds are exempt from state and local tax, but not federal tax. There is an exception if a taxpayer sells a bond back to the government and uses the proceeds to pay for qualified higher education expenses at eligible institutions in the same calendar year.

Taxpayers have two tax methods to choose from. The bonds can be taxed under the cash method by deferring tax until they are redeemed. Alternatively, tax can be paid based on the interest earned over a year through the accrual method.

Interest from I bonds is reported on Schedule B of Form 1040 using. According to TreasuryDirect, the department's online platform for buying U.S. securities, most taxpayers choose to defer reporting interest, "putting it off until they are filing a federal income tax return for the year in which they receive what the bond is worth including the interest." However, some taxpayers may want to report the interest every year, such as if the savings bond is in a child's name. A summary of transactions resulting in interest income will be furnished to a taxpayer on Form 1099-INT.

How to buy. A taxpayer can purchase up to $10,000 in electronic I bonds annually using TreasuryDirect. To create an account, a taxpayer provides basic identifying information, including their Social Security number. After creating a password, caption, and reminder, a onetime code is sent via email or text to register the user's device. Once the account is created and a bank account designated, a taxpayer can buy bonds, with a minimum of $25. There are options for one-off purchases and scheduled purposes. Bonds can be set to be purchased at a particular frequency or at specified dates.

Paper I bonds are also available, but only if a taxpayer uses their income tax refund to buy them, according to the IRS. By submitting a Form 8888, Allocation of Refund (Including Savings Bond Purchases), a taxpayer can opt to allocate all or a portion of their return. Bonds purchased this way must be bought in increments of $50, and the annual limit for paper I bonds is $5,000. A taxpayer can gift these bonds to someone else using Form 8888, but gifts are counted toward the purchaser's annual limit.

No TreasuryDirect account or bank information is needed with this method.