What Are I Bonds?

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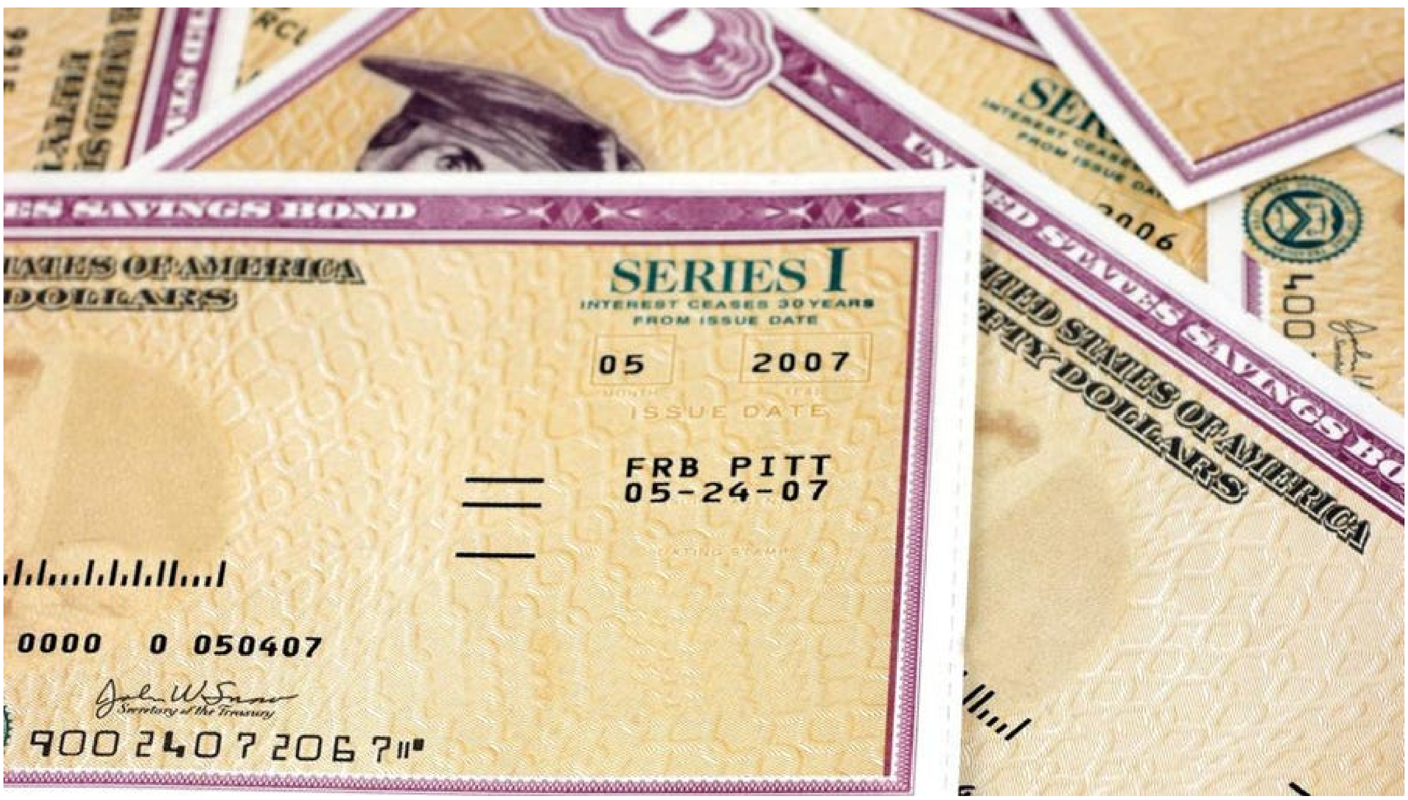

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I bonds are a type of U.S. savings bond designed to protect the value of your cash from inflation. With inflation hitting four-decade highs, investors are becoming more interested in higher-returning, lower-risk investments, and this variety of savings bond fits the bill.

"Today's I bond yield far surpasses that of any other government-guaranteed interest rate available from any bank, brokerage or other insured source," says Steven Jon Kaplan, CEO at True Contrarian Investments in Kearny, N.J.

I bonds are safe investments issued by the U.S. Treasury to protect your money from losing value due to inflation. Interest rates on I bonds are adjusted regularly to keep pace with rising prices. In addition, series I bonds are exempt from state and local income taxes, which makes them an even better low-risk investment for investors who live in high-tax states and cities.

Investors can buy up to $10,000 worth of I bonds annually through the government's TreasuryDirect website. You can purchase another $5,000 with your tax refund, upping the annual total purchase amount of series I bonds to $15,000 per person.

I bond interest is calculated using so-called composite rates based on a fixed interest rate and an inflation-adjusted rate, which we describe in depth below. I bonds earn interest monthly, though you don't get access to the interest payments until you cash out the bond. Interest you earn is added to the value of the bond twice per year. This means the principal amount you earn interest on increases every six months, positioning your money to compound over time.

You must own the bond for at least five years to receive all of the interest that is due. You cannot cash out an I bond before holding it for a year; if you do so after that point (but before five years), you forfeit three months of interest.

When Do I Bonds Mature?

I bonds have a maturity of 30 years. They carry a 20-year original maturity period immediately followed by a 10-year extended maturity period. There are several ownership caveats with series I bonds:

- I bonds cannot be cashed for one year after purchase. If a bond is cashed in year two through five after purchase, the prior three months of interest are forfeited.
- There is no interest penalty for cashing in the bonds after five years.

How Are I Bonds Taxed?

I bonds are exempt from state and municipal, but not federal, income taxes. If they're used to pay for qualified higher education expenses, however, I bonds may be completely tax-exempt. Owners can pay taxes on the interest earned annually, at maturity or when the bond is cashed. The only state tax due would be estate or inheritance taxes.

The owner of the bond is liable for the tax payments, regardless of who purchased the bond. So if you received an I bond as a gift, you are responsible for the tax payments.

What Are the Benefits of I Bonds?

but safe investments like I bonds can help you maintain the value of the cash component of your asset allocation.

Any security offered by the U.S. Treasury has nearly zero risk of default, and, as noted above, I bonds offer attractive tax benefits. Their interest payments, for instance, are exempt from state and local taxes, and they may be entirely tax free if used to pay for college tuition and fees at an eligible institution.

Marc Scudillo, managing officer of EisnerAmper Wealth Management and Corporate Benefits LLC likes I bonds for conservative investors. “Buying I bonds can be an attractive college savings strategy option as an alternative or in addition to 529 plans, which also grow tax free for qualifying higher education,” Scudillo says.

How to Calculate Series I Bonds Interest Rate

I bonds use what’s called a composite interest rate that consists of two parts:

- A fixed rate, set at purchase, that lasts for 30 years.
- An inflation rate that changes every six months, normally May 1 and November 1.

The composite rate isn’t quite as simple as adding these two rates together. Instead, it’s a more complex formula:

Composite rate = [fixed rate + (2 x semiannual inflation rate) + (fixed rate x semiannual inflation rate)]

For example, the composite rate for I bonds issued from May 2021 through October 2021 is 3.54%, which includes the 0.00% fixed rate and the semiannual inflation rate of 1.77%.

EE Bonds vs. I Bonds

The U.S. Treasury currently offers two types of savings bonds, series I bonds and series EE bonds. Whether you might prefer one over the other depends upon both the current interest rates and where you believe interest rates and inflation will trend in the future.

EE Bond and I Bond Similarities

- EE bonds and I bonds are sold at face value, and they both earn interest monthly that is compounded semiannually for 30 years.
- Both I bonds and EE bonds may be redeemed or cashed after 12 months. If cashed during the first five years, you forfeit three months of interest payments.

- for eligible higher education expenses.

EE Bond and I Bond Differences

- The interest rate on EE bonds is fixed for the life of the bond while I bonds offer rates that are adjusted to protect from inflation.
- EE bonds offer a guaranteed return that doubles your investment if held for 20 years. There is no guaranteed return with I bonds.
- The annual maximum purchase amount for EE bonds is $10,000 per individual whereas you can purchase up to $15,000 in I bonds per year.

Scudillo suggests that investors should consider that series EE bonds are guaranteed to double over 20 years and I bonds offer no similar payout guarantee. If interest rates and inflation remain low, then EE bonds, with their guarantee to double in 20 years would perhaps be best. Given lower trending inflation rates over the last couple of decades it would take longer to double your money. However, should inflation increase substantially, then I bonds holders would win out. Unfortunately, the only way to tell which bond earns more over time is in hindsight.

How To Buy I Bonds

You can buy I bonds electronically online at the TreasuryDirect website. You can also purchase up to $5,000 per year of paper I bonds with the proceeds from your tax return. There is no secondary market for trading I bonds, meaning you cannot resell them; you must cash them out directly with the U.S. government.

How to Cash in Savings Bonds

Electronic I bonds can be redeemed via the TreasuryDirect website. Paper bonds can be cashed in at a local bank.

How I Bonds Fit into a Low-Risk Investing Strategy

I bonds are an excellent choice for conservative investors seeking a guaranteed investment to protect their cash from inflation. Although illiquid for one year, after that period you can cash them at any time. The three-month interest rate penalty for bonds cashed within the first five years is minimal in light of the fact that they preserve your initial purchase amount and you would find similar penalties for early withdrawals from other safe investments.

I bonds are appropriate for the cash and fixed portion of most investment portfolios. Today, the I bond returns handily beat those of certificates of deposit (CDs). Parents might also consider accumulating I bonds to assist with future college payments.