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DISTRIBUTING U.S. GOVERNMENT SAVINGS BONDS

— by Neil E. Harl*

Series E and HH US. Government savings bonds pose difficult and troublesome challenges in planning.¹ First, taxpayers on the cash method of accounting have the option of reporting their interest currently for income tax purposes or deferring payment of income tax on the interest until the bonds are redeemed.² Deferral of income tax payment on accrued Series E bond interest appears to have been a common practice with farm families.³ Second, for taxpayers on the cash method of accounting who do not report the increment of increase in value of Series E bonds as taxable income, the increment in value up to the date of death becomes income in respect of decedent.⁴ Therefore, the accrued interest remains taxable after death of the owner.

General rules of taxability

A taxpayer may elect to include the periodic increase in redemption value of Series E bonds (and other non-interest bearing obligations issued at a discount) in income each year.⁵ The election is made on the taxpayer's return for any tax year.⁶ Once made, the election applies to all of the taxpayer's non-interest-bearing obligations for all succeeding tax years⁷ unless the taxpayer requests a shift in method of reporting by filing Form 3115 in a timely fashion for the year of change.⁸

In general, an owner of Series E bonds on the cash method of accounting who has not made the election to include the accrued interest in income⁹ must include the increment in value in gross income when the bonds are disposed of, redeemed or reach final maturity.¹⁰

The unreported increment in value reflected in the redemption value of Series E bonds as of the date of the decedent's death constitutes income in respect of decedent.¹¹ The decedent's estate may elect to report the unreported increment in value in the final income tax return of the decedent even though the bonds are held uncashed at death.¹² An estate on the cash method of accounting may elect to report the accrued interest on Series E bonds through the year of election on the estate's income tax return.¹³ The bonds could be held uncashed through the estate settlement process with the interest income reported by the ultimate beneficiary receiving the bonds by bequest or inheritance from the decedent.¹⁴

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Ltr. Rul. 9537011

In a 1995 private letter ruling, Series E and EE bonds were included in the decedent's residuary estate.¹⁵ The decedent and the decedent's estate were both on the cash method of accounting.¹⁶ Neither the decedent nor the estate had elected to report the accrued interest into income and the election had not been made to report the accrued interest income in the final return of the decedent.¹⁷

The decedent's will directed that the residuary estate was to be distributed in fractional shares to four charitable organizations¹⁸. The estate elected to distribute cash to three of the charities and bonds to the fourth charity.¹⁹ A 1969 revenue ruling²⁰ concluded that if a trustee is not authorized to make a non-pro rata distribution of property in kind but does so as a result of mutual agreement of the beneficiaries, the non-pro rata distribution is equivalent to a pro rata distribution followed by an exchange between the beneficiaries.

The Internal Revenue Service held, in the 1995 letter ruling, that the distribution of the bonds to one of the charities was not a taxable disposition by the estate.²¹ Because the decedent's will and local law both authorized the non-pro rata distribution of property to beneficiaries, the distribution of cash to three charities and bonds to the fourth was not deemed a pro rata distribution followed by an exchange.²² The interest income on the bonds was not includible in the estate's income (provided the estate does not elect to report the accrued interest in income²³); the accrued interest would be reportable in the gross income of the transferee charitable organization.²⁴

If property is paid or distributed in kind, no gain or loss is realized by the estate or other beneficiary by reason of the distribution unless the distribution is in satisfaction of a right to a specific dollar amount or in specific property other than that distributed.²⁵

Conclusion

With taxpayers typically wanting to defer recognition of the accrued interest as long as possible and to avoid taxability altogether if feasible, the 1995 letter ruling outlines an attractive strategy for some taxpayers.²⁶ If that is the objective, the bonds should be distributed in kind and not in satisfaction of a specific bequest. Unless both the will or trust and local law authorize non-pro rata distributions, it is important not to modify a plan by distributing cash to some beneficiaries and bonds to others.
FOOTNOTES

3 6 Harl, supra n. 1, § 47.03[1][b].
4 I.R.C. § 691(a); Treas. Reg. § 1.691(a)-2(b), Ex. 3. See Rev. Rul. 64-104, 1964-1 C.B. 223.
5 I.R.C. § 454(a); Treas. Reg. § 1.454-1(a)(1).
6 I.R.C. § 454(a).
7 Id.
8 Treas. Reg. § 1.454-1(a)(1).
9 I.R.C. § 454(a).
14 Treas. Reg. §§ 1.691(a)-2(a)(3), 1.691(a)-2(b), Ex. 3.
16 Id.
17 Id.
18 Id.
19 Id.
22 Id.
23 I.R.C. § 454(a).
24 Id.

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

BANKRUPTCY

GENERAL-ALM § 13.03.*

AVOIDABLE TRANSFERS. Prior to filing for bankruptcy, the debtor acquired a promissory note. The debtor also owed money to the debtor's parents and assigned the note to the parents. Despite the assignment, the debtor pursued collection of the note and eventually obtained a settlement in excess of the amount owed to the debtor's parents. The debtor paid a portion of the settlement to the parents within one year of filing for bankruptcy and the trustee sought recovery of the payment as a preferential transfer. The debtor argued that the payment was merely completion of the assignment. The court held that the assignment created only an unperfected security interest since the parents did not receive the entire settlement of the note and were entitled only to the amount of the note up to the amount owed to them by the debtor. Because the parents received more than they would as unsecured creditors in a Chapter 7 case, the payment of the note proceeds was an avoidable preferential transfer. In re Reeves, 65 F.3d 670 (8th Cir. 1995).

ESTATE PROPERTY. The debtor was a shareholder of an agricultural corporation and owned other agriculture-related businesses. Prior to filing for bankruptcy, the debtor's wife formed a new corporation which issued all of its stock to the wife. The debtor transferred all business assets to the corporation but did not receive any interest in the new corporation, although the debtor continued to operate the businesses transferred to the corporation. The court held that the transfers were fraudulent and imposed a constructive trust on the corporation's assets. The issue in this case was what post-petition assets were included in the bankruptcy estate. The court held that the constructive trust resulted in the stock of the new corporation being included in the bankruptcy estate. Therefore, the bankruptcy estate did not include post-petition assets acquired through post-petition transfers to the corporation or assets acquired through the uncompensated services of the debtor for the corporation. In re Reeves, 65 F.3d 670 (8th Cir. 1995).

EXCEPTIONS

HOMESTEAD. The debtor claimed a residence as an exempt homestead; however, at the time of the petition, the debtor was not living at the residence because of a fire which occurred more than six months before the petition date. Under Minn. Stat. § 510.07, if a home owner does not reside at a residence for over six months, a new declaration of homestead must be filed in order for the owner to claim a homestead exemption for the property. The debtor failed to file this notice and a creditor objected to the exemption based on the debtor's failure to file this notice. The Bankruptcy Court had cited a Minnesota Court of Appeals decision which held that the filing requirement did not have a casualty exception; however, the Bankruptcy Court rejected that decision and held that a casualty exception did exist and allowed the exemption. The District Court reversed, holding that the Court of Appeals' decision was applicable and denied the homestead exemption. The court noted that the fire did not prevent the debtor from meeting the filing requirements. In re Kasden, 186 B.R. 667 (D. Minn. 1995), rev'g, 181 B.R. 390 (Bankr. D. Minn. 1995).

SALE OF COLLATERAL. The debtor, a tomato farmer, filed for Chapter 11 but submitted a liquidating plan which was confirmed. The plan provided for abandonment of some property and a lifting of the automatic stay against other property to allow the secured creditor to foreclose against the debtor's land. The plan provided for the sale of the farm equipment and provided that the debtor would repair and maintain the equipment so as to realize the maximum selling price. The debtor was to be allowed the costs of maintenance and sale of the property from the proceeds as an administrative expense. The proceeds of the sale of all property exceeded the claim of the creditor. The Bankruptcy Court determined the amount of costs allowed to the debtor and assessed that amount against the secured claim of the creditor. The creditor argued that under the plan, the costs were assessable against the proceeds and did...