Gifts & Taxes: What to Know Before You Give

You can be generous with your loved ones during the gift-giving season without running afoul of the rules.

One way many individuals try to avoid estate and inheritance taxes is to give money away during their lifetime, effectively reducing the wealth that will be subject to federal taxes when it's passed on to heirs. This is a viable strategy, but it's important to know the gift tax rules so your generosity doesn't get you into trouble with the IRS.

What's considered a "gift"? Basically, any asset you give to another person without receiving something of equal value in return is considered a gift according to IRS rules. Most individuals give money without expecting anything in return, which would obviously qualify as gifts, but so would an interest-free loan that is forgiven at a later date. You can give property and shares of stocks, but the IRS's definition of "fair market value" will apply for the gift tax exemption.

Be aware that some transactions that you wouldn't think of as gifts may meet the IRS definition and could trigger a tax bill if the value is above the annual gift tax exemption. For example, paying $30,000 to cover the cost of a child's wedding reception or honeymoon would be a gift in the eyes of the IRS. So too would a $50,000 contribution to a child's 529 plan to cover the future costs of college tuition.

Know the limits. You're exempt from paying taxes on gifts if you keep them under the $15,000 per-person per-year limit. That's the exemption amount for 2020 and 2021. But even if you give above that limit, you can still avoid gift taxes by applying the amount above $15,000 to your lifetime gift tax exclusion. That exemption is $11.5 million in 2020. It's also indexed to inflation, so it will likely go up every year unless tax laws change.

The only catch with the lifetime gift tax exclusion is you have to report it to the IRS on Form 709. When you use your lifetime gift tax exclusion, you're effectively applying these gifts to your federal estate tax exemption while you're still alive. The filing requirement is how the IRS keeps track of how much of your remaining wealth may be subject to estate taxes after you pass away.

How to get around the gift tax. The laws around federal gift taxes provide plenty of leeway to help you give wealth to your beneficiaries without incurring tax penalties. For one, the $15,000 annual gift limit applies to each spouse in a married couple, so two people can give a total of $30,000 to another person in a calendar year. Also, the limit applies per person, not per couple or household. If your child is married, you can give up to $15,000 per year to that child and another $15,000 to his or her spouse.

Plus, there are no annual limits on gifts for college tuition, as long as you make the gift directly to the institution, not the student or the student's parents. There are also no limits on monetary gifts to cover someone else's medical expenses, as long as the money is paid directly to the health care provider.