

## Gift Tax 101: Tax Rules for Gifts

By Lori Rath and Alison Warden

Giving money away to family members and friends is a great way to not only pass on and share wealth, but to reduce the value of one's estate for tax purposes. Unfortunately, the taxation of such gifts is a frequently misunderstood area of the law. This article explains the basics of gift tax and answers questions about how to deal with it.

### **Rule 1: The Annual Exclusion**

As estate planning and tax attorneys, we frequently hear clients say something along the lines of this: "I can't give more than \$15,000 to anyone as a gift, right?" This belief stems from a common misinterpretation of the federal gift tax rules set forth in the Internal Revenue Code.

The general rule is that lifetime gifts are subject to gift tax, to be paid by the donor. One of the most widely used exceptions to this general rule, and perhaps the one most often misquoted, is the "annual exclusion" amount.

The annual exclusion, which has been set at \$15,000 since 2018, is not a limit on gifting but is instead a limit on the amount that a donor can gift during the year free of gift tax and, in most cases, free of gift-tax reporting requirements (i.e. no gift tax return is required).

This means that any living individual can give up to \$15,000 to one person in any one calendar year without having to report it to the IRS, without having to pay any gift tax, and without any gift tax consequences. The annual exclusion amount is *per recipient*, so a taxpayer can gift the \$15,000 amount to an unlimited number of recipients in a calendar year and remain in the clear. Because the annual exclusion applies to gifts made by each taxpayer, a couple can give double the annual exclusion amount to a recipient without having to pay tax or file a gift tax return.

While the annual exclusion is a valuable tool, gifts to certain trusts may not qualify for annual exclusion treatment, regardless of the amount transferred. Also, there may be good reasons to file a gift tax return even if a gift may be sheltered by the annual exclusion. For example, a gift tax return may be needed to allocate generation-skipping tax exemption to the gift, or to disclose the value of a gift that was in a form other than cash, such as a business interest.

### **Rule 2: Other Exceptions to the Gift Tax**

In addition to the annual exclusion, there are other exceptions to the gift tax. The gift tax does not apply to gifts made to qualifying charities, or to gifts made to qualifying

political organizations. Gifts to U.S.-citizen spouses may be made in unlimited amounts, free of tax and reporting requirements. Likewise, gifts made to cover another person's educational and medical expenses are exempt from gift tax and reporting, but only if the payments are made *directly* to the educational institution or medical provider.

### **Rule 3: Gifts in Excess of the Annual Exclusion**

If a gift is in excess of the annual exclusion amount, the donor must file a gift tax return. The good news, however, is that even though the gift needs to be reported, it is unlikely to be taxed due to the availability of the lifetime exemption from gift and estate tax, which under current federal law is \$11.58 million per person.

The lifetime exemption is a "unified" exemption – meaning it applies to gifts made during life and at death, cumulatively. Any gift made that is greater than the annual exclusion but sheltered by the lifetime exemption must be reported by the donor on a gift tax return (IRS Form 709). With each reportable gift, the donor's total lifetime exemption is reduced. The current lifetime exemption amount is set to drop back down to \$5 million (indexed for inflation) at the beginning of 2026.

So, how does this work in practice? Consider this example: Chris and Jane would like to give their unmarried son \$100,000 to buy a house and have made no prior lifetime gifts to any person. Chris and Jane write a check to their son for \$100,000. Because the annual exclusion amount is currently \$15,000 per person, Chris and Jane together can give their son \$30,000 (each year) without any gift tax reporting requirements or gift tax consequences. Because their \$100,000 gift exceeds this amount (in this case by \$70,000), Chris and Jane each will need to file gift tax returns to record the gift, but will not have to pay any gift tax. The tax effect is that Chris's and Jane's respective lifetime exclusions of \$11.58 million (under current law) will be reduced by \$35,000 each, to \$11.545 million.

Keep in mind that Washington state has its own estate tax, which is separate from the federal estate tax. Under current law, the Washington estate tax applies to estates over \$2.193 million. However, there is no state gift tax and also no state limit on lifetime gifting in Washington. This often creates opportunities for Washington residents to reduce or eliminate state estate taxes with advance planning and by implementing gifting programs.

Estate and gift plans involve complex issues and tax laws often change. Consulting with your tax and legal advisors to obtain advice about gift and tax planning matters is highly recommended.

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