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If you or a well-off relative are facing the gift and estate tax, here's a planning opportunity often overlooked: pay tuition and medical expenses for loved ones.

Such payments, structured correctly, do not represent gifts.

The monies spent by you on the qualified medical and tuition payments reduce your net worth and taxable estate, but they do no harm to your income, gift, or estate taxes.

Further, the loved one who benefits from your help does not incur any tax issues.

As unusual as this sounds, with the tuition and medical payments, you operate in a tax-free zone.

Gift and Estate Tax Exclusion

If you die in 2020, your heirs won't pay any estate or gift taxes if your estate and taxable gifts total less than $11.58 million.

If you are married and have done some planning, you and your spouse can avoid estate and gift taxes on up to $23.16 million.

Lawmakers set the current rates with the Tax Cuts and Jobs Act and also set them to drop by 50 percent in 2026. Gifts made now continue as excludable should they exceed the upcoming 50 percent drop.

Beating the Gift Tax with Tuition

The tuition exception to the normal gift tax rules involves direct payment of tuition (money for enrollment) made to an educational organization on behalf of another individual.

You may not two-step this. For example, you can't write a check to granddaughter Amy for $50,000 that she in turn uses for her tuition. Here, you made a $50,000 gift.

But if you write the $50,000 check directly to the educational organization to pay for Amy's tuition, you are in the tax-free zone. The $50,000 does not bite into your gift and estate tax exemptions, because it's for tuition.

The unlimited benefit here applies only to tuition for full-time and part-time students. You can't use it for items such as dorm fees and books. You can't pay the money to a trust and then require the trust to pay a grandchild's future tuition costs (this fails the test for direct to the institution).

Qualifying Educational Organization

The tax code defines "educational organization" as "an educational organization which normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on."

The regs elaborate by explaining that the term "educational institution" includes primary, secondary, preparatory, or high schools, and colleges and universities.

Example. You have four children, ages 7, 8, 9, and 10, at a private school where the tuition is $17,000 per year per student. Grandma Grace pays directly to the school the tuition for each of the children. Grandma Grace has no gift tax or other tax issues. Her payments are in the tax-free zone.

You can also pay the tuition to a foreign university. That tuition payment is in the tax-free zone just as if you had paid it to the University of Chicago.

Irrevocable prepaid tuition meets the rules and offers planning opportunities. Grampa Zeke has four grandchildren all in the first and second grades. He sets up and funds an irrevocable plan with each of the schools to pay the tuition at their respective schools. The plans qualify for tax-free zone treatment.

Planning note. Prepaid tuition can be a great death-bed strategy.

Beating the Gift Tax with Medical

The tax-free zone treatment of medical expenses requires that you pay the money directly to the medical care provider or insurance company (when paying for health insurance).

Under this plan, you avoid gift taxes when you pay directly to the provider any medical expense that would qualify as an itemized deduction on your Form 1040. Here are the basics:

- Qualifying medical expenses are limited to those expenses defined in Section 213(d) and include expenses incurred for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body or for transportation primarily for and essential to medical care. (See IRS Pub. 502, Medical and Dental Expenses for an easy-to-understand list of itemized medical deductions—note this link produces a PDF of the publication.)
- In addition, the unlimited exclusion from the gift tax includes amounts paid for medical insurance on behalf of any individual.

- The unlimited exclusion from the gift tax does not apply to amounts paid for medical care that are reimbursed by the donee's insurance. Thus, if payment for a medical expense is reimbursed by the donee's insurance company, the donor's payment for that expense, to the extent of the reimbursed amount, is not eligible for the unlimited exclusion from the gift tax, and the gift is treated as having been made on the date the reimbursement is received by the donee.

Example. Sam, your buddy, takes a big fall while climbing Mount Everest. You pay $67,000 of his medical bills directly to the medical providers. You are in the tax-free zone and face no gift tax.

Say that the insurance company reimburses Sam for $31,000 of the medical bills that you paid, and Sam keeps the money. Now, you have the following tax situation:

- You have $36,000 of medical bills that you paid directly to the provider that are in the tax-free zone and not subject to gift taxes ($67,000 - $31,000).
- You can avoid $15,000 of gift taxes because of the 2020 annual exclusion. Thus, of the $31,000 reimbursed to Sam by the insurance company, you pay gift taxes on $16,000 and avoid taxes on the remaining $15,000 because of the annual exclusion.

Final Thoughts

The primary rule to remember when using the tuition and medical gift tax-free strategy is that you must make the payments directly to the institutions and providers. Imbed this rule in your brain as rule one for this strategy. Don't violate it.

If you have a loved one who needs tuition or medical help from you, use the tax-free zone method. For example, you have an estate tax problem, but Uncle Jimmy needs help with his medical bills. Don't make a monetary gift to Jimmy to help him.

Even if you don't have a gift tax problem today, use the tax-free method because, who knows, you could win the lottery tomorrow.

And don't forget this strategy. Sure, you have an $11.58 million estate and gift tax exemption this year. In 2026, that's scheduled to drop by 50 percent (adjusted for inflation). But the current deficit issues could trigger a drop to, say, the 2008 exemption amount of $2 million, or lower.