# Take caution when including employees in your estate plan

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If you're the owner of a small business, you may think of your tight-knit group of employees as a family. If you wish to include them as beneficiaries in your estate plan, it's critical to be aware of possible unintended tax consequences.

**Unraveling the (tax) code**

Generally, money or other property received by gift or inheritance is excluded from the recipient's income for federal tax purposes. But there's an exception for gifts or bequests to employees: Under Internal Revenue Code Section 102(c), the exclusion doesn't apply to "any amount transferred by or for an employer to, or for the benefit of, an employee."

Certain gifts to employees aren't taxable, including "de minimis" fringe benefits, employee achievement awards and qualified disaster relief payments. Otherwise, the IRS generally views transfers to employees as "supplemental wages" subject to income and payroll taxes.

**U.S. Supreme Court weighs in**

Despite Section 102(c), it may be possible to make a gift to an employee that avoids income taxes. According to the U.S. Supreme Court, such a gift must be made under "detached and disinterested generosity" or "out of affection, respect, admiration, charity or like impulses." In contrast, if a gift is intended to reward an employee for past performance or serve as an incentive for future performance, it's considered compensation and is subject to income and payroll taxes. Unfortunately, the intent behind a gift can be difficult to prove.

Treating a gift or bequest as compensation isn't necessarily a bad thing. In some cases, the income and payroll taxes may be less severe than the gift, estate and generation-skipping transfer taxes that otherwise would apply. And you can always "gross up" the transferred amount to ensure that the recipient has enough cash to pay the taxes.

Please contact us if you're considering including employees in your estate plan.



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