

Chapter 6

Payroll and Pastoral Remuneration

Dual Status

A pastor has a dual status for tax purposes. Internal Revenue Service publication 517, *Social Security for Members of the Clergy and Religious Workers*, states the following regarding pastors:

You are considered a self-employed individual in performing...ministerial services for social security purposes. However, because of common law rules...you may be considered an employee for other tax purposes.

Under common law rules,

you are an employee if your employer has the legal right to control both what you do and how you do it, even if you have considerable discretion and freedom of action.

Most pastors have this dual status. Some tax advisors recommend that churches issue a Form 1099 to their pastor, considering him to be self-employed. This may be proper if your pastor arranges for and provides services for several churches. However, in most situations, a minister serves just one church. In that case, the IRS considers him an employee with the common law rules stated above. Therefore, you should prepare a W-2 Form for your pastor.

Publication 517 contains a comprehensive example of a minister's earnings. It shows how the pastor's salary and benefits should be reported on a W-2 Form. It also demonstrates how your pastor should complete each of the income tax schedules. We recommend that you get a copy of this publication from the IRS each year for you and your pastor.

There are several advantages for treating the pastor and other staff members as employees (if they meet the criteria for being an employee):

- Some *fringe benefits* can be excluded from income for employees. For independent contractors, you must report fringe benefits as income.
- If the church sets up an *accountable reimbursement plan*, employees can be reimbursed for their expenses without having to report those monies as income. You must report reimbursements to independent contractors as income.
- Employees have a lower risk of audit by the IRS. The IRS is beginning to investigate more extensively whether someone is an independent contractor. Suppose the pastor receives only one Form 1099, as would probably be the case if you pay him as an independent contractor. This could be a "red flag" to the IRS to audit your pastor.
- The IRS may determine that your pastor was improperly classified as an independent contractor, when he should have been considered as an employee. In that case, the church would be subject to unpaid taxes and penalty assessments.

Some people believe the IRS is employing questionable tactics in checking whether an individual should be treated as an independent contractor or an employee. There are several steps the church should take if it hires independent contractors and the IRS audits it.

- Don't answer *any* questions without competent tax or legal advice. The law allows the church to get a copy of the publication, *Your Rights as a Taxpayer*, before responding to any audit questions.
- Don't offer information about other churches or organizations that treat individuals as independent contractors. The IRS may use your information to investigate that organization.
- Don't let an agent intimidate you. They may suggest that your church "must have something to hide" if you want to contact a tax or legal advisor first. Also, do not be fooled by an agent who says that he is trying to be "nice to you." He or she may offer to "help you and work with you so that the workers will be treated as independent contractors."

Pastoral Remuneration Package

The church should pay its pastor an adequate salary. For a full-time pastor, this is a salary that allows him (and his family) to live at the same general level as the rest of the congregation and community in which he serves. Many pastors and church people are uncomfortable discussing salaries. Paul addressed this issue several times in his epistles to the first century churches. Paul was a tentmaker, supporting himself and his ministry by his trade. Yet he was very clear in stating that a worker who gives his life to the gospel should receive his living from the gospel (1 Cor. 9:1-18; Gal. 6:6). Focus on three considerations when you discuss salaries in the church.

- Seek to place in leadership men and women who commit themselves to scriptural principles.
- Determine **how** you will make decisions about remuneration.
- Set up clearly defined policies to deal with this issue.

The total salary and benefits "package" for a pastor contains several parts. Some of these are taxable sources of income, and others are non-taxable. Keep aware of current tax law developments that relate to clergy. This will help you *maximize* the benefits that your pastor(s) receives. We have included in **Appendix B**, a list of several publications that are updated annually.

The pastor's remuneration package may consist of the following:

Salary – This is a basic amount, part of which should be designated as "housing allowance." We will discuss housing allowances below. Report the part of the pastor's salary that is not designated as housing allowance as taxable wages on his W-2 Form. This amount, along with the housing allowance, is subject to self-employment tax.

Social Security Grant – Some churches provide an extra payment to the pastor to cover all or part of his Social Security Self-employment tax. This must be reported as taxable wages on the W-2 form; it is also subject to self-employment tax.

Expense Reimbursement/Allowance. This is for expenses such as travel, study, books, and entertainment. See the section on **Reimbursement of Expenses** below to determine its tax treatment.

Insurance – This can include life, medical, dental, and disability insurance. If the pastor is considered an employee for income tax purposes, do not report the amount the church pays for the premium as taxable wages. The exception is if you provide life insurance coverage in excess of \$50,000. Report the portion of the premium that is for the coverage over \$50,000 as W-2 taxable wages. (See **Chapter 8** for more information on insurance.)

Pension –The church may pay for his participation in an individual retirement account (IRA) or tax deferred annuity (TDA). Depending on the type, these are usually not immediately taxable (that is, they are *tax-deferred*) to the pastor for income tax purposes. For self-employment tax purposes, IRAs are taxable, but TDAs paid directly by the church to the investment company are not.

Equity Grant – If the church provides a parsonage, the leadership should consider contributing money to a tax deferred annuity (TDA) for the pastor. The pastor can then use this money to obtain housing when he retires. This is important, since he is not able to build up equity for this purpose as most homeowners do. This is different from other retirement funds, which are for general living expenses in retirement. A pastor may save funds using some other method for retirement housing. However, the TDA approach has an advantage: it is not taxable to the pastor (until he retires) for income taxes or self-employment taxes.

Setting the Pastor's Salary

Consider these factors as guidelines in setting your pastor's salary:

- Salaries paid to other professionals in the area
- Salaries that other churches similar in size in your area pay their pastors. Many churches are willing to share this information. However, note that some churches severely underpay their pastor.
- The cost of living in your area
- Average salaries of the members of the congregation
- Implications of IRS Intermediate Sanctions (discussed in detail in Chapter 9)

The governance authority may want to survey the congregation, following a form similar to the available sample. Note the following:

- State on the survey that the governance authority will use it to help determine the level at which you will pay the pastor.

- You may want to give several ranges to choose from in question #3, rather than asking for a specific amount.
- State on the form that it is confidential; many people do not like to discuss salaries.

Note: if this is a developing church, the district Church Planting Director, in consultation with the Advisory Committee, sets the pastor's salary.

Housing Allowance

A housing/parsonage allowance is a designated **portion** of the pastor's salary. It is *not* an amount in addition to his salary. As a result of specific laws, he does not report it as income for federal income tax purposes. However, it is generally subject to self-employment taxes. The housing/parsonage allowance may be in the form of a parsonage or an allocation of cash.

For a pastor who receives a rent-free parsonage as part of his compensation, the governance authority of the church should draw up a resolution that specifies the value of the rent-free parsonage and that states that the pastor may also exclude as parsonage allowance any utilities, maintenance, insurance or furnishings provided for the parsonage from the pastor's cash compensation. A pastor doesn't report the value of the rent-free parsonage and other related expenses as compensation on his federal income tax return. The value of a rent-free parsonage and related expenses is included in the pastor's self-employment income.

For a pastor who rents his home, the computation is straightforward. The sum of rent, insurance, maintenance, furnishings, and utilities is compared to the church-designated allowance and the lesser amount is deductible.

For a pastor who owns his home, the actual amount that a pastor can exclude from his gross income is the *least* of these three amounts:

- His church-designated housing allowance
- The amount he actually spent on housing expenses
- The fair rental value of his furnished home including insurance, maintenance, furnishings and utilities

He must determine the amount of actual expenses paid, which may include mortgage payments, acquisition costs, interest, taxes, insurance, maintenance, and utilities, and then apply the above criteria.

The pastor can exclude his housing allowance from his income only if the church governance authority officially designates the amount of the allowance before it is paid. We recommend that the church governance authority make this decision in the form of a continuing resolution. This is a statement that a designated amount is in effect until the governance authority changes it. The governance authority may forget to approve a housing allowance for the new year. By following this guideline, the continuing resolution from the previous year remains in effect. The church secretary must include this designation, as shown below, in the governance authority minutes. It

also may be helpful to get a letter from the church secretary for the pastor's file that states the governance authority's action.

Be it resolved that the (governance authority) approved a housing allowance for Rev. _____ in the amount of \$_____ for the year _____, and for future years unless changed by specific action of the (governance authority).

The pastor can exclude only the amount that he actually spends for running his home. For example, the governance authority designates the pastor's housing allowance as \$15,000, but he actually spends only \$12,000. He must report the difference of \$3,000 for income tax purposes on line 22 of Form 1040 as "Excess Housing Allowance." Similarly, if the fair rental value as calculated above is \$11,000, then he must report \$4,000 for income tax purposes.

Suppose the pastor buys a house for cash (as he might for instance, if he sells one house and buys a less expensive house for cash). The law no longer entitles him to most of his housing allowance benefit. This is because he does not have a mortgage payment. He cannot "spread out" over several years the cost of buying a home for cash.

The pastor is responsible for keeping records of all his housing allowance expenditures. He must be able to produce them if the IRS audits him.

Reimbursement of Expenses

Under current law you can reimburse the pastor for business or ministry expenses under an "Accountable Reimbursement Plan." If you do so, he is not required to report these reimbursements as income. The church must have a *written* policy describing the procedures of this reimbursement system. The reporting system should require the pastor to submit written records and receipts that detail each expenditure. These should include:

- the date
- the type of expense
- to whom it was paid
- the business or ministry purpose

We recommend that you photocopy these records. While law does not require this, it provides a set of records for the pastor.

As support for his travel expenses, the pastor should keep a "log" of all business mileage. He should note:

- the date
- the number of miles (the IRS is beginning to ask for odometer readings in some cases)
- the business or ministry purpose

The pastor's mileage expenses may be reimbursed at the current rate that the IRS allows, as well as for his actual costs for tolls and parking.

If expenses are reimbursed without an Accountable Reimbursement Plan, the pastor must report them as income. In this system, the pastor is sometimes given a "flat" monthly allowance for car or ministry expenses. He does not have to provide receipts and records to the church but should retain them in his own records should he be audited. He then deducts these expenses on **Schedule A** of his income tax return. However, under this system, his meal and entertainment expenses are reduced by 50 percent (IRS Publication 463). These are combined with other expenses, and are further reduced by two percent of his adjusted gross income. These rules can add a significant amount to the pastor's income tax liability. This amount can be avoided if the church uses an Accountable Reimbursement Plan.

Moving Expenses

When a church calls a pastor, it normally pays for the cost of moving him and his family. A portion of moving expenses is deductible if the following conditions are met by the pastor's acceptance of the new job:

- His new place of work (office or church) must be at least 50 miles farther from his former home than his former place of work was.
- As an employee, he must be employed full time in the new area for at least 39 weeks during the twelve-month period immediately following the move. If self-employed, he must work full time; comply with the previous 39 weeks rule, and for a total of at least 78 weeks during the first twenty-four months in the new area.
- His move must be closely related, both in time and place, to the start of the work at the new job location. The general rule is one year.

Deductible expenses allowed include:

- The cost of packing, crating, and transporting household goods and personal effects for the whole family. You may also deduct the cost of storing and insuring your goods and effects within any consecutive 30-day period after the things are moved from your former home and before being delivered to your new home.
- Travel expenses including transportation and lodging (but not meals) for the whole family while traveling to the new home.

Nondeductible expenses include:

- Temporary living expenses.
- Pre-move house hunting trips.
- Expenses related to the sale of a house or settling of a lease including mortgage penalties, home improvements to help sell the house or a loss on the sale. Expenses of purchasing a new home or obtaining a new lease.
- Meal expenses incurred while moving to new home.

- Real estate taxes.

In 1998 moving expense reporting significantly changed. The amount that the church pays for moving a pastor may be reported in a number of ways. Allowable moving expenses that are paid directly to a third party on behalf of the employee are not reported on the W-2. Allowable moving expenses that are reimbursed directly to the employee are reported in Box 12 of the W-2 and identified using Code P. Reimbursement of nondeductible moving expenses is to be included in Box 1 of the W-2 as taxable income.

Form 3903 is still the form that the pastor uses to compute his moving expense deduction for unreimbursed moving expenses or expenses reimbursed under a nonaccountable arrangement.

Expenses that the IRS allows the pastor to deduct for income tax purposes are also deductible from his self-employment earnings.

Honoraria and Love Offerings

Occasionally, the pastor may receive payments for performing weddings or funerals, or speaking at other churches. These payments could be referred to as “honoraria” or “love offerings.” Regardless what they are called, if they are for services performed, they must be treated as income for both income tax and self-employment tax purposes. Note that business expenses associated with these honoraria can be offset against the income.

As a rule, “love” gifts are considered compensation to the pastor and reported on his W-2 since he is an employee particularly if the church leadership initiates or assists in the collection of the gift through announcements or letters of solicitation. If the church board sees this gift as part of the compensation package, it is even more determinative of the compensation treatment. The gift can be determined by the IRS to be compensation even if you do not supply a tax deductible receipt to the donors. With that said, it is possible for a “love” gift to not be compensation, if it can be shown that it was truly a grassroots collection out of love and concern for the pastor by the members. This would mean that members wanted to give without any encouragement from the church, governance authority, or other church leaders. It is our opinion that the cleanest and easiest is to treat any kind of love gift for a pastor as compensation. The tax deductibility of love offerings is discussed under “Tax Deductibility Questions” in Chapter 3 above.

Earned Income Credit (EIC)

Many pastors and staff members may be eligible for the EIC, but not be aware that they are. It is a credit for certain workers. It reduces tax they owe and may give them a refund even if they don't owe any tax. The criteria for claiming the EIC has changed from year to year, as have the taxable and nontaxable earned income amounts that qualify, so we won't include the specific criteria here. Rather, we would encourage you to have your pastor and staff members check the requirements for the current year to see if they qualify.

Federal and State Unemployment Insurance

In general, nonprofit organizations are exempt from federal unemployment insurance. In most cases, they are also exempt from state unemployment insurance. While a church doesn't have to do anything to be exempt from federal unemployment insurance, the procedures for exemption from state unemployment insurance vary from state to state. In some states, a church must file the appropriate forms to be exempt. In other states, the exemption is automatic UNLESS the church files the appropriate forms to participate in the unemployment insurance program. Where a church chooses to participate in the unemployment insurance program, there is sometimes a choice of either paying a quarterly percentage of payroll, or in only reimbursing the state for actual unemployment claims. If the church has not already checked to see what the requirements are in its state, it should do so, either by calling the district office, or by calling the state department of revenue.