

Servant Solutions Memo #4

Strategies for Structuring Ministerial Compensation

This memo is written as a help guide for the Church of God

A review of the patterns of ministerial compensation over several decades would indicate that significant changes have taken place. Gone are the days when the majority of ministers received a large portion of their compensation in the form of food and clothing supplied by members of the congregation. The implications of the 1986 Tax Reform Act and subsequent IRS regulations also have made an impact.

The Impact of the 1986 Tax Reform Act

The 1986 Tax Reform Act had the most significant effect on tax law since its previous major overhaul in 1954. Along with many other things for which it is blamed, the Act's revisions made it much more difficult for ministers to avoid paying income taxes on unreimbursed business expenses. For example, unreimbursed automobile expenses cannot be deducted dollar for dollar from compensation, but must be deducted as a part of itemized deductions on Schedule A. With a high standard deduction allowance, many parsonage families find it impossible to itemize deductions. The result is the payment of more income tax for those ministers who cannot deduct unreimbursed automobile expenses.

The same problem applies to many of the business and professional expenses which a minister incurs in the exercise of ministry. In addition to the high standard deduction allowance, these expenses must also exceed 2 percent of the adjusted gross income reported on the federal tax return. Furthermore, entertainment expenses are only 50 percent deductible if not reimbursed.

Such regulations have caused many ministers to reevaluate the structuring of their compensation.

IRS Regulations for Business Expense Reimbursements

Requirements for business expense reimbursements are based on IRS Regulation 1.62-2(d)(3). These requirements apply to *every* church and affect *all* employees. They are not optional - they must be followed, or the church employee may pay significantly greater amounts of unnecessary taxes.

The IRS Regulations require that business reimbursements be included on Form W-2 as taxable income to the individual *unless* paid through an "accountable reimbursement plan" which has been "formally" adopted by the church board. The requirements for the accountable reimbursement plan are three-fold:

1. The church may reimburse only those business expenses that an employee substantiates within 60 days of the expenditure with receipts and/or in writing as to the date, amount, place, and business nature.
2. The employee must return any "excess" reimbursements (i.e., unused expense advances) within 120 days of the expenditure. The excess reimbursement may not be treated as a bonus or gift.
3. Any advance must be made within 30 days of when the expense is paid or incurred.

Form W-2 income cannot simply be reduced "after the fact." In other words, the IRS will not allow reimbursements to be paid through a retroactive reduction of salary. For reimbursements to be paid

and qualify under an accountable reimbursement plan, properly substantiated expense reimbursements must be paid separately from the employee's salary. The salary amount and the accountable reimbursement plan must be established in advance of payment. If the church establishes a dollar limit on the expense plan (instead of reimbursing 100% of expenses), any balance remaining in the expense plan at year-end should remain with the church. If the balance is paid to the employee, all other plan payments made to the employee during the year become reportable as taxable income on Form W-2.

The Cost of a Minister vs. the Cost of a Ministry

For too long, churches and ministers have lumped together into a single concept the "cost of a minister" and the "cost of a ministry." These are actually two distinct concepts. For proper planning and church budgeting, they must be kept separate.

The "cost of a ministry" includes those costs related to the work of the minister and is properly a part of local church expenses. Among these are the expenses that will be incurred without regard to which minister is serving the congregation at a particular time.

On the other hand, the "cost of a minister" relates to those items that are directly and indirectly related to compensating the particular minister serving the church at the current time. These costs include the general categories of employee benefits and actual salary.

The *least* advantageous way for a minister to be paid is to be given a lump sum amount out of which the minister must provide for professional expenses, employee benefits, and cash salary. Unfortunately, in most situations where these are lumped together, both the local church and the minister assume that the total amount of the "package" is compensation. In reality, part is for the "cost of a ministry" and part is for the "cost of a minister."

What is the Cost of a Ministry?

The following list includes business and professional expenses that are identified with the "cost of a ministry." They should be recognized and budgeted as local church expenses, *not* compensation.

When the minister is expected to pay for these items out of the amount provided in the church's "package," it will result in the parsonage family paying higher taxes on money they used to operate the local church's ministry. However, when these items are "reimbursed" through an accountable reimbursement plan (even if it means dividing the minister's previous "package" into two distinct amounts), it usually will result in lower taxes, a more accurate reflection of the minister's real compensation, and a simpler tax return to file.

The cost of maintaining a ministry includes the following business and professional expense reimbursements:

- Automobile
- Continuing education
- Conventions/assemblies
- Hospitality
- Pastor's professional library
- Dues to professional organizations
- Church supplies (birthday cards, postage, etc.)

What is the Cost of a Minister?

The "cost of a minister" is made up of appropriate employee benefits, provision for housing, and the actual cash salary paid.

Some of the items related to these are not discretionary since the minister and family have no choice as to how the money is spent. Items of a nondiscretionary nature include most of the employee benefits listed below. The list includes the type of basic employee benefits that should be provided in a well-balanced compensation plan:

- Social Security
- Tax-sheltered annuity (retirement)
- Health insurance
- Dental insurance
- Group term life insurance
- Long-term disability insurance
- Accidental death & dismemberment insurance
- Cash bonuses
- Paid holidays
- Vacation

The "cost of a minister" also includes the provision for housing: a cash housing allowance, a parsonage plus utilities, or a combination of the two. Many churches provide a parsonage and utilities. Therefore, in most cases, the minister has no discretion as to how that part of compensation will be spent. The minister cannot voluntarily choose to live in a less expensive home and thereby free up income to cover other personal needs. Also, the minister cannot build equity for retirement housing. The church board should recognize that when the minister leaves the church, a significant portion of the compensation that has been "paid" is left behind in the form of the parsonage. Fortunately, many churches are now recognizing their obligation to assist the minister in preparing for retirement housing by depositing monthly amounts into the minister's retirement fund on a tax-advantaged basis. This is an essential part of the compensation package. For more information on a minister's housing, see [MEMO #1](#) "Housing for Your Pastor: Parsonage or Housing Allowance?" and [MEMO #10](#) "The Minister's Housing Allowance."

The remaining item in the "cost of a minister" is the cash salary. This is the amount the minister and family use to meet living expenses and with which they have some discretion in spending. Among the factors many church boards consider when determining their minister's cash salary are: job requirements, professional qualifications, educational background, personal experience and expertise, socioeconomic factors affecting the pay scale in the local community, and such subjective factors as merit pay for a job well done. Cost of living adjustments should be considered in each annual salary review of all church employees.

Structuring Ministerial Compensation

Ministers and churches are realizing the need to differentiate between the "cost of having a ministry" and the "cost of compensating a minister." More and more churches are recognizing that their "package" approach does not provide nearly as much true cash salary as they had thought. They are making efforts to reimburse compensation above the "package" amount for business and professional expenses.

Other churches are financially unable to increase compensation above the amount committed to their "package." However, they can still help the minister by differentiating between these two kinds of costs and by allowing the minister to re-categorize the total amount provided by the church into these

distinct expense categories. The result of this restructuring costs the church no additional funds, but provides a legitimate opportunity for the minister to reduce the potential impact of taxes. For more information see MEMO #5 "Minimizing Income Taxes for Church Employees" and MEMO #8 "Auto and Other Business Expense Reimbursements."

KEY RESOURCES SUGGESTED BY SERVANT SOLUTIONS

This is such an important area in the life of the church. Servant Solutions suggests the following resources which can help church leaders and the minister in the area of compensation planning and proper benefits.

"The Compensation Handbook for Church Staff"

Updated annually, this outstanding publication provides national survey findings for churches of various sizes and demographics. It can be ordered from:

www.churchlawandtax.com or call (800) 222-1840

"Compensation Planning"

Updated annually, this is a general guide to stimulate lay-leaders and church board members in their thinking relative to compensation packages for ministers.

Contact Servant Solutions: (800) 844-8983 or (765) 642-3880
email: info@servantsolutions.org

It's also on our website: servantsolutions.org

Disclaimer

The information contained in this MEMO series is of a general nature. It is not offered as specific legal or tax "advice." Each person or local church board should evaluate their own unique situation in consultation with their local legal and tax advisors.

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