

Areas of Concerns for Church Financial Administrators

by Larry Howlett, CPA

THE FOLLOWING CONCEPTS of administration are given to ease your concerns about areas of your ministry.

CLASSIFICATION OF INDIVIDUALS AS EMPLOYEES OR CONTRACT LABORERS.

When an individual is being paid to assist the church, it is critical you classify that person either as an employee or as a contract laborer. The classification is based on the position the individual has and the degree of control the church has over the individual. The degree of control is determined by how, when, where the individual works, the equipment the individual uses, how the individual is paid, and the requirements for the end product.

Some factors that may assist in the contract laborer determination are the following:

1. Does the individual do similar work for other businesses or individuals?
2. How did you find out about the individual's services?
3. Do you have a written contract as compared to a oral agreement?
4. Did you solicit bids for the work being done?

Example:

1. If an individual is a paid nursery worker on Sunday morning weekly during church services, the church determines where, when, and how the individual works; therefore, the individual would be classified as an employee.
2. If an individual, not regularly working for the church, has agreed to paint the rooms of the Sunday school area of the church for \$2,000, the individual would likely be a contract laborer.

In the first example, the church exercises a high degree of control over the performance of the work of the individual, and in the second example the church exercises a minimum amount of control and is primarily interested in the finished product being done at the best prices.

- A primary concern related to contract labor classification is the control, payment, and tax form reporting for guest speakers and musicians. The church merely controls when the individuals come to the church and their compensation. Their engagement is on a non-recurring basis. They also minister in other churches. Their services would generally be a contract situation.
- The church is required to secure a Form W-9, *Request for Taxpayer Identification Number*, from this individual and issue a Form 1099 MISC, Miscellaneous

Income, to the individual by January 31, of the year following the performance of the work, if the total payments to the individual are \$600 or more during the calendar year.

- When it is determined the individual should be classified as an employee, the church is required to secure a Form I-9, *Employment Eligibility Verification*, and Form W-4, *Employee Withholding Allowance Certificates*, from the individual. When securing either the Form I-9 or Form W-4, the church should make a copy of the individual's social security card. If the individual's business has an Employee Identification Number (EIN) the church should secure a copy of the form the Internal Revenue Service issued to give the EIN. These copies assure the church that the name and the social security number or EIN number match exactly. If either the name or the number does not match the IRS records the IRS will propose penalties for the Form 1099 MISC or W-2 not being correct.

A source for understanding the principle of control may be researched at the IRS Web site www.stayexempt.org. This Web site includes discussion and training on the following topics:

- Tax exempt status
- Unrelated business income

- Employment issues
- Form 990
- Required disclosures

The "employee issues" section discusses the control factors.

COMPENSATION

Compensation of the staff of the church includes the salary, fringe benefits, any payments by the church that benefits the individuals personally, honoraria, bonuses, anniversary gifts, wedding fees, and unreimbursed credit card charges.

The total of each primary individual's compensation should be established by the governing board or some committee charged with that duty. Every benefit paid to or for the benefit of the individual should be approved by the board, committee, or congregation.

The salaries or wages of non-primary ministers, staff, or employees may be established by a personal committee or designated individual.

Any payments to individuals in recognition of their services to the church that have not been designated by the board or committee may be designated as excess benefits under the rules of the Internal Revenue Code and subject to the procedures and penalties of intermediate sanctions. The reimbursements to the church and penalties to the Internal Revenue Service (IRS) could amount to 225% of the amount of the excess benefits.

An example of intermediate sanctions would be if the church allowed the minister to use a vehicle it owned or leased, and neither had the committee included the fair market value personal use in the authorization of compensation nor had the minister reimbursed the church for the value of the personal use, the amount of the personal use would be excessive benefit.

If the fair market value for the percentage of personal time the vehicle was \$300 per month the total of the excess benefit for a year would be \$3,600 a year. If the minister did not reimburse the church for this amount after the notices by the IRS the minister would have to pay a penalty of \$540 plus reimburse the church \$7,200 for a total of \$7,740. If there is no effort to document the business and personal use all use is assumed to be personal by the IRS. The following are the factors to be considered in establishing the amount of compensation for ministers and staff:

1. Housing Allowance

A church-designated housing allowance may allow ministers to exclude income for tax purposes. The governing board, committee, or congregation approves the housing allowance as estimated by each minister. To be eligible for housing allowance an individual must be licensed, commissioned, or ordained and be performing sacerdotal functions.

The approving board or committee must record in writing the amount approved for each minister and the approval must be made before any payments. The board or committee may change the amount of the housing allowance as the need of the minister may change, but again the approval must be recorded in the minutes of the board or committee prior to the payment of the increased housing allowance. Retroactive approval of the amount the housing allowance is not allowed.

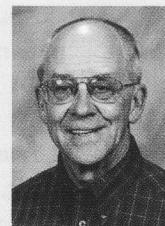
The application of the comparison of (1) the housing allowance, (2) the expenditures for housing purposes, and (3) the fair market value of the residence with furniture, plus the related utilities, is the responsibility of the minister for her/his personal income tax return. The church's responsibility is only in approval and payment of the housing allowance to the minister.

Summary

- The classification of an individual as "employee" or as "contract laborer" is based on the position the individual has and the degree of control the church has over the individual. Some factors to consider and some examples are given here for determining classification.
- Compensation of the staff of the church includes salary, fringe benefits, any payments by the church that benefits the individuals personally, honoraria, bonuses, anniversary gifts, wedding fees, and un-reimbursed credit card charges.
- Factors to be considered in establishing the amount of compensation for ministers and staff are housing allowance, reimbursement plans for expenses, and inclusion of taxable income.
- Unrelated business income is the gross receipt from a trade or business that is regularly carried on and that is not substantially related to the exempt purposes of the church; this article contains examples of what would be included and what would be excluded.
- Ministers may apply for exemption from self-employment taxes for services in performance of their duties of the church if they meet requirements provided here.
- In seeking advice of a tax professional, the church should seek an attorney or certified public accountant (CPA) who has had substantial experience in advising ministers and churches.

Author

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2. Accountable Reimbursement Plans for Expenses

Churches, charities, or any business organizations should operate accountable reimbursement plans for employee travel, educational, and other types of employee reimbursement. Church reimbursed expenses under an accountable reimbursement plan are excluded from the minister's or employee's taxable income. The governing board or committee responsible for the finances of the church should adopt and record in the minutes of the meeting an accountable reimbursement plan.

When an accountable reimbursement plan is not used, the amount paid the individual for travel, education, etc., is included in taxable income, and the cost of these items may be claimed as a deduction on Schedule A of Form 1040, Individual Income Tax Return. When an accountable reimbursement plan is used, the individual reports to the church, rather than to the IRS.

Accountable reimbursement plans should meet these IRS requirements:

- There must be adequate substantiation of all expenses. There must be written documentation of all expenses over \$75.00.
- The substantiation must include the date, amount, place, business purpose, and the personal portion of the changes.
- Excess reimbursement of advance must be returned to the church within "reasonable period of time" gener-

ally considered to be 120 days. The substantiation of the expenses to the church should be 60 days to be within the "reasonable period of time."

3. Inclusions in Minister's Taxable Income

The following items are included in the minister's or staff taxable income on their Form 1040, Individual Income Tax Return, to be filed with the IRS:

- Salary.
- Unaccountable reimbursement travel, educational, and other expenses.
- Unreimbursed personal purchases made by the minister on the church's credit card if she/he hasn't reimbursed the church or ministry.
- Unreimbursed personal use of the church's automobile the minister has not reimbursed.
- Unreimbursed personal payments made by the church, such as attorney fees of a personal nature.
- Medical expenses if the church issues Form 1099 MISC, Miscellaneous Income, instead of Form W-2, Wage and Tax Statement.
- Medical insurance is recognized as a non-taxable fringe benefit to the employee. Employees receive Form W-2; whereas, a contract individual is given a Form 1099 MISC. The church's payment of medical insurance for a contract laborer causes the medical insurance to be taxable income. To be

a qualified medical insurance plan it must not discriminate in favor of highly qualified employees.

- Premiums for a life insurance policy over \$50,000 if the minister or staff member's family is the beneficiary. If the church is the only beneficiary of the life insurance policy no portion of the premium is included in the taxable income of the minister.
 - Gifts, wedding fees, funeral fees paid to the minister in any form of recognition of service performed for the church or participants in the church.
 - Benevolence for the assistance of the ministers or staff. Benevolence to non-ministers or non-staff individuals is not taxable income to these individuals.
 - Personal use of the church-owned cell phone. If the individual owns the cell phone the church should only pay for business use of the cell phone.
 - Retirement Plans—Payments to qualified pension plans are not included in the taxable income in the year of payment by the church. The plan must meet certain requirements of the Internal Revenue Code, so consult with a pension specialist for preparation and operation of a qualified pension plan.
 - Loans from the church to a minister at below market rates as determined by the IRS is taxable for the difference of the interest rate being paid by the minister and the going market rate when the loan originated. Churches may make loans to ministers for purchase or construction of a residence or for emergency need. The loan should be supported by adequate documentation establishing the liability of the minister to the church and the rate of interest to be paid.
- During the life of the loan there must be documentation that the loan is being repaid. Any forgiveness of the indebtedness is taxable income to the

minister or staff. The church should determine if the loan is legal under state law. If any of these expenditures or personal use are not approved by the proper authority and included in the individual's taxable income, excess benefit procedures may apply.

UNRELATED BUSINESS INCOME

Unrelated business income is the gross receipt from a trade or business

1. regularly carried on
2. that is not substantially related to the exempt purposes of the church.

Income from an activity that would otherwise be an unrelated business activity would be excluded from this classification if substantially most of the work is done by volunteers or if substantial amount of the merchandise has been donated by retailers, manufacturers, or homeowners.

Also excluded from unrelated business income by the Internal Revenue Code are rent from real property, dividends, interest, royalties, gain, or losses from sale of real estate property. Rent from personal property, such as the church's organ for organ lessons, is completely taxable as unrelated business income.

An exception from the exclusion of real property rental income being unrelated business income is when the property is debt-financed property. Debt-financed property is any property which has debt that is considered to be acquisition indebtedness and is held to produce income.

Examples of gross receipts that would be from the recognized exempt purpose of the church would be the following:

1. A daycare center that produces services for families so they can be employed.
2. After-school care programs that enable the parents to be employed and that may provide additional education for the children.

3. A school to provide education for children. Education is a recognized charitable activity of the Section 501(c)(3) of the Internal Revenue Code.
4. A drug treatment program that assists in the relief of poverty for the participants.
5. A counseling center that also provides services for individuals who are unable to pay for these services.

A main principle to be considered related to unrelated business income is the principle of commerciality. If the business is comparable to a commercially operated business it will likely be generating unrelated business income. If the business hires employees, purchases merchandise at regular market prices, and sells the merchandise or services at prevailing public prices, the business would likely be an unrelated business activity.

An example of this policy would be a religious bookstore operated by the church. The religious books and intellectual property it sells that further the church's purpose of promotion of religion would not be unrelated business income. However, the sale of greeting cards, collectables, pictures etc. would be unrelated business income because they are comparable to non-religious items sold in commercial greeting card retail stores.

In consideration of unrelated business income, it is important in the planning and operation of the activities to remember if the amount of time required for the activity and the gross receipts generated by the activity are a substantial amount of the total time for staff and volunteers to operate the church and of the total of all gross receipts of the church, the exemption of the church could potentially be jeopardized.

The Internal Revenue Service has not specifically defined what percentage constitutes a substantial amount of time or gross receipt that would jeopardize the exempt status of the church. A facts and circumstances test would be involved in

the evaluation of the activity. There is no set standard by which a church would be examined and be expected to comply. Each examination of a church would be judged on the operation activities and financial records.

For the Internal Revenue Service to examine potential unrelated business income, they must learn of the potential of the size of the activity and in turn follow the rules of section 7611 of the Internal Revenue Code before that agency can commence the examination of the church.

The Internal Revenue Service does not want to examine the activities of a church unless it has very substantial reason to believe that there is a potential problem with inurement or unrelated income.

SOCIAL SECURITY EXEMPTION ELECTION

Ministers may apply for exemption from self-employment taxes for services in performance of their duties of the church if the following requirements are met:

1. The minister must be ordained, licensed, or commissioned to be a minister of a church.
2. The church or denomination that ordained, licensed, or commissioned the minister must be a tax-exempt religious organization.
3. The minister must file Form 4361, *Application for Exemption from Self-Employment Tax for Use by Ministers, Members of Religious Orders and Christian Science Practitioners*, in triplicate with the IRS.

The minister should be opposed to participation in the self-employment tax for one of the following reasons:

- a. *Conscientious* opposition based on religious belief.
- b. *Opposition* to acceptance of public insurance benefits.

Professional TRAINING

CERTIFICATION SEMINARS SCHEDULE 2008-2009

Assemblies of God

Theological Seminary

Seminar I-A • June 16-20, 2008
Seminar I-B • June 23-27, 2008
Seminar II-A • June 15-19, 2009
Seminar II-B • June 22-26, 2009
Dr. Randy Walls
(800) 467-2487
rwalls@agts.edu

California Baptist University

Seminar I • May 14-23, 2008
Dr. Andrew Herrity
(951) 343-4574
aherrity@calbaptist.edu

Candler School of Theology

Emory University

Seminar I • June 17-27, 2008
Seminar II • July 29-August 8, 2008
Rev. Beth Luton
Ms. Charity Simpson
(404) 727-0714
csimps2@learnlink.emory.edu

Southwestern Baptist

Theological Seminary

Seminar II • June 9-19, 2008
Dr. Judy Stamey, FCBA
(817) 568-8966
cbaassociates@sbcglobal.net

Union - PSCE

Seminar I-A • July 15-18, 2008
Seminar I-B • July 21-24, 2008
Seminar II-A • July 21-24, 2009
Seminar II-B • July 27-30, 2009
Dr. Stan Hargraves
(800) 229-2990, ext. 383
shargraves@union-psce.edu

The Saint Paul Seminary

School of Divinity

University of St. Thomas

Seminar I-A • May 12-16, 2008
Seminar I-B • May 19-23, 2008
Seminar II-A • May 11-15, 2008
Seminar II-B • May 18-22, 2008
Dr. Jan Viktora
(800) 328-6819, ext. 25050
jmviktora@stthomas.edu

Additional information on certification and certification centers is available at www.nacba.net/certify.

4. The exemption application must be filed by the due date of the individual's second year in which the minister has net earnings from the self-employment of \$400 or more from the performance of services as a minister.
5. The ordaining, licensing, or commissioning church or denomination must be informed that the minister is opposed to the Social Security System for any non-church employment they may have.
6. Please see pages 449 to 464 of *Church & Clergy Tax Guide 2007* by Richard Hammar cited in a late section of this

report for more details about this self-employment exemption.

RECOMMENDATION FOR TAX ADVICE AND COUNSEL

If a minister or church administrator seeks advice on the business activities of the church and the payments to or for ministers, staff, and contract laborers, they should refer to qualified publications as

1. *Church & Clergy Tax Guide 2007* by Richard Hammar, J.D., LL.M., CPA, Christianity Today.
2. *Church and Nonprofit Tax and Financial Guide* by Dan Busby, CPA, Zondervan Publishing.

3. *Minister's Tax and Financial Guide* by Dan Busby, CPA, Zondervan Publishing.

If advice of a tax professional is sought be sure the attorney or certified public accountant (CPA) has had substantial experience in advising ministers and churches. There are many principles with which a typical attorney or CPA may not have experience. Avoid the advice of any advisor who creates fear of the legal or tax systems. 