CHURCH PAYROLL TAX AUDITS—
THE IRS IS WATCHING

You may have heard that the Internal Revenue Service hasn’t been auditing churches since 2000.

This is generally true because of the challenge the IRS faces with clearing the hurdles of the Church Audit Procedures Act (IRC 7611). For several years now, the IRS has been unable to finalize regulations related to the law concerning who is a “high ranking” IRS official authorized to approve church income tax audits.

However, based on what I’m told by churches and tax professionals, the IRS is active in church payroll tax audits. These audits are not subject to the IRC 7611 limitations.

Two reasons may be driving this IRS activity with churches:

1. Limited resources. IRS officials consistently say their funding is tight. In addition, a string of congressional investigations involving the IRS in recent years has cost the agency millions of dollars and diverted IRS staff members from their regular work to instead provide information to Congress.

As a result, there generally appears to be some strain on the IRS’s availability for in-depth audits. However, payroll tax audits generally take a few days, making them easier to schedule and conduct, even with these resource limitations.

2. The Affordable Care Act. The Employer Shared Responsibility provisions of the Affordable Care Act (ACA) begin to unfold in 2015 for large employers, including churches that meet the definition of a large employer. A large employer is one with the equivalent of 50 or more full-time employees (a full-time employee is an individual employed, on average, at least 30 hours of service per week).

To avoid penalties, a large employer’s health plan must have “Minimum Essential Coverage”; the plan must provide “Minimum Value” (meaning it pays for at least 60 percent of total allowed health costs); and the plan must be affordable.

The IRS has expressed concern that some employers might be classifying employees as independent contractors to stay under the 50-employee threshold and dodge these penalties. A payroll tax audit by the IRS can help identify these misclassifications.

The IRS may never do a payroll tax audit of your church, but from Scripture we know “the noble man makes noble plans, and by noble deeds he stands” (Isaiah 32:8, New International Version). This article will explore how your church can prepare for a payroll tax audit. The potential problems that can arise, if you’re not prepared, can prove costly.

What the IRS reviews
A payroll tax audit may sound less involved than a church income tax audit, leading one to believe it won’t consume much staff time or resources, much less reveal any significant issues. Think again!

Let’s walk through 11 types of records the IRS often requests in church payroll tax audits. It’s worth noting that the IRS rarely audited the most recent year—more than likely, it will look at the earliest open year, which is two or three years back. In general, it’s wise for churches to retain the documents listed below for at least seven years:

- **General ledger.** This shows how much income the church received and how much the church spent during the year.
- **Forms W-4.** Every employee has a Form W-4 to show how much in federal and state taxes the employee elects for the church to withhold from his or her paycheck.
In an IRS payroll tax audit, any or all of these records could be requested and examined. Under this type of scrutiny, any number of problems can be identified, proving potentially costly to the church, its ministers, and its staff.

report those values as taxable income to respective employees.

- **403(b) plan payments.** Any church that offers a 403(b) plan must keep a copy of the plan document on file and then keep records showing how it complied with its plan document for employees during the year.

- **Educational expenses.** Any church that pays educational expenses for ministers or staff (or family members of ministers or staff) must keep records showing those payments were treated as taxable income to the respective employees.

- **Staff gifts for holidays or special occasions.** All cash gifts, including love offerings collected by the church to be given to ministers and staff, and cash equivalents (such as gift cards), must be reported as taxable income on employee Forms W-2. Only property or services with a lower market value (also known as de minimis fringe benefits) may be given and not treated as taxable income (if it would be unreasonable or administratively impracticable to account for it).

- **Property transfer.** The fair market value of any property transferred to a minister or staff member as a gift must be recorded as taxable income.

This may sound like a large amount of records for churches to keep. But in an IRS payroll tax audit, any or all of these records could be requested and examined. Under this type of scrutiny, any number of problems can be identified, proving potentially costly to the church, its ministers, and its staff.

Consider these scenarios:

- **In a review of the Forms W-4,** the auditor discovers incomplete records for each employee. The auditor can propose a penalty for failure to have the appropriate forms in the file for each employee relating to all tax years under audit.

- **In a review of W-2s,** the auditor notices one that shows no federal income tax withholding and asks why. You tell her that the W-2 is for the senior pastor. That leads the auditor to ask why that particular W-2 shows FICA withheld and matched. The auditor observes that the senior pastor (with ministerial status under the tax code) is not subject to FICA—he is subject to SECA calculated on the pastor’s Form SE.

- **The auditor reconciles the data on Forms W-2 to the general ledger.** The dollars posted to the general ledger were higher than the W-2 data. Upon inspection, she finds that Christmas bonuses given to the staff were not reported on either the Forms 941 or Forms W-2 as compensation. Additionally, gift cards were purchased by the church at intervals during the year, given to the church staff, and recorded in the payroll account but not reported on Forms W-2. Thus, compensation was understated for each affected staff person and for lay employees, resulting in FICA taxes being under-withheld and matched.

- **The auditor finds an account in the general ledger labeled “Fees Paid.”** The auditor asks for the supporting documents for each of these expenses. She finds three payments to individuals for services rendered—in each case over $600 per individual. A Form 1099-MISC was only filed for one of the individuals, so the auditor proposes a penalty for failure to file the Form 1099-MISC to the other two individuals.

- **For each minister on staff,** the auditor asks for a copy of the ordination or licensing documentation and the position description. The church does not have any of these materials. Based on the information provided to the audi-
All of these issues—and more—really can arise simply as a result of an IRS payroll tax audit. Could these issues create a large bill from the IRS? Absolutely!

Before the IRS comes knocking
What can a church do BEFORE it receives a notice of an IRS payroll tax audit? As a part of reviewing the types of records noted above, pay particular attention to these eight common problem spots:

- **Review the church’s accountable expense reimbursement plan.** If you don’t have a written plan, establish one.
- **Test expense reimbursement substantiation.** In some churches, the pastoral staff may not be adequately forthcoming with expense substantiation. Is the business purpose for travel recorded? For meals, does the documentation reflect not only the date and the amount, but who participated in the meal and the business purpose of the meal?
- **Review worker classifications.** Are you treating workers as independent contractors who really have significant employee characteristics? If so, consider using the IRS voluntary classification settlement program: irs.gov/Businesses/Small-Businesses- & Self-Employed/Voluntary-Classification-Settlement-Program.
- **Review the 403(b) plan provisions.** Be sure that the church is making all employer contributions in agreement with the plan and allowing all eligible plan participants to have pre-tax money withheld and contributed into the plan.
- **Review taxable and non-taxable fringe benefits.** Be sure that all taxable fringe benefits, such as property transfers, Christmas gifts, and more, are reflected on Forms W-2.
- **Review the personal-use records for all church-owned vehicles.** If the church owns one or more vehicles, there is undoubtedly some personal use of the vehicle(s)—which means there is reportable compensation.
- **Check Forms 1099-MISC filings.** Is a Form 1099-MISC being filed for all applicable payments to independent contractors of $600 or more in a year?
- **Check the completeness of the Form W-4 file.** Be sure there is a Form W-4 in the file for each staff member for each year.

If the IRS comes knocking
What should a church do if it receives notice of an IRS payroll tax audit? The two key choices are to say “come on down” or to call your certified public accountant (CPA) or other tax professional for advice. My preference is always to transfer the audit to the office of the tax professionals. Transfer the requested documents to the professionals, and let them deal directly with the auditor. This may seem like a very expensive proposition, but it could save the church a lot of money and grief.

Dan Busby is a certified public accountant and the president of ECFA (Evangelical Council for Financial Accountability), an oversight and accreditation organization. He also serves as an editorial advisor for Church Finance Today.

IN DEPTH
The 2014 edition of Richard Hammar’s Church & Clergy Tax Guide covers critical payroll tax issues, including ministerial classification, 403(b) plans, accountable reimbursement plans, taxable income, Forms 1099-MISC, and more. Order this resource by calling 1-800-222-1840 or by visiting ChurchLawAndTaxStore.com.

### Financial Q&A

**SHOULD WE ALLOW MULTIPLE BANK ACCOUNTS?**

The risks of allowing each church group to have one.

*By Vonna Lave*

**Q:** Most of our church’s Sunday school classes and groups have their own bank accounts, but use the church’s federal identification number for those accounts. The finance committee has no oversight of these accounts, and no control over the funds or how they’re spent. Is this appropriate?

**A:** It seems convenient to let each group have an account so that each can tap into its budgeted money when needed. But such an approach isn’t advisable. The conventional wisdom in the church finance world is for churches to limit the number of bank accounts the church uses. Ideally, a church should use only one or two. The logic is generally based upon the following five tips:

1. The more accounts created, the easier it is for someone to disguise and/or mask fraudulent activity;
2. The more accounts created, the more administrative work required to monitor, oversee, and reconcile accounts on an ongoing basis;
3. The more accounts created, the greater the likelihood of having funds erroneously deposited or withdrawn from the wrong accounts;
4. The more accounts created, the more chances created for outsiders to steal account numbers that can be used for electronic fraud;
5. The more accounts created, the more checkbooks created, and the harder it will be to track and to secure blank checks.

Vonna Lave is a partner and West Region Director with Capin Crouse LLP, a certified public accountant firm specializing in nonprofit organizations, and an Editorial Advisor for Church Finance Today.

To submit a question for consideration in a future Q&A, email CFEditor@ChristianityToday.com.
TAKE YOUR FINANCIAL MANAGEMENT TO THE NEXT LEVEL

New, free PDF covers critical church financial skills.

With this issue of Church Finance Today, we’re pleased to unveil SkillBuilders, a new, two-page PDF supplement available—for free—bimonthly to all subscribers of Church Finance Today.

By surveying and talking with some of you, we learned a lot. You told us the print newsletter does a good job with addressing new developments and upcoming deadlines. And you told us you would love it if we covered more about the best practices and skills that business administrators, executive pastors, treasurers, bookkeepers, and volunteers need to lead and manage their churches’ finances well.

Enter SkillBuilders. When you go to CLTStore.com/SkillBuilders, you’ll put the May/June 2014 issue in your cart and then get it for free at checkout by using this code: tinsof.

The inaugural issue you download features an article on how to create a variety of financial reports for pastors, staff, and the congregation. You’ll find a tip, an infographic, and a finance-related cartoon, too. We’re already working on future issues covering a variety of skills alongside these helpful nuggets of information. Tell us your ideas and impressions at CFEditor@christianitytoday.com.

—Matthew Bramaugh, Editor

Tax Calendar

Important Tax Deadlines in July 2014

In addition to the regular semiweekly and monthly withholding requirements, churches should note the following dates for this month. If the regular due date falls on a Saturday, Sunday, or legal holiday, file by the next business day.

July 1

• Now is a good time to review the housing allowance designated for any minister on your staff for 2014. If the allowance designated for 2014 was too low, it can be increased for the remainder of the year. Simply have the church board (or other group that designated the original allowance) adopt a resolution amending the allowance. This need not result in any additional compensation being paid to a minister. Rather, a minister’s salary can be decreased by the amount of the increase in the housing allowance. But remember—any amended housing allowance is only effective from the date of the amendment. It cannot be applied retroactively.

July 30

• Churches hiring their first nonminister employee between April 1 and June 30 may exempt themselves from the employer’s share of Social Security and Medicare taxes by filing Form 8274 by this date (nonminister employees are thereafter treated as self-employed for Social Security purposes). Conditions apply.

July 31

• Churches having nonminister employees (or one or more ministers who report their federal income taxes as employees and who have elected voluntary withholding) must file an employer’s quarterly federal tax return (Form 941) for the second quarter of 2014 by this date. Enclose a check in the total amount of all withheld taxes (withheld income taxes, withheld Social Security and Medicare taxes paid by the employee, and the employer’s share of Social Security and Medicare taxes) if less than $2,500 on June 30, 2014.■