Setting Pay Packages for Pastors

Why churches need to get three tax issues right with compensation.

By Richard R. Hammar

Compensation planning for clergy and other church staff presents several unique tax issues that are not well understood by many church leaders and their advisers. Here are three key considerations to review when structuring compensation plans.

1. Salary

The most basic component of church staff compensation is salary. There are two important considerations to keep in mind with respect to staff salaries: (1) the amount of the salary, and (2) the use of “salary reduction agreements.” If a church pays unreasonably high compensation to a pastor or other employee, the church may lose its tax-exempt status or face intermediate sanctions, including tax on disqualified persons, additional tax on disqualified persons, and tax on organization matters.

Recommendation: Churches that pay a minister (or any staff member) significantly more than the highest 25 percent for comparable positions should obtain a legal opinion from an experienced tax attorney confirming that the amount paid is not “unreasonable” and will not expose the employee or the board to intermediate sanctions.

Many churches have established “salary reduction agreements” to handle certain staff expenses. The objective is to reduce an employee’s taxable income since only the income remaining after the various reductions is reported on the employee’s W-2 at the end of the year. It is important for churches to understand that they cannot reduce an employee’s taxable income through salary reductions unless specifically allowed by law. There are three ways taxable income can be reduced through salary reduction agreements: (1) tax-sheltered annuity contributions, (2) “cafeteria plans,” and (3) housing allowances.

2. Housing and equity allowances

The most important tax benefit available to ministers who own or rent their homes is the housing allowance. Ministers who own or rent their home do not pay federal income taxes on the amount of their compensation that they employ church designates in advance as a housing allowance to the extent that the allowance represents compensation for ministerial services, is used to pay housing expenses, and does not exceed the annual fair rental value of the home (furnished, plus utilities). Housing-related expenses include mortgage payments, rental payments, utilities, repairs, furnishings, insurance, property taxes, additions, and maintenance.

Ministers who live in a church-owned parsonage that is provided “rent-free” as compensation for ministerial services do not include the annual fair rental value of the parsonage as income in computing their federal income taxes. The annual fair rental value is not “deducted” from the minister’s income. Rather, it is not reported as additional income anywhere on Form 1040 (as it generally would be by nonclergy workers). Further,

Help Us, Help Yourself

Great data is the cornerstone of good salaries. When you participate in the National Church Compensation Survey, you help yourself and other church workers. Visit bit.ly/CTSalary by March 31, 2017, to take part in this confidential survey. Complete the survey and receive a free finance eBook, a free subscription to Christianity Today, or a free Bible study series on giving.
ministers who live in a church-provided parsonage do not pay federal income taxes on the amount of their compensation that their employing church designates in advance as a parsonage allowance, to the extent that the allowance represents compensation for ministerial services and is used to pay parsonage-related expenses such as utilities, repairs, and furnishings.

Note that the parsonage and housing allowance exclusions only apply in computing federal income taxes. Ministers cannot exclude them when computing their self-employment (Social Security) taxes.

**Recommendation:** Be sure that the designation of a housing or parsonage allowance for the subsequent year is on the agenda of the church board for one of its final meetings of each calendar year. The designation should be an official action of the board or congregation, and it should be duly recorded in the minutes of the meeting. The IRS also recognizes designations included in employment contracts and budget line items—assuming in each case that the designation was duly adopted by the church board (or the congregation in a business meeting). Also, if the minister is a new hire, the church should designate a housing allowance prior to the date he or she begins working.

Ministers who live in church-owned parsonages are denied one very important benefit of home ownership: the opportunity to accumulate “equity” in a home over the course of many years. Many ministers who have lived in parsonages during much of their active ministry often face retirement without housing. To avoid the potential hardship of no equity and no housing, some churches increase the minister’s compensation as an “equity allowance” to provide the equivalent of equity in a home.

**Recommendation:** An equity allowance is an excellent idea that should be considered by any church having one or more ministers living in church-provided housing. The equity allowance should not be accessible by the minister until retirement, so it should be placed directly in a minister’s tax-sheltered retirement account. Equity allowances should also be considered by a church whose minister rents a home.

---

**Behavioral Red Flags Displayed by Perpetrators of Fraud**

Certified Fraud Examiners pinpoint these warning signs.

- **45.8%** Living beyond means
- **30.0%** Financial difficulties
- **13.4%** Divorce/family problems
- **10.0%** Addiction problems
- **7.8%** Refusal to take vacations
- **9.0%** Complained about inadequate pay
- **15.3%** Control issues, unwillingness to share duties

For help preventing fraud in your church, read “Maintaining Sound Internal Control” chapter in Church Finance by Michael E. Betts and Richard R. Hammar (available on ChurchLawAndTaxStore.com).

Source: Report to the Nations on Occupational Fraud and Abuse: 2016 Global Fraud Study. Conducted by the Association of Certified Fraud Examiners. Report based on 2,410 online surveys completed by Certified Fraud Examiners. This is a partial list of the 17 behavioral red flags listed on the survey. For the complete list, see Figure 4 on the survey—available in a downloadable PDF at ACFE.com.

---

**In Depth**

To go deeper on church salary decisions and tax issues related to clergy, see these resources at ChurchLawAndTaxStore.com:

- **2016–2017 Compensation Handbook for Church Staff**
- **2017 Church & Clergy Tax Guide**
- **Setting a Pastor’s Pay**
Housing Allowance Challenge Continues

FFRF's renewed effort may negatively affect this important benefit.
By Richard R. Hammar

The constitutionality of the ministerial housing allowance benefit is again in question, thanks to one organization’s ongoing efforts to challenge it.


The federal government, which defended the housing allowance since it is a federal statute, asked the court to dismiss the lawsuit on the ground that the plaintiffs lacked standing to pursue their claim in federal court.

Standing is a constitutional requirement of any plaintiff in a federal case and generally means that a plaintiff must have suffered some direct injury as a result of a challenged law. The Wisconsin court concluded that the plaintiffs had standing on the ground that they would have been denied a housing allowance exclusion had they claimed one on their tax return. The government appealed this ruling to a federal appeals court (the Seventh Circuit Court of Appeals in Chicago).

On November 13, 2014, the appeals court issued its ruling reversing the Wisconsin court’s decision. Freedom From Religion Foundation, Inc., v. Lew, 2014 WL 5861632 (7th Cir. 2014). It concluded that the plaintiffs lacked standing to pursue their challenge to the housing allowance. The plaintiffs had asserted that they had standing due to their “injury” of being denied a tax-free housing allowance should they claim one on their tax returns. But the appeals court refused to base standing on theoretical injury. It concluded: “Only a person that has been denied such a benefit can be deemed to have suffered cognizable injury. The plaintiffs here have never been denied the parsonage exemption because they have never requested it; therefore, they have suffered no injury.”

It suggested that this deficiency could be overcome if the FFRF’s officers filed tax returns claiming a housing allowance that was later rejected by the IRS in an audit. “The plaintiffs could have sought the exemption by excluding their housing allowances from their reported income on their tax returns and then petitioning the Tax Court if the IRS were to disallow the exclusion. Alternatively, they could have ... paid income tax on their housing allowance, claimed refunds from the IRS, and then sued if the IRS rejected or failed to act upon their claims.”

The FFRF responded to the appeals court’s ruling by designating a housing allowance for two of its officers. The officers reported their allowances as taxable income on their tax returns, and thereafter filed amended tax returns seeking a refund of the income taxes paid on the amounts of their designated housing allowances. FFRF claims that in 2015 the IRS denied the refunds sought by its officers (one of whom had died, and was represented by the executor of her estate).

**Noteworthy developments**

Having endeavored to correct the standing problem, the FFRF renewed its legal challenge to the housing allowance in the federal district court in Wisconsin where the litigation began. Two developments are noteworthy.

First, the US Department of Justice, which defends the constitutionality of federal legislation (such as the housing allowance), filed a brief with the court asking it to dismiss FFRF’s challenge to the constitutionality of the parsonage exclusion. The Department of Justice noted that section 107 of the tax code grants tax exclusions both for the rental value of parsonages provided to clergy as compensation for the performance of ministerial services, and for housing allowances provided to clergy who own or rent their home. But, since none of FFRF’s officers were living in housing owned by FFRF, they lacked standing to challenge the constitutionality of section 107’s exclusion of the rental value of church-owned parsonages.

Second, the Department of Justice brief states that “the United States does not contest plaintiffs’ standing to sue under section 107(2)” (i.e., the housing allowance). This concession means that the federal appeals court will now have the opportunity to address the merits of FFRF’s constitutional challenge to the housing allowance. The appeals court ultimately may rule that the housing allowance is constitutional. Or it may decide that it is not. Either way, the ruling likely will be appealed to the United States Supreme Court.

**Possible effects**

Should FFRF and its two officers ultimately prevail in their quest to strike down the housing allowance as an unconstitutional preference for religion, what would be the effects for churches and pastors? A ruling by the Seventh Circuit Court of Appeals would apply to ministers in that circuit, which includes the states of Illinois, Indiana, and Wisconsin. It would become a national precedent binding on ministers in all states if affirmed by the Supreme Court—an unlikely outcome because the Supreme Court accepts less than one percent of all appeals. Note, however, that the IRS would have the discretion to follow or not follow such a ruling in other circuits and might be inclined to follow it to promote consistency in tax administration.

Ministers and churches should be aware that the housing allowance remains under attack and one day may be invalidated. Should that occur, two actions will then need to be implemented quickly:

1. Since ministers will experience an immediate increase in income taxes, they should be prepared to increase their quarterly estimated tax payments to reflect the increase in income taxes in order to avoid an underpayment penalty. Note that there will be no effect on self-employment taxes for which the housing allowance is not tax-exempt.

2. Many churches will want to increase ministers’ compensation to offset the financial impact. Such an increase could be phased out over a period of years to minimize the effects on the church.

For a complete analysis of several tax developments that affect tax reporting by ministers, church staff, and churches, see “Understanding the 2017 Tax Season” in the January/February issue of Church Law & Tax Report—also available on ChurchLawAndTax.com.
When a Contribution Is $250 or More

In order for a donor to receive a deduction for a single contribution of $250 or more, the law specifies that the church (donee) must provide a written acknowledgment with the following information:

- Name of organization
- Amount of cash contribution
- Description (but not the value) of noncash contribution (if the contribution was not monetary)
- Statement that no goods or services were provided by the organization in return for the contribution (if that was the case)
- Description and good-faith estimate of the value of goods or services, if any, that an organization provided in return for the contribution
- Statement that the goods and services, if any, that an organization provided in return for the contribution consisted entirely of intangible religious benefits (if that was the case)

For other important details regarding charitable contributions, see the "Charitable Contributions" chapter in the Church & Clergy Tax Guide.

Another Good Reason for Cash Reserves

[Reserves] provide financial flexibility and foster strategic decisions. Reserves do more than allow you to react to fiscal emergencies. If you have reserves and enough positive cash flow, you can make sensible choices, like making bulk purchases to take advantage of better prices. They also position you to seize opportunities that you may not have been able to take advantage of otherwise.

—npENGAGE.com

Developing a Comprehensive Energy Program

Our church wanted to reduce our rising utility costs so we could redirect the savings to our missional purpose.

To get started, we conducted a comprehensive energy audit in order to develop a holistic, energy conservation program—prioritizing replacement and modernization of systems. Our end goal was to optimize how we could lower our utility costs at the lowest possible capital cost.

Along with creating a project team to guide the process, our church hired a mechanical engineering firm and a consulting firm that specializes in commercial solar feasibility modeling. Working with these experts, we developed a long-term plan that prioritized our various energy needs.

We estimate that our plan will cost our church around $1.2 million over about eight years. All of our retained consultant costs have been funded through solar project financing with a third-party bank. Our LED retrofit project was funded, with no "carrying costs" (such as interest, fees), through a special incentive program with our electric utility company. Our HVAC and roof replacement programs are being paid for, debt free, using funds from our capital replacement reserve funding budget. Once our comprehensive, energy-efficiency program is completed and paid for, we anticipate future savings in excess of $100,000 per year. In around 25 years, we anticipate an overall savings in excess of $2 million.

The best thing we did was work with specialized consultants to develop a comprehensive program. The key is holistic—making it all work together for greater savings and energy efficiency, and a good consultant ensures that happens.

—Dave Cowin, chairman of the board of elders, The Bridge Church (Fresno, California)

"How We Saved Money" features stories from treasurers, church business administrators, pastors, and other church leaders, detailing ways their ministries changed services, practices, or policies and procedures—all resulting in lower costs and added savings for their ministries.

Send your own money-saving stories to editor@churchlawandtax.com.

Eight Signs of a Financially Dying Church

1. Failed to preach and teach stewardship.
2. Took on too much debt.
3. Was not transparent with finances.
4. Used very few dollars to reach and minister to the community.
5. Did not have multiple options for giving.
6. Did not constantly evaluate how funds were spent.
7. Never took wise steps of financial faith.
8. The church relied on a few big givers.

—ThomRainer.com

ChurchFinanceToday

Volume 25 • Number 2 • February 2017

Senior Editor: Richard R. Hammes, J.D., LL.M., CPA
Editor: Matthew J. Orahaugh
Associate Publisher: Louise Ferrebee
Executive Editor: Chris Lutes
Art Director: Veali Nazer
Designer: Mary Billus

Resources and Special Projects Editor: Jim Bolton
Associate Editor: Samuel Odes
Editorial Coordinator: Michelle Dowell
Marketing Project Manager: Sandra Hordocks-Lawson
Editorial Advisors: Richard Hammes (senior advisor), Michael Baets, Dan Budy, Ann Buskawa, Gregg Capin

CHURCH FINANCE TODAY is published 12 times a year by Christianity Today, 45 E. Randolph St., Carol Stream, IL 60188. 630-690-3995. CHURCH FINANCE TODAY editor@churchlawandtax.com All rights reserved. The publication is designed to provide accurate and authoritative information in regard to the subject matter covered. It is sold with the understanding that the publisher is not engaged in rendering legal, accounting, or other professional service. If legal advice or other expert assistance is required, the services of a competent professional should be sought. From a Declaration of Principles jointly adopted by a Committee of the American Bar Association and a Committee of Publishers and Associations. Annual subscription: $195 in the U.S. and Canada; $235 for non-U.S. and non-Canadian subscribers. Church Finance Today, PO Box 37012, Boonie, IA 50037-0012.