Federal Judge: Housing Allowance Unconstitutional

In October, Wisconsin federal district court judge Barbara Crabbb once again ruled that the clergy housing allowance was unconstitutional. The first time was in 2013, but a federal appeals court overturned her decision, “ruling that the atheist plaintiffs from the Freedom From Religion Foundation (FFRF) [were] not sufficiently harmed by the tax break to challenge it in court,” reported ChristianityToday.com. “The FFRF changed how it compensates its leaders to match the housing allowances that churches give pastors, and sued again when its co-presidents were denied the tax break.” This led to Crabbb’s most-recent decision.

Note that the parsonage allowance isn’t being challenged, and “Crabbb’s ruling would only apply to pastors in Wisconsin, Illinois, and Indiana if upheld by the Seventh Circuit Court of Appeals,” reported ChristianityToday.com. However, the IRS would also have to consider whether to apply a Seventh Circuit ruling nationally for tax purposes, reported attorney Richard Hammar.

See Hammar’s analysis of this decision in “5 Takeaways from the Clergy Housing Allowance Ruling,” on ManagingYourChurch.com.

Overtime Rule Invalidated

The Department of Labor (DOL) exceeded its authority when it doubled the minimum salary levels for exempt executive, professional, and administrative employees under the Fair Labor Standards Act (FLSA), ruled federal judge Amos Mazzant of the US District Court for the Eastern District of Texas… Judge Mazzant determined that the DOL’s new overtime rule “effectively eliminates a consideration of whether an employee performs ‘bona fide executive, administrative, or professional capacity’ duties.” Judge Mazzant wrote that… Congress was clear when enacting the FLSA that the exemption determination needs to involve a consideration of an employee’s duties, rather than relying on salary alone.

—HollandHart.com

5 Unique Features of Church Compensation

How compensation in a church differs from a for-profit business.

By Lee A. Dean

The November 2017 issue of Church Finance Today looked closely at the overall compensation-setting process in churches. In this issue, we cover five key aspects of that process—and the significant differences in how churches handle them compared with employers in the for-profit sector.

Building compensation packages for church pastors and staff is a process markedly different than setting salary and benefits in the for-profit world. Accountants and attorneys serving nonprofits know this, but the realization of the differences can be jarring to newcomers to a church setting.

“Clergy compensation is an animal in and of itself,” said Ben Rhodes, a CPA who serves as chief financial officer and business administrator for Faith Assembly of Orlando, Florida. “When we have new board members come on, many of them have never even heard of a housing allowance exclusion. When I begin to explain how we compensate our clergy, their eyes begin to glass over.”

Board members and new church financial managers may not have experience setting compensation for church staff. Knowing the distinctive features driving nonprofit compensation is vital to adequately pay staff, be good stewards of the congregation’s giving, and stay on the right side of the Internal Revenue Service.

To help financial managers navigate this complex process, Church Finance Today interviewed Rhodes, along with two other CPAs and an attorney who serve as editorial advisors for this publication, to address five key differences.

Difference No. 1: tax-exempt considerations

Churches and other 501(c)(3) organizations are subject to unique federal tax rules covering compensation. Specifically, 501(c)(3) organizations are prohibited under federal tax law from paying compensation above that which is “reasonable” to their leaders. Although situations in which churches pay excessive compensation are rare, these regulations should nevertheless be taken into consideration.

The difference is that a church has tax-exempt status and the private business does not.

“ln a for-profit business, such as a corporation, if the IRS determines there is unreasonable compensation, the deduction for the unreasonable portion of the compensation is disallowed and the business goes on. More taxes will be paid, but the business still exists,” said Elaine Sommerville, a CPA focusing primarily on tax compliance aspects of nonprofit organizations.

However, if the IRS determines a church paid excessive compensation, the church could lose its tax-exempt status, explained Sommerville. Or the recipient of the unreasonable compensation could be forced to return the portion deemed to be “unreasonable” to the church, owe the IRS an intermediate sanction of 25 percent, and if not corrected, be assessed an additional penalty of 200 percent. Those who authorized the payment of the excessive compensation may individually be assessed a penalty of 10 percent of the unreasonable amount.

“Reasonable compensation is defined as what other similar organizations pay similarly qualified people to perform similar work,” added Michael Batts, a CPA and managing partner of Batts Morrison Wales & Lee, a firm that exclusively serves nonprofit organizations and their affiliates.

Difference No. 2: housing arrangements

Under IRS rules, ordained, licensed, or commissioned ministers who perform their duties in the exercise of ministry may qualify for parsonage or housing allowances. Either option is among the most valuable tax breaks for ministers—and not common in other employment sectors, making it all the more important for church leaders to understand parsonage and housing allowances.

With a parsonage, the church provides the home to the minister as a part of the minister’s compensation package. In return, the minister does not include the annual rental value of the parsonage, nor any allowance provided for utilities, repairs, and furnishings, as income in computing federal income taxes—as long as the...
total amount does not exceed the fair rental value of the parsonage (including furnishings and utilities).

Although a parsonage allowance may prove valuable during active ministry, it poses one potentially significant drawback down the road. Pastors who live in a parsonage for many years are unable to build equity. Some churches compensate for this by giving the pastor an equity allowance, which is deposited annually into a tax-favored retirement program not currently accessible to the minister, and used upon retirement to fund a home.

"Funding the retirement plan does not create current taxable income," Sommerville said. "Additionally, certain retirement plans may designate a portion of the retirement payment as a housing allowance to assist in providing a home during retirement years."

If ministers own or rent their own home, they are eligible to have part of their salaries set aside for housing allowances. Like a parsonage allowance, the amount designated is exempt from federal income tax. When determining the amount of a housing allowance, the tax code stresses the church and minister must make sure the funds are actually used for housing expenses—and that the allowance does not exceed the residence's fair rental value plus utilities.

The church board should set the pastor's parsonage or housing allowance, in writing, and in advance of payment.

For more help with parsonage and housing allowances, see chapter 6 in the Church & Clergy Tax Guide.

Difference No. 3: 403(b) retirement plans

The major difference between churches and for-profit entities regarding retirement planning is the availability of 403(b) plans for nonprofit employees, said Danny Miller, an attorney who advises churches and nonprofits on employee benefit issues. One particular option for churches—403(b)(9) accounts—offers two major advantages, he said. One is that it allows churches to use investment options that are screened to reflect a particular church's faith and beliefs. A 403(b)(9) plan also permits an annuity form of benefit to be paid directly from the plan.

Regarding 403(b) plans in general, another benefit "is that a church can continue to contribute to them five years after an employee's termination of employment," Miller said. "That can be a nice way for a church to make a substantial contribution for pastors who haven't saved enough for retirement."

Retirement benefits payable from 403(b) plans also can be applied toward housing costs on a tax-excludable basis, another benefit not available outside of the church world.

Yet another benefit: flexibility on applying the plan to different employees.

"The plan allows for a church to discriminate on its contributions, so the church can make contributions just for one pastor or different amounts for different staff members," Sommerville said. In contrast, she added, for-profit retirement plans generally have strict nondiscrimination requirements.

For more details about common retirement options and various issues that must be addressed with retirement planning, see the November/December 2017 Issue of Church Law & Tax Report or chapter 10 of the Church & Clergy Tax Guide.

Difference No. 4: Social Security for clergy

When working with church compensation, one important aspect to know is that clergy are treated as self-employed for Social Security tax purposes.

"Instead of living in the FICA tax world where employers pay half and the employee pays the other half of FICA taxes, ministers are responsible for paying all of their Social Security taxes under SECA (Self-Employed Contributions Act)," Miller said.

The tax code related to this is Internal Revenue Code Section 1402(c), which "states that a 'trade or business' for purposes of SECA will include the performance of services by a duly ordained, commissioned, or licensed minister in the exercise of his ministry—retirement contributions as provided by IRC Sec. 1402(c) is in effect," Sommerville said. "This explanation demonstrates that, by law, the compensation paid to a minister—for the performance of ministerial duties—is a trade or business subject to self-employment tax. It can't be considered as wages for FICA withholding and matching."

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### Financial Worries in the Pastor's Home

**Clergy spouses express concerns about their finances.**

- **68%** Over two-thirds of those surveyed said they're concerned about the level of retirement benefits they'll have in later years.

- **61%** Well over half said their family situation requires more than the salary received from the church.

- **54%** A little over half said salaries and other compensation from their church don't provide a strong enough financial base for their families.

- **49%** Almost half of those with children said it's difficult to provide the same standard of living for their children as most of their peers.

- **46%** A little under half said their inability to save on a regular basis creates worry.

- **41%** Around 4 out of 10 said that unexpected financial demands create havoc for their family.

Bonuses: Proceed with Caution

Churches must closely follow specific rules or face IRS scrutiny.

By David Middlebrook

I’m often asked this question: Is it legal to pay bonuses to pastors or employees at a church? The short answer is yes. There’s no prohibition on the payment of bonuses by a nonprofit organization to its employees. The only requirement is that the bonus, as part of the employee’s total compensation, is reasonable.

If you are paying bonuses, you have to take that into account when determining whether or not total compensation is reasonable. In other words, a bonus must be reasonable when it’s viewed as part of the total compensation for the employee.

The importance of parameters

There’s no law or rule that says your church has to formally define a bonus plan. That means your church’s board could simply decide that the merits of one or more individual’s work warrants additional compensation that can be paid as a bonus.

For instance, board members could decide to make additional payments of certain amounts at a specified time, such as at year’s end. The board would then need to set parameters—or limitations—to ensure compensation is not excessive or unreasonable. The bonus program really needs to be stated as a range of absolute amounts of overall compensation, including the bonus that can be paid to any individual.

So, what happens if a church decides to give a bonus based on performance and an employee underperforms?

If a bonus is not paid, the board should document the decision and the basis for not paying it. But if a bonus is paid, even though the individual underperforms, then the board needs to document a justifiable reason for paying the bonus in light of the parameters or rules set in the bonus compensation plan.

A bonus is not a commission

Sometimes a bonus looks more like a commission rather than a bonus for performance. And that’s a big problem.

What do I mean? One example would be a bonus paid based upon the amount raised in a capital campaign. Or what if you had a bonus plan based upon the number of new salvations, or new members, or new baptisms, or new people who join the church or who begin tithing, and so on?

Some of these examples seem rather ridiculous, but they serve to make a point. Even if well-intentioned, such a bonus structure can trigger special IRS scrutiny because the compensation arrangement starts to look like a commission structure and possibly the distribution of net earnings, which is prohibited for nonprofit organizations. And it’s improper. And it’s a no-no.

Set a ceiling

After considering the potential pitfalls, you still may decide to come up with some sort of a percentage compensation program. You go to Pastor Smith and say, “We’re going to give you a bonus if X, Y, and Z happen.” Let’s say X, Y, and Z happened ten times more than you ever imagined it would and it happened all of the sudden. It could result in the pastor getting, for example, 300 percent or three times more than what could be considered “reasonable compensation.”

That’s why a solid, board-approved bonus program should place a ceiling on the amount of the bonus to be paid. A ceiling is a safeguard against any windfall and makes it easier to justify the compensation as reasonable. It also helps you avoid the appearance of possible inurement.

The board’s fiduciary role

Your church’s board plays a very important role in the annual review of compensation and its approval, including any bonus awarded to employees. And the Federal Tax Law has evolved to the point that boards are considered to have an obligation to participate in setting the parameters of compensation, budgeting, and other fiduciary responsibilities for a church. And that would include anything pertaining to bonuses.

A final caution

Can you pay bonuses? Yes. Is it a treacherous area? Yes, because it’s a hot-button with the IRS. If you don’t structure it right or it’s not properly documented, it’s a gotcha. And I don’t want you to be gotten by the IRS.

David Middlebrook leads the Church Law Group practice section for Anthony & Middlebrook, PC. He is an editorial advisor for Church Finance Today.
The Cost of Doing Ministry in 2018

As you plan ahead for the costs of staffing, health insurance, staff travel, and property in the new year, keep in mind these predictions from The Kiplinger Letter:

- Average pay raises: 2.7 percent, versus 2.5 percent in 2017. Pay hikes for skilled workers will run 3.5 percent as the labor market tightens and qualified workers become harder to find.
- Overall benefit compensation will be up 2.5 percent in 2018, compared with 2.3 percent in 2017, including the cost of 401(k) contributions, paid vacations, sick leave, etc.
- Employers’ cost for health-care plans will rise about 4 percent.
- Airfares: up as much as 2 percent, on average, on most domestic routes. Transatlantic fares will stay steady and may even drop a bit from this year’s prices.
- Car rentals will cost about 3 percent more after staying flat for several years.
- The price of hotel rooms: up 2.2 percent, a slowdown from increases seen in 2017.
- Deals will be plentiful.
- Office rents are set to increase about 3 percent. But hot markets in major cities, such as NYC, San Francisco, and Washington, D.C., will command steeper rent hikes.
- Retail property rents: up 2 percent. Rises will be kept in check by store closings.

Key Tax Deadline

January 1, 2018

- The Social Security and Medicare tax rate for employers and employees remains at 7.65 percent of employee wages for 2018 for a combined tax rate of 15.3 percent.
- Churches having nonminister employees (or a minister who has elected voluntary withholding) should begin withholding federal income taxes according to the tables and instructions available on IRS.gov.

The free Tax Calendar—available on ChurchLawAndTax.com/tc—provides reminders about regular, semimonthly, and monthly withholding requirements, plus other upcoming dates and deadlines related to church taxes.