



MEMO #4

Pensions and Benefits USA

Strategies for Structuring Ministerial Compensation

A review of the patterns of ministerial compensation over several decades would indicate that significant changes have taken place. Because of many social changes, 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 are among the reasons causing these changes.

The 1986 Tax Reform Act had one of the most significant impacts 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 their compensation structuring.



Caution! Business reimbursements must be included on Form W-2 as taxable income

unless they are paid through an “accountable reimbursement plan” which has been “formally” adopted by the church.

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



Idea! Set up an “accountable reimbursement plan” to maximize tax-free reimbursements.



Caution! The IRS will not allow reimbursements to be paid through a retroactive reduction of W-2 salary.



Remember! The “cost of a minister” and the “cost of ministry” are two distinct concepts.



Caution! The *least* advantageous way to pay your minister is by the “lump sum” method.

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 the reimbursements to be paid through a retroactive reduction of salary. In order 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 are 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 another 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 having to pay higher taxes on money they used to operate the local church’s



Remember! If a minister has to pay “cost of ministry” expenses out of a “salary package,”

the parsonage family taxes will be higher than necessary.

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 will usually 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 ministry includes the following business and professional expense reimbursements:

- Automobile
- Continuing Education
- Convention
- 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 that are related to these are not discretionary since the minister and family have no choice as to how the money is spent. The 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
- Nazarene 403(b) Retirement Savings Plan
- 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. Most 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 Nazarene 403(b) Retirement Savings Plan account 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 #13, “The Minister’s Housing Allowance.”

The remaining item in the “cost of a minister” is the cash salary. This is the amount that the minister and family use to meet living expenses and



Idea! Provide for your pastor’s retirement *and* retirement housing through the pastor’s

Nazarene 403(b) Retirement Savings Plan.



See: MEMO #1, “Housing For Your Pastor: Parsonage or Housing Allowance?” and MEMO

#13, The Minister’s Housing Allowance.”

over which they have some discretion in spending. Among the factors that many church boards consider when determining their minister's cash salary are the following: the job requirements, the individual's professional qualifications, educational background, personal experience and expertise, the 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 above the "package" amount for business and professional expenses.

Other churches are financially unable to increase 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 two distinct expense categories. The result of this restructuring costs the church no additional funds, but does provide 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 #11, "Auto and Other Business Expense Reimbursements."



Idea! Allow your pastor to have two distinct expense categories to reduce potential taxes.



See: MEMO #5, "Minimizing Income Taxes for Church Employees," and MEMO #11, "Auto and Other Business Expense Reimbursements."

Pastor's Compensation Worksheet

Salary:

- A. Cash¹ _____ (3A)²
- B. Fair Rental Value of parsonage and/or _____
- C. Housing Allowance _____ (1B)
- D. Parsonage utilities _____ (5B)

Total Salary

Employee Benefits:

- A. Social Security³ _____ (3B)
- B. 403(b) Retirement Savings Plan (employer's addition or match) _____ (3B)
- C. Health Insurance _____ (3B & 1C)
- D. Dental Insurance _____ (3B)
- E. **Group Term Life Insurance** _____ (3B)
- F. Long-Term Disability Ins. _____ (3B)
- G. AD&D Insurance _____ (3B)
- H. Cash Bonus from church funds³ _____ (3B)
- I. Number of Holidays⁴ _____
- J. Vacation (weeks/days)⁴ _____

Total Employee Benefits

Benefits

Salary

divided by =

To meet the national average released by the U.S. Chamber of Commerce, this should be 0.376 (37.6%).

¹taxable as income for ministers (except for any 403(b) "salary reduction" portion)

²reference locations on the Annual Report of Pastors to the District Assembly

³taxable as income for ministers

⁴typically, taxable dollar amounts are already included in "cash salary"

(OVER)

This is the minister's discretionary income.

This represents the actual "salary" paid to your minister: cash plus housing.

This provides pension benefits in retirement years and can be used for retirement housing.

Up to \$50,000 coverage can be a tax-free employee benefit.

These employee benefits are *not taxable* to the minister (except Social Security Allowance and cash bonuses), when premiums are paid directly to the vendor by the church.

The numbers and letters in this column tell where these amounts are recorded on the "Annual Report of Pastors to the District Assembly."

A minister pays S.S. taxes on the total of cash salary and housing provided. Any S.S. allowance also is taxable as cash income.

Dollar amounts are not assigned for reporting these.

This national average for all employed persons is computed annually. How does your local church compare?

Local Church Expenses

Business and Professional Expense Reimbursements¹:

- A. Automobile _____
- B. Continuing Education _____
- C. Convention _____
- D. Hospitality _____
- E. Pastor's Professional Library _____
- F. Dues to Professional Organizations _____
- G. Church Supplies (birthday cards, postage, etc.) _____
- H. Other _____

Reimbursed expenses of the local church:

These expenses are not compensation to the minister. They are actually local church expenses (the "cost of a ministry") that should be *reimbursed* to the individual when incurred in doing the job.

When properly "reimbursed" through an accountable reimbursement plan, these are *not* taxable. However, if the minister is given an "allowance" for these and does not report back to the church employer how the funds are spent, it must be reported on Form W-2 as taxable income. It is more important than ever to "reimburse" these local church expenses fully and properly.

¹Reported on line 5A of the Annual Report of Pastors to the District Assembly

(OVER)