

Minimizing Income Taxes for Church Employees

One of the many responsibilities church boards face is that of minimizing income taxes for their church employees by appropriately structuring their compensation packages. IRS tax rulings not only make this possible but also make it very important. Unfortunately, some church employees pay additional income taxes simply because of the way their church employer has structured their salary. Changing IRS regulations and current rulings make it all the more important for church boards to periodically review the salary structure of all their employees.

This review is also important from the standpoint that IRS procedures require the church employer to issue annual Wage and Tax Statements, Form W-2, to *all* church employees, both lay and ministerial. The church treasurer's bookkeeping accounts should be set up to carefully reflect the amounts that should and should not be reported on the annual Form W-2. (See ["Tax and Reporting Procedures for Congregations"](#) in the Servant Solutions' Treasurer's Toolbox)

Tax-Free Employee Benefits

In addition to "cash" salary an employee usually receives some benefits that are paid for by the employer. Many of these benefits are "tax-free" to the employee if paid directly by the employer (not reimbursed). Unfortunately, some church employees pay for these "benefits" out of their pocket with after-tax dollars and therefore lose a legitimate tax advantage simply because of the manner of payment. Some examples of employee benefits which may be provided by the employer on a tax-free basis include: group health insurance, dental insurance, group term life insurance, the Servant Solutions Retirement Plan, disability insurance, and accidental death and dismemberment insurance.

Business Transportation, Travel, and Related Expenses

Most church employees incur business transportation and travel expenses in the course of conducting the ministry of the local church. Many churches are careful to reimburse their employees *in full* for these expenses. In recognition of the fact that these are business expenses and not personal expenses, the IRS allows these reimbursements to be provided tax-free to the employee if they are paid through an "accountable reimbursement plan." Unfortunately, sometimes reimbursements are insufficient to cover actual expenses. In such cases, employees find themselves paying out of their own salary what is recognized as a local church operating expense. However, careful planning can ensure that the salaries of your church employees are actually theirs to spend.

In the past an employee used Form 2106 to deduct *unreimbursed* expenses from income taxes. However, the Tax Reform Act of 1986 changed the procedures for using Form 2106 to the extent that many employees may not be able to claim the deductions. This makes it even more important that all business transportation, travel, and related expenses be fully reimbursed. Full reimbursement for automobile mileage should be either on a dollar-for-dollar basis for business expenses incurred or on a cents-per-mile basis at the standard mileage rate. It is necessary to maintain accurate records of business mileage and/or expenses. However, instead of using the records to support a deduction on tax forms, they should be supplied to the church treasurer as substantiation for the reimbursements. (See also ["Auto and Other Business Expense Reimbursements"](#) in the Servant Solutions' Treasurer's and Minister's Toolboxes)

Other Business and Professional Expenses

Church employees incur not only business transportation and travel expenses, but often they sustain other business expenses along with "professional" expenses in the course of their ministry. Examples of such items include: business-related entertainment, professional books and magazines, memberships and dues in professional organizations, stationery and supplies, and other ministry expenses. Normally, the church board recognizes these are necessary for the ongoing work of the church and as such they are viewed as local church expenses. The employee should be reimbursed in full for such expenses. If the reimbursements are paid properly through an accountable reimbursement plan, the IRS recognizes them as tax-free. When a church employee incurs this type of expense and is not reimbursed in full, the situation becomes a bit more complicated.

At one time the ministerial employee used IRS Schedule C to report the income and expenses related to the work as a local church employee. By this means, all of his/her unreimbursed business and professional expenses were exempted, dollar for dollar, from the "salary" and, therefore, from income tax. In this situation, the ministerial employee, while having to pay the expense out of his or her own pocket, at least did not need to suffer a tax loss. But the IRS has eliminated the use of Schedule C by the ministerial employee in relation to church salary; therefore, both the ministerial employee and the lay employee suffer when they incur unreimbursed business and professional expenses.

The ministerial or lay employee may be able to treat a portion of the unreimbursed business and professional expense (if proper substantiation is provided) as a tax deduction. As such, it would be claimed on Schedule A, Itemized Deductions, when the annual tax return is filed. By using this means, some employees may be able to deduct a portion of their expenses, but many will lose the tax break. This is because to claim these items as deductions, the expenses must exceed two percent of adjusted gross income and the individual employee must file an itemized return and have more deductions than the standard deduction. If all itemized deductions do not exceed the standard deduction, the unreimbursed business and professional expenses will simply be absorbed and lost in the standard deduction amount. The Tax Act of 1993 limited the deductibility of many entertainment expenses to 50 percent of value. Therefore, 50 percent of these types of unreimbursed business expenses cannot be deducted even if all other conditions are met.

Whether the unreimbursed business expenses are taken as a tax deduction or are lost in the standard deduction amount for income tax purposes, there still remains the question of Social Security/Medicare taxes. Either way, the ministerial employee could avoid self-employment taxes (SECA-Social Security/Medicare taxes) on the total of unreimbursed business expenses, since many of those expenses remain exempt from SECA taxes. However, the lay employee would not be able to recover any FICA taxes withheld nor would the church be able to recover their portion of FICA taxes paid.

The Accountable Reimbursement Plan

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.

IRS regulations require that business reimbursements be included on Form W-2 as taxable income to the individual **unless** paid through an "accountable reimbursement plan" that 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. The payment of the balance to the employee makes all payments made to the employee under the plan during the year reportable as taxable income on Form W-2.

What the Church Could Do

Obviously, most churches will want to make sure that church employees are fully reimbursed for all business-related expenses through an accountable reimbursement plan, since the IRS recognizes these reimbursements as nontaxable to the employee for income tax and Social Security/Medicare tax purposes. When this is done, the employee's "salary" can remain whole.

If a church finds that it simply cannot afford to reimburse all the business-related expenses its employees incur, it can still attempt to minimize the income tax for them. The church board may wish to consider the following plan:

1. The church board will want to consider how many of these expenses it can begin to fully reimburse now through a board-adopted accountable reimbursement plan. (It will also want to develop a plan whereby it can begin reimbursing any remaining expenses as soon as possible.)
2. The church board, in working with the church employee, will want to determine how much of the present salary is actually being spent for unreimbursed business-related expenses. Together they can arrive at a new "salary" figure that truly reflects actual cash compensation the church board is paying to the individual.
3. The difference between the two figures (that is, the amount being paid out of personal salary for unreimbursed expenses) should now be designated in the budget for the reimbursement of these expenses.
4. The newly determined actual salary to be paid weekly or monthly in regular amounts should be recognized in a separate action by the board. It would be reported on Form 941. The salary would not be adjusted "after the fact" to reflect local church expenses. (See "**Tax and Reporting Procedures for Congregations**" in the Servant Solutions' Treasurer's Toolbox)
5. A portion of the business expense reimbursement amount would be advanced to the employee (e.g., \$100 or \$200) as a business expense petty cash fund. As the employee incurs business-related expenses, receipts and/or mileage statements would be kept to be turned in to the treasurer. When they are turned in, the amounts are refunded to the employee's business expense petty cash fund, bringing it back up to the original advance amount. Ultimately, any unused portion of the advance needs to be returned to the church employer.

By following these procedures the actual salary is clearly separated from the business expense reimbursements which do not need to be reported on Form W-2. The employee does not need to

worry about deducting these business expenses or substantiating them on his or her annual tax return. Since the amount is not reported as income nor deducted on the tax return, the return is greatly simplified and less likely to be audited. If the return is audited, there will generally be no complicated justification of business expenses since they were substantiated to the treasurer (when they were reimbursed) with receipts and/or mileage statements according to IRS regulations.

Summary

In minimizing taxes for all church employees, proper handling of tax-free employee benefits and reimbursements for business transportation/travel and other business and professional expenses is vital. However, these require careful planning and proper board action. Specific guidelines and accounting standards are available from the IRS (www.irs.gov or 800-TAX-FORM).

Those employee benefits that can be considered tax-free should be paid directly by the church and not reimbursed.

All business transportation/travel and all other business and professional expenses should be reimbursed in full to each employee through an accountable reimbursement plan adopted by the board which results in the proper substantiation to the church of all business and professional expense reimbursements.

While Servant Solutions cannot offer legal or tax "advice," your comments and questions are welcomed. Please feel free to contact us if we may serve you in any way.

Disclaimer

The information contained in this Toolbox Series is of a general nature. It is not offered as specific legal or tax "advice." Each person or local church board should evaluate their own unique situation in consultation with their local legal and tax advisors.

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