

— MEMO #4 —

Strategies for Structuring Ministerial Compensation





Significant changes have occurred in the patterns of ministerial compensation over the decades. Gone are the days when ministers received a portion of their compensation in the form of food and clothing supplied by members of the congregation. The 1986 Tax Reform Act and subsequent IRS regulations affected the finances of ministers, as has the Tax Cuts and Jobs Act of 2017 (TCJA).

With the 2018 tax year, the TCJA made it impossible to use Schedule A to recover a portion of monies spent on unreimbursed business expenses, as had been possible in previous years. Now, with a high standard deduction allowance, many parsonage families will find it difficult to itemize deductions. The same problem applies to many of the other business and professional expenses incurred in the exercise of ministry. The result is additional income tax for ministers who do not use accountable reimbursement plans.

With this in mind, ministers need to reevaluate the structuring of their compensation.

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. 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 which has been formally adopted by the church board.

There are three requirements for the accountable reimbursement plan:

- ▶ 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;
- ▶ 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); and
- ▶ Any advance must be made within 30 days of when the expense is paid or incurred.

Form W-2 income cannot be reduced after-the-fact. In other words, the IRS will not allow reimbursements to be paid through a retroactive reduction of salary. 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 must 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.



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.

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





The Cost of a Minister vs. The Cost of a Ministry

For too long, churches and ministers have failed to distinguish between 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 separated.

The cost of a ministry includes outlays related to the work of the minister and should be understood as a part of local church expenses. Among these are the expenditures incurred without regard to who is serving the congregation at a particular time.

On the other hand, the cost of a minister relates to items that are directly and indirectly related to compensating the particular minister serving the church at the current time. These expenses 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 he or she must provide for professional expenses, employee benefits, and cash salary. Unfortunately, it is common, in situations where these are lumped together, for the local church and the minister to assume that the total amount of the package is compensation. In reality, part is the cost of a ministry and part is 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 paying taxes on money actually used to operate the local church’s ministry. However, when these items are reimbursed through an accountable reimbursement plan (even if it means dividing the minister’s previous compensation package into two



CAUTION

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



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.

distinct amounts), the result is usually lower taxes, a more accurate reflection of the minister's real compensation, and a simpler tax return.

The cost of maintaining a ministry includes, but is not limited to, the following business and professional expense reimbursements:

- ▶ Automobile
- ▶ Continuing education
- ▶ Conventions/assemblies
- ▶ Hospitality
- ▶ Pastor's professional library
- ▶ 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 related to these are not discretionary since the minister and family have no choice as to how the money is spent. Items of a nondiscretionary nature include most of the employee benefits listed below which represent what 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



IDEA

Provide for your pastor's retirement and retirement housing by contributing monthly to his or her Nazarene 403(b) Retirement Savings Plan account.

The cost of a minister also includes the provision for housing in the form of a cash housing allowance, a parsonage plus utilities, or a combination of the two.

Some churches provide a parsonage and utilities. In such cases, the minister has no discretion as to how that part of compensation will be spent. He or she cannot 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. In such a situation, 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 equity in the parsonage.

Fortunately, many churches now recognize their obligation to assist the pastor 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?

Memo #13: The Minister's Housing Allowance

The remaining item in the cost of a minister is the cash salary. This is the amount the minister and family use to meet living expenses and with which they have some discretion in spending. Among the factors most church boards consider when determining their minister's cash salary are: job requirements, professional qualifications, educational background, personal experience and expertise, 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

More churches are realizing the need to differentiate between the cost of a ministry and the cost of a minister. They recognize that the package approach does not provide nearly as much true cash salary as they had thought, and they are making efforts to reimburse compensation above the package amount for business and professional expenses.

Some churches are financially unable to increase compensation 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 recategorize the total amount provided by the church into these distinct expense categories. The result of this restructuring costs the church no additional funds, but provides 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

Memo #11: Auto and Other Business Expense Reimbursement



IDEA

Allow your pastor to recategorize income provided by the church to reduce potential taxes.



SEE

*Memo #1:
Housing for Your
Pastor: Parsonage
or Housing
Allowance?*

*Memo #13: The
Minister's Housing
Allowance.*

A photograph of a church interior, showing rows of wooden pews in the foreground and middle ground. The background features a white wall with several stained glass windows of various designs, including a large one on the right and smaller ones on the left. A cross is visible on the wall above the pews. The lighting is soft and natural, coming from the windows. A green triangular graphic element is in the top right corner.

The information contained in this memo series is of a general nature reflecting USA Nazarene Church polity.

It is not offered as specific legal or tax advice. Each person, local church board, and district should evaluate their own unique situation in consultation with their local legal and tax advisors.

SERVING THOSE WHO SERVE

Other NBUSA Memos That May Be Helpful

- #1:** Housing for Your Pastor: Parsonage or Housing Allowance?
- #2:** Church Employees or Independent Contractors?
- #3:** Tax and Reporting Procedures
- #5:** Minimizing Income Taxes for Church Employees
- #6:** Housing Allowance in Retirement
- #7:** Financially Caring for the Minister
- #8:** The Annual Church Audit
- #9:** Workers' Compensation Laws and the Local Church
- #10:** Can Ministers Opt Out of Social Security?
- #11:** Auto and Other Business Expense Reimbursements
- #12:** Who Is a Minister for Tax Purposes?
- #13:** The Minister's Housing Allowance

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