

Employee Compensation and Tax Planning Considerations for Pastors

There are a number of employee compensation components churches can consider for pastors, from health plans to even how expenses are reimbursed. Several of these components have important tax planning considerations, however.

Careful employee compensation and tax planning can provide significant savings, particularly as state and federal tax rates increase. We've outlined six potential compensation components and their tax considerations below. The goal is to help your church identify which options may be most helpful and plan accordingly. Note that your church may decide to offer some of these options equally to all employees, while others may need to be tailored to specific situations.

- 1. Minister's housing allowance** – You are probably aware of the substantial benefit the housing allowance can provide. Note that your church must designate the minister's housing allowance before payment. Please contact us if you have questions about the allowance.
- 2. Health insurance plans** – Although the health reform legislation made health care plans more complicated, they continue to be a substantial non-taxable employee benefit. Health plans (self-insured, insured, and cafeteria plan arrangements) cannot discriminate in favor of highly paid employees, but careful use of a cafeteria plan may still provide more benefit to higher-paid employees. By considering these options together, a church may provide a good level of health coverage to all regular employees.
- 3. Retirement plans** – There are several tools available to help employees save for retirement, including qualified retirement plans, 403(b) plans, SIMPLE IRAs (an acronym for "Savings Incentive Match Plan for Employees"), and SIMPLE Plans. For churches, 403(b) plans have the added benefit of allowing discriminatory contributions. (This must be allowed by the plan document.)

You can learn more about the retirement plan options useable by churches in IRS Publication 4484, "Choose a Retirement Plan for Employees of Tax Exempt and Government Entities," available at www.irs.gov/pub/irs-pdf/p4484.pdf. The IRS also provides tax information about retirement plans at www.irs.gov/retirement-plans.

If your church offers a retirement plan, we recommend that you read [this post](#) about the minister's housing allowance and calculating retirement plan contributions.

- 4. Non-qualified deferred compensation plans** – These retirement programs offer significant flexibility in funding and pay-out provisions. They can be developed to precisely meet the specific requirements of the church and individual employees.

"Non-qualified" primarily means plans that are not a regular pension, retirement, or 403(b) plan. Under a non-qualified deferred compensation plan, assets belong to the church and nothing is taxed to the employee until paid to the employee. Due to documentation and operation requirements, any deferral of compensation payments beyond the year in which they were earned should be discussed with your tax professional.
- 5. Expense reimbursements** – For the employee or pastor, the most tax-advantageous way to reimburse church-related expenses is through an accountable reimbursement plan (ARP). Under an ARP, the church only reimburses expenses that are related to the church's ministry, properly documented, and submitted within a reasonable timeframe. No income or Social Security tax is paid on the reimbursed expenses. If your church is concerned about excessive reimbursements, you can require authorization or set restrictions on the purpose or financial amount of expenses.

6 **Education** – Many church employees, including pastors, attend seminars and classes to develop new expertise and skills. While there are several provisions that provide tax benefits for such education, many times confusion about the requirements results in the benefits going unused. Churches can reimburse expenses associated with the following options:

A. Education that enhances an employee's skills or knowledge used in their job, but which does not lead to a new career. This can be provided to any employee at the employer's discretion, and without a required "plan." It could cover reimbursement for books, tuition, and travel to and from the educational institution. If the educational institution is out of town, the expense reimbursement could also include food and overnight lodging. There is no statutory amount limit.

B. Education provided under an "Employer's Educational Assistance Program" using a nondiscriminatory plan. This may be used for nearly any subject and even lead to a new career. An employee's annual benefit limit is \$5,250, and this can only be spent on tuition, fees, books and similar supplies. Although this program can't discriminate in favor of highly compensated employees, a church may restrict the usage to subjects helpful to the church.

For example, a church might use Option A to help a pastor who is already preaching earn an advanced theology degree by extension, which might require periodic trips to the seminary. Option B could be used to help clerical staff take accounting courses, even though these courses may be part of an accounting degree program.

One final consideration: while many churches do their tax planning at the end of the year, it can be more effective to start the process earlier. This is particularly true for employee compensation options, most of which provide more benefit when operating for the entire year. In addition, some compensation options need to be determined and in place before January 1.

Planning to save taxes requires time and thought, and many times should involve joint consideration between the church and its pastors or employees. Professional assistance is often required to assure correct implementation and operation as well. This planning can result in savings for your employees, however, making the extra effort and consideration worthwhile.

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