

Minimizing Income Taxes for Church Employees

**NBUSA
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Nazarene Benefits USA
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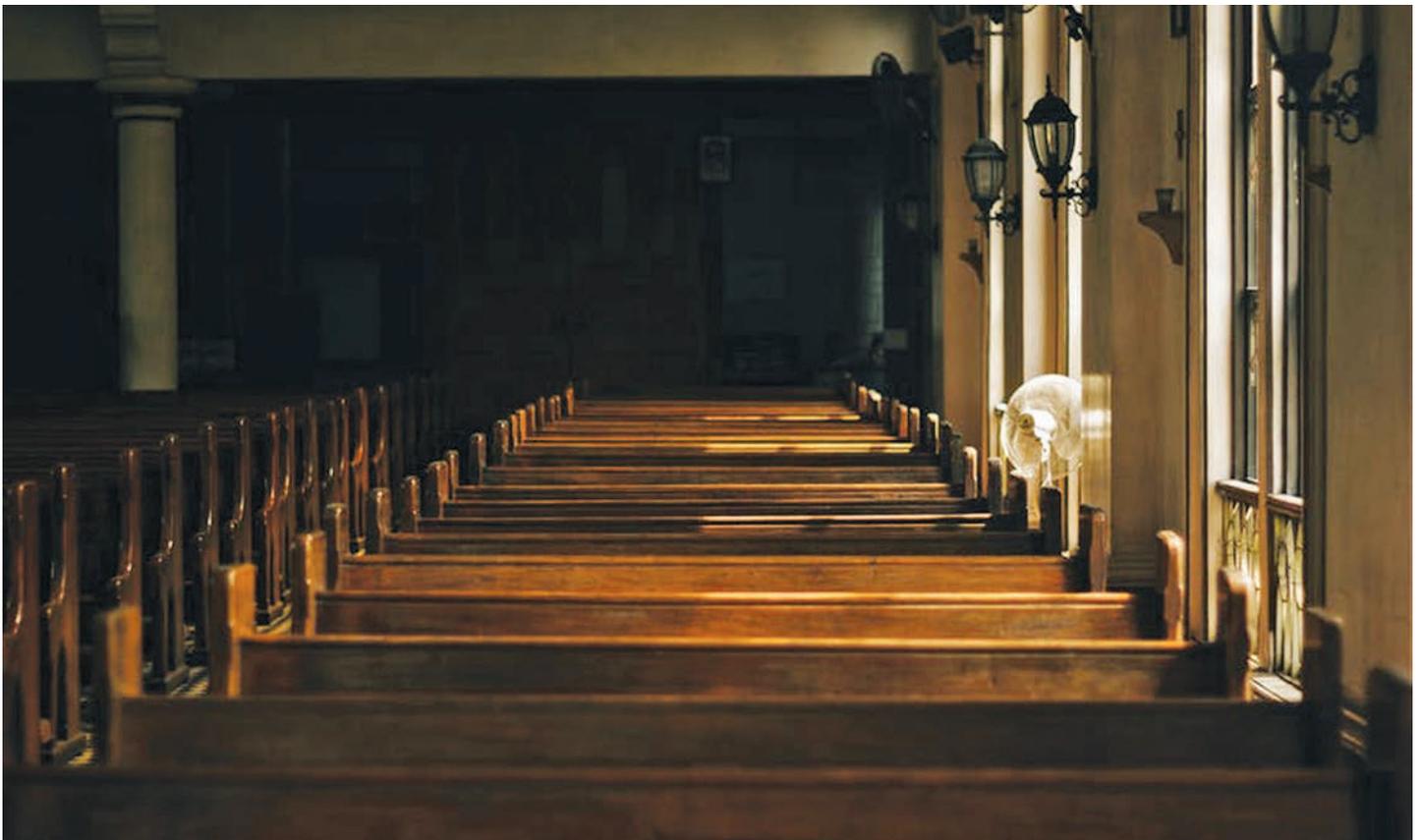


IRS tax rulings often make it possible for church employees to save money if their compensation packages are properly structured and certain guidelines are followed. Church boards and treasurers play an important role in enabling this to happen by periodically reviewing the packages of all employees and by assuring that appropriate accounting procedures are followed.

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 Memo #3: *Tax and Reporting Procedures for Congregations*.)

**See:**

Memo #3: *Tax and Reporting Procedures for Congregations*.



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 pocket with after-tax dollars and therefore lose a legitimate tax advantage simply because of the manner of payment. Some examples of tax-free employee benefits which may be provided by the employer include: group term life insurance, the Nazarene 403(b) Retirement Savings Plan, salary continuance insurance, health insurance, and accidental death and dismemberment insurance.



Idea!

Visit nbusa.org to learn more about tax-advantaged 403(b) retirement assistance and insurance plans.

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. Churches should try to reimburse their employees in full for these expenses. In recognition of the fact that these are business and not personal expenses, the IRS allows such 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. When this happens, employees find themselves paying out of their own salary what is actually a local church operating expense. However, careful planning can ensure that this does not happen.

With recent changes in tax law, it is very important that churches try to fully reimburse employees for all business transportation, travel, and related expenses. 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 Memo #11: *Auto and Other Business Expense Reimbursements*.)



Caution!

Be sure to keep accurate records of business expenses and mileage.



See:

Memo #11:
*Auto and Other
Business Expense.*

Other Business and Professional Expenses

Church employees often 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 as 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.

Prior to the 2018 tax year, ministerial and lay employees were able to deduct a portion of their unreimbursed business and professional expenses as a tax deduction by filing an itemized return and claiming the unreimbursed expenses on Schedule A. The passage by Congress of the “Tax Cuts and Jobs Act” (TCJA) in December 2017 eliminated this option. This change in law makes it even more important for church employees to establish—in advance—an accountable reimbursement plan with their churches.



Remember!

The IRS allows churches to reimburse employees for business expenses tax-free *if* the reimbursements are paid through an “accountable reimbursement plan.”

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 will pay unnecessary taxes.

IRS regulations require that business expense 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 received within 30 days of when the expense is paid or incurred.



Caution!

IRS regulations regarding business expense reimbursements apply to *all* churches and church employees.



Caution!

Business expense reimbursements must be included on Form W-2 as taxable income unless they are paid through an accountable reimbursement plan that has been formally adopted by the church.

Form W-2 income cannot 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 plan at year-end must 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.

Caution!

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



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 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. Here are some possible steps a church can take.

1. Consider how many of these expenses it can begin to fully reimburse 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 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 pays to the individual.
3. The difference between the two figures (i.e., 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 *Memo #3: Tax and Reporting Procedures for Congregations*.)
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 would be returned to the church employer.



Caution!

If reimbursed expenses are factored out of a pastor's compensation, the resulting salary should be approved by church board action.



See:

Memo #3: Tax and Reporting Procedures for Congregations.

By following these procedures, actual salary is clearly separated from 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 or 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

Proper handling of tax-free employee benefits and reimbursements for business and other professional expenses is vital in minimizing taxes for all church employees. However, this requires careful planning and proper board action. Specific guidelines and accounting standards are available from [irs.gov](https://www.irs.gov) or by calling **1.800.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.



Remember!

Careful planning and proper board action are important.

Other NBUSA Memos that May Be Helpful

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

MEMO # 2: *Church Employees or Independent Contractors?*

MEMO # 3: *Tax and Reporting Procedures for Congregations*

MEMO # 4: *Strategies for Structuring Ministerial Compensation*

MEMO # 6: *Housing Allowance in Retirement*

MEMO # 7: *Financially Caring for the Minister*

MEMO # 8: *The Annual Church Audit*

MEMO # 9: *Workers' Compensation Laws and the Local Church*

MEMO #10: *Can Ministers Opt Out of Social Security?*

MEMO #11: *Auto and Other Business Expense Reimbursements*

MEMO #12: *Who Is a Minister for Tax Purposes?*

MEMO #13: *The Minister's Housing Allowance*

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.

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