

## CHAPTER IV: TAXES AND THE EPISCOPAL CHURCH

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### **Introduction**

Timely and accurate compliance with all applicable Federal and State tax laws is an essential element of sound management of church finances. Federal and State governments have increased pressure on all governmental units to increase revenues through intensified application of existing tax laws to all types of organizations, including churches.

All churches should be particularly attentive to three areas of taxation:

- Payroll taxes and related reporting
- Unrelated Business Income Taxes
- Treatment of cash and non-cash contributions received in connection with certain types of fundraising events

Officers and directors of an organization, including wardens and Vestry, can be held personally liable for unpaid payroll taxes.

Penalties are levied against those who fail to file, fail to pay, are late in filing or paying, or understate any tax reported on a return. In addition, interest is charged on any unpaid balance from the date the tax return was due to the date of payment.

### **Section A. Payroll Taxes**

The determination of whether a person is an employee or an independent contractor is typically based on three factors of the business relationship:

1. Behavioral control: does the employer direct where and when the provider can work; what tools he may use; or does the provider supply his own tools?
2. Financial control: is the worker free to seek out similar business opportunities; can he/she realize a profit or loss?
3. Type of relationship: is there a written contract; are employee-type benefits provided; is the relationship expected to continue indefinitely; is the provider's service a key aspect of the employer's regular business?

The Internal Revenue Service uses the 20 Common Law factors, established in Revenue Ruling

87-41, as a guideline when determining if sufficient control is present to establish an employer-employee relationship. While not all factors need to be “met,” the more factors established in favor of classifying a worker as an independent contractor, the stronger the position for treating them as such. The factors are:

1. *Instructions:* A person who is required to comply with instructions about when, where and how to work is ordinarily an employee.
2. *Training:* The training of a person, by an experienced employee or by other means, is a factor of control indicating that the worker is an employee.
3. *Integration:* Integration of a person’s services into the business operations generally shows that the person is subject to direction and control and accordingly is an employee.
4. *Services rendered personally:* If services must be rendered personally by the individual employed, it suggests an employer-employee relationship. Self-employed status is indicated when an individual has the right to hire a substitute without the employer’s knowledge.
5. *Hiring, supervising, and paying assistants:* Hiring, supervising, and paying assistants by the employer generally indicates that all workers on the job are employees. Self-employed persons generally hire, supervise, and pay their own assistants.
6. *Continuing relationship:* The existence of a continuing relationship between an individual and the organization for which the individual performs services indicates an employer-employee relationship.
7. *Set hours of work:* Establishing set hours of work by the employer is indicative of control and accordingly the existence of an employer-employee relationship. Self-employed persons are “masters of their own time.”
8. *Full time required:* If the worker must devote full time to the business of the employer, he/she ordinarily will be an employee. A self-employed person, on the other hand, may choose for whom and when to work.
9. *Doing work on employer’s premises:* Doing the work on the employer’s premises may indicate that the worker is an employee, especially if the work could be done elsewhere.
10. *Order or sequence of work:* If a worker must perform services in an order or sequence set by the organization which he/she serves, this indicates that the worker is an employee.
11. *Oral or written reports:* A requirement that workers submit regular oral or written reports to the employer is indicative of an employer-employee relationship.
12. *Payment by hour, week or month:* An employee usually is paid by the hour, week, or month, whereas a self-employed person usually is paid by the job on a lump sum basis, although the lump sum may be paid in intervals.
13. *Payment of business expenses:* Payment by the employer of the worker’s business or travel expenses suggests that the worker is an employee. Self-employed persons usually are paid on a job basis and take care of their own business and travel expenses.
14. *Furnishing of tools and materials:* The furnishing of tools and materials by the employer indicates an employer-employee relationship. Self-employed persons ordinarily provide their own tools and materials.
15. *Significant investment:* The furnishing of all necessary facilities (equipment and premises) by the employer suggests that the worker is an employee.
16. *Realization of profit or loss:* Workers who are in a position to realize a profit or suffer a loss as a result of their services generally are self-employed, while employees ordinarily are not in such a position.
17. *Working for more than one firm at a time:* A person who works for a number of persons or

organizations at the same time is usually self-employed.

18. *Making services available to the general public:* Workers who make their services available to the general public are usually self-employed. Individuals ordinarily hold their services out to the public by having their own offices and assistants, hanging out a “shingle” in front of their office, holding a business license, and by advertising in newspapers, telephone directories, and electronic media.
19. *Right to discharge:* The right to discharge is an important factor, which indicates the person possessing the right is an employer. Self-employed persons ordinarily cannot be fired as long as they produce results that measure up to contract specifications.
20. *Right to terminate:* An employee ordinarily has the right to end a relationship with an employer at any time he or she wishes without incurring liability. A self-employed person usually agrees to complete a specific job and is responsible for its satisfactory completion or is legally obligated to compensate for failure to complete the job.

The following persons are normally considered to be employees:

- Rectors, vicars, and their assistants;
- Interim clergy and regularly employed supply clergy who consistently work at the same congregation; and
- Secretaries, sextons, directors of Christian education, childcare providers who are not volunteers (including teenagers), yard maintenance workers (including the teenagers who cut the lawn regularly), the organist and choir director, and all others to whom a fee is paid for their services and who are controlled by the Church.

Churches should be careful to issue or timely file the following documents:

- IRS Form W-2 must be issued after each year end to all church employees (full time, part-time, retired part-time clergy, and lay persons)
- IRS Form W-2 and the corresponding Form W-3 “Transmittal of Wage and Tax Statement” must be filed with the IRS
- IRS Form 941 “Employer’s Quarterly Federal Tax Return” must be filed by employers. “
- IRS Form I-9 “Employment Eligibility Verification” must be completed for all lay and clergy employees, regardless of citizenship, prior to the first paycheck
- IRS Form W-4 “Employee Withholding Allowance Certificate” should be completed when a clergy or lay employee is hired or when a change in withholding is requested

Clergy and lay employees are generally treated in different manners for Social Security and for Federal income tax withholding purposes.

### **Special Instructions for Reporting Clergy Compensation**

Clergy are recognized as employees only for Federal (and, where applicable, State) income tax purposes. With respect to FICA (Social Security and Medicare) tax, Clergy are considered self-employed, and therefore the income is not included as wages subject to Social Security or Medicare tax. Additionally, these taxes are not to be withheld, and compensation is not to be reported on Form 941 or Form W-2 for purposes of these taxes.

The following items are considered compensation and must be reported as compensation for

services in gross income (box 1) on the IRS Form W-2 (please note that this is not meant to be an all-inclusive list of items considered to be compensation):

- Salary, excluding housing and utility allowance
- Honoraria
- Bonuses
- “Love offerings,” even if there is a special offering to provide the income
- Retirement gifts when 1) any of the funds were provided by the church or 2) the gift has been given as a tax-deductible contribution by the donor(s). If the recipient is still considered an employee, it should be included on the Form W-2; otherwise a Form 1099 should be provided.
- Personal use of a church-provided car (leased or owned by the congregation) usually must be reported on the Form W-2 as income. There are several methods of including such income as compensation (see Internal Revenue Service publications).
- Amounts received for weddings and funerals
- An amount to cover the clergy self-employment taxes paid either directly to the clergy or reported and paid as income tax withheld
- Transfers of property by the church to an employee, such as automobiles, homes, furniture, etc., based on the fair market value, less any amount paid by the employee
- Travel and expense allowances for which an “accountable plan” is not provided to the employer; reference Section B of this chapter
- Moving expenses reimbursed to the employee are to be included in Form W-2 as taxable wages (subject to withholding and Social Security and Medicare taxes if for a lay employee).

Clergy compensation attributable to housing and utility expenses (parsonage allowance) as declared by the clergy (in conjunction with the Church) may be excluded from taxable income, but are included in earnings for self-employment tax. Clergy should complete housing and utility allowance resolutions prior to the start of the calendar year. Refer to Appendix A for sample housing allowance resolutions and forms for estimating housing allowance. The Vestry shall designate and record the housing and utility allowance in its Minutes before the clergy receives a paycheck in any year.

Housing and utility allowances are not reported on the Form 941 or the Form W-2. A memo of the amounts excluded for housing and utilities may be noted in the memo notation box of Form W-2 (box 14) or in other appropriate boxes.

Clergy may elect to have Federal income tax withheld. If the cleric is the only employee and does not choose to have tax withheld, a Form 941 and a Form W-2 must still be completed and submitted noting taxable wages and other income.

If a clergy person is participating in a tax deferred annuity plan, taxable gross wages are reduced by the amount of the contribution to the tax-deferred annuity. An authorization signed by the employee is required.

### **Special Instructions for Reporting Lay Employee Compensation**

Lay employees are classified as employees for both income tax and Social Security tax purposes.

Lay employees are not eligible to designate a portion of their compensation for housing and utility allowance. Withholding is required from lay employees' pay for federal and state income taxes and for Social Security and Medicare taxes.

If a lay employee is participating in a tax-deferred annuity plan, the taxable gross wages for Federal income taxes are reduced by the amount of the contribution to the tax-deferred annuity. However, gross wages subject to Social Security and Medicare taxes are not reduced. The employee must sign an authorization for the deduction from wages.

Churches are not subject to the Federal Unemployment Tax Act but may be subject to state unemployment laws.

### **Special Instructions for Reporting Non-Employee Income**

IRS regulations require that "every person engaged in a trade or business" shall issue a Form 1099 for each calendar year with respect to payments made during the calendar year in the course of the trade or business to another person. Churches are considered to be in trade or business by the IRS for purposes of issuing a Form 1099.

The following individuals must receive a Form 1099 or Form 1099-NEC:

- Any individual or unincorporated entity that was paid \$600 or more in the form of self-employment earnings (Form 1099 MISC, Box 7)
- Any person who receives a scholarship, which is not used for payment of tuition and related expenses (Form 1099 MISC, Box 1)
- Any person who is paid \$600 or more for real estate or machine/equipment rentals (Form 1099-MISC, Box 1)
- Any person who receives \$600 or more in a settlement for taxable damages that are not classified as wage-related payments (Form 1099-MISC, Box 3)
- Attorneys who receive proceeds from any settlement or legal action, regardless of whether services are provided to the Church by the attorney (1099-MISC, Box 14)
- Any person who was paid \$600 or more in interest, including those persons who purchase bonds for a church's capital project (Form 1099 INT)
- Any person who receives at least \$10 in gross royalty payments (Form 1099 MISC, Box 2)
- Any person who receives qualified retirement or annuity income from a qualified retirement plan (Form 1099-R)

The following exceptions may be applicable for compensation reporting:

- Payments of income required to be reported on Forms 941 and Form W-2 (i.e., employee income)
- Payments to a corporation (if in doubt whether or not a person or company is incorporated, issue a Form 1099 MISC)
- Payments of bills for merchandise, telephone, freight, etc.
- Advances and reimbursements for accountable business expenses.

IRS Form 1099 must be provided to recipients by January 31<sup>st</sup>. Copies of all Forms 1099 must

be transmitted to the Internal Revenue Service along with a transmittal Form 1096 by February 28<sup>th</sup>. The maximum penalty for failure to issue a Form 1099 is \$100 per form.

A congregation is responsible for obtaining the person's or company's Federal Employer Identification Number. This may be in the form of a Federal Employer Identification Number or an individual Social Security number. If a person refuses to provide an identification number, back-up withholding in the amount of 28% must be taken and reported on the Form 941

Resident and non-resident aliens are taxed in different ways. Resident aliens are generally taxed in the same way as U.S. citizens. Non-resident aliens are taxed based on the source of their income (whether it is effectively connected with a U.S. trade or business). Aliens and employers should refer to IRS Publication 519 *U.S. Tax Guide for Aliens*. In addition, payments to nonresident aliens are reported differently than payments to US residents. A nonresident alien will be issued a Form 1042-S for any payment other than employee payments that are subject to withholding.

A nonresident alien may be entitled to claim a tax treaty exemption from withholding on some or all compensation paid for personal services. In order to determine if the treaty exemption is applicable, refer to the section entitled "Pay for Personal Services Performed" in Publication 515, *Withholding of Tax on Nonresident Aliens and Foreign Entities* as well as Publication 901, *U.S. Tax Treaties* to verify the particular treaty position is applicable. Persons who wish to claim this exemption should provide the employer with Form 8233, *Exemption from Withholding on Compensation for Independent (and Certain Dependent) Personal Services of a Nonresident Alien Individual*.

### **Section B. Travel and Business Expense Reporting**

Amounts received by an employee under an "accountable plan" are not required to be included as compensation on Form W-2. An accountable plan must meet three criteria:

1. There must be a business connection for the expenses;
2. The expenses must be substantiated in writing to the employer within a reasonable period of time not to exceed 60 days after expenses are incurred; and
3. The employee must return amounts in excess of the substantiated expenses within a reasonable period not to exceed 120 days after expenses are paid or incurred. An accountable plan should be in writing and adopted by the governing body.

The following guidelines apply for claiming reimbursement for various types of travel and other business-related, out-of-pocket expenses under an accountable expense reimbursement plan:

- Reimbursement at no more than the standard mileage rate established by the Internal Revenue Service for business mileage (excluding personal and commuting miles). Tolls and parking fees are additional to the mileage rate. In lieu of the standard mileage rate, actual automobile expenses allocated to actual business miles driven can be claimed. (Note: Since the 1980s, the IRS charitable mileage rate has remained unchanged at 14 cents per mile. If a parish reimburses its volunteers at more than 14 cents per mile, any excess reimbursement that exceeds \$600 annually must be reported through an IRS Form 1099 as taxable income to the volunteer. In 2019, this would be necessary when the volunteer is reimbursed for more than

1,369 miles: IRS business allowance is \$0.58 minus charitable allowance of \$0.14 equals an excess reimbursement of \$0.44; \$0.44 times 1,369 miles equals \$601. The \$1 excess is reportable taxable income.);

- Reimbursement of travel reasonable and customary expenses away from home to conduct work or business. Examples are transportation fares, meals and lodging, cleaning and laundry expenses, and telephone. Deductions may be limited if the travel is extravagant, part of a vacation, or for travel outside the United States. Original supporting documentation is required for expenditures of \$75 or more. United States government per diem rates may apply in some instances for meals and lodging;
- Business gifts (up to but not exceeding \$25.00 per person); education expenses (if required by the employer or by law or regulation to maintain a salary, status, or job, or to maintain or improve the skills necessary to one's present work);
- Business expenses directly reimbursed for subscriptions and books related to the job; clothing that cannot take the place of ordinary clothing; business calls made on personal phones; professional memberships; licenses; and dues;
- Cell phones – recent legislation and IRS guidance has eliminated the need to quantify the amount of personal usage of cell phones provided by the Church or payment for cell phone service. Personal usage is now deemed de minimis as long as the Church has a policy stating that the provision of cell phones and/or payment of cell phone service fees are primarily for business purposes and it is expected that personal usage is minimal.
- Original documentation should be provided to the employer to support all expenses claimed by the employee. (The IRS exempts amounts below \$75, but most employers use a lower limit.)

Unsubstantiated business expenses paid to an employee in a “non-accountable plan” must be included on Form W-2 as wages paid to an employee. These wages are subject to Federal withholding and Social Security and Medicare tax withholding if paid to non-clergy employees and to clergy, who choose to have Federal income tax withheld.

Per Diem amounts in excess of Internal Revenue Service approved per diem rates must be included on the Form W-2.

### **Section C. Tax-Exempt Status**

All dioceses, congregations, and related institutions may be covered under the group tax exemption of the Domestic & Foreign Missionary Society of the Protestant Episcopal Church in the United States of America. (Contact your diocesan office or the Treasurer's Office of the Domestic and Foreign Missionary Society.) Alternatively, dioceses and/or congregations and related institutions may apply for and hold their own individual or group exemption. Note, however, that an entity electing to be covered under another's group exemption may not retain its individual exemption. In addition, electing entities are also subject to filing Form 990 (unless exemption from such is established) and their own Form 990-T.

**Exemption from Federal taxes does not extend to exemption from state sales taxes. Congregations may be subject to sales and/or use tax on purchases and may be required to report to their states.**

Regardless of whether they are covered under a group or individual exemption, all dioceses,

congregations, and institutions of the Episcopal Church must have their own Employer Identification Number. (Use IRS Form SS-4 “Application for Employer Identification Number.)

Contributions made in the name of the church and its affiliated and subordinate units are deductible in the manner and to the extent provided by Section 170 of the Code.

The notification of a granting of tax-exempt status was addressed to The Domestic and Foreign Missionary Society of the Protestant Episcopal Church in the United States of America on March 23, 1942. It was routinely confirmed on June 3, 1971.

The Episcopal Church is listed twice in the “Cumulative List of Organizations” Publication 78 (“the List”) in Section 170(c) of the Internal Revenue Code. Reference the List as revised to September, 1996, as follows:

**DOMESTIC AND FOREIGN MISSIONARY SOCIETY OF THE PROTESTANT EPISCOPAL CHURCH IN THE UNITED STATES OF AMERICA, NEW YORK, NEW YORK, PAGE 610.**

**EPISCOPAL CHURCHES AND DIOCESES IN THE UNITED STATES AND INSTITUTIONS THEREOF, NEW YORK, NEW YORK, CODE 1, PAGE 685.**

Reference to the listing of the Society in the foregoing manner should help to establish the deductibility of individual gifts to particular dioceses and parishes, although the Internal Revenue Service may take the position that inclusion on the list does not necessarily establish such deductibility.

*Charitable contributions:* Charitable contributions generally must satisfy the following six requirements to be deductible by the donor:

1. A gift of cash or property (*the value of services is not, unless provided by a professional who also includes that amount in their reported business income*);
2. Claimed as a deduction in the year in which the contribution is made (the date delivered or the postmark date on a contribution which is mailed are the controlling factors, not the date written on a check);
3. The contribution is unconditional and without personal benefit to the donor. As a general rule, tax deductible contributions may not be restricted by the donor to be used for specific individuals, regardless of the person’s great need. The donor may suggest a preference, but control resides with the tax-exempt organization;
4. The contribution is made to or for the use of a qualified charity;
5. The contribution is within the allowable legal limit; and
6. The contribution is properly substantiated.

Non-cash contributions should not be valued by the institution.

For gifts of property valued at \$500 or more, a donor must submit a Form 8283, and, for property valued at more than \$5,000, a donor must obtain a qualified appraisal of the property and attach an appraisal summary to the tax return on which the contribution is claimed. If the property is sold within a three-year period, the recipient of the donation must submit an information return, Form 8282 to the IRS.



## Section D. Unrelated Business Income Tax (UBIT)

Income earned by a church from activities that are unrelated to its exempt purpose may be considered taxable income. The following factors determine Unrelated Business Income:

- The organization must be engaged in a trade or business
- The trade or business must be regularly conducted
- The conduct of the trade or business must not be substantially related to the organization's exempt purpose or function.

Income derived from unrelated business activities used by a church for its operations is recognized as unrelated business income subject to tax and reporting, unless the income is derived from:

- An activity where substantially all work is performed without compensation (e.g., a church bookstore which sells other than religious books, substantially run by volunteers);
- A trade or business carried on for the convenience of the students or members of another 501(c)(3) organization;
- The sale of merchandise received as gifts or contributions;
- A trade or business that consists of conducting qualified bingo games;
- The exchange or rental of member lists between exempt organizations to which deductible contributions can be made; and
- The distribution of low-cost articles incidental to the solicitation of charitable contributions for exempt organizations to which deductible contributions can be made.

Because charitable organizations often have difficulty in valuing nominal or token benefits received by donors, the IRS has established safe harbor rules under which the benefits will be treated as having such insignificant value that the charities may inform donors that the full amount of their contributions is deductible.

Certain types of unrelated income are exempt from Unrelated Business Income Tax:

1. Dividends, interest and annuities;
2. Payments with respect to securities loan;
3. Royalties;  
Rents from real property, unless more than 50 percent of the rent is attributable to personal property (i.e., furnishings and equipment leased with it); or where services are also provided (i.e., event coordination, catering, technical services);
4. Rents from personal property leased with real property if they are an incidental amount, but not exceeding 10 percent of the total rents from all property leased;
5. Gains or losses on the sale or exchange of property.

Note: if debt is used to purchase the underlying assets the above exemptions may not apply. In addition, if an investment is with a limited partnership, the Form K-1 received from such LP must be reviewed to determine if any UBI exists.

The Tax Revision of 2018 now requires a tax-exempt organization to add back as UBIT certain

fringe benefits it either subsidizes for its employees or for which it allows those employees to set aside pre-tax dollars to pay. A parish must report in line 34 of its IRS Form 990-T any amount that it provides in:

- Free or subsidized parking that is not included as taxable compensation to employees
- Pre-tax deferrals of wages for purposes of parking
- Pre-tax deferrals of wages for commuter passes
- Any other subsidized transportation benefit

A church that has Unrelated Business Taxable Income must complete IRS Form 990-T. The state where the revenue is generated may also require a filing. Any church that believes it may have Unrelated Business Taxable Income is encouraged to seek the assistance of a licensed or certified public accountant for accounting and reporting purposes.

### **Section E: Jeopardizing Tax-Exempt Status and Intermediate Sanctions**

Churches and religious organizations, like all exempt organizations under IRC section 501(c)(3), are prohibited from engaging in activities that result in directing the organization's income or assets to insiders (e.g., the minister, church board members, officers). Examples of such prohibited inurement include the payment of dividends, the payment of unreasonable compensation to insiders, and transferring property to insiders for less than fair market value. The prohibition against inurement to insiders is absolute; therefore, any amount of inurement is, potentially, grounds for loss of tax-exempt status. Note that prohibited inurement does not include reasonable payments for services rendered, payments that further tax-exempt purposes, or payments made for the fair market value of real or personal property.

An IRC section 501(c)(3) organization's activities must be directed exclusively toward charitable, educational, religious, or other exempt purposes. The exempt organization's activities may not serve the private interests of any individual or organization. Rather, beneficiaries of an organization's activities must be recognized objects of charity (such as the poor or the distressed) or the community at large (for **example**, through the conduct of religious services or the promotion of religion). Private benefit is **different** from inurement to insiders. Private benefit may occur even if the persons benefited are not insiders. Also, private benefit must be substantial in order not to jeopardize tax-exempt status.

In 1996, the Taxpayer Bill of Rights 2 added section 4958 to the Internal Revenue Code. Prior to section 4958, if a transaction with an exempt organization resulted in private inurement or private benefit, the only option available to the Service was to revoke the organization's exemption. Section 4958 adds "intermediate sanctions" as an alternative, allowing the IRS to impose penalties (i.e., excise taxes) on persons who improperly benefit from transactions with an exempt organization. Intermediate sanctions penalize the person(s) who benefit from an improper transaction, rather than the organization.

Intermediate Sanctions may be imposed on any "disqualified person" who receives an excess benefit from a covered organization and on each "organization manager" who approves the excess benefit transaction. A disqualified person is generally any person (individual, organization, partnership or unincorporated entity) that was in a position to exercise substantial influence over the affairs of an exempt organization.

Automatic Excess Benefit transactions – even if compensation is considered “reasonable”, if it is not reported correctly for tax purposes, it may be considered an automatic violation of the Intermediate Sanctions rules and become subject to correction and taxes. An example of this is if the Church pays for the companion of a disqualified person to travel when no clear business purpose is established and does not treat it as taxable wages for the employee.

Penalties for excess benefit payments include:

- a. Correction: In all cases, the excess benefit must be undone to the extent possible in cash.
- b. Excise Penalties on the disqualified person: an amount equal to 25% of the excess benefit.
- c. Tax on the Organization Manager equal to 10% (up to \$20,000 per transaction) of the excess benefit may also be imposed on each organization manager who participates in the transaction, knowing that it is an excess benefit transaction, unless the participation is not willful and is due to reasonable cause.

Even if a transaction is not an excess benefit transaction under the Intermediate Sanctions laws, it may still be found to be illegal. The ability of the IRS to revoke the exempt status of an organization that engages in private inurement or private benefit has not been modified. Intermediate Sanctions simply provide another weapon in the arsenal of the IRS. The IRS may use either or both weapons.

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