

## **CLERGY HOUSING TAX SCAM**

Frank Sommerville, JD, CPA

Every year creative ministers try to minimize taxes by adopting plans that appear legitimate but have serious problems. Some clergy have even been charged with tax crimes related to these plans. This article identifies a common plan that can cause serious problems.

### **THE PLAN**

Under this plan, the minister already owns his home but transfers it into the church's name. Since the church is the owner, many states exempt the house from state and local property taxes. Since the church owns the house, then it may spend tax exempt money on the house and the minister does not pay taxes on these expenses. For example, the church may add a new room or remodel the kitchen.

Part of the agreement between the minister and the church requires the church to transfer the property back to the minister upon termination or other event. At the end of his tenure, the minister receives an improved, more valuable home and has not had to pay for the improvements.

### **FEDERAL TAX PROBLEMS**

Unfortunately, the perceived benefits are illusory. First, since the transfer to the church was conditioned upon the church's requirement to return the house, the transfer was not effective for tax purposes. To use legal terms, the transfer conveyed legal title but not equitable title. Since the minister retained equitable title, the IRS will treat all the improvements as additional compensation to the minister. The minister will owe income taxes, penalties and interest on the amount of the expenditures. Further, the expenditures will likely not qualify for the exclusion under Section 107 (housing allowance) because the church did not designate the payments as housing allowance and the expenditures will also likely exceed the fair rental value of the house.

Next, since the board did not approve the expenditures as compensation, the minister is likely liable for intermediate sanctions. This means the minister owes the IRS a penalty in the amount of 25% of the expenditures on the house that he failed to report as income. If the minister fails to repay the full amount of the expenditures within a year, then the minister will owe the IRS a penalty in the amount of 200% of the expenditures.

It gets worse. Since the minister willfully did not report the expenditures as taxable income, the IRS may choose to charge the minister with the crime of tax evasion, a felony. If convicted, this crime is punishable by a fine and prison term of 5 years for each year involved. The minister may not avoid the criminal charges by saying that other ministers told him that it was acceptable. Also, paying the taxes does not necessarily avoid the criminal charges.

### **STATE TAX ISSUES**

The problems do not stop with the IRS, state taxing authorities get involved as well. If your state has a state income tax, then they typically follow behind the IRS with their taxes, penalties and interest. Many times they will also follow with their own criminal tax evasion charges. Forty-nine states have information sharing agreements with the IRS. Nevada is the lone holdout. When the IRS finds something wrong, then it notifies the state taxing authorities of the problem and the amount of underreported income.

Besides income taxes, many states impose sales taxes. Most states exempt from sales taxes purchases by churches for church purposes. For example, the church may buy office supplies without paying a sales tax. Many ministers improperly believe that purchases for their home fall within the church's sales tax exemption. When they transfer the home to the church, then the improvements and furnishings are purchased by the church using its sales tax exemption. Guess what? The wrongful use of the church's sales tax exemption can result in criminal charges against the minister. Depending on the amount of sales taxes evaded, the minister could go to prison for up to 20 years and be fined up to \$5,000.00. The criminal charges are added to the taxes, penalties and interest that the minister would owe.

### LOCAL TAXES

The reduction of property taxes is a major reason for doing the scheme in the first place. Yet this area is another source of woe. To secure the property tax exemption, the church must file an application for exemption. The minister typically signs the application under "penalties of perjury." When the transfer was not effective, the application was false. The local property taxing authorities may charge the minister with perjury, another criminal offense that can rise to a felony. The criminal charges will be in addition to the back taxes, penalties and interest.

### FINAL THOUGHTS

I have not addressed the additional tax issues that arise when a church transfers its house to its minister. This transaction presents additional opportunities for the IRS, state authorities and local taxing authorities to bring civil and criminal charges.

I have presented a single plan. Many variations of this plan exist, including the use of trusts, partnerships and limited liability companies. Sometimes the transfer is only for a portion of the house. Sometimes, it is contained in a contract between the church and minister. However, the result is the same.

If you have unknowingly participated in one of the plans, I suggest that you engage a competent lawyer to sort through it, negotiate with the tax authorities and unwind the mess. If you correct it properly before the tax authorities discover you, then you have greatly improved your chances to avoid starting a prison ministry from the inside.