IRS CHARGES MINISTER AND HIS FAMILY WITH INTERMEDIATE SANCTIONS

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What started out as a simple IRS examination of a tax return of a church employee has turned into a major tax problem for a minister and his family. In five Technical Advice Memorandums, the IRS has demonstrated the details that it will examine.

FACTS

A nondenominational independent church was founded by a minister. He was given the power to select all directors. He selected himself, his wife, two sons and his daughter to serve as the church's directors. The church was apparently successful because the church paid cash for several homes. The church secured several vehicles and credit cards, which it distributed to the minister, his wife, two sons and son-in-law. The church also secured cell phones for the family members.

The church never adopted or followed a qualified accountable expense plan. No one accounted for the personal use of church assets or credit cards. The family members charged a large amount of personal expenses to the credit cards. They lived in the church's homes and drove the church's cars. Virtually, no receipts were kept. No logs were kept.

The IRS examined the family's tax returns. They discovered that the church was paying substantial amounts of their living expenses. Instead of opening a church examination, they simply asserted penalties and taxes that could exceed 265% of the benefits that the church conferred on the family.

PENALTIES

In lieu of revoking the church's tax exempt status, the IRS asked Congress to allow it to assess an excise tax on the bad actor who wrongfully exploited the church's assets. Congress then passed what is commonly called "intermediate sanctions." This sanction is imposed on insiders who work for the church and who benefit from "excess benefit transactions." An excess benefit transaction is one where the insider is paid more than is reasonable. The IRS has interpreted this sanction to apply to transactions where an insider receives a taxable benefit, but that benefit is not included in the insider's taxable income on the church's Form W-2.

First, an excise tax in the amount of 25% of the excess benefit transaction is imposed on the insider who received the benefit. This tax is in addition to income taxes on the amount of the benefit. The insider must make the church whole by paying the amount of excess benefit transaction to the church within the same taxable year that he received the excess benefit. If the amount is not repaid, then an excise tax in the amount of 200% of the excess benefit transaction is imposed.

Since 1989, Treas. Reg. Section 1.62-2 has required employers to adopt and follow a qualified accountable expense reimbursement plan. The plan must be written and communicated to employees. It must require that the employee document all expenses timely and in the manner required by Section 274 of the Internal Revenue Code. The regulation requires other details to be covered as well.

APPLICATION

Since the church did not have a qualified accountable expense reimbursement plan, all expenses that benefited the family members were excess benefit transactions. The charges included department store purchases, car repairs, food purchases, hotel charges, clothing purchases, etc. Except for the charges the family proved up related to attending a seminar, the credit cards charges were excess benefit transactions. Since no records were kept, all costs related to their cell phones were excess benefit transactions. The family kept no mileage logs, so all vehicle costs were excess benefit transactions.

The church provided multiple homes to the pastor and paid some expenses related to the home owned by the minister. Since the church provided more than a single parsonage, the fair rental value of the additional homes was an excess benefit transaction. Even the satellite TV charges and phone charges at the minister's home were excess benefit transactions. The IRS also asserted the sanction for the security systems charges related to the minister's home.

One family member wrote a church check for a computer. Since he could not produce the actual receipt, the IRS imposed the sanction in the amount of the check.

The church also paid a private investigator to follow a daughter-in-law. Since this was a personal expense, the sanction was imposed.

The church paid a lawyer to advise a family member regarding her network television appearance. This payment was an excess benefit transaction.

SUGGESTIONS

Here are my suggestions to avoid the sanctions imposed above:

1. Adopt a qualified accountable expense reimbursement plan.
2. Have the plan reviewed by a professional tax adviser.
3. Follow the qualified accountable expense reimbursement plan.
4. Have the expense reports reviewed by an independent party for appropriateness and documentation.
5. Hire independent finance people and give them the authority to question any transaction.

6. Hire an outside tax adviser to audit whether the W-2 includes all taxable income.
7. Review all fringe benefits to determine whether they are taxable.