

SETTING REASONABLE COMPENSATION

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One of the most sensitive issues in the church world is the setting of the Senior Pastor's compensation. For that matter, the setting of staff compensation creates also political issues. The church is motivated to pay their minister(s) and staff well, yet not exceed the boundaries of reasonableness. So those setting the compensation ask, what is reasonable?

This reasonable compensation issue is also very important to the Internal Revenue Service. It recently instructed its agents how to analyze this issue. If a church follows the procedures that the IRS outlined in its training materials, then churches should be safe.

To give you some idea how important this issue is from an IRS perspective, consider the consequences if the church pays more than a reasonable amount of compensation. If the church pays \$1.00 over a reasonable amount of compensation, the IRS may revoke the church's exempt status. Instead of revoking exemption, the IRS may under IRC Section 4958 elect to impose a penalty on the board members who approved the excessive compensation. In addition, the IRS may also force the minister to pay a penalty and repay the excess compensation or face penalties up to 200% of the excess compensation. With such large dollars at risk, the church must take this issue very seriously.

WHAT IS COMPENSATION?

To determine a reasonable amount of compensation, the church must first determine what is included in the definition of compensation. The IRS defines "compensation" to include anything of value that the employee receives or has the right to use. The definition includes salary, love gifts, housing allowance, health insurance, disability insurance, pension contributions or benefits, and any allowance for anything except expenses paid under a qualified accountable expense reimbursement plan. The only non-includible items are the tax-free fringe benefits under Section 132 (working condition fringes, etc.).

SAFE WAYS TO SET COMPENSATION

Since the financial risks are so great, the IRS has published procedures that create a presumption that the approved compensation is reasonable. If a church meets these requirements, then the IRS must prove that the compensation was unreasonable. If the church fails to meet these requirements, then the IRS will consider the compensation unreasonable and the church must prove that the compensation was reasonable.

To take advantage of the presumption, a fully informed body that is free from conflicts of interest must approve the compensation. Typically, the decision making

body is the board of directors, but it also could be a compensation committee. The church must create and retain specific records to support compliance with these requirements.

FULLY INFORMED DECISION MAKERS

A fully informed decision maker will secure and review comparable data from similar organizations before making a decision. One way to become informed is to hire a compensation expert to render a formal opinion whether the proposed compensation is reasonable. This formal opinion must be based surveys of comparable positions at similar churches. The decision makers must have studied that expert opinion before setting the compensation.

This requirement has created a new business for some CPA and law firms. Unfortunately, in the rush to fill this need, many provide this service without securing the proper qualifications. Recently, Tax Court Judge Halpern threw out the expert testimony of a CPA/attorney regarding reasonable compensation. He observed that CPA and legal training do not prepare one to be a compensation expert. Judge Halpern stated that a compensation expert needs formal training in conducting compensation surveys; comparing or evaluating types or components of compensation; corporate finance; or valuation appraisal. The IRS expert was certified specialist in compensation planning. Judge Halpern accepted his report because he had formal training in compensation planning and secured appropriate surveys to support his opinion.

The church should check out the credentials of the compensation expert before hiring. When selecting an expert, the church should not use a CPA firm or law firm that does any other work for it, such as auditors or general counsel. The courts and the IRS use these other business connections to claim that the expert exhibits bias in rendering her opinion. Since these business connections lessen the credibility of the expert, the IRS and courts may reject her opinion.

For churches with an annual budget of less than \$1 million, the church may survey the minister's compensation from three comparable churches instead of hiring the expert. For churches with annual budgets exceeding \$1 million, they may conduct a compensation survey without an expert or purchase a compensation survey from a commercial source. Since the survey has technical requirements, most experts recommend that these churches hire an expert or purchase a survey instead of conducting the survey in house.

FREE FROM CONFLICTS OF INTEREST

The second requirement requires the decision making body to be free from conflicts of interest. This means that the minister, his family members and subordinates are prohibited from serving on the decision making body. The body must not include anyone who has a financial interest in the compensation decision. The church should

document this requirement by having each member sign a statement meeting these requirements.

ADEQUATE DOCUMENTATION

If the church attempts to meet these standards, it must be able to prove it by contemporaneous documentation. The church should retain a copy of the expert's report along with the statements from the decision makers that they are free from conflicts of interest. Finally, the minutes should reflect that each member received a copy of the expert's reports and reviewed it carefully before voting. The minutes also should reflect the actual vote.

If you need assistance with detailed policies and procedures for setting compensation, please email me at fsommerville@nonprofitattorney.com.