

## **WHAT IS TAXABLE?**

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Many churches seek ways to express their appreciation to their staff. Often lacking the cash budget to compensate them fairly, churches provide fringe benefits in lieu of additional salary. While the motives are pure, often these fringe benefits result in additional taxable income. Since the benefits are not processed through the payroll system, the employee's Form W-2 understates taxable compensation. If revealed later, the church and the employee may owe the Internal Revenue Service back taxes, penalties and interest. This article will give the church a few rules of guidance.

**Rule No. 1: All fringe benefits are taxable unless a specific Internal Revenue Code section excludes the benefit from income tax.**

This means that the church should examine all of its fringe benefits and include them to the taxable compensation of its staff members, unless it determines a specific exclusion from income tax.

**Rule No. 2: All non-taxable fringe benefits have conditions that must be met before the fringe benefit is non-taxable.**

It is virtually impossible for a church to accidentally create a non-taxable fringe benefit. Just because a fringe benefit is non-taxable at one employer, it may not be non-taxable at the church. The church must purposely set out to establish a fringe benefit as non-taxable. If the church relies on informal advice from members, insurance agents, or even CPAs and attorneys, it is highly unlikely that the church will have created a non-taxable fringe benefit.

**Rule No. 3: The church is allowed to provide taxable fringe benefits, as long as the appropriate authorities have approved the benefit.**

Some churches shy away from providing a fringe benefit simply because it is taxable. The law allows a church to provide fringe benefits so long as the overall compensation of the employee is reasonable. The key to taking care of your staff members is not whether the benefit is taxable. Many churches routinely pay for spouses of senior ministers to accompany the employee when traveling on church business. This is an example of a taxable fringe benefit.

**Rule No. 4: Dependent care benefits must be made available on a non-discriminatory basis if the church wants the benefit to be non-taxable.**

Section 129 of the Internal Revenue Code prohibits the church from discriminating in favor of highly compensated employees if the dependent care benefits are to be tax-free. Highly compensated employees are defined as those employees making \$100,000 or more annually. In determining whether the plan is discriminatory, the church may

exclude those employees under 21 years of age or who have worked for the church less than one year. The church may also exclude employees who work part time.

In addition to the non-discriminatory rules, the dependent care benefit plan must be in writing, and the church must prove that each employee received notification of the availability of the benefit. Any competent employee benefits attorney can draft a plan that will meet all of the tax requirements.

**Rule No. 5: Churches may discriminate in the amount it contributes to a qualified church retirement plan.**

Church retirement plans specifically allow for varying contribution rates among staff members. For example, the church could contribute \$20,000 to the senior minister's account in the church retirement plan, while contributing \$500 to the receptionist's account in the church retirement plan.

All retirement plans provided by a church are not church retirement plans. If the church set up its retirement plan through a commercial broker or insurance company, it is highly likely that the retirement plan is not a church retirement plan. The plan documents will then dictate whether the church may discriminate in its contribution rates and the above rule will not apply.

I strongly suggest that churches participate in denominational retirement plans or work with a company who specializes in church retirement plans if it wants to take full advantage of a church retirement plan.

**Rule No. 6: Under federal tax law, churches may discriminate in providing employee health insurance.**

This rule is slightly misleading because federal tax law is not the only rule applicable to providing employee health insurance. Some states have passed laws prohibiting employers from discriminating in the availability and payment of employee health insurance. In other instances, the insurance company requires that the employer provide employee health insurance to all employees and not discriminate in the availability or cost to the employee. The church can determine if it may discriminate in providing employee health insurance by consulting with an attorney familiar with employee benefits in its state and asking the insurance company providing the coverage.

Again, churches are generally better off participating in denominational health insurance plans because they provide maximum flexibility to the church.

To be tax-free, the employer must be providing group health insurance to its employees. Absent a medical expense reimbursement plan, an employer may not pay the premiums for a personal health insurance policy on a tax-free basis. Also, the employer may not reimburse the premiums paid through a spouse's employer unless the church has adopted a medical expense reimbursement plan.

**Rule No. 7: Medical expense reimbursement plans must be in writing and must be made available on a non-discriminatory basis.**

Churches may adopt a medical expense reimbursement plan to reimburse employees for out-of-pocket medical expenses such as doctor co-pay, prescription co-pay, or health insurance. The key is that the plan must not discriminate in favor of highly compensated employees.

As discussed above, it is highly unlikely that a church has created a qualified medical expense reimbursement plan without the assistance of a professional.

All fringe benefits have additional rules that must be met before the benefit is tax-free. The church should check with its tax adviser regarding taxable benefits. If you have a specific fringe benefit that you would like for me to address in this column, please e-mail me at [fsommerville@nonprofitattorney.com](mailto:fsommerville@nonprofitattorney.com).