

IRS PROPOSES SANCTIONS ON A MINISTER

Frank Sommerville, JD, CPA
fsommerville@nonprofitattorney.com

Recently, the Internal Revenue Service (IRS) issued its first guidance regarding whether intermediate sanctions should be assessed against a minister and his family. Since the IRS answered affirmatively, I thought you should know the rules regarding intermediate sanctions.

INTERMEDIATE SANCTIONS

In 1998, IRS asked Congress for a new tool to combat abusive transactions involving charities. Before 1998, the IRS could only revoke the organization's tax exempt status, a harsh remedy that punished the organization. It asked Congress for authority to impose an excise tax on the wrongdoer. Congress then passed what has become commonly known as "the intermediate sanction" (called this because the excise tax became an intermediate punishment between doing nothing and revoking the organization's tax exempt status).

In simplest terms, an excise tax is imposed on a "disqualified person" who benefited from an "excess benefit transaction" or on a superior who failed to prevent the excess benefit. The terms in quotation marks are discussed below. An excise tax is imposed on the disqualified person in the amount of 25% of the excess benefit transaction, plus the disqualified person must repay the excess benefit to the organization. If the disqualified person fails the repay the excess benefit timely, then a 200% excise tax is imposed. These excise taxes are in addition to any income taxes that may be owed on the excess benefit.

Those supervising the disqualified person must pay a 10% excise tax for knowing about the excess benefit and failing to prevent the excess benefit transaction, capped at \$10,000.00. The supervisors' excise tax is imposed jointly on all supervisors and the cap applies to the group.

The statute also prevents these taxes from being covered by directors' and officers' insurance. As result, the excise taxes must be paid from the personal funds of the disqualified person and the organization cannot reimburse them for the outlay.

WHO IS DISQUALIFIED PERSON?

A "disqualified person" is a mover, shaker or other significant person to the organization. This list would include all officers and directors. It would also include a significant donor and the head of areas within an organization. It also includes independent advisors who may exercise significant influence over an organization's affairs. A disqualified person's relatives are also disqualified persons.

In the recent IRS technical advice memorandum, the IRS found that the minister who was also the founder was a disqualified person. Since his wife served as a director, she was a disqualified person. Their two sons and son-in-law were also disqualified persons (the sons because they were directors and relatives, the son-in-law because he was a relative).

WHAT IS AN EXCESS BENEFIT TRANSACTION?

An excess benefit is generally a transaction where the disqualified person received a benefit in excess of the value received by the charity, or where the disqualified person is paid an amount less than the value delivered by the charity, or where the disqualified person received a taxable benefit but the benefit was not properly reported on the Form W-2.

The most common application will be in the area of compensation. If a disqualified person is paid more than a reasonable amount of compensation, then the difference between the amount paid and the reasonable amount of compensation is an excess benefit transaction. For example, if the Senior Pastor is paid \$200,000.00 and a reasonable amount of compensation is \$150,000.00, then the pastor received an excess benefit of \$50,000.00.

When the IRS talks about compensation, it means total compensation, both taxable and nontaxable. It means including the housing allowance, insurance and retirement contributions. Since most churches are not knowledgeable about minister compensation, I suggest that the church engage a compensation expert to assist them. If you are a small church (per IRS less than \$1 million annual budget), then you may conduct your own study by calling three similar churches and securing what they pay their minister(s) for similar positions.

An example of the disqualified person benefiting at the expense of the organization would be where the disqualified person sells something to the organization for an amount exceeding the item's fair market value. For example, the minister sells a lake lot to the church for \$5,000.00 when it was really worth only about \$750.00.

The most difficult excess benefit transaction deals with misreported taxable benefits. This is where the IRS assessed the minister and his family all their intermediate sanctions. For an example from the recent IRS actions, the minister and his family used the church's credit card for personal items and failed to submit adequate documentation for the church's expenses. Those charges were excess benefit transactions. The church provided a car to minister and family members, but the church did not add the appropriate amount to the person's taxable income. The amount of the error was an excess benefit transaction. The church paid the cable and/or satellite bill for the minister and his family members. This amount was excess benefit transactions. The church provided a cell phone to the minister and his family members. Since the minister and his family did not account for the business use of the cell phone, the entire amount of the cell phone bill was

an excess benefit transaction. The amount the church paid for security at the minister's residence was also an excess benefit transaction. Finally, the amount the church paid a private detective to follow a daughter-in-law was also an excess benefit transaction.

PREVENTING INTERMEDIATE SANCTIONS

The church can prevent most intermediate sanctions by following good business practices. First, the church should adopt and follow a conflict of interest policy. In any dealing with a disqualified person, the church should require evidence of the reasonable amount of compensation. The compensation must be set by independent decision makers who have the evidence in hand. Further, they must set the compensation before it is paid. The compensation decision should include all forms of compensation, taxable and nontaxable, and be recorded in contemporaneously kept minutes.

When buy or selling from a disqualified person, the church should ascertain the value from independent parties before consummating the transaction.

To prevent taxable benefits from slipping through unnoticed, the church should adopt a written, qualified accountable expense reimbursement plan. The senior minister should submit his expense reports and credit card statements to an independent board member for review and approval. The church should have all fringe benefits and perks reviewed by a knowledgeable tax professional to assure that all are properly classified as taxable or nontaxable. The finance office should be instructed to notify an independent director anytime a questionable transaction is presented for payment.