

PASTOR APPRECIATION GIFTS AND TAXES

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Many churches and church members really appreciate their pastors. Often they seek to demonstrate their appreciation in tangible ways by giving gifts to the church and designating the gift for the benefit of a specific pastor, or they give the gift directly to their pastor. Unfortunately, many pastors naively believe that these gifts are not taxable. This article explains the tax rules surrounding gifts that a pastor receives.

For example, a wealthy member commented to the pastor that he needed a family vacation. The pastor agreed, but told the member that he could not afford a family vacation on the compensation paid to him by the church. The member then proposed to give \$20,000 for the pastor's vacation. Using this example, I will show application of the tax rules.

CHURCH GIFTS TAX RULES

Annually many churches set aside a time where the church body expresses appreciation to their pastors. Some churches receive an offering, sometimes called a "love gift," that is designated to benefit one or more pastors.

The first issue is whether the gift may create an excessive amount of compensation for the receiving pastor. If the church pays the pastor more than a reasonable amount of compensation, it can lose its tax exempt status. Further, the pastor can be penalized up to 225% of the excess compensation and forced to return the excess compensation.

The church must take steps to prevent the payment of excess compensation. Occasionally, a generous member will want to make a large contribution in the pastor appreciation offering. While this possibility may seem highly unlikely to occur, the church governing body must prevent the payment of excessive compensation by setting a maximum amount of the gift that will be given to each pastor in advance of the offering.

Many state laws require churches to be transparent when soliciting contributions. Stated another way, if a church solicits contributions for a specific purpose, or a donor restricts a gift to a specific purpose, then the church must spend the contributions for the designated specific purpose. If the church does not honor its representations to donors or the donor designation, then the donors may sue the church under state deceptive trade practices acts. These acts typically award the donor attorneys' fees and punitive damages.

The church must take steps to prevent violating the deceptive trade practices acts when dealing with donors regarding the pastor appreciation gifts. Generally, the church should announce to donors that any amounts received in excess of the maximum set by the church governing body will be transferred to another church project selected by that

body. If a donor wants to give the pastor a gift through the church, the church must reject the gift unless it fits within the gift maximum set by the governing body.

Under the example above, the member must propose the gift to the church's governing body. Assuming the pastor is under compensated by at least \$20,000, the church's governing body may agree to accept the gift. Assuming the gift is accepted, the church must document that all funds were spent within the designated purpose. The pastor should be required to submit receipts showing that the funds were spent on his family vacation. The church should reach a written agreement with the member to transfer the unused portion of the gift (assuming the pastor either does not spend the entire amount or submit appropriate documentation for the entire amount) to the church's general fund (or some other church fund agreeable to the member). Finally, the church should add the gift amounts to the pastor's taxable income on Form W-2.

PASTOR TAX RULES

Section 102(a) of the Internal Revenue Code exempts from income tax gifts that are received. Section 102(c) makes gifts that flow from an employer to an employee subject to income taxes. No exceptions are allowed.

Generally, gifts are defined as those transfers given with "detached and disinterested generosity." In one sense, this means that the donor had no reason to make the transfer other than the donor's generosity. The donor and the recipient must have a special relationship. The courts sometimes use the term "natural object of affection" to describe this special relationship. In most cases, the natural object of affection will be a close relative, such as a father or mother. Nontaxable gifts include amounts received "out of affection, respect, admiration, charity or like impulses."

The analysis starts with examining the relationship between the donor and the recipient. If the only relationship between the donor and the recipient is that of being a relative, then the gift will be generally free from income tax. If the only relationship is between a member and a pastor, then the IRS and the courts generally hold that the gift is payment for past or future services rendered by the pastor. That is, the payment was being made for services because there is no other relationship between the donor and the recipient to support a tax free gift.

The analysis gets complicated when multiple relationships exist between the donor and recipient. In one court case, the donor (church member) and recipient (pastor) were friends for more than 20 years, but pastor of the member's church only for the past three and one-half years. The recipient provided spiritual help to the donor when she needed it, as she did with others. Donor would give the pastor cash gifts from time to time. When the IRS audited the pastor, she claimed the cash payments were based on the 20 year friendship and nontaxable. The IRS claimed the payments were for the ministerial services that the pastor had provided. The IRS won and all gifts were taxable. *Banks v. Commissioner*, T.C. Memo 1991-641.

The safest approach is for the pastor to report and pay income taxes on all gifts received from members of the church. If the gift is ruled to be taxable and the pastor failed to report it as taxable income, the pastor could be subject to income taxes, severe penalties and interest.

Under the example above, if the donor gave the \$20,000 to the pastor directly, the pastor should pay income taxes on the amount received. The donor will not be able to claim contribution credit for the gift. Also, the donor may owe a gift tax if the gift to the pastor exceeds \$12,000.