Tax Compliance Issues

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Compliance with complex and ever-changing tax laws is a real challenge for churches. Despite the best efforts of dedicated staff, many churches are not in full compliance. This can lead to penalties for both the church, and church officers. Consider the following:

1. Intermediate Sanctions

Larger churches are finding it more difficult to attract qualified individuals to serve on boards and committees. One reason is concern over intermediate sanctions. Under proposed IRS regulations, an intermediate sanction (in the form of a 10% excise tax) can be imposed on individual board or committee members who approve an "excess benefit transaction." The definition of an excess benefit transaction is expansive and extends to many common compensation and fringe benefit arrangements that would not appear to be "excessive." For example, a travel or entertainment expense that does not have adequate documentation may be an excess benefit transaction. Since board and committee members rarely review expense documentation, they have no idea whether they have exposure or not. Further, most board and committee members do not have the time or inclination to review expense documentation.

The imposition of the intermediate sanction is part of the IRS strategy to hold board and committee members individually liable for the church's mismanagement. In effect, the IRS wants the board and committee members to be the watchdog for tax noncompliance.

The potential board and committee members are also alarmed to learn that the payment of the intermediate sanction is not covered by most officers' and directors' liability insurance. As a result, their personal assets are at risk.

To make matters worse, most board and committee members incorrectly assume that the financial audit is checking for tax compliance. CPAs that audit nonprofit organizations are rendering an opinion on the financial statements - not on whether the organization has complied with federal or state tax laws. The CPA usually spends very little time, if any, on tax issues.

2. Inurement

A church's tax-exempt status is jeopardized if any of its resources "inure" to the benefit of a private individual, other than as reasonable compensation for services rendered. The IRS and the courts have defined "inurement" to include a wide range of compensation arrangements, including excessive salary, personal loans, the payment of legal fees, salary based on a percentage of church revenue, or the payment of personal expenses. The tax code specifies that "no part" of the net earnings of a religious organization may inure to the benefit of a private individual, and therefore the amount or extent of benefit is immaterial.

3. Failure to Comply with Payroll Tax Obligations

Any corporate officer, director, or employee who is responsible for withholding taxes and paying them over to the government is liable for a penalty in the amount of 100 percent of such taxes if they are either not withheld or not paid over to the government. This penalty is of special relevance to church leaders, given the high rate of noncompliance by churches with the payroll reporting procedures. In larger churches, this penalty can be substantial. The IRS has applied it to senior pastors and board members.

The IRS can impose several other penalties if a church fails to comply with payroll tax reporting requirements. They are summarized in a table.

SUMMARY OF PAYROLL TAX REPORTING PENALTIES

Code section	**Action**	**Penalty**
3403	failure to withhold payroll taxes	employer liable for full amount of taxes (which can be deducted from future wages paid to the same employees)
3509	failure to withhold payroll taxes from a self-employed worker the IRS later reclassifies as an employee	(1) employer liable for a 1.5% x wages paid to the worker (3% if no 1099 was filed) for income tax purposes, and 20% x employee's share of FICA taxes (40% if no 1099 was filed) (2) employer liable for full employer's share of FICA taxes (3) employer generally liable for full amount of taxes if intentionally disregards withholding rules
6721	(1) failure to file a correct "information return" (1099, W-2) with IRS by due date (February 28 of following year) (2) failure to report all required information on a return (3) including incorrect information on a return	(1) *3-tier penalty*: $15 per return (if correct return filed within 30 days after due date); $30 per return (if correct return filed by August 1); $50 per return (if correct return not filed by August 1) (2) no penalty if failure due to reasonable cause (and not willful neglect) (3) no penalty applies if no more than 10 returns filed without full information or with incorrect information, and errors corrected by August 1 (and error not due to willful neglect) (4) in case of intentional disregard of filing requirement, penalty is larger of $100 per return or 10% of the total amount of items required to be reported correctly
6722	(1) failure to furnish a correct "payee statement" (1099, W-2) to workers, by due date (January 31 of following year) (2) failure to report all required information on a payee statement (3) including incorrect information on a payee statement	(1) penalty of $50 per statement (2) no penalty if failure due to reasonable cause (and not willful neglect) (3) in case of intentional disregard of filing requirement, penalty is larger of $100 per return or 10% of the total amount of items required to be reported correctly

6723	failure to insert taxpayer identification number (employer identification number) on any return or statement (e.g., W-2, 1099, W-3, 1096, 941)	$50 per failure
6656	failure to make timely deposits of payroll taxes	*4-tier penalty:* penalty equal to 2% of amount of underpayment if failure corrected not more than 5 days after due date; penalty equal to 5% of amount of underpayment if failure corrected after 5 days but not more than 15 days after due date; penalty equal to 10% of amount of underpayment if failure corrected after 15 days but not more than 10 days after date of first delinquency notice to taxpayer; penalty equal to 15% of amount of underpayment if failure not corrected within 10 days after date of first delinquency notice to taxpayer
6672	willful failure to withhold or deposit payroll taxes	civil penalty equal to 100% of taxes not withheld or deposited assessed against either the employer, or its officers (may apply to volunteer officers or directors of nonprofit organizations)
7201	willful attempt to evade or defeat tax	a felony, with a criminal penalty of up to $100,000 (up to $500,000 for a corporation), and imprisonment of up to 5 years (or both)
7202	willful failure to withhold or deposit payroll taxes	a felony, with a criminal penalty (in addition to the section 6672 civil penalty) of up to 5 years imprisonment or $10,000 fine (or both) generally applies to officers
7203	willful failure to file a return, pay a tax, or supply required information	a misdemeanor, with a criminal penalty of up to $25,000 ($100,000 for a corporation), and imprisonment of up to 1 year (or both)
7204	willful failure to provide a W-2 to employees, or willfully including false information on a W-2	a misdemeanor, with a criminal penalty of up to $1,000, and imprisonment of up to 1 year (or both)
7207	willfully providing the IRS with a false return or statement	a misdemeanor, with a criminal penalty of up to $10,000 ($50,000 for a corporation), and imprisonment of up to 1 year (or both)

The "Tax Compliance Review"

Many of our clients have requested a service that will address current and potential concerns associated with tax compliance. We call it a "Tax Compliance Review." A team consisting of an attorney and a CPA go to a church and conduct procedures similar to an Internal Revenue Service exam. Upon completion of the review our firm issues a report to the church board detailing the areas of noncompliance. The reports routinely exceed 20 pages in length.

This approach is unique in the following areas:

1. The team effort approach to this service uniquely combines the experience of the CPA and the attorney, giving the church a fuller and more complete review of its operations for compliance issues. Only CPAs and attorneys with extensive experience in church tax law will be utilized for this work.

2. One of the ways a church, its officers, and its directors may avoid intermediate sanctions is by obtaining a written legal opinion. The report issued will help officers and directors avoid these penalties by detailing their exposure.

3. The information contained in the report from the law firm will be covered under the attorney-client privilege and will not provide a road map for the IRS (or anyone else) to follow in the event of an investigation. Even with a similar privilege that is now available to CPAs, the information is more secure when processed through an attorney.

Benefits to Your Church

Your church can benefit from a Tax Compliance Review in the following ways:

1. Identify policies and procedures that do not comply with tax laws

2. Identify governance issues that do not comply with tax laws

3. Identify financial transactions that do not comply with tax laws

4. Identify transactions that may give rise to income tax liabilities

5. Identify transactions that may cause board and committee members to have a personal tax liability

6. Identify factors that may cause the church to lose its tax-exempt status

7. Identify factors that may cause the church to lose its property tax exemption

8. Suggest ways to solve each of the problems identified above

9. Allow the church board to weigh the tax risks associated with certain activities

10. Present the risk factors if the church were to be audited by the Internal Revenue Service

Fees

The cost of a Tax Compliance Review will depend on several factors, including your annual church budget, the existence of affiliated organizations, the number of employees, the qualifications of the bookkeeping and accounting staff, whether the church has been audited by a CPA firm, and the general condition of the church's recordkeeping.

Who We Are

[insert qualifications of Rich and Frank]