Religious Organization Law: Minister Compensation, Benefits, and Related Issues

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Religious organizations have unique rules and laws surrounding clergy and religious worker compensation. The main source of these rules is IRS Publication 517.

First Determination: Employee, Independent Contractor (self-employed), or Volunteer?

Employment Law

- Religious organizations, like other employers, are regularly being thrust into costly and time-consuming employment disputes. These disputes can result from many factors, including: 1.) ignorance or a misunderstanding of employment law, 2.) limited funds, 3.) leniency towards issues until a "problem" arises, and 4.) inadequate staffing.
- The importance of religious organizations understanding and appropriately applying employment law principles cannot be overemphasized. Religious organizations must seek education about employment law, and its application to churches and other religious organizations, to help avoid such disputes.
- Supervisors should be aware of all levels of employment law applicable to the religious organization: federal, state, and local.
- This presentation explains the application of *federal* employment law to religious organizations. For information on applicable state and local law, a local attorney should be consulted.

Worker Classification

Who are the religious organization's employees?

- It sounds like a simple question, but for religious organizations, which often have strained budgets, the distinction between employees and volunteers sometimes is unclear. For example, a church secretary, who is paid for his or her secretarial services, also may donate time to the church as an usher.
- In addition, some individuals work for religious organizations as independent contractors, rather than as employees. Employment laws are applicable to employees (and applicants for employment), rather than to volunteers or independent contractors. Thus, it is important to understand the distinctions between employees, volunteers, and independent contractors.
- Religious organizations should clarify in writing whether a worker is an employee, independent contractor, or volunteer.

Worker Classification

Employee v. Volunteer:

- In basic terms, the distinction between an employee and a volunteer is that an employee is paid for time worked, while a volunteer is not.
- Ideally, a religious organization should clarify a worker's position as an employee or volunteer prior to commencement of work. Preferably, the clarification should be done in writing. The written clarification may be as elaborate as a set of employee or volunteer policies with an acknowledgment, or as simple as a short form letter confirming a volunteer relationship, or an annual volunteer thank-you letter.
- For a worker who serves both as an employee and a volunteer, the organization must separate those roles and keep records with respect to each. The volunteer time truly *must* be voluntary and the volunteer activities *must not* be the same or similar to the activities the employee is employed to perform. Dep't of Labor Op. Ltr. FLSA 2005-33 (Sept. 16, 2005). Workers whose roles change, such as from volunteer to employee, must be reclassified, effective as of the time of the role change.

Worker Classification

Employee v. Independent Contractor:

- A number of organizations use independent contractors in addition to or instead of employees. Independent contractors are not employees of the religious organization. No single test exists for determining whether a worker is an independent contractor or an employee. However, calling a person an independent contractor is not dispositive; if the person subsequently is determined to be an employee, penalties may be assessed against an employer that did not appropriately deduct certain amounts from pay, such as for income tax withholding and employee benefit plan contributions.
- Ministers, even if employees, are responsible to pay self-employment tax for social security purposes on the majority of their income.

Worker Classification

Employee v. Independent Contractor:

- Generally, the determination comes down to the following 3 tests:
  - A.) Right to control test: The IRS uses a right-to-control test in determining a worker's status as an independent contractor or employee. The crux of the IRS test is: 1.) whether the employer has a right to direct and control *how* the worker does the task for which the worker is hired (behavioral control); 2.) whether the worker has the ability to affect financial decisions that impact the worker's pay or profit (i.e., financial control); and 3.) whether or not there is a contract between the worker and the organization and how it is worded (the relationship of the parties).

Worker Classification

Employee v. Independent Contractor:

- Generally, the determination comes down to the following 3 tests:
  - B.) Economic realities test: The "economic realities test" considers the worker's economic dependence on the business. This test is used to determine employees' status under the Family and Medical Leave Act, the Fair Labor Standards Act, the Worker Adjustment and Retraining Notification Act, and the Equal Pay Act. According to the United States Department of Labor, factors that may be considered in determining whether a worker is an employee or independent contractor under the Fair Labor Standards Act are: 1.) the extent to which the worker's services are an integral part of the employer's business; 2.) the permanency of the relationship; 3.) the amount of the worker's investment in facilities and equipment; 4.) the nature and degree of control by the organization; 5.) the worker's opportunities for profit and loss; 6.) the level of skill required in performing the job; and 7.) the amount of initiative, judgment or foresight in open market competition with others required for the success of the claimed independent enterprise.

Worker Classification

Employee v. Independent Contractor:

- Generally, the determination comes down to the following tests (cont.):
  C. Common law test: The common law test, which is used by the EEOC, includes the following factors: 1.) whether the work is performed on the employer's premises; 2.) how the worker is paid: (by the hour, week, or month, rather than by the job); 3.) whether the worker hires and pays assistants; 4.) whether the employer provides the worker with benefits, such as insurance, leave, or workers' compensation; 5.) whether the worker is considered an employee of the employer for tax purposes; and 6.) whether the employer can discharge the worker.

Worker Classification

Employment at Will:

- Before a religious organization employs any employees, rather than only retaining independent contractors, or relying solely on volunteers, various employment laws and doctrines should be considered, although not all of them will be applicable. One such doctrine is the “employment at will doctrine.”
- The traditional relationship between an employer and an employee hired for an indefinite term is called employment at will. “[E]mployment at will is an employer-employee relationship in which workers are free to sell their skills and labor to the highest bidder and move freely from job to job and employers are free to hire and fire employees without notice and without cause.” Mark R. Filipp & James Ottavio Castagnera, Employment Law Answer Book 2-6 (6th ed. 2006).
- Although the employment at will doctrine exists in one form or another in most states, many exceptions to the doctrine exist that limit the employer’s right to terminate an employee.

Worker Classification

Exceptions to Employment at Will:

- Described are a few of the more significant exceptions to the employment at will doctrine. However, it is important to start with the premise that no reason for discharge is needed, and then to examine whether any exceptions are applicable, rather than to assume that an employee’s employment cannot be terminated.

Worker Classification

Exceptions to Employment at Will:

Exception #1: Contract

- Written Contract. The most obvious exception to the employment at will doctrine is a written employment contract, including one arrived at through collective bargaining. If a written contract exists, the rights of both the employer and the employee are determined under the terms of the contract.
- Implied Contract. Like an express written contract, an implied contract is an exception to the employment at will doctrine. A common source of implied contracts is the employee handbook. For example, a religious organization's employee handbook may state that employees can be terminated "only for just cause after a thorough investigation and an opportunity to improve performance," and describe steps to be taken before termination. If, due to budget constraints, the organization decides to lay off an employee with good job performance, a court could interpret the handbook as an implied contract entitling the employee to remain on the payroll. Other examples of implied contracts include a "welcome letter" or other document that classifies an employee as "permanent" or "a member of our church family." "Full-time" is a better choice because it does not imply a long-term contractual employment relationship.
- In some religious denominations, the call of a pastor to ministry may be viewed by the pastor as including an implied contract for lifetime employment at a particular church or religious organization, since it may be believed that the call to ministry is for life. However, the permanency of the call should not translate to a contract for permanent employment.

Worker Classification

Exceptions to Employment at Will:

Exception #2: Public Policy

- Another exception to the employment at will doctrine is discharge contrary to public policy, such as termination for refusing to falsify a record.
- Some states have a restrictive definition of what constitutes a violation of public policy, limiting it to a violation of a statute or regulation. Employers should check the specifics of state law to determine whether a public policy exception may apply to a particular situation.
- In addition, the federal Sarbanes-Oxley Act provides certain protections to whistleblowers. BoardSource, *The Sarbanes-Oxley Act and Implications for Nonprofit Organizations, available at* http://www.boardsource.org/clientfiles/sarbanes-oxley.pdf (last visited Jan. 8, 2012).

Worker Classification

Exceptions to Employment at Will:

Exception #3: Arbitrary and Capricious Discharge

- An employee should not be discharged when other employees in similar situations have been disciplined less severely for the same or similar conduct. Otherwise, in some states such a discharge could be found to be arbitrary and capricious, even when a consideration of the conduct of the particular employee, in isolation, appears to be sufficient for discharge.
- For example, it is appropriate for a church to insist that its employees conduct themselves in accordance with the firmly held religious beliefs of the church. However, if they allow one employee who has violated a specific religious belief to remain, it will be difficult to justify a subsequent firing of another employee for the same behavior.

Worker Classification

Exceptions to Employment at Will:

Exception #4: Discharge in Violation of a Statute

- Discharge in violation of a statute is the most common exception to the employment at will doctrine.
- This category includes termination constituting unlawful discrimination, such as termination on the basis of age, sex, race, color, national origin, military status, religion, or disability. Importantly, some of the statutes that restrict employment at will apply differently to religious organizations than they do to other employers.

Special Legal and Tax Treatment of Ministers

Ministers – Who Qualifies?

- Clergy – Who qualifies as a “minister”?:
  - Ministers are individuals who are duly ordained, commissioned, or licensed by a religious body constituting a church or church denomination.
  - Ministers have the authority to conduct religious worship, perform sacerdotal functions, and administer ordinances or sacraments according to the prescribed tenets and practices of that church or denomination.
  - If a church or denomination ordains some ministers and licenses or commissions others, anyone licensed or commissioned must be able to perform substantially all the religious functions of an ordained minister to be treated as a minister for social security purposes.
  - Examples: ministers, priests, rabbis, etc.

Ministers – Who Qualifies?

- Social Security Coverage for Clergy Members:
  - The services you perform in the exercise of your ministry, of the duties required by your religious order, or of your profession as a Christian Science practitioner or reader are covered by social security and Medicare. Your earnings for these ministerial services are subject to self-employment tax for social security purposes unless one of the following applies:
    - You are a member of a religious order who has taken a vow of poverty.
    - You ask the IRS for an exemption from self-employment tax for your services and the IRS approves your request.
    - You are subject only to the social security laws of a foreign country under the provisions of a social security agreement between the United States and that country.
    - You are not a "minister" (i.e., you're a general religious worker (church employee). General religious workers are not subject to self-employment tax; rather, they are subject to social security and FICA)
  - Clergy members can apply to be exempt from self-employment tax under social security coverage (i.e., "opt out"). IRS Publication 517 describes the process for seeking exemption.

Ministers – Who Qualifies?

How to calculate income for the purposes of self-employment tax:

- Amounts included in a minister's gross income (for the purposes of determining net earnings from self-employment):
  - Salaries and fees for your ministerial services;
  - Offerings you receive for marriages, baptisms, funerals, masses, etc.;
  - The value of meals and lodging provided to you, your spouse, and your dependents for your employer's convenience;
  - The fair rental value of a parsonage provided to you (including the cost of utilities that are furnished) and the rental allowance (including an amount for payment of utilities) paid to you; and
  - Any amount a church pays toward your income tax or self-employment, other than withholding the amount from your salary. This amount is also subject to income tax.
- Deduct all expenses related to ministerial services that were performed as a self-employed person (unless the expenses were reimbursed). These are ministerial expenses incurred while working other than as a common-law employee of the church. They include expenses incurred in performing marriages and baptisms, and in delivering speeches.
- For services in the exercise of the ministry, members of the clergy receive a Form W-2, but do not have social security or Medicare taxes withheld. Social security and Medicare taxes must be filed using the Schedule SE (Form 1040) with the minister's tax return.

Ministers – Who Qualifies?

How to calculate income for the purposes of income tax:

- Amounts included in a minister’s gross income (for the purposes of determining income tax)
  - Members of the clergy must include in their income offerings and fees received for marriages, baptisms, funerals, masses, etc., in addition to salary. If the offering is made to the religious institution, it isn't taxable to the minister;
  - Outside earnings; and
  - Any amount a church pays toward your income tax or self-employment, other than withholding the amount from your salary. This amount is also subject to income tax.
- The federal income tax is a pay-as-you-go tax and normally requires an employer to withhold and remit income earned during the year. However, ministers are not subject to federal income withholding for ministerial services performed.

Housing Allowances

Housing Allowances

- In terms of a housing allowance, the housing allowance is in lieu of SALARY paid, and is generally exempt from income tax.
- To qualify for a housing allowance, you must:
  - Qualify as a "minister;"
  - Personally own the property (the charitable organization cannot own the property);
  - Set the amount of the housing allowance properly:
    - If the minister owns a home and receives as part of their salary a housing or rental allowance, the minister may exclude from gross income the smallest of:
      - The amount actually used to provide a home;
      - The amount officially designated as a rental allowance; or
      - The fair rental value of the home, including furnishings, utilities, garage, etc.
    - A minister must include in gross income the amount of any rental allowance that is more than the smallest of:
      - His/her reasonable salary,
      - The fair rental value of the home plus utilities, or
      - The amount actually used to provide a home.
  - And, the minister must pay self-employment tax on the amount of the housing allowance, if the clergy member is still "opted in" to the Social Security System.

How to Establish Reasonable Compensation

Determining Compensation

- IRS requires the nonprofit organization to ask 6 key questions when determining compensation:
  - Are the individuals approving compensation following a conflict of interest policy?
  - Is the approval of compensation in <u>advance</u> of payment?
  - Is approval of compensation being documented?
  - Is each Board member's vote regarding the compensation matter being properly documented?
  - Is the compensation payment decision being based on payment(s) made by similarly-situated **<u>nonprofits</u>**, surveys, or other third-party data [benchmarking materials]?, and
  - Did the organization document what benchmarking materials they used in setting compensation and their source?
- Benchmarking: Many states have associations that track nonprofits' compensation data (i.e., Minnesota Council of Nonprofits); you can also search Form 990s to benchmark.
- If an exempt entity answers "no" to any of the six questions, the rebuttable presumption of reasonableness is broken and the IRS can then asks for explanation to make sure compensation is reasonable. Even without the threat of intermediate sanctions (or worse), it is usually easier to follow the IRS roadmap than to create a new pathway to reasonable compensation.
- Areas of HIGH risk: non-fixed payments (bonuses, severance packages, deferred compensation, fringe benefits, and/or retirement), paying Directors (EXTREMELY discouraged, but not prohibited – see IRC §4941), and paying family members or other disqualified persons.

Minnesota Nonprofit Salary and Benefits Survey

2016

How will the passage of the *Tax Cuts and Jobs Act of 2017* (hereinafter “the Act”) and other legislation affect the determination of reasonable compensation and employee benefits?

Executive Compensation: *§ 4960*

- The Act creates a 21% excise tax on the compensation of any "covered employee" earning in excess of $1 million.
- The term "covered employee" means any employee (including any former employee) of an exempt organization, if the employee: 1.) is one of the five (5) highest compensated employees of the organization for the taxable year; or 2.) was a covered employee in any preceding taxable year after Dec. 31, 2017.
- Covered employees will most likely include an Executive Director/CEO, CFO, and perhaps other upper-level management positions.
- The Act essentially labels any compensation exceeding $1 million as excessive instead of presuming "reasonableness" if the compensation is benchmarked to peer organizations and approved by the Board of Directors prior to payment.
- This change will largely affect nonprofit hospitals and healthcare entities, **private** colleges and universities, and other large exempt organizations.

Executive Compensation: *§ 4960*

- In addition, a 21% excise tax is imposed on excess parachute payments, defined as "a severance payment, including transfer of property, to any highly compensated employee, that is greater than three times the individual's average salary for the previous five years."
- Highly compensated employees include employees who received compensation exceeding $120,000 in 2018.

Employee Benefits: *§ 132*

Fringe Benefits: Certain fringe benefits are no longer deductible by employers, including commuter transportation, mass transit passes, parking facilities, and onsite athletic facilities (gym, pool, tennis court, golf course, etc.). Exempt organizations providing such benefits must report the expenditure as UBI unless the benefit is directly connected to a taxable activity already included on Form 990-T.

Employee Benefits: *§ 132*

Temporary Family and Medical Leave: The Act creates a paid family and medical leave credit for tax years after December 31, 2017, and before January 1, 2020. The employer must provide at least two (2) weeks (but not more than twelve (12) weeks) of paid leave at a rate that is at least 50% of the employee's ordinary wages. In addition, the employee must have been employed for at least one (1) year prior to the paid leave, and the employee's prior year compensation cannot have exceeded $72,000. Leave mandated or paid for by a state or local government does not count for purposes of the federal credit.

Employee Benefits: § *132*

Employee Achievement Awards: Awards for things such as length of service or an exemplary safety record that are awarded as part of a meaningful presentation, can be excluded from the employee's taxable income as long as they are not disguised compensation.

Employee Benefits: *§ 132*

Employer Entertainment Deduction:

- In general, the Act provides for stricter limits on the deductibility of business meals and entertainment expenses.
- Under the Act, entertainment expenses incurred or paid after December 31, 2017 are **non**deductible unless they fall under the specific exceptions in Code Section 274(e).
- One of those exceptions is for "expenses for recreation, social, or similar activities primarily for the benefit of the taxpayer's employees, other than highly compensated employees" (i.e. office holiday parties are still deductible).
- Business meals provided for the convenience of the employer are now only 50% deductible whereas before the Act they were fully deductible. Barring further action by Congress those meals will be nondeductible after 2025.

http://www.hertzbach.com/2017/12/meals-and-entertainment-changes-under-tax-reform/

Employee Benefits: ***§ 132***

ACA Individual Mandate: While the Act repeals the Affordable Care Act's individual mandate, the employer mandate remains in effect. This means obtaining health coverage will be purely voluntary for individuals starting in 2019. Despite this, employers with more than 50 full-time employees will still be required to provide health coverage for their employees or face stiff penalties.

Examples of Church Employment Contracts and Compensation Agreements

- Samples of these types of contracts are readily available on the internet.
- Examples:
  - Employment covenant:
    - https://alsbom.org/wp-content/uploads/2015/07/sampleemploymentagreement.pdf
    - www.mbcm.ca/policies/documents/MBCMTemplateEmployeeAgreement2011.doc
  - Pastoral contract: https://www.freechurchforms.com/support-files/pastoralcontract.pdf
  - Minister Compensation Agreement: http://www.raleighbaptists.org/wp-content/uploads/PastorCompensationandVacationGuidelines.pdf

Thank you!!!

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