

# Preventing Payroll Problems: Part 2

By Rollie Dimos, CIA, CISA, CFE



The payroll process for churches can be a difficult and confusing task. There are a myriad of rules, forms and deadlines involved in processing payroll.

Contributing to the confusion are the special rules and exceptions that exist for ministerial staff. Due to the complexity and difficulty involved with processing payroll, it is understandable that churches sometimes process payroll incorrectly.

As I discussed last month, here are a few of the more common errors that churches make when processing payroll:

- Treating ministers as self-employed for federal income taxes.
- Treating ministers as employees for Social Security and Medicare.
- Withholding federal taxes for ministers (without authorization).
- Not making payroll tax deposits.
- Not filing Form 941.
- Not sending 1099-Misc forms to contractors.
- Mishandling fringe benefits, allowances and reimbursements.
- Not including gifts and other income items as wages.

In last month's article, I discussed the first six errors. These errors involved the proper classification of ministers and the proper way to withhold, report and remit taxes. Part 1 of this article can be found [here](#).

This month, I'll discuss the last two errors that deal with calculating taxable income and conclude with a discussion of the significant consequences

that churches can face if they mishandle or misreport payroll.

## Proper Calculation of Taxable Income

The last two areas that cause confusion and trouble for churches is not handling fringe benefits properly or not reporting all taxable income as wages when appropriate.

Here are some common items that should generally be included as income:

- Cash bonuses for birthdays and holidays.
- Cash equivalents, like gift cards for restaurants and retail stores.
- Monthly allowances that are non-accountable, such as allowances for cell phone, automobile expenses, or purchasing health insurance.
- Love offerings and pastor appreciation gifts given through the church.
- Payments to pastors to help offset social security taxes.
- Mileage reimbursements in excess of IRS-approved mileage rates.
- Church-paid golf club memberships or utilities and lawn care at staff members' personal homes.
- Personal use of church-owned vehicles.
- Holy Land trips paid with church funds.
- Non-accountable reimbursements of business expenses.

## Consequences for Improper Reporting

It's very important to make sure income is reported properly and all required payroll forms are complete and timely. If not, the church could face unintended scrutiny from the IRS.

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The IRS has significant fines and penalties for underreporting income. Failure to properly classify taxable income could have severe consequences for the employees and organization. For example, besides the unpaid taxes, the employee faces a 25% penalty and a 200% excise tax. Organizational leaders also face a 20% penalty up to \$20,000, and the organization could lose their nonprofit status, which would impact donor contributions and confidence.

Failing to file the required forms also exposes the church and its officers to penalties and fees.

For example:

- Failure to file Forms 1099-Misc or W-2 will result in a \$30, \$60 or \$100 penalty per form, based on how many days late.
- Failure to withhold or deposit payroll taxes will result in a penalty equal to 100% of the taxes not withheld or deposited. The penalty can be assessed against the organization or its officers.
- If the failure to withhold or deposit payroll taxes is willful, the officer or employee responsible can be charged with a felony, fines, and face up to 5 years imprisonment.

Consider these examples:

- A church had one employee—the lead pastor. Because the sole employee was a minister, the church was not required to withhold and deposit Social Security and Medicare taxes. Unfortunately, for several years, the church filled out the minister's W-2 and Form 941 incorrectly by reporting that the minister's wages were eligible for Social Security and Medicare withholding. This error caused the IRS to look for withheld taxes.

When the IRS determined that taxes were not remitted, they sent a delinquency notice to the church and assessed back taxes, penalties and fines totaling \$44,000. Now the church has to work with the IRS to get this reporting issue resolved. Unfortunately, until the situation is resolved, the IRS will continue to accrue penalties and fees for the perceived delinquent taxes.

- Another church properly withheld taxes from their employees' wages, but failed to deposit those taxes with the IRS for several years. Instead, the church used those funds to pay other operating expenses. The IRS quickly identified the delinquency and sent several notices to the church.

Unfortunately, the church didn't resolve the situation, and the IRS placed a lien on the church and assessed \$400,000 in back taxes, penalties and fees. If the IRS determines the church acted willfully, the officers and employees responsible could face felony charges, fines and imprisonment.

- In the most extreme case, the U.S. government seized an Indianapolis church in 2001 for failing to withhold taxes from their employees' wages and remitting those taxes to the IRS. The IRS assessed the church over \$6 million in fines and penalties. After seizing the church (considered to be the first ever in U.S. history), the congregation was forced out and the building was sold to help pay the debt.

## Preventing Payroll Problems: Part 2 (cont.)

### Resources

Even though these issues are complex and confusing, the church has the responsibility for timely and accurate reporting. For this reason, some churches have outsourced the payroll function to a local CPA firm or a payroll service provider. If you want to consider this option, there are several national providers to consider, such as [MinistryWorks.com](http://MinistryWorks.com).

If you want to keep the payroll function in-house, but need additional help in preparing these payroll forms, I recommend Richard Hammar's annual *Church & Clergy Tax Guide*. This resource has a wealth of information to help bookkeepers and treasurers report wages properly and submit required forms. You can purchase this resource [here](#).

Of course, for those that are interested in digging deeper, the IRS has several publications specifically dealing with payroll and reporting, such as Publication 15, *Employer's Tax Guide* and Publication 15-B, *Employer's Tax Guide to Fringe Benefits*.

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### About the Author:

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