Deferring a Pay Raise

By Rollie Dimos

Q: Recently, a senior pastor declined a bonus that the church board authorized. However, the church board placed the funds in a separate account and told the pastor he could have the funds whenever he wanted. When do these funds become taxable income to the pastor?

A: Properly accumulating and reporting taxable income is an area that is often mishandled by churches. Various rules and exceptions exist for ministers, which makes this topic difficult for even the most experienced bookkeepers.

To answer the question of when this type of compensation becomes taxable income, we must consider the topic of constructive receipt. According to Income Tax Regulations, constructive receipt is defined as:

> *Income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. [Income Tax Regulation 1.451-2(a).]*

The regulations state that once the funds are set aside for the pastor's use, the funds become taxable in the same year. Notice that the pastor doesn't have to actually take receipt of the funds or draw money from the account. Once the funds are earmarked for the pastor, they are deemed constructively received.

There is one important exception noted in the tax regulation definition: If the funds have substantial limitations or restrictions, then the income may not be constructively received. Significant limitations may include restrictions such as "you can't receive these funds for two years", or "you will be limited to four equal payments over four years." These type of restrictions would limit how much of the funds would be deemed constrictively received in the current year.

However, these restrictions have to be defined before the income is awarded. The taxpayer, or pastor in this case, cannot self-impose certain restrictions, or simply refuse to withdraw the funds once they have been awarded, in order to defer recognition of income. [See Oliver v. United States [193 F. Supp. 930, 933 (E.D. Ark. 1961)], and Williams v. United States [CA-5, 55-1 USTC paragraph 9220]].

To complicate matters, this type of arrangement may qualify as a deferred compensation plan. Congress added section 409A to the tax code in 2004 after the Enron scandal that stated deferred compensation is taxable in the current year unless certain requirements were met. Church boards should be cognizant of these requirements when trying to defer compensation. If the church board defers compensation but doesn't meet the three requirements, the IRS can impose penalties if the compensation wasn't made taxable in the current year.

Continued on next page...

Because the IRS can impose penalties on churches who mishandle or underreport compensation, I would suggest consulting a qualified CPA in your area if you have additional concerns.

For more on this topic, see chapter 10, Retirement Plans, in Rich Hammar's annual Church & Clergy Tax Guide available at MyHealthyChurch.com.

About the Author:

Rollie Dimos, CIA, CISA, CFE, is the Internal Audit Director at the AG National Leadership and Resource Center. As an auditor in the government and nonprofit sectors, Rollie has been helping leaders assess the strength of their organizational controls for over 20 years. If you have a question about this article, you can contact Rollie at 417-862-2781, or by email at rdimos@ag.org.