

Preventing Payroll Problems: Part 1

By Rollie Dimos, CIA, CISA, CFE

The payroll process for churches can be a difficult and confusing task. Requirements include filling out withholding forms (W-4), withholding federal income taxes, Social Security and Medicare taxes from employees' wages, depositing these taxes with the IRS, filing quarterly tax returns (Form 941), and issuing year-end statements (Form W-2) to employees.

Most churches are subject to these rules, but special rules and exceptions exist for ministerial staff, which contributes to the confusion. More importantly, the consequences for failing to properly capture income, withhold appropriate taxes and deposit them with the IRS can be significant—and in some cases, devastating for the church, its leaders and employees.

There are a myriad of rules, forms and deadlines involved in processing payroll. Due to the complexity of this area, here are a few of the more common errors that churches make. These include:

- 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 this month's article, I'll discuss the first six errors that deal with the proper classification of ministers and the proper way to withhold, report and remit taxes.

Proper Classification and Withholding

The first three problems listed above deal with the proper classification of ministers and the proper reporting of their wages.

Employee or Contractor: In many of our AG churches, a minister will be classified as an employee for federal tax purposes. There will be some cases where a pastor may be contracted to perform services for the church, but in many of our churches, the minister should be treated like an employee. This means the minister will receive a Form W-2 at the end of the year instead of a Form 1099-Misc. For more information on determining whether a minister (as defined by the IRS) is an employee or contractor, refer to this [article](#) or Richard Hammar's annual *Church & Clergy Tax Guide*.

Federal Tax Withholding: Even though a minister may be an employee of the church, the minister is exempt from federal tax withholding. Unlike other employees who must have taxes withheld from their wages, ministers who receive compensation for ministerial services are exempt; however, ministers may elect voluntary withholding of income taxes. Box 2 of the W-2 should be blank unless the minister has elected voluntary withholding.

Social Security and Medicare Withholding: To confuse matters even more, ministers have dual tax status. Ministers are usually treated

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as employees for federal tax purposes, but are treated as self-employed for Social Security and Medicare purposes. Therefore, Social Security and Medicare taxes should not be withheld from ministers' wages.

Ministers do not have the employee's one-half of Social Security and Medicare withheld, matched by the employer's half, and shown as Social Security and Medicare wages and withholding on their Form W-2. Boxes 3 through 6 of the W-2 should be blank. Ministers are required to report and pay self-employment tax on Schedule SE of their federal income tax return (unless they have an approved exemption from self-employment tax).

Although a church does not pay FICA (Social Security and Medicare tax) on its ministerial employees, most churches are required to pay FICA tax on their non-ministerial employees just like for-profit companies are required to do. This means that the church is required to withhold the employee portion from the employees' paychecks and match this amount with the employer's portion and deposit both amounts with the IRS.

Proper Reporting and Remitting

There are several payroll reporting requirements for churches. As churches are withholding taxes from the non-ministerial employees (or ministers that have requested voluntary withholding), these taxes must be deposited with the IRS. These deposits must be made either weekly, monthly or quarterly, based on the amount of tax withheld.

Form 941, Employer's Quarterly Federal Tax Return: The church must also submit Form 941 each quarter. It is important to report ministerial wages properly on these forms. For example, ministers housing allowance will not be reported on the 941. Often times, ministerial wages are

misreported and included as Social Security and Medicare wages. This overstates the amount of wages that must have taxes withheld.

Form W-2, Wage and Tax Statement: Annually, the church must complete forms W-2 and W-3 (Transmittal of Wage and Tax Statements). These forms report the taxable wages for each employee and the amount of taxes withheld during the year. These forms, including the amount of wages and taxes withheld should agree with the totals of the quarterly Forms 941.

Form 1099-Misc, Miscellaneous Income: Any self-employed person, independent contractor or service provider who is not incorporated, that receives \$600 or more from the church in any calendar year should receive a 1099-Misc. Examples would include lawn maintenance providers, guest speakers, plumbers, carpenters, and evangelists. In order to correctly prepare a 1099-Misc, you will need to have the independent contractor fill out an IRS Form W-9, Request for Taxpayer Identification Number and Certification.

Next month, I'll continue this article and discuss the last two errors that deal with calculating taxable income. I'll conclude with a discussion of the significant consequences that churches can face if they mishandle or misreport payroll.

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About the Author:

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