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Excess Benefit Transactions

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Learn what common practices may expose senior pastors to substantial excise tax.

Richard R. Hammar [posted 3/03/2020]



Intermediate sanctions

If excessive compensation is paid to a “disqualified person,” Section 4958 of the tax code authorizes the Internal Revenue Service (IRS) to impose an excise tax—also called “intermediate sanctions”—against that disqualified person; and in some cases, against church board members individually. A disqualified person generally is any officer or director, or a relative of an officer or director. Most senior pastors will meet the definition of a disqualified person.

These taxes are substantial: up to 225 percent of the amount of compensation the IRS determines to be in excess of reasonable compensation. As a result, governing boards or other bodies that determine clergy compensation should be prepared to document any amount that may be viewed by the IRS as excessive. This includes salary, fringe benefits, and special-occasion gifts. If in doubt, obtain the opinion of a tax attorney.

Automatic excess benefits

In 2004, the IRS announced a new interpretation of section 4958. For the first time, the IRS asserted that some transactions will be considered “automatic” excess benefit transactions resulting in intermediate sanctions regardless of the amount involved. Even if the amount involved in a transaction is insignificant, it still may result in intermediate sanctions.

For example, a church’s payment or reimbursement of a pastor’s personal or business expenses under a nonaccountable arrangement, may constitute automatic excess benefits, regardless of the amount involved, unless they are reported as taxable income

by the church on the pastor's W-2, or by the pastor on Form 1040, for the year in which the benefits are provided.

This was an important development, since it exposed virtually every pastor and some nonministerial church employees to intermediate sanctions that had been reserved for a few highly paid charity CEOs. The term "excess," in effect, has become irrelevant to the concept of excess benefits.

Check benefits carefully

In addition to a salary, churches often provide benefits to their employees. These benefits may include personal use of church property, payment of personal expenses, and reimbursement of business or personal expenses under a nonaccountable arrangement.

Pastors and church treasurers are often unaware that these benefits must be valued and reported as taxable income. This common practice may expose the pastor, and possibly church board members, to substantial excise taxes, since the IRS views these benefits as automatic excess benefits resulting in intermediate sanctions unless the benefit was reported as taxable income by the church or pastor in the year it was provided.

The lesson is clear: Sloppy church accounting practices can expose ministers, and in some cases church board members, to intermediate sanctions in the form of substantial excise taxes. It is essential for pastors and church treasurers to be familiar with the concept of automatic excess benefits so these penalties can be avoided.

Additional Reading

For more on excess benefit transactions and related topics, see the following:

- [*2020 Church & Clergy Tax Guide*](#) (chapter 4)
- [*Church Compensation: From Strategic Plan to Compliance*](#) (chapters 2 and 3)
- [*Church Finance: The Church Leader's Guide to Financial Operations*](#) (chapter 9)
- [*Pastor, Church & Law*](#) (on this [website](#) or [in book format](#))
- ["Setting Reasonable Compensation"](#)
- ["Tax Law and Compensation Planning"](#)

- [“Q&A: Does Tax Reform Affect Reimbursements of Entertainment Expenses?”](#)

Go to the next article, “[Inspection of Church Records](#)” or return to “[15 Things Richard Hammar Wants Pastors to Know](#),” to choose an article of interest or that fits a particular need.

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