LILLY ENDOWMENT, INC.
National Initiative to Address Economic Challenges Facing Pastoral Leaders, 2024

Legal and Tax Implications of Support for Pastoral Leaders through Ministerial Excellence Funds

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February 1, 2024

This outline summarizes several legal and tax issues that church-related organizations, including denominations, judicatories, dioceses, foundations, and funds, should consider as they develop programs and establish procedures to provide financial support to pastoral leaders, congregations, or others under the Lilly Endowment National Initiative to Address Economic Challenges Facing Pastoral Leaders, 2024 (the "Initiative").

Background

Request for Proposals:

> *It is very important that organizations conduct research regarding how they will address potential income tax consequences to pastoral leaders who would receive financial support from their Ministerial Excellence Funds.*

As explained in the materials describing this project, Lilly Endowment designed the Initiative (i) to assist invited national and regional church-related organizations with programs to reduce or alleviate some of the key financial pressures that inhibit effective pastoral leadership and (ii) to improve the financial literacy and management skills of pastoral leadership. Understanding the legal and tax implications of Ministerial Excellence Fund payments, to the organizations administering the funds and to the individual pastoral leaders and others who benefit from those payments, will be important in the pursuit of both aims.

Ministerial Excellence Fund payments may take many forms and may provide assistance to pastoral leaders or others in a variety of ways, for example: awarding grants to pastoral leaders to enable them to reduce or eliminate their educational loans; making payments, on behalf of pastoral leaders, directly to seminaries or other lenders to reduce or eliminate educational debt; making emergency grants or loans to individuals to assist with special medical, housing, or financial needs; establishing retirement plans or paying post-retirement support; funding college savings accounts or scholarship programs for the children and dependents of pastoral leaders; making supplemental compensation payments through congregations or other employers, or directly to pastoral leaders; or providing financial planning resources, education, or advice.

Outside Boundaries for Ministerial Excellence Fund Payments – The Legal Landscape

Most, if not all, organizations establishing Ministerial Excellence Funds pursuant to this Initiative are nonprofit church-related organizations that are exempt from the payment of federal income taxes pursuant to Section 501(c)(3) of the Internal Revenue Code of 1986, as amended (the "Code"). A Code section 501(c)(3) organization must at all times be organized and operated ". . . for religious, charitable, . . . or educational purposes" and ". . . no part of [its] . . . net earnings [may inure] . . . to the benefit of any private shareholder or individual . . . ."

The Treasury Regulations expand upon the no "private inurement" concept to prohibit improper "private benefit" generally:

> *An organization is not organized or operated exclusively for one or more of the [exempt] purposes specified . . . unless it serves a public rather than a private interest. Thus, to meet the requirement of this subdivision, it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.*

Treasury Regulations section 1.501(c)(3)-1(d)(1)(ii). The Internal Revenue Service (the "IRS") has emphasized the private inurement and private benefit restrictions in determining whether an organization deserves recognition, or may continue to be recognized, as a Code section 501(c)(3) tax-exempt entity. These same principles underlie the "excess benefit transaction" rules embodied in Code section 4958, which are used to penalize improper behavior with onerous taxes, rather than attacking the tax-exempt status of an organization directly.

These fundamental principles define the outside boundaries of Ministerial Excellence Fund payments – i.e., those payments must further the religious or other exempt purposes of the payor, and they may not constitute improper private inurement or private benefit.

> *Good Example* – Seminary loan repayment fund benefits made available to all currently serving ordained pastors with 10 or more years of service in a diocese.
>
> *Bad Example* – Post-retirement vacation slush-fund for former bishops.

Individual Tax Implications

Assuming that Ministerial Excellence Fund payments are "in bounds" for the payor, the tax consequences to recipients of those payments may affect the measure of real benefit received. In many cases, direct or indirect payments that provide an economic benefit to a pastoral leader, a dependent, or another individual will be subject to federal income tax, the Self-Employment Contributions Act, and various other federal, state, and local taxes.

Every participant in a program like this is expected to comply fully with their tax withholding, reporting, and payment obligations. The rules are not always obvious, though, and each church-related organization that administers a Ministerial Excellence Fund or conducts other activities under this Initiative should take the lead in ensuring that pastoral leaders and other ultimate beneficiaries do not

experience unforeseen adverse individual tax consequences from the assistance provided through the Initiative.

Here is a summary of some basic individual income tax principles to keep in mind. For individuals, "[g]ross income" generally includes "all income from whatever source derived, including . . . [c]ompensation for services, including fees, commissions, fringe benefits, and similar items; [and] . . . [i]ncome from discharge of indebtedness." Code section 61(a)(1) and (11). Specific exclusions from this characterization of gross income include:

a. Certain prizes and awards that are "transferred by the payor to [a governmental unit or charity] . . . pursuant to a designation made by the recipient." Code section 74(b)(3).

b. In the case of a "minister of the gospel": (i) the rental value of a home furnished as part of compensation; or (ii) the rental allowance paid as part of compensation, to the extent used by the minister to rent or provide a home, and to the extent such allowance does not exceed the fair rental value of the home. Code section 107.

c. "[A]ny amount received as a qualified scholarship by an individual who is a candidate for a degree at an educational organization." Code section 117(a).

d. Discharge of indebtedness of any "student loan if such discharge was pursuant to a provision of such loan under which all or part of the indebtedness of the individual would be discharged if the individual worked for a certain period of time in certain professions for any of a broad class of employers." Code section 108(f)(1). The term "student loan" includes any loan made by "an organization exempt from tax under section 501(a) to refinance a loan to an individual to assist the individual in attending any such educational organization but only if the refinancing loan is pursuant to a program of the refinancing organization which is designed as described in subparagraph (D)(ii) [i.e., to encourage its students to serve in occupations with unmet needs under direction of an organization described in Code section 501(c)(3)]." Code section 108(f)(2).

e. "[P]roperty acquired by gift, bequest, devise, or inheritance." Code section 102(a). But this does not apply to "exclude from gross income any amount transferred by or for an employer to, or for the benefit of, an employee." Code section 102(c)(1).

   The distinction between gifts and payments that are made to achieve a particular purpose – whether or not to an employee – gives rise to several difficult questions: Are unrestricted payments, like support for sabbaticals or funds collected for "love offerings," gross income or excluded gifts? When does a payment result from "detached and disinterested" generosity? If payments are excluded gifts, are criteria required to decide eligibility (e.g., income level, medical or other special need, etc.) or does every pastoral leader qualify?

Funds Given as Part of a "Plan"

The determination of the transferor's dominant motive does not rest upon any single factor but is rather a conclusion reached after due consideration of all the relevant factors. On the facts of this case, in light of the aforementioned legal principles, it is the opinion of this Court that the payments were not gifts. The widow's benefits paid to petitioner were pursuant to a plan which had been in existence for fifty years. The plan encompasses all employees of the Seventh-Day Adventist Church and is financed by a percentage levy on all Church organizations. It provides for identical treatment of all employees whether they are ministers of the gospel or are employed in another of the Church's varied undertakings. The benefits payable to a worker, and similarly those paid to his widow, are fixed according to a computation based upon the length of service by the employee to the Church. Consideration is also given to the degree of major responsibility borne by the worker.

In many respects, therefore, the Church's plan, though voluntary, is the equivalent of a retirement plan.

Joyce v. Commissioner, T.C. Memorandum 1966-175, 25 T.C.M. (CCH) 914 (Tax Court of the United States, July 25, 1966).

Funds Given as "Love Offerings"

[I]t is stipulated that Church members made the special occasion gifts out of love, admiration, and respect, not out of a sense of obligation or fear that Goodwin might otherwise leave. We disagree.

From an objective perspective, the critical fact in this case is that the special occasion gifts were made by the congregation as a whole, rather than by individual Church members. The cash payments were gathered by congregation leaders in a routinized, highly structured program. Individual Church members contributed anonymously, and the regularly-scheduled payments were made to Reverend Goodwin on behalf of the entire congregation.

Viewing the question of transferor intent from this perspective makes it clear that the payments were taxable income to the Goodwins. The congregation funds the Church, including Reverend Goodwin's salary. The special occasion gifts were substantial compared to Goodwin's annual salary. The congregation, collectively, knew that without these substantial, on-going cash payments, the Church likely could not retain the services of a popular and successful minister at the relatively low salary it was paying. In other words, the congregation knew that its special occasion gifts enabled the Church to pay a $15,000 salary for $30,000 worth of work.

Goodwin v. United States, 67 F.3d 149, 152 (8th Cir. 1995).

See also, Swaringer v. Commissioner, T.C. Summ. Op. 2001-37 (2001) (citing Goodwin v. United States)[1]:

On the other hand, the evidence that we do have strongly suggests that the transfers were not gifts within the meaning of section 102(a). The transfers arose out of petitioner's relationship with the members of his congregation presumably because they believed he was a good minister and they wanted to reward him. Furthermore, petitioner testified that without the gifts his activity as a minister was essentially a money losing activity. In short, as petitioner recognized, the so-called gifts were a part of the compensation he received for being a minister. As such, the transfers are not excludable from income under section 102(a).

In most cases, a church is not required to withhold federal income tax from compensation paid to, or for the benefit of, an ordained minister. Therefore, some pastoral leaders may receive Ministerial Excellence Fund or other payments that are subject to federal income tax but with respect to which no tax has been withheld and remitted to the IRS. (Ministers may enter into voluntary withholding agreements with their churches to have taxes automatically withheld from their pay, but this is not a requirement.) If federal income tax over a threshold amount (basically, $1,000) is not withheld from gross income paid to an individual, the individual must pay the tax during the year on a quarterly "estimated tax" basis.

The payor of benefits to, or on behalf of, an individual often must send notice of such payment to the IRS and the individual recipient – Form W-2 is the basic wage and tax statement from an employer; Form 1099-C is the form reporting income realized from the cancellation of a debt; Form 1099-NEC is the general income statement from a payor who is not an employer; and Form 1099-MISC was revised after the creation of the Form 1099-NEC to report certain miscellaneous income. It is important to note, however, that an individual may receive benefits that are subject to federal income tax but that will not be included on any of these forms. For example, the provider of a taxable scholarship or fellowship generally is not required to report the award to the IRS or to the recipient, but there may still be tax payment obligations regarding the award.

In addition to federal income tax obligations with respect to benefits received under this Initiative, pastoral leaders and others may have employment tax responsibilities relating to those benefits. Compensation paid to a minister for services in the exercise of the ministry typically is not subject to the Federal Insurance Contributions Act ("FICA"), the statute under which most employees pay taxes to support Social Security and Medicare. Instead of FICA, however, most ministers are subject to tax under the Self-Employment Contributions Act ("SECA"), which normally requires direct payment on an "estimated tax" basis. (As with the federal income tax, ministers may enter into voluntary withholding agreements with their churches to cover all or part of their SECA obligation, but this is not a requirement. Moreover, some churches may reimburse pastors for their portion of SECA; however, the amount of such reimbursements will be treated as compensation and subject to tax.)

- Ministers may make an irrevocable claim of exemption from Social Security and Medicare by filing Form 4361 by the due date of the return for the second year in which the minister had

1 Although Tax Court summary opinions may not be cited as precedent for other cases, they do provide an indication of how the Tax Court has ruled on certain legal issues in particular facts and circumstances.

earnings in excess of $400. The minister must certify in Form 4361 that he or she is "conscientiously opposed to," or because of religious principles is opposed to, the "acceptance . . . of any public insurance that makes payments in the event of death, disability, old age, or retirement; or that makes payments toward the cost of, or provides services for, medical care." Form 4361 and Code section 1402(e).

- Prior to filing Form 4361, the minister must provide notice to the ordaining body of the opposition to receipt of coverage. As such, denominations and commissioning bodies should be in a position to advise new ministers regarding the implications of making a Form 4361 filing – especially the long-term impact of not receiving Medicare benefits in retirement.

Tax Implications for Payors

When the owner of a Ministerial Excellence Fund makes payments to an individual or to a congregation, seminary, or other institution to benefit a designated individual (for example, a grant to a seminary to apply against the educational debt of a particular graduate), that owner generally will have tax information reporting obligations (typically, Form W-2 or Form 1099). Moreover, institutions that receive such payments may have corresponding tax information reporting duties as "nominee recipients" of payments benefiting named individuals.

Here is a brief summary of some of these requirements:

1. Grants to Congregations or Other Entities.

   As a general proposition, the transfer of funds from a Ministerial Excellence Fund to a congregation or other entity for the congregation or entity to use, in its discretion, for wage supplements or other payments to undesignated pastoral leaders or other unspecified individuals should constitute a grant that does not trigger Form 1099 or other tax reporting obligations by the payor. (Instructions for Forms 1099-MISC and 1099-NEC, pages 3 and 9.)

2. Paying Wages Directly to Pastoral Leaders or Others – Who is the Employer?

   a. Full Employers.

   - Common Law Employer – directs activities, place of work, equipment and supplies, etc.

   - "Statutory Employees" – special classes, like commission-drivers and real estate agents.

   - Otte Employer – third-party payor who has "control of the payment of wages," such as a trustee in bankruptcy for the estate of bankrupt employer. (Otte v. United States, 419 U.S. 43 (1974), and subsequent cases.)

b. Employer-Proxies – Internal Revenue Code section 3505(a) – *For purposes of sections 3102 [FICA], 3202[railroad retirement], 3402, and 3403[federal income tax withholding], if a lender, surety, or other person, who is not an employer under such sections with respect to an employee or group of employees, pays wages directly to such an employee or group of employees, employed by one or more employers, or to an agent on behalf of such employee or employees, such lender, surety, or other person shall be liable in his own person and estate to the United States in a sum equal to the taxes (together with interest) required to be deducted and withheld from such wages by such employer.*

- "The liability of the lender, surety, or other person in such a case is to pay the taxes only where the employer does not do so." Revenue Procedure ("Rev. Proc.") 78-13, Sec. 4.01, 1978-1 C.B. 591.

- "The liability imposed under section 3505(a) of the Code upon the payor of wages is limited to the taxes which are required to be deducted and withheld from the wages of the employees, plus interest from the due date of the employer's return." *Id*. at 4.02.

3. Earmarked Wages – Internal Revenue Code section 3505(b) – *If a lender, surety, or other person supplies funds to or for the account of an employer for the specific purpose of paying wages of the employees of such employer, with actual notice or knowledge (within the meaning of section 6323(i)(1)) that such employer does not intend to or will not be able to make timely payment or deposit of the amounts of tax required by this subtitle to be deducted and withheld by such employer from such wages, such lender, surety, or other person shall be liable in his own person and estate to the United States in a sum equal to the taxes (together with interest) which are not paid over to the United States by such employer with respect to such wages. However, the liability of such lender, surety, or other person shall be limited to an amount equal to 25 percent of the amount so supplied to or for the account of such employer for such purpose.*

4. Employer's Tax Obligations for Proxy or Earmarked Wages – "Section 3505 of the Code does not relieve an employer of responsibilities with respect to . . . withholding taxes even though a lender, surety, or other person may be paying the employees' wages. The employer is required to file the usual employment tax returns and furnish statements of withholding tax to employees with respect to employees' wages paid by the employer and by others." Rev. Proc. 78-13, sec. 7, *supra*.

Examples (from IRS Field Service Advisory -- 2002 WL 1315722)

The following examples are in the university context, but comparisons can easily be made to funds distributed through the Initiative. Although a field service advisory opinion is not binding, it offers insight into how the IRS may rule on similar facts in the future.

1. *An accounting firm contributes money to a university foundation to fund an annual award for an outstanding accounting professor. A committee from the university selects the award recipient based on performance at the university. No further commitment of services is required of the recipient. The committee advises the university foundation of its selection and*

requests that a check be made out to the employee and returned to the university for presentation. The university foundation issues a Form 1099 to the employee.

2. *The university athletic department requests that an athletic booster group issue a check as an award to an employee for outstanding performance in preparing a team for an important game. The university employee provides no current services to the booster group nor is the employee obligated to provide any future services to the university. The athletic booster group prepares a check, gives it to the athletic department for presentation to the employee, and issues a Form 1099 to the employee.*

3. *A university foundation provides a monthly expense account to certain university employees for expenses incurred in connection with university duties. The monthly expense accounts are nonaccountable plans under section 62(c) of the Internal Revenue Code. The university foundation issues Forms 1099 to the employees.*

Impact on the University:

- The payments, although not made with the university's own funds, "represent additional compensation and wages for FICA, FUTA, and federal income tax withholding."

- "Furthermore, although the payments originate from the booster group, the university has ultimate control over which employees receive the wage payments. Thus, the university is the responsible 'employer' under section 3401(d)(1) of the Code, Otte, and Otte's progeny."

Impact on the University Foundation and the Booster Club:

- "[Rev. Proc. 78-13] provides guidance to taxpayers that are required to deduct and withhold taxes under section 3505 of the Code. Section 7 of [Rev. Proc. 78-13] provides that section 3505 does not relieve an employer of responsibilities with respect to such withholding taxes even though the other person may be paying the employees' wages. According to Rev. Proc. 78-13, the employer is required to file the usual employment tax returns and furnish statements of withholding tax to employees with respect to employees' wages paid by the employer and by others."

- "Section 3505(a) of the Code may be applied to require a university foundation or an athletic booster group to deduct the amount of tax equal to the taxes (together with interest) required to be deducted and withheld by the employer."

Emergency Hardship Assistance

In light of the recent COVID-19 pandemic and various other recent crises and emergencies, some churches, denominations, or other organizations may wish to consider using a portion of the Ministerial Excellence Fund payments for emergency hardship assistance, e.g., in connection with hardships resulting from a disaster (wildfires, tornadoes, or hurricanes, etc.), or caused by illness, death, accident, violent crime or other personal events. In general, payments that individuals receive

under a charitable organization's program to alleviate such disaster or emergency hardships may be treated as gifts that are excluded from the gross income of recipients under section 102 of the Code if properly structured. Nevertheless, payments that otherwise may be non-taxable as gifts, if they are paid to ministers by congregations or denominations, could be treated as taxable compensation. The rules relating to the tax treatment of such payments are quite complex.

In addition to ensuring that recipients of such payments are members of a large and indefinite charitable class that may properly receive assistance, payors must make a specific assessment that a recipient of aid is financially or otherwise in need (charitable funds cannot be distributed to individuals merely because they are victims of a disaster) and maintain appropriate documentation. Adequate records should show the amounts paid, the purposes of such payments, and information to establish that payments were made to meet charitable purposes and the needs of recipients. Moreover, determinations regarding who receives assistance under the hardship program should be made by an independent selection committee pursuant to objective criteria. Again, such payments to ministers/employees could lead to tax consequences that are different from payments to others (e.g., payments to individual church members from a congregational benevolence fund). In light of the technical nature of the rules encompassing emergency hardship assistance payments, and the complexities associated with making such payments to ministers, an organization interested in pursuing such a program should consult with its tax advisor and review IRS Publication 3833, *Disaster Relief: Providing Assistance Through Charitable Organizations*, for additional information: p3833.pdf (irs.gov)

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