6 STEPS
TO STRENGTHEN YOUR CHURCH'S FINANCIAL HEALTH

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StartCHURCH®

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INTRODUCTION

Many pastors and church leaders lack adequate training when it comes to handling church finances. Because of this, the financial health of many churches is deficient.

I imagine if you were to be honest with me, and yourself, you would agree with those two statements. Sure, there are churches that are financially healthy, and there are pastors and church leaders who know how to properly handle church finances. But the problem is that there are far too many churches that are not financially healthy, and far too many pastors and church leaders who are not properly trained when it comes to church finances. Many pastors and church leaders readily admit that church finances are not their strong suit.

Although one may attend seminary or Bible college and receive a stronger understanding of the Bible and theology, spiritual formation, and practical tools to spiritually lead a congregation, many pastors that graduate do not know the first thing about balancing a church budget or how to nurture healthy financial practices for a church. This generally leads to higher stress levels for pastors and church leaders. There is a longing and desire amongst pastors to be good financial stewards with church finances, but most simply do not know how or where to begin.

Depending on the size of your church, you may have the direct responsibility of your church's finances, or maybe you are able to delegate the financial responsibilities to another staff member or financial advisory board. Regardless of your situation, the financial health of your church is ultimately your responsibility, which can be a lot for one person to handle, especially when you are not sure where to begin.

This ebook is intended to help you begin taking the necessary steps for establishing a financially healthy church, no matter its size. But first, there is something that needs to be clarified, upon which I think we will all agree.

A financially healthy church is not simply referring to a church that has a lot of money in its bank account or several wealthy donors in its congregation. Rather, **a financially healthy church is one that has taken certain steps to implement healthy financial practices into its daily operations, and then continues to operate according to those practices.**

Before we begin looking at some practical steps that you can take towards having a financially healthy church, let us look at three benefits resulting from financial health in your church.

3 BENEFITS OF HAVING A FINANCIALLY HEALTHY CHURCH

1. LESS STRESS

According to a 2015 survey by the American Psychological Association1, 64 percent of Americans said that money is a "somewhat" or "very significant" source of stress. No matter what your thoughts are on money, the fact is that we need it to survive. We need money for our most basic of needs: food, clothing, and shelter. We also need money to pay our bills, our children's schooling, and entertainment. And when there does not seem to be enough money, our stress levels tend to rise, which is one reason why there are ministries and resources like Dave Ramsey's Financial Peace University. People are looking for ways to relieve the burden and stress that money sometimes brings. In order to do this, healthy financial practices must be implemented.

The same can be said for churches.

Your church needs money in order to operate. It needs money to secure a building or location at which to meet. Your church also needs money for services and activities, salaries, outreach events, sound equipment, furniture, and the list keeps going. If you do not have a financial plan in place or your church has not implemented healthy financial practices, there is a good chance that your church will not be financially healthy. A couple of "bad" Sunday offerings in a row can seem detrimental to your church if it is already financially unhealthy. As a result, your stress can begin to rise, a cycle which eventually leads to burnout.

But when healthy financial practices are learned, implemented, and then put into practice, the same stress that once came from having unhealthy church finances is no longer the "bear" that it once was. The simple fact of the matter is that when you, as the pastor and spiritual leader of your church, begin to implement healthy financial practices within the church, you will begin to notice a dramatic change in your stress levels. (And for the good, or course.)

2. BUILDS TRUST WITH YOUR CHURCH MEMBERS

Have you ever truly thought about why your church members give to the church? Sure, most, if not all, who give do so out of obedience to God and His Word. But besides that, are there any other reasons?

Or how about this? Have you ever asked yourself why some of your church members do not give to the church on a regular basis…or at all, for that matter? For some, it may be a simple matter of not understanding the principles of giving and how it is an act of faith that honors God. But for others, it may be that they do not trust the church. Maybe they have heard too many stories about churches that mishandle money. Or perhaps they had a bad experience with giving at a previous church, and they are not sure if they can now trust yours.

Your church members need to know when they give to your church that it will be put to good and proper use. They need to know that they can trust you and your staff members to be good stewards with the church finances. One such way to build this trust is to implement healthy financial practices. Be open with your church members and tell them what projects or areas their offerings are going to support. Allow them to ask questions, and be honest in your communication with them about church finances. Then make available an annual budget so that people can see what their offerings are being allocated towards. These are just some of the healthy financial practices you can implement to begin building trust with your church members.

3. ABILITY TO DO MORE FOR THE COMMUNITY

The third benefit of implementing healthy financial practices in your church is that it affords you the ability to do more for your community. I do not know of a pastor who does not want to do more for his or her community. Although pastors want to do more for their communities, they often feel as though their church is limited because they are not sure if they have enough available resources (or money) to allocate to outreach. Most often this is because the church lacks a financial plan or budget in place, and they have no idea precisely where the money is going. They just know that the church has bills and salaries to pay, and by they end of the month, they are usually not sure where the rest of the money went.

This is why it is imperative for every church to implement healthy financial practices, such as creating a budget. Doing this enables you to know exactly where the money your church receives is going and then you will be able to set money aside each month in order to do more for your community.

So now that you are familiar with the benefit of having a financially healthy church, let us look at 6 steps you can begin taking today towards obtaining financial health for your church.

STEP 1: OPEN A BANK ACCOUNT AND SELECT AN ACCOUNTING METHOD

If your church has been around for some time then odds are that you have already opened a bank account in the church's name. But if you are planting a church, one of the first steps your church needs to take towards financial health is to open a bank account. Doing so allows you to process donations, tithes, and offerings, and to pay church related expenses. However, opening a bank account for your church can sometimes be easier said than done. Because of this, many ministers will open the church's bank account in their own name.

This may seem like an okay thing to do, but this can easily lead to the mishandling of church funds and an infraction the IRS refers to as private inurement. Private inurement occurs when an "insider", such as a pastor, directly benefits from the church because of his or her position. In addition, private inurement can lead to hefty penalties and taxes on the individual who directly benefits, as well as on the board members.

"Private inurement can lead to hefty penalties and taxes on the individual who directly benefits, as well as on the board members."

So, what do you need in order to open a bank account in the church's name?

In essence, there are two things that the bank will definitely ask for in order for you to open a bank account for the church:

1. **Your church's approved articles of incorporation:** The approved articles of incorporation should have a timestamp date indicating when your state approved the document. It is a good idea to bring with you both the original and a copy of your approved articles of incorporation. (Do not leave your original with them.)

2. **Your church's Federal Employer Identification Number (FEIN):** If your church does not yet have an FEIN then you will need to obtain one from the IRS. (You can apply for one here.) Your church's FEIN is equivalent to your Social Security number. It is used to identify your church, and it will stay with your church for the duration of its existence.

These are the two main items the bank will request from you when opening your church's bank account. It may also be a good idea to bring your church's Resolution to Open a Bank Account. One step that many churches do not consider is that to open a bank account, the resolution must be approved by the board of directors. (Each church that goes through our StartRIGHT® Program receives everything necessary to open a bank account.)

While at the bank, make sure that you discuss any and all bank fees that could apply. You do not want to be in a situation where you are caught off guard by hidden bank fees.

Remember, you will also need to bring your identification since your name will be on the account. We suggest that two names be on the church's bank account: your name and another board member (such as the treasurer) who is not related to you. Lastly, do not forget to bring money for the opening deposit.

Once your bank account is open, you will need to choose an account method and period for which your church will operate. We will take a quick look at that next.

CHOOSING AN ACCOUNTING METHOD

An accounting method is a set of rules used to determine when income and expenses are to be reported. Your organization may choose the method that best fits its needs, however, **once you have determined the accounting method, it must be used consistently.**

The most common accounting methods that churches and ministries use are the **cash method and the accrual method.** Although there are other methods, since these are the most widely used amongst churches and ministries, these will be the only two we discuss.

1. Cash accounting

The cash accounting method is the simpler of the two accounting methods. It is a method that records financial transactions based on the actual exchange of cash. Income is not considered income until the actual cash has been received, and an expense is not considered an expense until the cash has left the church.

Unfortunately, this method does not make room for accounts payable or receivable, and taking those into account is particularly useful if you have a building campaign. The cash accounting method does not permit the organization to account for pledge donations. Those pledges only count when the money is actually received. However, **because of its simplicity, we recommend to all churches and ministries that go through our StartRIGHT® Program to start out by using this type of accounting system.**

2. Accrual accounting

While the cash accounting method is straight forward and easy to grasp, it is not the generally preferred method for more mature organizations. Instead, the accrual accounting method is the preferred and most widely accepted accounting method because it is more accurate in its financial forecast.

With this method, you report income in the tax year that you earn it, regardless of when the payments are received. In the same way, you deduct expenses in the tax year that you incur them, regardless of when you actually make the payments. This is beneficial because it creates a very useful report called the balance sheet. This report allows you to more accurately see what your organization's true financial state is, and this method does not require additional calculations on the back end.

Using this accounting system may take some getting used to, but in the end you have a method that grows with you as you transition from a small church into a large church.

Now that you are aware of the two common types of accounting methods used by churches and ministries, we will next look at choosing an accounting period.

CHOOSING AN ACCOUNTING PERIOD

Accounting systems will generally be guided by the accounting period or tax year that you choose. **When an organization is created, whether it is for-profit or nonprofit, it must determine an accounting period.** Taxes are computed and filed based on the organization's tax year. Although taxes are not typically computed for tax-exempt organizations, the accounting period is still important.

"When an organization is created, whether it is for-profit or nonprofit, it must determine an accounting period."

There are two types of tax years: a fiscal year and a calendar year. Both work well, and the option to choose which one to go by is yours. Following is a brief description of each

Option 1: The calendar year

The calendar year can be chosen by any organization, and is the default tax year for those organizations that have no previous records or accounting books, no previous method of accounting, or that are required to use a calendar year because of a provision of the Income Tax Regulations or by the Internal Revenue

Code. **The calendar year consists of 12 consecutive months, beginning on January 1st and ending on December 31st.** Therefore, income and expenses are to be reported from January 1st to December 31st.

Option 2: The fiscal year

The fiscal year and the calendar year are quite similar; the difference is in the beginning and ending dates of the year. The fiscal year consists of 12 consecutive months, beginning on the first day of the chosen month and ending on the last day of the month preceding the beginning month. For example, a fiscal year can begin on July 1st and end on June 30th of the following year.

There is a variation of the fiscal year that your church may want to consider. It is known as the **52-53 tax year**. The use of this tax year would mean that the tax year must end on the same date of the week each year. In addition, the 52-53 tax year must end on one of the following:

- Whatever date this same day of the week last occurs on in a calendar month, or
- Whatever date this same day of the week falls on that is nearest to the last day of the calendar month.

You may be scratching your head with this last option, and that is okay; the 52-53 tax year is not for everyone. You will be safe choosing either the calendar year or fiscal year as your church's accounting period.

STEP 2: CREATE A BUDGET

This may seem like a "no brainer" part of the process, but you would be surprised how many churches actually skip this step. This is especially so for church plants and newly started churches because they generally do not know where to begin. They find the task of creating a budget from scratch very intimidating.

If I were to ask you, "Is it necessary for your church to operate on a budget?", my guess is that you would answer me with an emphatic, "YES". But have you ever really considered why this is true? As long as things are going smoothly and the church bank account is not negative, all is well, right?

Well, not necessarily. **Creating, implementing, and sticking to a budget is important to the financial health of your church.** Here are a few reasons why:

- **It lets you know where you are and where you are going.** Establishing a budget gives you a complete picture of how much money the church receives, and how it is being, or will be, spent.

- **It providers protection for the board of directors.** Having a budget is a "frontline defense" in proving that the board of directors is operating in the best interest of the church.
- **It helps you identify weak areas of fiscal administration.** Creating a budget helps you and your staff see areas where you may have missed the mark in managing church finances.

Now that we are all on the same page as to the importance of creating, implementing, and sticking to a budget, we will look at 6 easy steps to take when creating a budget for your church.

6 EASY STEPS TO CREATE A BUDGET

1. **Begin planning early.** Start planning next year's budget a few months early so that any details can be worked out before the next fiscal year begins. You can even establish a budget committee to prepare a budget for the board to approve.
2. **Get a realistic idea of the income you expect.** This is your guide to figuring out how and when you can reach your financial goals. Consider how many individuals are currently attending your church and how many you expect to be attending within the next 12 months (be realistic). If you are already receiving tithes and offerings then you can use what you receive on average to help with this process.
3. **Determine your financial responsibilities.** What expenses must you incur to function? Does your church have a building? Are utilities included in the rent? Are you needing to purchase new furniture, sound equipment, or instruments? Is anyone on salary? What about guest speakers; will you be giving them an honorarium? How about the children's and youth ministry; will money need to be allocated to those ministries? Allocate funds there first.
4. **Determine your financial goals.** Then determine where you should save and fundraise to meet those goals. Is your church wanting to obtain its own facility within the next 12 months? Is your church wanting to buy property and build? Determine what your goals are and begin saving, even if it is just a little, so that you can reach that goal. Even if your church does not have a "big" financial goal that it is looking to meet, it is still good practice to set money aside and save each month.
5. **Create "buy-in" to the budget.** A budget is necessary, but keeping one going long-term and setting up the right procedures to carry it out takes commitment. Therefore, "buy-in" about the necessity of a budget is important. This "buy-in" keeps your entire team motivated. Be sure that the members of the board have a chance to review the budget and share their concerns.

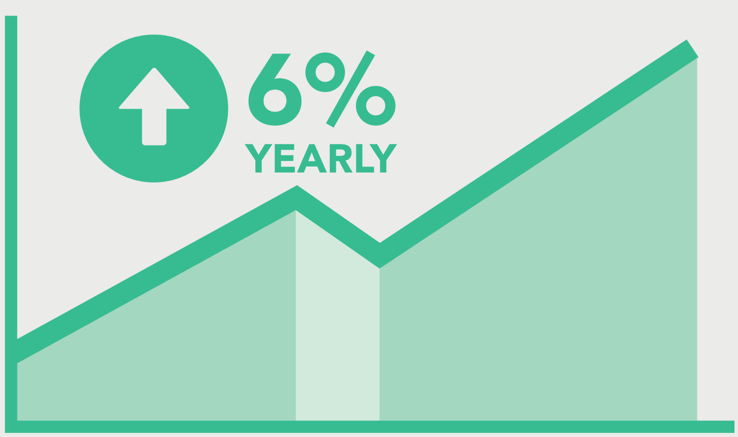
6. **Make a team plan for interoffice management of expenditures.** Use the necessary forms to track who spends what, when, where, and why, to be sure that regular accountability is maintained regarding the use of church funds. Additionally, create a contingency plan for emergency expenses outside of the budget. Be sure that every department is aware of the protocol.

STEP 3: CORRECTLY RECEIVE TITHES AND OFFERINGS

When it comes to receiving tithes and offerings, one might think that it is a fairly simple task: ushers pass around a collection plate during a worship service, members place their tithes and offerings in the collection plate, ushers count the tithes and offerings received, and then they give to the pastor or secretary to deposit in the church's bank account the money that came in during the service. While technically that is correct, there is, in fact, a lot more that needs to be considered in order to have a financially healthy church when it comes to receiving tithes and offerings.

Unfortunately, church fraud is a growing issue that researchers say is increasing at a rate of nearly six percent per year. In addition, research indicates that by 2025, church fraud is expected to reach nearly $60 billion. So when you consider that, it is easy to see why the manner in which you receive tithes and offerings matters.

Before we look at what you should consider when it comes to receiving tithes and offerings, we will first examine different ways your church can receive the money given.



"Research indicates that by 2025, church fraud is expected to reach nearly $60 billion."

4 ADDITIONAL WAYS FOR YOUR CHURCH TO RECEIVE TITHES AND OFFERINGS

Obviously, there is the traditional way of receiving tithes and offerings: passing around a collection plate on Sunday mornings. But let us spend some time looking at other avenues you can utilize. There is a good chance that your church is already using, or will be using, some of these methods, but we want to give you a little more information to help you consider other options with which you might not be too familiar.

Option 1: Online giving

Online giving is one of the most common giving methods to date. Many churches already have websites that allow members to donate using a credit/debit card or even an eCheck.

To do this, you need an account with a merchant service, such as SecureGive, PayPal or PayoLee, that serves as an intermediary to receive funds from donors and to transfer those funds to your banking institution.

Merchant services charge a small transaction fee, which is either a small dollar amount or a percentage of the transaction. However, many of these services give a discounted transaction fee for public charities like churches and ministries.

Option 2: Automated drafts

Many people today already enjoy the convenience of establishing automated drafts from their bank accounts in order to pay bills. In a similar fashion, many people would also enjoy (and many already do) **the convenience of an automated giving option.**

This possibility for your members is connected with the online giving alternative mentioned above. The merchant service you choose should have options so that donors can choose to give a one-time gift or to create recurring payments. This is an easy way for your members to continue their giving even if they are out of town on vacation.

Option 3: Text to give

A more recent development is the text-to-give option. This alternative allows givers to text their donations to a number that is specific to your church. The text sends a link to download an app or gives them access to an app or webpage where they can donate to your church.

To utilize this option, you can check out platforms from Tithe.ly or Pushpay by eChurch.

Option 4: Church app

Statistics indicate that nearly 80% of churchgoers show up on Sunday having had zero interactions with the church during the previous week. Therefore, how can you keep your congregation engaged on a regular basis?

Creating an app for your church can serve multiple purposes. You can use it to keep your church members informed of upcoming events and weekly announcements, and you can even include links to archived sermons.

Additionally, your ministry's app can include a link to give. Cellular devices as well as laptops and computers are moving towards using apps more and more exclusively for functionality. As a result, more and more churches are using this to their advantage.

You can check out Custom Church Apps for more information on building and designing an app specific to your church.

DO'S AND DON'TS OF COUNTING CHURCH MONEY

We just discussed 4 ways that your church can utilize today's technology to receive tithes and offerings. But there are those who will still prefer to give their offerings during the worship service on Sunday morning. **Subsequently, in order to have a financially healthy church, what do you need to know about counting tithes and offerings?**

By its very nature, the church is a place of trust and safety. As the Church, we want to see the best in people because our Heavenly Father first saw the best in us. But unfortunately, because we live in a fallen world, the trust we give is at times abused. This is where accountability comes into play.

Based upon best practices, we have developed a list of some do's and don'ts of counting church money that every church should take into serious consideration.

Do's

- Select multiple money counters, regardless of the size of your church.
- Select a safe room for the counters to do their job.
- Ensure that all counting is done on the same day that the offerings are collected.

- Adopt a tithe and offering counting policy that all counters, whether paid staff or volunteers, follow. (Click here to download a tithe and offering counting policy.)
- Utilize an offering counting sheet that details tender and the amount. (Click here to download an offering counting sheet.)

Don'ts

- Don't allow this job to be done by just one person during any given worship service.
- Don't allow anyone to interrupt the selected counters while they are counting the offerings.
- Don't simply put the money in a safe and use the cash as needed. Always deposit the cash into the church's bank account. This will help keep everyone accountable.

"Misappropriation can occur when donations are solicited for a specific reason and then used for a completely different reason without informing the donors."

HOW TO AVOID MISAPPROPRIATING CHURCH FUNDS

Earlier this year (February 2016), former members of Mars Hill Church in Seattle, Washington filed a lawsuit against former pastor and founder, Mark Driscoll, and the then general manager and executive elder of the church, John Sutton Turner. Both Driscoll and Sutton Turner are being accused of misappropriating a total of $92,700.00 between the two plaintiffs who filed suit.

The plaintiffs in the case claim that both Driscoll and Sutton Turner defrauded them, along with thousands of other church goers, by telling them that certain funds collected were for one purpose, such as overseas missions, and then used for other purposes. The suit claims that Driscoll and Sutton Turner used church funds that were solicited for specific purposes to support and promote a personal book endeavor of Driscoll's.

As of the writing of this eBook, both Driscoll's and Sutton Turner's attorneys have filed a motion to dismiss the lawsuit; **however, there are some valuable lessons we can learn from the matter at hand involving a church's responsibility with the donations it receives and having a financially healthy church.**

The legal definition of misappropriation is "the intentional, illegal use of the property or funds of another person for one's own use or other unauthorized purpose, particularly by a public official, a trustee of a trust, an executor or administrator of a dead person's estate, or by any person with a responsibility to care for and protect another's assets."

Misappropriation can occur when donations are solicited for a specific reason and then used for a completely different reason without informing the donors.

This is where many churches and ministries can find themselves in a messy situation. The key here is for your church to have a clear understanding about handling the donations it receives.

(Case update: The lawsuit that was filed against Mark Driscoll and John Sutton Turner earlier in 2016 was dismissed by a U.S. District Judge on Thursday, August 25, 2016. This is due to the fact that neither Driscoll nor Sutton Turner was ever served with the lawsuit.)

Below are 5 ways you can avoid misappropriating church funds:

1. Know the difference between designated and restricted funds.

- **Designated donation:** when a donor gives, noting a ***desired intent*** for his/her donation. These are donations given with a suggested use from the donor. Designated donations may be claimed as a tax-deductible donation by the donor.
- **Restricted donation:** when a donor gives with a ***required intent*** for his/her donation. In other words, a donor requires that his/her donation must be used for a specific purpose and for that specific purpose only. **Restricted donations are not tax-deductible to the donor** because the nonprofit does not have control over the use of the funds.

The best way to handle donations depends upon how you solicit the donations and the **donors' intent** when they give.

2. Understand donor intent.

The key in understanding whether a donation is considered designated or restricted, and therefore tax-deductible or not tax-deductible, is to determine **donor intent.** The following is a excerpt from IRS PLR-200250029:

> *"The organization must have control and discretion over the contribution, unfettered by a commitment or understanding that the contribution would benefit a designated individual... The donor's intent must be to benefit the organization and not the individual recipient."*

In essence, this means that **in order for a donor to claim a tax deduction on a donation given to your church, he must relinquish control, thus giving your church the ability to use the donation**

at your discretion.

3. Inform your donors of the necessity to relinquish control of their donations in order to claim a tax deduction.

This can be done by adding certain language to your offering envelopes or to your website for when donors give online, or at giving kiosks. This wording can be as simple as the following:

> *"This church is a qualified 501(c)(3) organization. All tithes, offerings, or donations of any kind are deductible under IRC section 170(c)(2). Unless otherwise noted and in accordance with IRS regulation, you agree to relinquish control of the donated funds to the discretion of this church."*

It is also best practice to inform any donor who restricts his donation(s) to a specific use that his donation is considered a restricted donation and is not a tax-deductible contribution.

4. Clearly indicate whether or not a solicited fund may be used for another purpose

One mistake Mars Hill Church may have made was not making donors aware that when necessary, funds may be directed to other needs of the ministry. When your donors are fully informed and aware of how their donations may be used, a certain bond and trust is built between your church and its donors. This is an invaluable attribute for churches to have.

5. If donations for a solicited fund are no longer needed or the project is closed, notify the donor.

There may come a time when your church receives a donation for a project that has been completed or terminated. What should you do in this instance?

In a situation like this, your church has the responsibility of informing the donor that the fund no longer exists and then offering to the donor one of two options.

1. **Offer to redirect the donation:** The first thing your church needs to do is inform the donor that there is no longer a need for that specific fund or purpose. You should then ask if he would like to redirect his donation to the general fund or to another ministry program.

2. **Offer to refund the donation:** If the donor does not want to redirect the funds, the church is under legal obligation to offer a refund because it is a program that the church set up and asked

people to support. These funds are restricted and can only be used for their intended purpose.

If the donor wants a refund for the donation, it is important for the church to send the refund with a letter explaining that if the taxpayer claimed a tax deduction on his tax return, he may need to amend the tax return using Form 1040X.

STEP 4: DETERMINE REASONABLE COMPENSATION

The next step towards having a financially healthy church pertains to compensation. It is safe to say that as a minister called by God to teach and preach the Gospel of Jesus Christ, you did not enter the ministry looking to "strike it rich." But this does not mean that you should not or do not want to receive compensation for your service. After all, although you were called into the ministry, this is also your occupation and you most likely have a family to support.

That being said, I believe we can all agree that it is okay for you to receive a salary from your church as the pastor. However, **when it comes to church compliance and having a financially healthy church, the key to pastoral compensation (and the compensation of anyone else at your church) is that it must be reasonable.**

Before we begin looking at how to determine reasonable compensation, it will do us good to make sure we are all on the same page regarding what ministerial compensation encompasses.

"When it comes to church compliance and having a finacially healty church, the key to pastoral compensation is that it must be reasonable."

WHAT DOES MINISTERIAL COMPENSATION ENCOMPASS?

When it comes to ministerial compensation, there are numerous words that can be used to describe it. Perhaps you have heard it described as love offerings, honorariums, stipends, salary, housing allowance, and cash gifts to name a few. What is important to note here is that all of these are considered forms of taxable income to the pastor.

There is much more to consider concerning pastoral compensation, but for the purposes of this eBook we want to spend time concentrating on the root of the matter: the reasonableness of one's compensation. (If you are interested in knowing more about pastoral compensation, our Compensation Suite is a good resource for you and your church.)

WHAT YOU NEED TO KNOW ABOUT REASONABLE COMPENSATION

Unfortunately, with regards to taxation, you are generally guilty until proven innocent. However, Treasury Regulation 53.4958-6 provides us with an exception to this rule. The regulation considers a situation in which there is the presumption that compensation is reasonable. There are several criteria that allow compensation to be considered reasonable by default and that force the IRS to prove otherwise. These are found in Treasury Regulation 53.4958-6(a), which states,

> "(1) The compensation arrangement or the terms of the property transfer are **approved in advance by an authorized body of the applicable tax-exempt organization** (or an entity controlled by the organization within the meaning of §53.4958–4(a)(2)(ii)(B)) **composed entirely of individuals who do not have a conflict of interest** (within the meaning of paragraph (c)(1)(iii) of this section) with respect to the compensation arrangement or property transfer, as described in paragraph (c)(1) of this section; (2) **The authorized body obtained and relied upon appropriate data as to comparability prior to making its determination,** as described in paragraph (c)(2) of this section; and (3) **The authorized body adequately documented** the basis for its determination concurrently with making that determination, as *described in paragraph (c)(3) of this section."*

That is a lot and nobody really wants to read part of a Treasury Regulation to know what the criteria are that allow compensation to be considered reasonable. So, in short, this is saying that one's compensation is considered reasonable if:

- **a "balanced" board uses comparable salaries,**
- **the board documents those comparable salaries, and**

- **the board records everything in board meeting minutes approving the salary, and it does all of this before making any payments.**

The presumption of reasonableness is important because it relieves the church, its board, and the individual receiving the benefit from having to prove that the benefit was one of reasonableness.

Next we will look at how you can determine and approve reasonable compensation when applying these three points.

HOW TO DETERMINE REASONABLE COMPENSATION

1. Is your board "balanced"?

Although the term "balanced board" is not actually used within section 4958, we can gather that it is implied within Treasury Regulation 53.4958-6(C)(iii). It is this portion of the Code that requires nonprofit organizations to have a **conflict of interest policy.**

Within Treasury Regulation 53.4958-6(C)(iii), we see three things:

1. That no individual can vote on his/her own compensation or the compensation of a spouse or other related individual;
2. That no individual can vote on the compensation of someone with whom he/she has a close working relationship; and
3. That no individual already receiving compensation from the church can vote on the compensation of another individual.

"There must always be a majority of unrelated and uncompensated individuals serving on your board"

From this, we are able to gather that your board of directors must be balanced. In short, this means that there must always be a majority of unrelated and uncompensated individuals serving on your board of directors in order to properly approve one's compensation.

2. Salary comparability

As previously mentioned, and as discussed in Treasury Regulation 53.4958-6(c)(2), there are several different components to consider when attempting to determine reasonable compensation. One can utilize **salary comparability data** as an effective means for measuring reasonableness. The most common elements to consider when using such data are as follows:

1. **Organization income:** Organization income is generally the key concern. The organization's income heavily dictates the amount that can be paid to its employees.

2. **Geographic location:** Another key criterion is geographic location because incomes vary greatly from one location to the next. This impacts not only the amount needed by the individual, but also the amount donated to the organization.

3. **Organization size:** Depending on the type of organization, this can mean congregation size, or the number of employees, or the number of customers (for lack of a better term). Organizations of similar size can be used for comparability data.

4. **Functionally equivalent position:** As we know, not all employees in an organization receive the same pay. We also know that a position of a certain title in one company may be very different than a position under the same title within a different company.

5. **Individual's qualifications:** Income levels in all sectors vary based on qualifications such as time in the industry, past experience, applicable knowledge, courses/degrees completed, and recommendations/endorsements. Individuals with similar qualifications can be used in obtaining comparability data.

Without board meeting minutes showing that compensation was approved by a balanced board of directors, it is as if the meeting never happened and the compensation was never approved. Therefore, without adequate documentation (board meeting minutes), the compensation could potentially be penalized up to 225%, as noted in Treasury Regulation 53.4958-4(c)(1).

STEP 5: SET UP PAYROLL

The 5th step you need to consider for establishing a financially healthy church is how your church sets up its payroll. When a church hires a worker, one of the initial decisions that must be made is whether to treat the worker as a contract worker or as an employee. This decision may seem insignificant, but it has huge implications when it comes to payroll.

Many churches are unaware that section 3121(b)(8)(A) **prohibits the church from withholding Social Security and Medicare tax on the wages earned by a minister.** It is in fact the responsibility of the minister to pay the 15.3% self-employment tax on his/her salary and housing allowance unless he/

she has applied for self-employment tax exemption. Additionally, ministers are exempt from income tax withholding. **It is important to note that this does not mean that ministers are exempt from having to pay income tax; rather, the church does not have to withhold income tax from his/her pay.** However, according to IRS Publication 517, a minister "can enter into a voluntary withholding agreement with the church to cover any income and self-employment tax that may be due."

For any and all non-ministerial employees, the church, as the employer, is responsible to withhold appropriate taxes. **Unless the church files a timely Form 8274, it is required by law to withhold federal, Medicare, and Social Security tax on all employees of the church who are not ministers.**

This is perhaps the one area that can cause a church the most "hiccups" when it comes to church payroll. To help further your understanding, we will take a look at the difference between an employee and a contract worker. Then, we will take a look at the unique status of ministers.

EMPLOYEE VS. CONTRACT WORKER

In order to understand the unique status of ministers, you must first understand how the IRS classifies an employee vs. a self-employed individual (contract worker). Once that is clear, you will be able to better understand the unique status of ministers.

Oftentimes, when a church hires a worker, one of the most important, initial decisions the church must make is whether to treat the worker as an employee or contract worker. Many churches mistakenly believe that this decision is up to their discretion, when in reality, the federal government uses common-law rules to determine whether a worker is an employee or contract worker.

IRS Publication 15-A states,

> *"Under common-law rules, anyone who performs services for you is generally your employee if you have the right to control what will be done and how it will be done. This is so even when you give the employee freedom of action. What matters is that you have the right to control the details of how the services are performed."*

Common-law rules are composed of three factors: behavioral control, financial control, and the relationship of the parties. Following is a brief look at each.

- **Behavioral control:** Does the church have the ability to dictate how and when the person performs his/her duties? If so, the individual is an employee.
- **Financial control:** Does the church control the business aspects of the person's job? Is the

individual able to seek other job opportunities? If the worker is not permitted to seek other job opportunities then he/she is an employee of the church.

- **Relationship of the parties:** Does the individual provide duties/services that are vital to the church's existence? If so, he/she is an employee.

Using what we have just learned, let us take a look at an example to help solidify our understanding.

Many churches utilize the talents of various musicians to help lead worship on the praise team. To show appreciation for their time and talents, a church often compensates these musicians. In most instances, the church pays the musicians in cash and then gives them each a 1099-MISC at the end of the year.

However, based on what we just learned, is this correct? The answer is actually, NO!

Here is why:

> *"Church musicians are considered employees of the church and should each receive a Form W-2 rathern than a 1099-MISC."*

When we look at the common-law rules then we see that these musicians actually meet two of the three factors discussed above: behavioral control and relationship of the parties. Here is how:

Behavioral control: The church lets the musicians know when they need to be present. Their presence is generally required on Sunday mornings during the worship service, and in some instances they may even need to attend a weekly worship practice.

Relationship of the parties: Most often, the musicians provide a service that is integral to the worship gathering, as their absence from a given worship service could greatly impact the experience of the worshippers attending that gathering.

Therefore, in such instances, church musicians are considered employees of the church and should each receive a Form W-2 rather than a 1099-MISC. According to the IRS, "what matters is that you have the right to control the details of how the services are performed."

THE UNIQUE STATUS OF MINISTERS

The dual tax status of ministers

According to IRS Publication 517, most ministers have a dual tax status. **What this means is that a minister is an employee of the church for federal income tax purposes and self-employed for Social Security purposes.**

Oftentimes, churches treat their pastors as self-employed persons and assume that they can issue pastors a Form 1099-MISC. In actuality, since a minister is usually considered an employee under common-law rules, the minister should be treated as an employee for federal income tax purposes and should receive Form W-2 indicating the wages that the church paid to him/her.

When it comes to Social Security taxes, the minister is considered self-employed and is responsible to pay 100% of those taxes. Unlike the rest of the taxpaying population, when a minister completes his/her tax return, **he/she is responsible for paying federal income tax and self-employment taxes.** For instance, when a person works a secular job, the employer withholds federal income tax and Social Security tax. That simply is not the case for a minister because of his/her dual tax status. Therefore, a minister employed by your church should receive a Form W-2 indicating his/her wages earned from the church, and not a Form 1099-MISC.

Now that you have a better understanding of how the IRS classifies an employee using common-law rules, and that ministers have a dual tax status, allow me to give you some recommendations pertaining to church payroll that will help your church to maintain financial health.

4 CHURCH PAYROLL RECOMMENDATIONS

1. Decide who handles payroll

Choose early who will handle your church's payroll. If you decide to keep payroll in-house, it is important that the church carefully calculate how much federal income tax to withhold. (See IRS Publication 15 as a reference.)

Keep in mind that your church should not withhold Social Security and Medicare tax from ministers unless there is a voluntary withholding agreement. If you decide to hire a professional payroll company, make sure that the company you choose has experience with churches.

2. Collect a completed Form W-4 from each employee

Form W-4 is used to gather the information necessary to withhold the correct amount of taxes. The

IRS requires employers to keep this form in their records at all times.

Whether you have a minister (especially if he or she has entered into a voluntary withholding agreement) or a regular employee, this is an important and necessary step to take to ensure that the correct amount of tax is deducted. This form will not be submitted to the IRS.

3. Choose a payroll frequency

In my experience, most churches that do their own payroll prefer a weekly pay schedule, and those who hire a payroll company prefer a biweekly and sometimes monthly payroll.

No one way is better than the other. The important part is that your church choose a payroll schedule that it can manage.

4. Know which informational returns to use

If you have more than one employee then you are required to file a quarterly Form 941. This form needs to reflect the grand total of wages subject to federal income tax withholding, Social Security and Medicare tax, and how much tax was withheld and sent to the IRS.

If the minister is the only person receiving compensation and he or she does not have a voluntary withholding agreement in place, the church technically does not have to file a quarterly Form 941. **However, it is recommended that your church still file Form 941.**

In this instance, you would simply indicate $0.00 on Form 941 since ministers are responsible to withhold their own taxes. Most likely, once the IRS has received a year's worth of Form 941's indicating $0.00, it will send you a letter requesting the church to instead file an annual **Form 944.**

Take note that once your church begins paying a non-ministerial employee, you will be responsible to file a quarterly Form 941.

Individuals classified as employees will receive Form W-2 from the church, and contract workers that receive more than $600 in yearly earnings from the church will receive Form 1099-MISC. In addition, it is necessary that you receive Form W-9 from contract workers and guest speakers.

Your church will then need to submit to the IRS copies of all W-2 statements with Form W-3, and copies of all 1099-MISC statements with Form 1096.

STEP 6: ESTABLISH REIMBURSEMENT PROCEDURES

Reimbursements can save your church or ministry from a tough spot by allowing staff the freedom to make needed purchases for ministry operations when a church debit/credit card is not available. However, reimbursements can also get your church into a world of trouble if you do not handle them properly.

The last step being presented to you in order to have a financially healthy church is to make sure that you establish proper reimbursement procedures. Now, before we get into the "nitty-gritty" of what this will look like for your church, I want to present you with an example of how reimbursements are commonly handled amongst churches.

> *"Reimbursements can also get your church into a world of trouble if you do not handle them properly."*

A COMMON EXAMPLE

It was his custom to take guest speakers to lunch or dinner after a church service. Pastor John felt it was part of being hospitable. In fact, he held on to Galatians 6:10, which commands us to "do good to all people, especially to those who belong to the household of faith." And so, as was his custom, he always took guest speakers out to a meal, paid for it out of his pocket, and then turned in the receipts while requesting a reimbursement from the church.

Everyone would agree that such a practice is not only common, but also good.

However, when his personal income tax return was audited, the agent had a problem...not with the practice, but with the way in which it was done. **Now pause for a moment and ponder this:** The practice was OK but the method was wrong, and it cost him dearly.

HERE IS HOW PASTOR JOHN DID IT

Guest Speaker X spoke at Pastor John's church, and after the service, Pastor John and his wife invited Guest Speaker X and his wife to lunch, which cost a total of $97.00 (tip included). Afterward, Pastor John turned in the receipt to get reimbursed for the cost of the lunch. The church treasurer then wrote him a check for $97.00. It may seem difficult to believe that this got Pastor John into trouble, but it did, and here is why.

1. Pastor John's church did not have an accountable reimbursement policy in place that meets IRS requirements in section 62 of the tax code.

2. Pastor John's wife was not an employee of the church. Therefore, the cost of her meal is not allowed to be included in the entertainment expense because they could not document that it served a legitimate business purpose.

HOW PASTOR JOHN SHOULD HAVE DONE IT

This type of transaction is referred to as an "entertainment expense," and such expenses have very strict reporting requirements in order for them to be legal. Below are the five requirements.

1. The church has to have an accountable reimbursement policy that meets the requirements of section 62.

2. The meal has to be directly related to the ministry.

3. The meal has to occur directly before or immediately after a substantial business-related activity. This means that the meal has to be immediately before or after the service.

4. The pastor must submit the reimbursement request using a church approved reimbursement form that allows him/her to document the purpose of the expense and how his/her spouse helped to serve a business purpose.

5. The pastor must attach the receipt to the reimbursement form.

When done right, the ability to reimburse one's church-related expenses can be very convenient to the organization. With a well-established reimbursement policy, your staff knows when expenses are reimbursable and when they are not. This plan also keeps the board from making costly mistakes that can jeopardize your organization's tax-exempt status.

Perhaps you are not too familiar with the necessity of your church having an accountable reimbursement plan. Because it is vital to your church's financial health, we will now take some time to address this topic.

THE ACCOUNTABLE REIMBURSEMENT PLAN

The IRS defines reimbursements as "a system or plan that an employer uses to pay, substantiate, and recover the expenses, advances, reimbursements, and amounts charged to the employer for employee business expenses."

Simply put, reimbursements are a way for staff members to recover personal expenses made on behalf of their employer's business.

The key here is that any employee expense that is reimbursed must be **substantiated** (i.e. there must be proof that the expense was a necessary business expense). **Documenting the "when, where, and why" of an expense holds the employee or staff member accountable for the reimbursement he or she is requesting.** This documentation is the proof that the employee's funds were truly used for a business expense necessary to keep your organization going. The fact that the employee's expense on behalf of the business was **"accounted for"** makes the reimbursement nontaxable.

> *"Documenting the 'when, where, and why' of an expense holds the employee or staff member accountable for the reinbursement he or she is requesting."*

Non-accountable reimbursements

Many churches and ministries are guilty of allowing non-accountable reimbursements. Here is one example. A church gives the pastor a gas allowance of $200.00 per month. The church board does it to cover the pastor's gas as he uses his personal car to do church ministry. Every month, the church issues him a check for $200.00 and writes "gas allowance" on the memo, assuming that he is being reimbursed for his gas.

While that may be true, the IRS considers this a non-accountable reimbursement because there is no official record of the actual miles for which he is being reimbursed. **Under current regulation, non-accountable reimbursements must be treated as gross income and must be reported on the recipient's tax return as wages.**

Now maybe you are beginning to wonder, "What, exactly, can be reimbursed?" We will examine that next.

WHAT CAN BE REIMBURSED?

Your organization can reimburse legitimate business expenses needed in order to operate your corporation. ***There must be a business-related reason for the expense to be reimbursed.***

Even with this understanding, determining where to draw the line with reimbursements can be fuzzy. Sometimes your ministry may not have funds to reimburse every expense. If you have an established budget, this makes managing reimbursements much easier. Those with access to spending accounts should know the types of purchases they are authorized to make. Clearly communicating to the staff that only expenses made according to the church's budget will be reimbursed helps ensure that everyone is on the same page.

As it is important to have a good understanding of what can be reimbursed, it is just as important to know what cannot be reimbursed, which is our next topic of examination.

WHAT CANNOT BE REIMBURSED?

Business expenses that are claimed as a personal deduction on a tax return cannot be reimbursed by an employer. For instance, if a pastor pays the rent for his new church and properly claims it as an unreimbursed business expense on his tax return, that pastor is not able to also receive a reimbursement from his church. He has already used a tax deduction to recover the expense of the rent he paid on his ministry's behalf.

Additionally, keep in mind that every reimbursed expense must be substantiated. Usually, substantiation is proved using receipts; however, the receipts should be accompanied by a log detailing where all monies were spent in order for the expenditure to be considered accountable. If an expense is made, but no receipt is retained and no log is kept, then there is no way to validate the expense and therefore, it cannot be considered accountable.

Additionally, according to IRS Publication 463, reimbursements must be requested within 60 days of incurring the expense. After this time frame, the organization is not permitted to offer a reimbursement. In this instance, what options are available to an individual with unreimbursed expenses?

WHAT TO DO WITH UNREIMBURSED EXPENSES

There may be times when you need to make a legitimate business purchase for the church, but the church is unable to reimburse you. There are several situations that can lead to this, and solutions to accompany them as well.

If an employee of the church makes an authorized purchase with his or her own money, then submits a reimbursement request along with a receipt, the church does have the option not to reimburse the employee. If the church does not have the funds to cover the reimbursement to the employee, then the church may issue a denial. At this time, **the employee may claim the purchase as an unreimbursed business expense and claim a deduction for the amount on his/her personal income tax return. However, this is only true if the church has an accountable reimbursement plan in place.**

WHEN REIMBURSED FUNDS ARE NOT RETURNED

In addition to unreimbursed expenses, there may be times when an employee receives too much of a reimbursement or an advanced reimbursement that is more than the expenses incurred. **If an employee receives too much of a reimbursement, or if he or she receives an advanced reimbursement and does not use the entire amount, the unused funds must be returned to the church/ministry.** Any unreturned funds must be counted as taxable income for the person who received them because there is no substantiation to prove that the funds were used for church purposes.

Any advanced reimbursement that is not used must also be returned in a timely manner. The IRS also states in Publication 463 that you have 120 days to return the funds. After that time frame, the reimbursement must be considered taxable income and listed on the employee's W-2, or on the 1099 for an independent contractor.

120 DAYS

"Any advanced reimbursement that is not used must also be returned in a timely manner. You have 120 days to return the funds."

HOW TO PROPERLY HANDLE REIMBURSEMENTS

Every church should have an accountable reimbursement policy in place in order for a reimbursement to be considered accountable. The policy should clearly explain the principles of business connection, the substantiation, and the return of unused funds, as well as how any infractions on those principles would result in denial of reimbursement. The policy should also state the correct manner of reporting any expense on the employee's W-2 or 1040.

The policy should explain the protocol for taking an unreimbursed business expense deduction in the case that the organization cannot support the reimbursement at that time. The policy should also explain that a denial letter with an explanation as to the reason for denial shall be issued to any employee with a legitimate business expense that simply cannot be reimbursed at the time.

Furthermore, when an employee needs to report a reimbursement, he or she should fill out a reimbursement request form and turn it in to the church, or proper church personnel, for reimbursement.

Adopting and implementing an accountable reimbursement policy is an important and necessary step towards having a financially healthy church. If your church is in need of an accountable reimbursement policy and/or a reimbursement request form, you can click here to download the policy, and here to download the request form.

CONCLUSION

Every pastor wants his or her church to succeed. While having a financially healthy church is by no means the most important and only way for that to happen, it is an important factor. At StartCHURCH, we understand that your job as pastor is not easy, and at times it may feel like you are fighting an uphill battle. That is why we created this eBook. We are cheering you on, and we want to help you and your church succeed by providing you with resources like this.

Within the eBook, we looked at six steps that you can begin taking today towards having a financially healthy church. Perhaps some of the steps or concepts introduced in this eBook are new to you, which is okay. When you begin to apply yourself to learning what was presented, then you will begin to see positive change take place; you will begin to see and experience a financially healthy church.

But you cannot stop here.

Having a financially healthy church is a continual process. It is something that requires discipline and diligence. However, it is not a goal for you to tackle alone. As a pastor you have so many other responsibilities that it can be easy to get overwhelmed, and the first thing that tends to take a backseat is the church's financial bookkeeping. **This is where we can help!**

We know that in the same way you strive to live above reproach before others, you also want your church's financial bookkeeping to be above reproach, which is why we created the StartCHURCH Bookkeeping Service.

Our bookkeeping service employs the latest strategies in financial management to help protect and grow your ministry, while easily and strategically helping you manage, record, and properly report your church finances. With the StartCHURCH Bookkeeping Service as your hub, you are well on your way to leading your ministry with the financial health and strength you have always wanted.

For more information on how our bookkeeping service can work for you, click here or feel free to give our office a call at 770-638-3444, and ask to speak with one of our representatives.

END NOTES

[1] American Psychological Association; "Stress in America: Paying With Our Health"; http://www.apa.org/news/press/releases/stress/2014/stress-report.pdfConclusion

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