Finance, Tax, and Accounting Best Practices

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This paper examines best practices in nine areas of finance, tax, and administration.

1. Payment/reimbursement of non-employee spouse and dependent travel

The Tax Code distinguishes between payment or reimbursement of ordinary and necessary business expenses and personal expenses.[1] Travel expenses incurred by an employee in ordinary course of his or her employment are therefore payable or reimbursable on a tax free basis. Such expenses incurred by a non-employee spouse[2] or dependent when accompanying an employee are deductible (and therefore reimbursable) if the spouse or dependent's "presence on the employee's business trip has a bona fide business purpose and if the employee substantiates the travel [pursuant to an accountable expense reimbursement plan]."[3] Alternatively, travel expenses incurred by a bona fide volunteer may be reimbursed to that volunteer on a tax free basis.[4] If the travel expenses of non-employee spouse and/or dependents do not meet the bona fide business purpose test, then reimbursement of such expenses creates taxable wages for the employee, wages that are subject to income tax and employment tax withholding.

Expenses serve a bona fide business purpose if they:

- Are more than incidental;[5]
- Are ordinary, necessary, and directly attributable to the conduct of a trade or business;[6]
- Are necessary to the conduct of the employee's business;[7]
- Are "[r]equired or necessary for the business";[8] and
- Involve "substantial services directly and primarily related to the carrying on of [the employee's] business".[9]

Accordingly, if your organization pays for the travel expenses of a non-employee spouse and/or dependents during home assignment, the bona fide business purpose of the spouse and/or

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[1] I.R.C. § 162 permits a deduction for "ordinary and necessary business expenses." I.R.C. § 262 disallows a deduction for "personal, living, or family expenses."
[2] For purposes of this paper, a non-employee spouse includes a spouse who is an employee but for whom the subject travel is outside the scope of his or her employment.
[3] Treas. Reg. §§ 1.132-5(t)(1) and 1.162-2(c).
[4] Letter from the IRS to U.S. Senator Richard Durbin dated August 11, 2006.
[5] Treas. Reg. § 1.162-2(c).
[6] Rev. Rul. 56-168.
[7] Rev. Rul. 55-57.
[8] Rev. Rul. 55-57 (*citing Stokby v. Comm'r*, 12 T.C.M. 761 (1953).
[9] *Hosbein v. Comm'r*, T.C. Memo 1985-373 (1985) (*citing Weatherford v. United States*, 418 F.2d 895, 897 (9th Cir. 1969)).

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dependent's purpose should be substantiated. A volunteer's presence should similarly fulfill a bona fide business purpose to justify his or her classification as a volunteer.

The following services performed by a spouse have been deemed to be *insufficient* to find a bona fide business purposes:

- Typing notes from a meeting;[10]
- Accompanying the employee-spouse to luncheons or dinners;[11]
- Mere presence of the spouse;[12]
- Services that were merely "helpful" and not "necessary" (translating services were found to be necessary);[13] and
- Attending a conference at the request of a company vice president and working in the company "hospitality suite".[14]

Finding a bona fide business purpose

Material participation of a spouse and dependent in church meetings, meetings with donors, and similar home assignment activities should constitute a bona fide business purpose. However, it would be difficult to demonstrate material participation by minor children, particularly very young children, and merely being present at such home assignment activities would at least facially be insufficient.

Might the impact of the presence of an intact family on fundraising justify the presence of a spouse and dependents?

It is at least anecdotally clear that fundraising is more effective when the entire family unit is represented at a church or other fundraising event. This raises the question of whether empirical data could be gathered to demonstrate this as a fact in support of the mere presence of the intact family as a bona fide business purpose.

Disney Case

There is an older case[15] involving the spousal travel of the wife of Roy Disney that validated the payment of her travel expenses when accompanying Mr. Disney. Mrs. Disney's activities while accompanying Mr. Disney were largely social or aimed at generating goodwill. It's unclear how useful this case would be today.

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[10] Rev. Rul. 56-168.
[11] Rev. Rul. 56-168.
[12] *Hosbein v. Comm'r*, T.C. Memo 1985-373 (1985).
[13] *Kerr v. Comm'r*, T.C. Memo 1990-155 (1990).
[14] *Johnson v. Comm'r*, T.C. Memo 1966-164, (1966).
[15] *United States v. Disney*, 413 F.2d 783, (9th Cir. 1969).

Best Practices

First, institute a policy that requires that the bona fide business purpose be documented for each business trip. Second, determine whether it is appropriate to classify a non-employee spouse as a bona fide volunteer. Third, examine fundraising records to determine if data exists to demonstrate empirically that the presence of an intact family can be demonstrated as a benefit to accomplishing the fundraising objective.

2. Payment of children's education expenses

Expenses associated with the K-12 education of children are a personal expense of the parents. Accordingly, to the extent such expenses are paid by the employer, they are compensation to the parents.

The survey of mission organization practices revealed that a variety of methods are used to provide for children's education, including:

- Boarding school
- Day school for expatriate children
- Local schools in the host country
- Teachers provided by the mission
- Homeschooling
- Online or distance education programs

Each of these forms of education may include some costs. To the extent such costs are paid for by the mission agency, either directly or from the missionary's support account, the cost is taxable to the missionary.

Where the mission provides teachers to educate missionary children, the cost of providing this service should be taxed to the parents of the children served. The taxable cost may be determined by a survey of comparable education alternatives as opposed to simply dividing the salary and benefits among the children.

College expenses are similarly deemed a form of compensation to the missionary. Some mission organizations may have a scholarship program with the intention that scholarships awarded to missionary children are tax-exempt to the employee-parents and/or the recipient. The IRS has issued guidelines for employer scholarship programs that impose certain requirements on the number of employees and children of employees who may receive scholarships to avoid disguised income.[16] Absent compliance with those guidelines, it is likely such scholarships are taxable to the children.

[16] Rev. Proc. 76-47

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Best practice

The cost of providing for the education of missionary children should be included in the taxable wages of the parents.

3. Children's travel expenses to and from college

The cost of transporting a college-bound or adult child from the field to their country of nationality does not serve a bona fide business purpose; it is a personal expense of the family. Accordingly, payment of this expense by the mission organization or from the parents' ministry account results in a taxable expense to the family.

Similarly, a policy that covers the cost of a child traveling to his or her parents' country of service during college, regardless of the number of such trips allowed, does not serve a bona fide business purpose. Accordingly, payment of this expense is taxable to the parents.

Best practice

The cost of providing for travel for college age children to and from college to their parents' country of service should be included in the taxable wages of the parents.

4. Use of preference/variance language in fundraising materials

Contributions to a charitable organization must be subject to the discretion and control of the organization to be a completed gift eligible for a charitable income tax deduction. A contribution earmarked for a specific individual may be deemed by the IRS to be a gift to the individual instead of a gift to the organization. A 2000 letter from the IRS to an *ad hoc* group detailed several guidelines designed to demonstrate discretion and control including[17]:

- Setting salaries by reference to considerations other than an amount of money a deputized fundraiser collects;
- The absence of any commitment that contributions will be paid as salary or expenses to a particular person; and
- Regular communication to donors of the organization's full control and discretion over all its programs and funds through such means as newsletters, solicitation literature, and donor receipts.

The IRS has suggested the use of the following language in solicitation materials:

> Contributions are solicited with the understanding that the donee organization has complete discretion and control over the use of all donated funds.

[17] A copy of this letter appears in Appendix A. In addition, the IRS published a discussion of deputized fundraising in its 1999 continuing education materials.

This language can be augmented by language (printed on response devices or by the donor on his or her check) in which the donor expresses his or her preference, but not direction, as to the use of his or her contribution.

In addition, the IRS has suggested the use of the following language on donor receipts:

> This contribution is made with the understanding that the donee organization has complete control and administration over the use of the donated funds.

ECFA has published a small book entitled Charitable Giving Guide for Missionaries and Other Workers that includes a detailed discussion of these guidelines.

In addition to exercising discretion and control over contributions received, a charitable organization must honor restrictions a donor places on contributions made.[18]

5. Support account balances upon separation from service or death

As noted above, support account balances are the property of the mission organization. Failure to manage support account balances consistent with this legal reality calls in to question the tax treatment of the funds upon contribution.

Because the funds are the property of the mission organization, the missionary who raised the support should not have unfettered discretion to direct the use of the funds upon separation from service or death. Rather the disposition of the funds should be subject to the control and discretion of the organization. A support account balance should not be transferred to the missionary personally, other than as compensation approved by the organization. In addition, in the case of a death, the funds are not includible in the missionary's estate nor subject to the claims of the missionary's creditors or heirs.

Best practice

A policy should exist that governs the disposition of a support account. This policy should be coordinated with donor expectations as to the use of funds as disclosed in fundraising materials. The policy may specify that such funds are transferred to the unrestricted general fund, to a field account, to a project account, to another missionary account, or at the discretion of the organization.

In addition, if a missionary is permitted to make a request governing the disposition of his or her support account balance, the governing board or a delegated management committee should review and approve:

[18] A restriction differs from an earmark in that a restriction limits the use of a gift to program or project that is consistent with the charitable organizations exempt purpose as opposed to the charitable organization serving as a conduit for a gift to a third party.

- A missionary’s request to transfer a support account balance to a successor organization where the missionary is now employed; or
- A missionary’s request to transfer a support account to another missionary’s account, a project account, or a field account.

6. Payment of support account balances post-retirement

There are two key issues to resolve when discussing paying retirees a stipend from continuing contributions to the retirees’ support account:

(i) The rationale for making the payment so that the payment is not impermissible private benefit; and
(ii) Tax reporting of the payment.

The whitepaper in Appendix A discusses this in detail and lays out at least one perspective on this issue. However, in brief, consider the following.

Note that for donors to receive a charitable contribution deduction for their contribution, the contribution must become subject to the ownership of the organization and its discretion and control. If the source of payments to a retiree who is no longer providing services to the organization is funds which belong to the organization, then the organization must have some basis to justify making the payment. Absent either employment or a qualified retirement plan, a payment to the retiree would likely be impermissible private benefit. However, payments may be made in relation to prior employment.

Note, Rev. Rul. 55-422 provides for tax-free gifts to retired ministers by their congregations. Some may point to this revenue ruling to assert that payments made to a retired missionary should similarly be tax exempt. I believe this interpretation is problematic for a few reasons. First, among the facts asserted in Rev. Rul. 55-422 was the existence of “far closer personal relationship between the recipient and the congregation than is found in lay employment relationships.” I believe the IRS would have difficulty finding this “closer personal relationship” where an individual’s relationship was limited to infrequent contacts during home assignment. Second, the payments are made through the intermediation of the mission board and its aggregation of gifts from donors who may not have a shared relationship. The intermediation of the mission organization-employer coupled with its assumption of ownership of the funds breaks the direct nature of the relationship between the donors and the missionary. This further infringes on the existence of a “closer personal relationship.” Finally, the enactment of I.R.C. § 102(c) in the Tax Reform Act of 1986, which does not permit an employer to make a tax-free gift to an employee, appears to further limit the application of the reasoning that animates Rev. Rul. 55-422. Thus, while Rev. Rul. 55-422 has not been withdrawn by the IRS, it would be a very slender reed on which to rely.

There is no direct authority that dictates the proper tax reporting method to use for payments made to missionary retirees from their support account. However; there are three potential tax reporting options:

(i) Form 1099-R
(ii) Form 1099-MISC
(iii) Form W-2

The instructions to Form 1099-R seem to limit the use of this form to qualified plans. Since these payments are not from a qualified plan, this form does not appear appropriate. If the payments are subject to income tax but exempt from FICA/Medicare tax or SECA tax, then this reporting method would appear to at least not create an improper result.

Whether Form 1099-MISC is appropriate to use is dependent on how you believe payments should be taxed. If you believe the payments are subject to income tax, but not subject to FICA/Medicare tax nor SECA tax, then reporting the payments on Form 1099-MISC using Box 3 would create this result. Note that this treatment is arguably proper for the continuation of payments to a non-employee spouse.

If you want to use an approach that ultimately defers the question of social security system taxation to the recipient, then reporting on payments on Form 1099-MISC using Box 7 would allow the recipient to argue the point with the IRS. I know of at least one or two cases where this has resulted in a successful removal of penalties for non-payment of SECA tax after some back and forth with the IRS.

Note that in either approach to using Form 1099-MISC (i.e., Box 3 or Box 7), if the payee was a minister when they performed services for your organization, it may be possible to treat a payment as a minister's housing allowance, in whole or in part. If this is done, then the amount treated as a minister's housing allowance would not be reported on the Form 1099-MISC. Rather, it would be reported in a separate letter for the recipient to provide his or her tax preparer to determine if any portion is subject to income tax. Note that if the payee is a non-employee spouse, the payee would not be eligible for a minister's housing allowance.

Using a Form W-2 is clearly the most conservative approach, but it has the highest cost. This is because it requires FICA/Medicare withholding and payroll tax for non-ministerial employees. However, if the employee was a minister, then the payment should not require FICA/Medicare withholding. Rather, follow normal minister withholding rules, which would require the recipient to file a Schedule SE and pay self-employment tax (or not and argue this point with the IRS). This means that if the employee was a minister, you can authorize a portion or all of the payment is a minister's housing allowance, which would then be excluded from Box 1 and (optionally) shown in Box 14. Note that if the recipient is a non-employee spouse, it is probably not appropriate to use a Form W-2. Rather, I recommend using a Form 1099-MISC and

reporting the payment in Box 3. In addition, a non-employee spouse would not be eligible for a minister's housing allowance.

Best practice

Adopt a board resolution authorizing payment from a support account to retirees. Consider whether prior service will be mentioned this resolution. Including a reference to prior service is a two-edged sword. It establishes a foundation for authorizing the payments, but also sets up a rationale for treating the payments as reportable on a Form W-2. Further consider whether there should be a means component to be eligible for the payments. This could create an alternative rationale for the payments, but it's effectiveness for this purpose is speculative at this point.

With respect to tax reporting, as an initial matter, it is a best practice to report these payments as taxable compensation to the recipient. The method of reporting remains an open question, but an organization should consider the rationale discussed in this paper in forming its own conclusion as to the appropriate method. Once a method is selected, it should be consistently followed to avoid undermining the position by waffling back and forth.

7. Employment classification/income tax reporting of married employees

An historical practice of some mission organizations has been to treat married couples as a "unit" and to only treat one spouse as an employee for payroll purposes. The practice has been falling out of favor. Survey respondents reported the following practices:

- 43 of 78 respondents reported that both spouses are treated as employees if they are providing services
- 18 of 78 respondents reported that only one spouses is classified as an employee regardless of the services being provided by the other spouse
- 6 respondents reported that they leave this up to the couple

There are several reasons why treating both spouses as employees is a best practice.

1. Paying only one spouse may create a risk that the non-employee spouse has a cause of action for nonpayment of wages. Depending on the jurisdiction, be it in the U.S. or international, it may be possible for a non-employee spouse to make a claim that they are owed wages for work performed. Classification of the non-employee spouse as a volunteer, including the individual's agreement to such a classification, may provide some protection, but this would not be an absolute protection. Much of this will depend on just how angry and disgruntled the non-employee spouse is.
2. This historical practice has an implicit gender bias as, in the vast majority of cases, the husband would have been the employee of record. Accordingly, the practice is likely to

create a barrier to recruiting new missionaries from recent members of recent generational populations.

3. Each spouse develops his or her own record of Social Security earnings. This ensures that each spouse will be eligible for a Social Security benefit at retirement.

   Arguments that putting all of the earnings in one spouse's name will increase the size of the retirement benefit don't hold up. My own computation of income split equally between spouses over a period of 35 years preceding retirement (assumes these are the highest 35 years of earnings), shows that paying both spouses produces a resulting benefit that is 129% of what the benefit would be if the same compensation has been paid to only one spouse.

   In addition, the reality of life today must account for divorce and depriving one spouse of the opportunity to create a record of Social Security earnings will have a negative impact on that spouse in retirement.

4. Each spouse develops his or her own record of work credits for Social Security disability income. Eligibility for Social Security disability income is predicated on an employee accumulating 40 quarterly work credits, 20 of which were earned in the 10 years ending in the year in which the employee becomes disabled. An employee must receive at least $1,360 in wages in a quarter to earn a work credit for that quarter.

   If a spouse does not develop their own work credits, there is no opportunity for Social Security disability income in the event of a disability.

5. The foreign earned income exclusion is available to each spouse with earned income. While the foreign earned income limit is currently in excess of $105,000, for some couples this income level could be reached either because of taxable allowances or one-time taxable events.

6. In some foreign jurisdictions, married couples do not report their income on a joint return. If that country has a graduated income tax rate schedule, paying compensation to each spouse will allow them to each take advantage of the lower tax rate applicable to the first wages earned.

7. As discussed above, working condition fringe benefits related to spousal travel become moot if both spouses are employees.

Best practice

8. Processing personal gifts of family members and supporters

Historically missionaries traveled to faraway places with infrequent contact with family, friends, and supporters and it was difficult and/or expensive to transmit funds from the U.S. to

their country of service. Out of necessity, mission organizations served as a form of clearinghouse for communications between missionaries and their family members, friends, and supporters, including receiving cash and other gifts for further transmission to the missionaries in their field of service.

In today's global world, it is much less difficult to transmit such gifts. Moreover, missionaries are frequently gone for shorter periods of time than in the past, enabling more frequent personal contact with family members, friends, and supporters. These factors have mitigated the necessity for the mission organization to serve as a clearinghouse.

Additionally, there is concern over whether gifts from supporters meet the "detached and disinterested generosity" test set forth in *Commissioner v. Duberstein*.[19] This test examines the donor's intent in making the gift. Where a gift is in consideration of the missionary's missionary service, then it is possible, if not likely, that the IRS would deem such a "gift" to be compensation to the missionary that is subject to income tax. It is this same rationale that operates to treat love offerings by churches for the benefit of their ministers as taxable income to the ministers who benefit.

Best practice

The best practice is to not accept personal gifts for missionaries. An alternative, second best, practice recognizes that the historic rationale for accepting and forward such gifts continues to exist in certain circumstances. For example, in certain cases where there is limited access and/or the gifts from persons with a clear family relationship such that detached and disinterested generosity is clear. However, any receipts issued for such gifts should be clearly marked as non-deductible and include a statement that the gift was not to the organization.

9. Titling property purchased using support account funds in the name of a missionary

It is not uncommon for a mission organization to be unable to purchase property or automobiles in a missionary's country of service if the mission organization does not have a branch office or other legal presence in the country. The workaround is often to purchase the property or vehicle using the missionary as a straw purchaser.

However, without a legally enforceable agreement between the missionary and the mission organization, the legal reality of the relationship is that there has been a transfer from the mission to the missionary. In the absence of consideration on the part of the missionary, this transfer is as taxable transfer to the missionary—taxable as wages. Depending on the amount of the transfer, this could be an excess benefit transaction. In addition, this may be a donor communication issue.

[19] *Comm'r v. Duberstein*, 363 U.S. 278, 285, (1960).

Other issues may arise later. For example, in the absence of an agreement to the contrary, the missionary may take the property when he or she separates from service. Given that the title documents are in the name of the missionary, in the absence of a separate agreement, it may be difficult to get the property back. In the event of a death or divorce, the assets may be includible in the missionary's estate or be included in the missionary's marital property and be subject to the claims of heirs or a spouse.

To create the best opportunity to avoid these issues, one approach is to enter into an agency agreement with the missionary. This agreement should be enforceable in the U.S. and, if possible, in the missionary's country of service. In addition, the agreement should:

- Spell out responsibility for maintenance and insurance
- Include an obligation to return funds upon sale
- Be signed by the missionary and the missionary's spouse

Best practice

Enter into an agency agreement with the missionary and the missionary's spouse that is enforceable in the U.S. and in the country of service.

Appendix A

Payments to Retirees from Continuing Contributions to the Retirees' Ministry Account

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A number of organizations, particularly mission agencies, maintain ministry accounts for their ministry employees into which contributions are credited to an individual employee's ministry account for the purpose of paying ministry related expenses, including the employee's compensation. In a number of cases, these organizations historically did not maintain a retirement plan for their ministry employees (e.g., a defined benefit or defined contribution pension plan). In the absence of such a retirement plan, the organization has continued to receive contributions from supporters of a retiree's ministry and has authorized those contributed funds to be distributed to the retiree to fund living expenses in his or her (or his or her spouse's) retirement years.

There are two questions that arise with respect to these payments:

1. Are such payments proper?
2. How should such payments be treated for income tax purposes?

Propriety of Retiree Payments Funded with Current Contributions
As an initial matter, we assume that the donor making the contributions that will fund the payments to the retiree (1) desires an income tax deduction, (2) is a church or other exempt organization that is funding the contribution with funds for which it issued a tax deductible receipt, or (3) desires to make a nondeductible, nontaxable gift to the missionary. In either of the first two cases, the recipient organization must exercise absolute control and discretion over the expenditure of the funds. To document that the organization is exercising the requisite control and discretion, two things should occur:

1. The donor should indicate that his or her "preference" is that the contribution be used to support the ministry of the retiree (i.e., there is not a legally enforceable "earmark" of the funds); and
2. The organization's governing board should authorize the expenditure of funds received with this indicated preference to support the indicated retiree.

Because in the first two cases the funds are under the discretion and control of the organization and the payments are being made because of the prior employment relationship, the payments to the retirees are at a minimum taxable under the income tax and (to be discussed below) possibly taxable under either the FICA or SECA rules.

In the third case, as a nondeductible gift by the donor, then the funds paid to the missionary are possibly nontaxable gifts to the retiree. In this case, the organization is simply acting as a conduit for aggregating and remitting the funds to the retiree. However, it is important to note that the IRS is likely to analogize this type of gift to love offerings paid to a pastor, which are deemed to be taxable

compensation for services rendered because the motivation for the gift is the missionary's past service and not an act of "detached and disinterested generosity." In other words, if the motivation for the gift does not arise from some relationship other than the missionary support relationship, the IRS is likely to deem the gift to relate to the missionary's prior service.

This still leaves the question of whether an exempt organization can authorize payments to its retirees in this fashion. Remember, these payments are not from a qualified plan. Generally an exempt organization cannot make payments to private individuals unless those payments are in furtherance of its exempt purpose. This prohibition on private inurement or private benefit is rooted in IRC § 501(c)(3) which requires that an exempt organization be "organized and operated exclusively" for one or more identified exempt purposes. Payments to the retirees in isolation could be construed as a private benefit; however, when viewed in the larger employment context, are most properly viewed as an element of compensation. In the case of the retirees, because these are not payments from a qualified pension plan, these payments are compensation (i.e., wages) for past services rendered (or in some cases, past services rendered by the spouse of the recipient). It is not relevant that the former employee is not currently rendering services; rather it is relevant that they are eligible to receive the payments due to their prior service.

Based on the forgoing discussion, so long as the payments are properly authorized by the board in recognition of past services, the payments to the retirees should be proper.

How Should Payments to Retirees Be Taxed

As a starting point, we consider whether there is any authority for treating the payments as nontaxable to the retiree. As noted above, if the payments are gifts from the donor to the retiree (i.e., they are nondeductible gifts to the retiree and not the exempt organization), then it is perhaps possible to view the payments as a nontaxable gift from the donor to the retiree with the exempt organization simply fulfilling a facilitating role. However, as noted above, it is likely the IRS would contest this treatment.

We next consider whether, given the financial challenges most of the retirees face, the payments can be properly characterized as a benevolence payment to the retiree. As noted above, to consider the payments to retirees as properly issued by the organization, their prior status as an employee (or the spouse of an employee) is a key factor in finding that it is proper to make the payments. Internal Revenue Code (IRC) section 102(c) specifically requires that gifts to employees (and presumably this extends to payments to former employees that arise out of the employment relationship) are income taxable to the recipient. In other words, the tax code precludes an employer from making a tax-free benevolence payment to an employee.[20]

If the payments are neither nontaxable gifts nor benevolence payments, what is their tax character? As previously stated, the payments are not a pension plan payment under IRC section 401(a), 401(k), 403(b), or 457(b). Nor are they properly classified as a pension for tax purposes merely because they are being paid to a retiree. For these reasons it is not possible to treat these payments in the same

[20] This rule is somewhat abridged in the narrow instance of disaster relief.

manner as pension plan payments made from such a plan. Since they are not pension payments and relate to prior services rendered, they are more properly treated as wages (albeit wages paid well after the employment services were rendered). Wages are subject to income taxation and FICA and Medicare taxation.

How are deferred wages taxed? There are a couple of code sections that involve payments of deferred compensation. First, IRC § 457(f) involves amounts promised to an employee that are subject to a substantial risk of forfeiture. These payments may be deemed to have some risk of forfeiture because the organization has control over the authorization of the payments and could cease making the payments at any time. But in the present case, there is no binding promise that the payments will continue. Accordingly, the payments are not from a nonqualified deferred compensation plan described in IRC § 457(f) (although were the payments from such a plan, the payments would be subject to both income tax and FICA and Medicare tax when the risk of forfeiture was lifted).

Another possible analog (although imperfect) is a nonqualified deferred compensation plan described in IRC section 409A.[21] While imperfect, the analogy is apropos because in both a 409A plan and this circumstance, payments made relate to prior services. Further, in both cases there is no income taxation until the payments are received.[22] In addition, for purpose of the application of the FICA and Medicare taxes, amounts under a section 409A plan are taxed at the *later of* the date when the services creating the right to the amount are performed or are no longer subject to a substantial risk of forfeiture.[23] In the case of these retiree payments, the relevant date is the date the payments are made.

In both the case of a 457(b) plan and a 409A plan, the amounts paid are reportable on IRS Form W-2, not Form 1099-R.

Because these retiree payments are properly treated as wages, then the employer is responsible for paying the employer share of FICA and Medicare. The forgoing is only modified by the rule for ministers that compensation, including earned income, is not subject to income tax withholding, nor is it subject to FICA and Medicare withholding. Rather a minister is treated as self-employed and pays into the Social Security system (absent electing out of Social Security) via SECA payments.

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[21] The imperfection in the analogy is twofold. First, an IRC § 409A nonqualified deferred compensation plan is required to have a written plan document. Treas. Reg. § 1.409A-1(c)(3)(i). Generally these arrangements are not documented in a written plan document. Second, the regulations under IRC section 409A state that the deferral of compensation occurs when "the [employee] has a legally binding right during a taxable year to compensation that, pursuant to the terms of the plan, is or may be payable to (or on behalf of) the employee in a later taxable year." Treas. Reg. § 1.409A-1(b)(1).

[22] A key feature of section 409A is that it defers income taxation of benefits conferred under an unfunded nonqualified deferred compensation plan until the later of when they are actually or constructively received. IRC § 451.

[23] Treas. Reg. § 31.3121(v)(2)-1(a)(2).

Most organizations have three potential populations of individuals that are receiving payments:

1. Past employees who are receiving payments as a consequence of their prior employment and who were not ministers during their term of service with the organization;
2. Past employees who are receiving payments as a consequence of their prior employment and who were ministers during their term of service with the organization; and
3. Spouses of past employees who were not themselves employees.

We consider each of these groups of retirees below.

Prior Employees Who Were Not Ministers
For prior employees who were not ministers, the proper reporting of these post-retirement payments for tax purposes is to issue a Form W-2 and withhold income tax and FICA and Medicare tax from the payments.

Prior Employees Who Were Ministers
For prior employees who were ministers, the proper reporting of these post-retirement payments for tax purposes is to issue a Form W-2 without withholding income tax and FICA and Medicare tax from the payments. This defers the Social Security question to the recipient in consultation with his or her own tax adviser. It should also be possible to designate (in advance of the payments) a portion or all of each payment to be a housing allowance.

Spouses of Prior Employees
Although the payments received by spouses of former employees are related to their spouse's service, because the spouse was not himself or herself an employee, these payments are not related to prior service and are not subject to FICA/Medicare nor SECA. Accordingly, the most appropriate tax reporting approach seems to be to report the payments in Box 3 (Other Income) of Form 1099-MISC. In this case there would be no income tax withholding in addition to no FICA or Medicare tax withholding. The recipient should take into account this income when determining his or her quarterly estimated tax payments.

Obtaining More Substantive Authority
This is a complex question and is not suitable for obtaining an answer on which a taxpayer can rely by calling the IRS's general taxpayer assistance phone number. Rather, to obtain an authoritative response from the IRS on which the taxpayer can rely, the taxpayer would need to submit a formal request for a ruling. Such requests require the payment of a user fee of at least $28,300[24] plus the cost of professional time to complete the request.

Relying on the Experience of Others
We understand from anecdotal evidence that some taxpayers who have been audited have successfully avoided paying FICA and Medicare on the type of retiree payments described in this whitepaper. While this is good news for those taxpayers, absent a reasoned tax opinion from the revenue agent conducting the audit, the positive result it does not represent authority on which others can rely.

[24] See Rev. Proc. 2018-1, Appendix A § (A)(3)(d).

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