IRS Audit Prevention Strategies

Stay Off the Government's Radar

Strategic Framework for Preventing Church Tax Audits

Church Clergy Tax Management & Compliance

Today's Agenda

- Understanding IRS Church Audit Process
- Red Flags That Trigger Audits
- Documentation: Your Best Defense
- Compensation & Housing Allowance Protection
- Tax Filing & Reporting Safeguards
- Audit Prevention Checklist & Implementation

Understanding Church Audits: What You Need to Know

- IRS has **LIMITED authority** to audit churches (IRC Section 7611)
- IRS must have "reasonable belief" of noncompliance BEFORE audit begins
- Churches have **greater protections** than most nonprofits
- Audits typically focus on: compensation, unrelated business income, lobbying activity
- Church audits increasing: IRS targeting exam activity up 25% in past 3 years
- Most common trigger: **Housing allowance errors** (85% of church audits)

Your Protection: IRC Section 7611 Requirements

IRS MUST Establish

Reasonable belief based on facts that church has failed to comply with law

IRS MUST Issue

Written notice to church (not pastor) 10+ days before exam

IRS MUST Limit

Scope to 3-year period, cannot go back >10 years without special approval

Red Flags That Trigger IRS Audit Attention

- **Housing Allowance Issues** - No designation, retroactive changes, excessive amounts
- **Compensation Inconsistencies** - No board approval documentation, sudden increases
- **Poor Tax Filing** - Late/missing 990-N, inaccurate 1099s, no Form 8274 (housing allowance)
- **Sloppy Documentation** - No board minutes, no financial records, cash-only operations
- **Political Activity Issues** - Candidate endorsements, campaign activity, political messaging
- **Whistleblower Reports** - Former members/employees reporting noncompliance to IRS

Housing Allowance: CRITICAL Audit Prevention

❌ Common Mistakes

- No designation document
- Designated in January (after year starts)
- Using previous year's amount
- Retroactive designation
- No fair market value analysis

✅ Correct Process

- Board resolution in DECEMBER
- Effective JANUARY 1 of new year
- Specific dollar amount designated
- Fair market value research documented
- Form 8274 attached to tax return

Fair Market Value Analysis: How Much is Reasonable?

- **Fair Market Value (FMV):** Amount reasonable to pay for comparable housing in area
- **Cannot Exceed:** Actual expenses (rent, utilities, maintenance, property tax, insurance)
- **Research Method:** Local rental listings, comparable apartments, real estate agents
- **Documentation:** Keep research showing FMV determination (saves in audit)
- **Annual Review:** FMV may change yearly - should be revisited annually
- **Danger Zone:** Over-designating is largest audit trigger (over 150% of FMV)

Compensation: Documentation That Prevents Audits

- **Board Resolution:** Approved compensation documented in meeting minutes
- **Reasonableness Analysis:** Research showing salary is fair market value for role
- **Job Description:** Document duties, hours, responsibilities for each position
- **Independent Review:** Board approval process shows no conflicts of interest
- **Annual Documentation:** Repeat process annually, document if no change
- **Written Employment Agreement:** Spell out salary, benefits, housing allowance

Board Minutes: Your Strongest Audit Defense

Minutes Must Document

- Compensation amounts approved
- Housing allowance designation
- Major purchase approvals
- Conflict of interest disclosures
- Financial reports reviewed

Audit Impact

- Proves good governance
- Shows intentional decisions
- Demonstrates accountability
- Supports compensation reasonableness

Tax Filing Compliance: Eliminate Audit Triggers

- **Form 990-N (e-postcard):** Churches under $50K gross receipts MUST file if they want safe harbor
- **Form 990-N Accuracy:** Exact reporting of revenue, expenses, mission statement
- **Form 1098-T (Housing Allowance):** Provided to clergy with W-2 designation amount
- **Form 1099-MISC:** For independent contractors (not housing allowance recipients)
- **W-2 Accuracy:** Match 1098-T housing allowance designation exactly
- **Timely Filing:** File by May 15 deadline (or extension by August 15)

Form 8274: Housing Allowance Documentation

What It Is

Church provides this form to clergy showing housing allowance designated for tax year

Critical Details

Must show: church name, clergy name, amount, year, designation date

Audit Significance

IRS expects to see this form - missing Form 8274 = major red flag

Political Activity: Stay Within 501(c)(3) Boundaries

- **PROHIBITED:** Endorsement or opposition of candidates (IRS audit trigger)
- **PROHIBITED:** Campaign activity or funds to candidates/PACs
- **PROHIBITED:** Partisan messaging in sermons/publications on election issues
- **ALLOWED:** Issue-based discussion (abortion, religious liberty, taxes) without candidate ID
- **ALLOWED:** Voter registration & education drives (neutral, nonpartisan)
- **ALLOWED:** Inviting all candidates to speak on equal terms

Unrelated Business Income (UBIT): Common Pitfalls

- **Taxable UBIT Examples:** Parking lot revenue, commercial space rental, gift shop sales
- **Non-Taxable Examples:** Donations, membership fees, fundraising event revenue
- **Form 990-T Requirement:** If UBIT >$1,000, must file Form 990-T
- **Common Audit Issue:** Not reporting rental income or misclassifying revenue as donations
- **Prevention:** Categorize all revenue accurately, document sources, work with CPA on UBIT

Case Study: The Housing Allowance Disaster

Situation: Church designated $3,000/month housing allowance in January (after year started). No fair market value analysis.

The Audit: IRS audited for improper designation. Disallowed entire housing allowance as taxable income.

Result: Pastor owed $18K in back taxes (12 months × $3K × 50% effective tax rate). Church liable for penalties.

✅ **Prevention:** Board resolution in December, FMV analysis, Form 8274 on 1098-T form.

Case Study: The Missing Board Minutes Audit

Situation: Church audited, no board minutes for 5 years. Couldn't document compensation approval or housing allowance designation.

The Problem: IRS challenged $50K in "excess" compensation. No documentation of reasonableness analysis.

Result: IRS disallowed $20K, issued penalty for excessive compensation (20% accuracy-related penalty).

✅ **Prevention:** Monthly board minutes documenting compensation decisions eliminate challenge entirely.

IRS Audit Prevention Master Checklist

- ☐ Housing allowance designated in December BEFORE year begins (board resolution)
- ☐ Fair market value analysis documented and filed with church records
- ☐ Form 8274 provided to clergy with W-2 and 1098-T
- ☐ Form 1098-T issued with exact housing allowance designation amount
- ☐ Board minutes document compensation approval and reasonableness basis
- ☐ Compensation research (job descriptions, market analysis) documented annually
- ☐ Form 990-N filed on time (or 990-EZ/990 if larger church)
- ☐ No political endorsements or campaign activity recorded in minutes/materials

Audit Prevention Checklist - Continued

- ☐ UBIT revenue identified and Form 990-T filed if >$1,000
- ☐ Independent contractors properly classified (Form W-9, 1099-MISC issued)
- ☐ Financial statements reviewed monthly by board
- ☐ Bank reconciliation completed monthly by independent person
- ☐ Conflict of interest disclosures documented annually
- ☐ All compensation paid through documented payroll (not cash advances)
- ☐ No unreasonable perks (personal vehicle, country club, excessive travel)
- ☐ Annual audit or review engagement completed

Audit Prevention: 90-Day Implementation Plan

Days 1-30

- Review past 3 years tax filings
- Identify compliance gaps
- Research fair market value

Days 31-60

- Draft board resolutions
- Prepare compensation analysis
- Review Form 990-N accuracy

Days 61-90

- Board adoption of resolutions
- Issue corrected 1098-T forms
- File amended 990-N if needed

Documentation Templates to Prepare

- **Housing Allowance Board Resolution** - December designation template with FMV analysis
- **Fair Market Value Analysis Worksheet** - Document local rental research and calculation
- **Form 8274 Template** - Ready to provide with W-2 and 1098-T forms
- **Compensation Board Resolution** - Document job descriptions, FMV analysis, approval
- **Board Minutes Template** - Include compensation, housing, financial review sections
- **Form 990-N Checklist** - Ensure accuracy before filing

Critical: Work With Your Church CPA

- **Housing Allowance Guidance:** CPA should verify FMV analysis annually
- **Form 1098-T Accuracy:** Ensure exact match with board designation amounts
- **Form 990-N Review:** CPA verifies completeness before submission to IRS
- **Compensation Analysis:** CPA researches fair market value for role/size church
- **UBIT Identification:** CPA categorizes revenue correctly (donation vs. business income)
- **Audit Readiness:** Annual "audit health check" identifies compliance gaps

Key Takeaways

- Housing allowance errors trigger 85% of church audits - protect this first
- December board resolution for housing allowance is ESSENTIAL - never retroactive
- Documentation (minutes, resolutions, analysis) is your strongest defense
- Form 8274 on W-2 shows IRS you understand requirements
- Proper compensation documentation prevents "excess compensation" challenges
- Churches have protections (Section 7611) - but only if you file correctly

Stay Off the IRS Radar

Prevention is infinitely better than audit defense - implement safeguards now

Next: Attorney General Compliance Deep Dive

Thank You

Mastering IRS Compliance for Long-Term Tax-Exempt Protection

Questions & Discussion Welcome