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CHURCH EMPLOYEES AND SEVERANCE PAY

This legal memorandum provides guidance regarding whether, when, and how severance pay may be provided to church employees who are terminated from church employment. This memorandum is written partly in response to concerns among some church leaders that severance pay may be contrary to IRS prohibitions. Overall, however, severance pay may be lawful and appropriate under certain circumstances, provided that applicable safeguards are satisfied. A church's responsible governing body should carefully evaluate the propriety and amount of severance pay according to several factors as explained below.

1. When Should a Church Consider Providing Severance Pay?

Severance pay should be considered whenever a church employee is laid off, terminated with or without "cause," or resigns from church employment. Employment termination can result from a variety of circumstances, some of which may involve contentious people and very challenging issues. Severance pay thus may be an appropriate risk management tool for avoiding potential litigation, adverse publicity, and other claims against the Church. In addition, since many state unemployment laws exclude churches from mandatory unemployment insurance coverage, severance pay may be an appropriate substitute benefit for employees who are laid off or otherwise terminated absent misconduct. Severance pay should not be presented or perceived as a "bribe," however, since numerous legitimate considerations may favor its provision under certain circumstances. It also generally should not be utilized as a substitute for retirement benefits, however, particularly in light of the very distinct tax rules that apply for such deferred compensation.

2. For Whom Should a Church Consider Severance Pay?

Given the general ineligibility of church employees for unemployment insurance benefits, severance pay may be appropriate for many church employees subject to the following caveats. First, churches should be careful about consistency among employees, to avoid later claims of inequity and even unlawful discrimination among differently treated employees. Second, churches should scrupulously avoid any communications, such as in employee handbook provisions, that would lead employees to reasonably expect severance pay upon termination.

3. May Severance Pay Be Legally Provided?

a. Tax Prohibitions

As an initial matter, no payments – whether severance or otherwise – may be provided that constitute an improper private benefit. As tax-exempt public charities, churches are legally prohibited from allowing both insiders and persons outside their organizations to receive financial benefits from the church’s resources, except through either (1) a *quid pro quo* arrangement (e.g., reasonable wages paid for work performed); or (2) other payments in furtherance of the church’s religious purposes, such as benevolence. When insiders improperly benefit, this is known as “inurement” and is illegal. For insiders who are in a position to exercise substantial influence over the church, their receipt of improper financial benefits may result in substantial excise tax liability for both them and the church under section 4958 of the Internal Revenue Code.

b. Not a Gift or Benevolence

Some pastors and churches have argued to the IRS that severance payments amount to legitimate non-taxable income because they constitute gifts. However, the term “gift,” at least in tax parlance, means something given “from a detached and disinterested generosity . . . out of affection, respect, admiration, charity or like impulses,” with the key consideration being the transferor’s intent. (See Commissioner v. Duberstein, 363 U.S. 278 (1960)). If a church is paying a pastor or other employee in recognition for his or her prior service, then by definition such payment does not amount to a “gift” and therefore constitutes taxable income. More significantly for a church, if it is paying any employee a “gift,” then the critical question arises of whether this payment is an improper use of the church’s assets. An IRS finding that the payment is improper could jeopardize the church’s tax-exempt status, and this issue is therefore extremely serious. The recommended (albeit more conservative) approach here is to *never* to categorize severance pay as a “gift.”¹

Similarly, severance pay should never be categorized as “benevolence.” Like a purported “gift” to a departing employee, this treatment raises significant tax issues regarding the propriety of the church’s payment. Although it is well recognized that churches may provide benevolent assistance, the IRS likely would classify such a payment as taxable compensation that is directly related to the employee’s prior services as an employee. The only exceptions, which should be very rare, would be (1) if the employee were one of many people affected by an emergency or urgent crisis (e.g., a natural disaster in which blankets, water, or other supplies are given to injured persons), or (2) if the employee – substantially later in time after his or her employment termination – were in financial need and sought benevolence on the same terms as other needy persons. In both cases, church leaders have a legal obligation, as stewards of church resources, to carefully exercise due diligence in ascertaining the needs of potential benevolence recipients and assuring that the benevolent funds are used properly.

¹ Note, however, that a *de minimis* retirement gift of low monetary value ordinarily would be appropriate and non-taxable. Also, church members are free to give separate gifts to a departing employee, which of course would not be tax-deductible contributions to the church.

c. *Quid Pro Quo* Payments or Other Legitimate Purposes

Generally speaking, a church employee may receive severance pay as a *quid pro quo* arrangement – i.e., something paid in return for the employee’s prior work for the church. In addition, severance pay may otherwise be appropriate for legitimate business purposes. Such arrangements are common within the for-profit sector for a variety of reasons, and the business rationales for such payments may apply equally for churches. The operative question for a church, in light of its privileged tax-exempt status, is whether the severance pay is an objectively reasonable use of its charitable assets. The answer will depend on a due diligence evaluation of factors such as the employee’s longevity of employment, his or her service, the reason(s) for termination, risk management considerations, the absence of available unemployment benefits, and comparable practices among other churches (to the extent information is available).

4. Should Severance Pay Be Provided as a Legitimate Church Business Expense?

a. Practical and Legal Analysis

The due diligence inquiry should help lead the church’s governing body to a determination of whether severance pay is a justifiable and appropriate church expense and, if so, how much severance pay should be provided. Two examples may help to flesh out whether and when severance pay is appropriate.

One simple scenario is a pastor who faithfully serves a church for many years but decides to leave the ministry for personal reasons. The church may legitimately provide a severance package based on his years of service. One or two weeks of severance pay per year of work may be deemed appropriate depending on the pastor’s prior dedication and service to the ministry, his personal circumstances, the church’s financial wherewithal, other available financial resources for the pastor such as retirement benefits, and available information about comparable employment practices within similar churches.

Another scenario, which may be problematic and unfortunately all too common, is a church whose members are dissatisfied with a pastor and wish for him to leave. He may have engaged in offensive behavior, not led the church as the leaders wanted, or otherwise not measured up to expectations. In that case, the analysis may need to be focused more on the extent to which a severance pay arrangement will buy “peace of mind” for the church. In other words, it may be prudent and worthwhile to pay the pastor some amount of money in order to eliminate the risk of future claims or other problems stemming from the pastor’s termination.

The analysis of whether to provide severance pay should include the following considerations:

- (1) The circumstances of the termination and whether it is likely the terminated employee will later cause problems for the church through making disparaging statements about the church, disclosing confidential information, or damaging church property;

- (2) Whether the employee's cooperation will be needed in the future, such as to maintain confidentiality, communicate positively with members and donors, surrender passwords, or complete a long-term project;²
- (3) Whether any valuable personal property needs to be returned by the employee, such as a computer;
- (4) The likelihood of whether the employee would later assert contract, tort, or other claims against the church, such as for unpaid compensation or defamation;
- (5) Whether the employee falls within one or more legally protected classifications such as age (over 40), race, national origin, or disability, and for which he or she may try to assert a claim; and
- (6) Whether the possibility of a retaliation claim may exist under discrimination, whistleblower, or other work-related laws, for which the employee may try to assert a claim.

Any or all of these reasons, as well as other reasons, may justify providing a severance package to a terminated employee, in exchange for an express waiver of claims and an agreement to cooperate with the church in various matters. Note, however, that at least for employment discrimination claims, and some contract and retaliation claims, a church should ultimately be to avoid liability. As uniformly interpreted by courts, the First Amendment of the U.S. Constitution prohibits judicial involvement in pastoral employment qualifications, even when illegal activity is claimed. In addition, church employees are generally exempt from federal, state, and local prohibitions on employment discrimination. Nevertheless, lawsuits – even ones that are ultimately defeated – cost money to defend, can cause much negative publicity, and can easily distract a church's leaders from their ministry. Properly structured severance pay agreements thus can bring many tangible and valuable benefits to a church, making them appropriate and justifiable.

A severance package may likewise be very attractive to a terminated employee. The prospect of severance pay may be a helpful "carrot" to encourage his or her future cooperation. In addition to providing for severance pay, the agreement could include benefits such as mutual non-disparagement between the employee and the church, a neutral or positive job reference, and perhaps continued health benefits.

b. Unemployment Insurance Benefits

Under most state laws, churches are exempt from mandatory unemployment insurance coverage.³ This categorical exclusion may reflect a public policy assumption that churches – unlike many other organizations – will exercise more compassion and financial concern for their

² A church could pay an employee separately for later church work after termination, although rehire is typically not recommended for an involuntarily terminated employee.

³ If the church is in fact covered by unemployment insurance, such as if it has voluntarily elected to participate in the state unemployment insurance plan, then the church should be mindful that unemployment insurance benefits cannot legally be waived through a severance agreement or otherwise.

own employees. Accordingly, and to some extent, severance pay may well be legitimate and appropriate in lieu of unemployment benefits.

The overarching purpose of unemployment insurance benefits is to provide a safety net to unemployed persons who have not voluntarily resigned or been discharged for serious misconduct. Accordingly, benefits will generally be awarded to persons who are laid off, discharged for negligence or incompetence, or otherwise terminated from employment without clear proof of wrongdoing. Notably, benefits terminate upon re-employment or full-time student enrollment and, at least theoretically, are conditioned on the unemployed person's continuing active efforts to obtain new work. Thus, unemployed persons do not have an unconditional right to continued unemployment insurance benefits.

The amount of unemployment benefits are slightly less than half of an employee's former earnings, with upward adjustments based on marital status and dependents, and they are subject to a significant rate cap based on average wage earnings within the work force. For example, currently in Illinois, the maximum available weekly unemployment benefit is \$385 for an individual, \$458 for a married individual, and \$531 for an individual with a dependent. Unemployment benefits are also limited in duration, and typically they can last up to twenty-six weeks.

Based on the above information, a church's leaders may – but are not required to -- evaluate unemployment benefits to which a terminated employee would be entitled, if he or she were not a church employee. If it chooses to do so, then the church should include consideration of whether the terminated employee would otherwise likely be eligible for unemployment benefits, how much the benefits would be, and how long the benefits would likely continue. This evaluation should not be conclusive regarding whether and how much severance pay is provided, particularly since (a) no legal right exists for pastoral unemployment benefits, (b) an inherent uncertainty will exist regarding the length of unemployment, and (c) the church must be continually mindful of its own limited financial resources and other stewardship responsibilities.

5. How Much Severance Pay Should be Paid?

No bright line rule exists for determining what how much severance pay to provide. The main concern should always be proper stewardship of the church's financial assets in furtherance of the church's religious purposes. If a long-term employee is leaving the church, it may be a very appropriate *quid pro quo* payment to provide generous severance. If a contentious pastor leaves, the church leaders may feel forced to provide extensive severance as a risk management decision. Generally, provision of a few weeks to a few months of severance pay should be deemed reasonable under many circumstances. In contrast, a year's worth of severance pay would be viewed as highly unusual and therefore would warrant extensive due diligence and substantiation to justify such a large severance package.

6. How Should Severance Pay Be Provided?

a. No Prior Expectation

As a preliminary matter, churches should never indicate orally or in writing that severance pay may be expected by its employees upon termination. Instead, each severance pay decision should depend on a variety of reasons including the employer's length of employment, the reason(s) for termination, risk management considerations such as the likelihood of later litigation or bad publicity, and the church's financial condition at the time of termination.

On the other hand, it is appropriate and even recommended that churches disclose in writing (and orally as appropriate) that employees will not be entitled to unemployment insurance benefits upon termination. Such disclosure helps prevent unpleasant surprises later that can be awkward for the church and very traumatic for the employee. Prior disclosure also should help prudent employees plan accordingly for potential future unemployment. The disclosure should be included in the church's employee handbook or other prominent employment materials.

b. Put It In Writing!

Severance pay should *always* be put in a written agreement, with assistance of legal counsel. The following key terms should be included in the agreement:

- (1) Correct identification of the parties;
- (2) Specific severance amounts to be paid according to a time table for paying installments, subject to applicable employment tax deductions and the employee's continued compliance with the agreement;
- (3) Confirmation that all earned compensation has been paid, including paid leave such as vacation;
- (4) Express waiver of the employee's potential discrimination, contract, wage, and tort claims against the church and its directors, volunteers, employees, and other agents, at all times through the date of the agreement;
- (5) Confidentiality of the agreement's terms; and
- (6) Acknowledgment that the employee has been notified of his or her rights to continued health insurance under COBRA or state law.

The waiver of claims provision should be a critical precondition to payment of any severance pay. The church's severance payments should never be allowed to fund an employee's subsequent lawsuit against it. In addition, *it is highly recommended that severance be paid in separate installments over time, and not in a lump sum.* For the church's cash flow, installment payments may very helpful. For the terminated employee, this safeguard should help promote his or her continued compliance with the agreement, including maintenance of the agreement's confidentiality and cooperation regarding other aspects of the agreement. Requiring installment payments also may provide a cooling down period for the employee, after which he or she may be much less likely cause difficulty for the church.

Additional terms to consider adding to the severance pay agreement include the following:

- (1) Prohibition against the church's future re-hire of the employee;
- (2) Mutual non-disparagement of the parties;
- (3) Provision of neutral (or positive) job reference;
- (4) Continued cooperation regarding confidential information and other church matters;
- (5) Return of personal property belonging to church;
- (6) Provision for official statement(s) to be publicized to the congregation regarding the employment termination, as appropriate; and
- (7) Twenty-one day time period to consider agreement (which may be waived) and seven-day revocation period after execution (which may not be waived), as legally required for terminated employees over forty years old.

c. Tax Reporting

The severance payments should ordinarily be reported consistent with other ministerial employee tax reporting requirements. Per IRS Publication 957, the IRS Form W-2 should be used, and not IRS Form 1099-MISC. The payments are properly reportable for tax purposes as special wage payments instead of "deferred compensation." An extended housing allowance may also be provided under certain circumstances.

d. Special Tax Considerations for Deferred Wages

Pursuant to recent tax law changes, severance pay may be subject to the deferred compensation rules of section 409A of the Internal Revenue Code. Two significant exceptions exist, either of which should apply in most termination situations *so long as the severance payments are not continued over a lengthy time period*. Accordingly, a church should not ordinarily be concerned about applicability of the section 409A rules to severance pay, except in very unusual circumstances.

The two pertinent exceptions to section 409A are as follows:

1. Involuntary termination, where the total severance payments are less than double the employee's annual compensation for the prior year (or \$440,000, whichever is less), and all payments are made by December 31 of the second calendar year following the year of termination; and
2. Short-term deferral, where the total severance amount is completely paid within two and a half months of the end of the calendar year (or organization's tax year, if different) in which a severance agreement was reached.

Based on the foregoing, a church should be attentive to the time periods involved in severance installment payments. To fall within the first exception, the agreement should provide expressly that employment termination was involuntary.

Other benefits provided under a severance agreement may likewise be excluded from section 409A coverage. Health insurance benefits are generally excluded if they fall within the eighteen-month COBRA period. In addition, retirement benefits are excluded within certain dollar limits. Reimbursements for reasonable moving expenses and outplacement services also may be excluded, provided that they are incurred by December 31 following the termination year.

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Because the matters covered herein are complicated, and this is intended only as a summary, this article should not be regarded as offering a complete explanation and should not be used for making decisions. If you have specific questions about how these issues may impact on your own situation, please call us for further review, or review the matter with your tax advisor.