

WHITE PAPER

The Compensation Problem in Ministry Organizations

Why Most Churches Lack a Defensible Compensation Framework, What the IRS Expects, and How to Build a Process That Protects Everyone

Most church compensation problems are not the result of bad intentions. They are the result of absent process: no defined framework for setting compensation, no documented rationale, no structured review cycle, and no clear line between who proposes compensation and who approves it.

This paper examines why compensation is fundamentally a governance problem, what the IRS requires of 501(c)(3) organizations when paying their leaders, how the dual tax status of ministers creates compliance complexity most churches do not fully understand, and how to build a compensation process that is defensible, fair, and structured. It addresses both the Elder Board's accountability relationship with the Lead Pastor and the Lead Pastor's responsibility to manage staff compensation through defined, consistent processes.

*This paper is part of the Stewardship Advisors library on church governance and organizational health. It is designed to be read alongside *The Three-Board Church* and the related Reference Guides.*

Introduction

A Process Problem Masquerading as a Pay Problem

When a church leader's compensation becomes a point of conflict, the conversation that follows almost always focuses on the number: too high, too low, inconsistent with peers, out of step with the organization's finances. The number is a symptom. The underlying problem is that there was no process to produce a defensible number in the first place.

Churches that lack a compensation process do not simply risk paying the wrong amount. They risk IRS scrutiny under the intermediate sanctions rules, they create governance conflicts when board members disagree about what a leader deserves, they expose the organization to legal liability when a departing employee challenges how compensation decisions were made, and they put the Lead Pastor in the position of either advocating for their own pay or receiving whatever the board decides without any structured input into the criteria.

The solution is not a formula. It is a process: one that defines who has authority, what data must be considered, how decisions are documented, and when reviews occur. This paper makes the case for building that process and explains what it must contain.

The church that has never defined its compensation process has not avoided the problem. It has simply deferred it until the problem becomes a crisis.

Part One: Why Compensation Is a Governance Problem

The accountability relationship that compensation decisions express

Compensation decisions are governance decisions. This is the most important structural point in this paper, and it is the point most churches miss.

The Elder Board holds the accountability relationship with the Lead Pastor. That accountability relationship is not abstract. It is expressed in concrete governance functions: setting expectations, evaluating performance, and determining compensation. When any one of those functions is absent or informal, the accountability relationship is weaker than it appears.

The Three Governance Functions

Setting expectations means defining what the Lead Pastor is responsible for, what success looks like, and what the criteria for evaluation are. If the board has never defined these criteria in writing, performance evaluation is impressionistic. If performance evaluation is impressionistic, compensation decisions have no foundation.

Evaluating performance means applying those criteria on a defined schedule, producing a documented assessment, and communicating it to the Lead Pastor in a structured setting. An annual performance review is not a formality. It is the mechanism through which the board exercises its accountability function and through which compensation changes are justified.

Determining compensation means translating the performance evaluation into a compensation decision using defined criteria, comparability data, and a documented approval process. The compensation decision is where the governance chain becomes most visible and most vulnerable.

These three functions are sequential. A compensation decision that is not grounded in a performance evaluation is not a governance decision. It is a preference. A performance evaluation that is not grounded in defined

expectations is not an accountability exercise. It is an impression. Churches that collapse these functions, or skip them, do not have a weaker compensation process. They have no process at all.

Compensation without a performance evaluation is not governance. It is a guess that will eventually have to be defended.

The Lead Pastor's Responsibility Downward

The accountability structure does not end with the Lead Pastor. The Lead Pastor is responsible for the compensation and performance management of all direct reports, which typically includes pastoral staff, ministry directors, and non-pastoral staff who report to the Lead Pastor or their designee.

This responsibility requires the same structural discipline that the Elder Board is expected to apply to the Lead Pastor: defined evaluation criteria, a documented annual review process, and compensation changes that follow a structured timeline rather than responding to individual requests or informal pressure.

When the Lead Pastor manages direct-report compensation without a defined process, several predictable problems follow. Staff members receive different treatment based on their relationship with the Lead Pastor rather than their performance. Raises and bonuses are granted in response to requests or emotional circumstances rather than performance criteria. Compensation becomes a tool for retention or conflict management rather than a reflection of contribution and market position. And the organization has no defensible basis for explaining why one staff member earns more than another.

The governance principle here is the same one that governs the Elder Board's relationship with the Lead Pastor: structured process produces defensible outcomes; informal process produces contested ones.

Part Two: What the IRS Requires

Intermediate sanctions, the rebuttable presumption, and the dual tax status of ministers

Churches that operate as 501(c)(3) organizations are subject to federal tax law requirements that most governing board members have never read and many pastors have never heard explained clearly. Two areas carry the most significant compliance risk: the intermediate sanctions rules that govern compensation of key leaders, and the dual tax status that applies to ministers.

Intermediate Sanctions and the Rebuttable Presumption

Section 4958 of the Internal Revenue Code prohibits "excess benefit transactions" between a 501(c)(3) organization and a "disqualified person," which includes the Lead Pastor and any other individual with substantial influence over the organization. An excess benefit transaction occurs when a disqualified person receives compensation or other economic benefit that exceeds the fair market value of the services they provide.

The IRS can impose excise taxes on both the disqualified person who received the excess benefit and the organization managers who approved it. These are not penalties reserved for egregious cases. They can apply whenever compensation is found to exceed fair market value and the organization cannot demonstrate that it followed a proper approval process.

The protection against this exposure is the rebuttable presumption of reasonableness. To establish the rebuttable presumption, a church must satisfy three requirements:

- The compensation arrangement must be approved in advance by an authorized body composed entirely of individuals who do not have a conflict of interest with respect to the compensation decision.

- The authorized body must have obtained and relied upon appropriate data as to comparability prior to making the determination.
- The authorized body must have adequately documented the basis for its determination concurrently with making the decision.

Each of these three requirements corresponds to a common failure point in church compensation practice. Churches routinely have board members with close personal relationships to the Lead Pastor participate in compensation votes. They rarely compile formal comparability data before making decisions. And they almost never document the basis for a compensation decision at the time it is made.

What Comparability Data Requires

The IRS does not require expensive compensation surveys. Appropriate comparability data can include:

- Compensation levels paid by similarly situated organizations for functionally comparable positions
- Written offers from similar institutions competing for the services of the same individual
- Independent compensation surveys conducted by a recognized independent entity
- Actual written employment agreements between the organization and the individual
- Published compensation studies from denominational bodies or ministry organizations

The key requirement is that the data be obtained before the decision is made and that the decision document reflect the data considered. Verbal familiarity with what other churches pay is not comparability data.

The Dual Tax Status of Ministers

Ministers occupy a unique position in the federal tax system. They are simultaneously employees and self-employed individuals, depending on which tax obligation is being evaluated. This dual status is not a technicality. It has material financial implications for the minister and for the church, and misunderstanding it is one of the most common sources of clergy tax compliance problems.

For federal income tax purposes, a minister who serves a congregation is treated as an employee. The church issues a W-2, and the minister pays income tax through standard withholding or estimated payments. This is the familiar employment relationship.

For Social Security and Medicare tax purposes, however, a minister is treated as self-employed regardless of the employment relationship. This means the minister pays both the employee share and the employer share of Social Security and Medicare taxes, which together equal 15.3 percent of net self-employment income up to the applicable wage base, with the Medicare portion continuing above that threshold. The church does not withhold FICA on ministerial wages and does not pay its own matching share.

The practical consequence is that a minister's true tax burden is significantly higher than a lay employee earning the same gross salary. A lay employee pays 7.65 percent for Social Security and Medicare and the employer pays the matching 7.65 percent. A minister pays the full 15.3 percent. This difference is not offset by the minister's W-2 status for income tax purposes.

The SECA Offset and Compensation Structuring

Many churches address the minister's higher Social Security and Medicare tax burden by providing a SECA offset, an additional cash payment equal to some or all of the self-employment tax the minister will owe. This payment is taxable income to the minister but allows the church to structure total compensation on a basis comparable to what the organization would pay for a lay employee in a similar role.

Whether and how to provide a SECA offset is a compensation policy decision. The important point is that the decision be made explicitly, documented, and consistently applied. Churches that address it informally or inconsistently create both equity and compliance problems.

The Housing Allowance

Section 107 of the Internal Revenue Code allows a minister of the gospel to exclude from federal income tax the portion of their compensation that is designated in advance as a housing allowance, to the extent it is used to pay housing expenses. The housing allowance is one of the most significant financial benefits available to ministers and one of the most frequently misapplied.

Three requirements must be met for the exclusion to apply. The allowance must be designated in advance by official action of the church. The minister must actually use the allowance to pay qualifying housing expenses. And the excluded amount cannot exceed the fair rental value of the home, including furnishings and utilities.

Common misapplication patterns include: designating the housing allowance after the fact rather than in advance, failing to document the board action that designates the allowance, designating an amount without confirming that the minister's actual housing expenses will support the exclusion, and failing to review the designation annually as the minister's housing costs or compensation changes.

The housing allowance exclusion is not available for Social Security and Medicare tax purposes. The minister's self-employment tax base includes housing allowance income. Churches and ministers that structure compensation assuming the exclusion applies to SECA tax are making a compliance error that can generate back taxes, interest, and penalties.

The housing allowance is one of the most valuable tax provisions available to ministers. It is also one of the most commonly documented incorrectly. The designation must happen before the compensation is paid, not when the tax return is being prepared.

Part Three: Common Failure Patterns

How compensation processes break down in practice

Compensation failures in church organizations follow recognizable patterns. They are not random. They are the predictable outcomes of specific structural absences, and understanding the pattern is the first step toward building a process that avoids it.

No Defined Approval Authority

In many churches, it is not clear who has authority to set the Lead Pastor's compensation. The Elder Board may have that authority under the governing documents but may have never formally exercised it through a defined process. The result is that compensation decisions happen informally: a motion at a board meeting, a vote without prior analysis, or a verbal agreement that is later disputed.

This ambiguity is not just a governance problem. It is a legal one. The rebuttable presumption procedure requires that compensation be approved by an authorized body acting independently. A vote taken without defined authority, without comparability data, and without documentation does not establish the presumption of reasonableness regardless of the amount approved.

The Lead Pastor Influencing Their Own Compensation

The Lead Pastor should not participate in setting their own compensation. This principle is straightforward, but it is routinely violated in churches where the Lead Pastor is also a voting member of the Elder Board, where the Lead Pastor prepares the compensation recommendation for the board's consideration, or where the Lead Pastor's close relationships with board members make genuine independence difficult to achieve in practice.

The conflict of interest is not eliminated by the Lead Pastor's good intentions. The IRS intermediate sanctions rules require that compensation be approved by individuals who do not have a conflict of interest. A Lead Pastor who is also an elder must recuse from any vote or deliberation on their own compensation. A board that is personally close to the Lead Pastor may need to engage an outside party to validate the comparability analysis.

Total Compensation Is Never Calculated

Churches frequently discuss the Lead Pastor's salary without ever calculating total compensation. Total compensation includes base salary, housing allowance, any SECA offset payment, health and dental insurance premiums paid by the church, retirement plan contributions, continuing education allowances, vehicle allowances or reimbursements, and any other economic benefit the church provides.

The IRS evaluates total compensation, not just base salary. Comparability analysis must be conducted on the same basis. A church that believes it is paying its Lead Pastor conservatively because the salary is modest may be significantly overcompensating on a total compensation basis once all benefits are included. The inverse is also common: a church that considers its total package competitive may be undercompensating when the minister's SECA obligation is factored in.

Ad Hoc Raises and Bonuses

One of the most common compensation dysfunction patterns in ministry organizations is the ad hoc raise or bonus: a compensation adjustment made outside any structured review cycle, in response to a specific circumstance, without reference to defined criteria, and without documentation that would allow the decision to be evaluated later.

Ad hoc raises are typically triggered by one of a few circumstances: a staff member indicates they are considering leaving, a staff member expresses financial hardship, the Lead Pastor advocates for a direct report outside the normal review cycle, or a board member with a personal relationship to a staff member champions an increase. None of these circumstances justifies a compensation adjustment outside the normal process, and each of them tends to produce decisions that are difficult to defend and impossible to apply consistently.

The structural problem with ad hoc bonuses is similar. A bonus that is not tied to defined performance criteria and approved through a structured process is not a performance incentive. It is a gift from organizational resources. Whether it is appropriate to make that gift is a separate question. Treating it as compensation-related decision-making when it is not creates a muddled record and a precedent that is difficult to manage.

No Structured Performance Review for Direct Reports

The Lead Pastor's failure to maintain a structured performance review process for direct reports is among the most consequential compensation management failures in ministry organizations, and among the least frequently addressed.

When the Lead Pastor has no defined evaluation criteria for staff, no documented annual review process, and no structured timeline for compensation adjustments, the result is a staff compensation system that reflects the Lead

Pastor's personal relationships and management preferences rather than organizational performance standards. Staff members who are well-liked or who are effective advocates for themselves receive better treatment than those who are quieter or less connected. The organization cannot identify or reward its strongest contributors on any consistent basis.

The Elder Board cannot effectively oversee staff compensation without a framework. When the board asks whether staff are compensated appropriately, the Lead Pastor who has no structured process has no answer beyond an impression. This is not an accountability response. It is an invitation for the board to either take on staff management directly or to accept oversight that is not meaningful.

Housing Allowance Mismanagement

Housing allowance failures tend to cluster in three areas: the designation is not made in advance, the designated amount is not supported by actual housing expenses, and the allowance is not reviewed annually. Each of these failures can result in the minister owing back taxes on income they believed was excluded, with interest and potential penalties.

The board action designating the housing allowance should occur before the beginning of each calendar year. It should specify a dollar amount or a percentage of compensation. It should be documented in the board minutes. And the minister should annually verify that their actual housing costs equal or exceed the designated amount so that the full exclusion can be claimed.

Part Four: Building a Defensible Process

What a structured compensation framework requires at every level of the organization

A defensible compensation process does not require a large organization, an HR department, or external consultants for every decision. It requires defined authority, documented criteria, consistent application, and a record that can be reviewed. The following framework applies to both the Elder Board's oversight of Lead Pastor compensation and the Lead Pastor's management of direct-report compensation.

Elder Board Process: Lead Pastor Compensation

The Elder Board's compensation process for the Lead Pastor should include five elements, applied in sequence and documented each time the process runs.

- Defined evaluation criteria, established at the beginning of the review cycle and communicated to the Lead Pastor in writing. These criteria should address the specific responsibilities of the Lead Pastor role as defined in the governing documents or employment agreement.
- An annual performance review, conducted by the Elder Board or a designated subcommittee, producing a written assessment that is shared with the Lead Pastor and retained in the board's records.
- Comparability analysis, conducted before any compensation decision, using data from similarly situated organizations for functionally comparable positions. The data sources should be documented and retained.
- A compensation decision made by board members who do not have a conflict of interest, documented in the board minutes with reference to the performance evaluation and comparability data considered.
- Annual review of the housing allowance designation, with board action occurring before the start of each calendar year and the designation documented in the minutes.

The recusal requirement deserves emphasis. Any board member with a close personal relationship to the Lead Pastor that would compromise their independent judgment should recuse from the compensation decision, not merely from the vote but from the deliberation. The independence requirement is substantive, not procedural.

Structured Bonus Process

If the Elder Board wishes to provide performance bonuses to the Lead Pastor, the process should follow the same discipline as base compensation decisions:

- Bonus eligibility and criteria should be defined at the beginning of the performance period, not at the end.
- The bonus amount or range should be established in advance, not determined after the fact based on available funds.
- The board's decision to award a bonus should reference the performance criteria established at the outset and document how the Lead Pastor's performance met them.
- The bonus should be approved through the same conflict-of-interest recusal process as base compensation.
- Ad hoc bonuses granted outside this process should be treated as gifts rather than compensation and reviewed against the organization's gift policies.

Lead Pastor Process: Direct Report Compensation

The Lead Pastor's process for managing direct-report compensation should mirror the structural discipline the Elder Board applies to Lead Pastor compensation, adapted to the organizational context. The absence of a defined process at this level is not a minor administrative gap. It is a governance failure with real consequences for staff equity, organizational culture, and the Elder Board's ability to exercise meaningful oversight.

A structured direct-report compensation process includes:

- Written position descriptions for each direct-report role, establishing the responsibilities and performance expectations against which the employee will be evaluated.
- Defined evaluation criteria for each role, communicated to the employee at the beginning of each review period. The criteria should be specific enough that both the Lead Pastor and the employee can assess performance against them independently.
- A documented annual performance review for each direct report, conducted on a consistent schedule, producing a written assessment that is retained in the employee's file.
- A compensation review cycle tied to the performance review, occurring on a defined annual schedule rather than in response to individual requests or circumstances.
- Raise eligibility and criteria defined in advance: for example, satisfactory performance reviews may make an employee eligible for a cost-of-living adjustment, and strong performance reviews may make an employee eligible for a merit increase within a defined range.
- Bonus criteria established at the beginning of the performance period, with specific metrics or thresholds that trigger bonus eligibility, rather than bonuses awarded at the Lead Pastor's discretion after the fact.
- Board approval thresholds that define which compensation decisions the Lead Pastor can make independently and which require Elder Board approval, with total compensation figures rather than just salary changes triggering the threshold review.

This framework does not eliminate the Lead Pastor's management authority. It provides the structure within which that authority is exercised in a way that is consistent, defensible, and subject to meaningful oversight.

A structured compensation process is not a constraint on the Lead Pastor's leadership. It is the foundation on which the organization can manage its people equitably and account for its decisions.

Documentation and Retention

The IRS rebuttable presumption procedure requires documentation that is prepared concurrently with the compensation decision. This means the board minutes or compensation committee records must reflect the decision, the data considered, and the basis for the determination at the time the decision is made, not reconstructed later.

For Lead Pastor compensation, the documentation should include: the date and composition of the approving body, a statement confirming that no member of the approving body had a conflict of interest, a summary of the comparability data reviewed, the compensation components approved (salary, housing allowance, benefits, any SECA offset), and the effective date. This record should be retained permanently.

For staff compensation, the documentation standard is lower but the principle is the same: written performance reviews, compensation decisions that reference them, and records retained long enough to respond to any future challenge.

Part Five: Diagnostic Questions

Questions for Elder Boards and Lead Pastors

The following questions are designed to surface structural gaps in compensation governance before those gaps become disputes. They can be worked through by an Elder Board in executive session or by a Lead Pastor reviewing their own staff management practices.

For the Elder Board:

- Has the Elder Board formally defined, in writing, the criteria by which the Lead Pastor's performance will be evaluated? Have those criteria been communicated to the Lead Pastor?
- When was the most recent documented performance review of the Lead Pastor? Is there a written record of that review that was shared with the Lead Pastor?
- Does the board have a current calculation of the Lead Pastor's total compensation, including all salary, housing allowance, benefit premiums, retirement contributions, and other economic benefits?
- Has the board compiled comparability data before any compensation decision in the past three years? Is that data documented in the board records?
- Are there any board members who should recuse from Lead Pastor compensation decisions due to a conflict of interest? Has the board discussed and documented its recusal practices?
- Has the housing allowance been designated by formal board action before the beginning of the current calendar year? Is the designation documented in the board minutes?
- If the board has provided bonuses to the Lead Pastor, were the criteria for those bonuses established before the performance period in which they were earned?
- Could the board produce documentation sufficient to establish the rebuttable presumption of reasonableness for the Lead Pastor's current compensation if asked to do so by the IRS?

For the Lead Pastor:

- Does each direct report have a written position description that defines their responsibilities and the criteria against which their performance will be evaluated?
- When was the most recent documented performance review for each direct report? Is there a written record retained in each employee's file?
- Are compensation reviews for direct reports conducted on a defined annual schedule, or do they occur in response to requests and individual circumstances?

- Are the criteria for raises defined in advance, so that an employee who performs well knows what that means for their compensation eligibility?
- Are bonuses for direct reports tied to criteria established before the performance period, or are they awarded based on the Lead Pastor's assessment after the fact?
- Is there a defined board approval threshold for staff compensation changes? Does the Lead Pastor know what decisions they can make independently and which require Elder Board approval?
- If a departing employee challenged the consistency or fairness of compensation decisions, does the organization have documentation sufficient to respond?

Conclusion

Compensation governance is not an area where good intentions are sufficient protection. The IRS intermediate sanctions rules exist because Congress determined that excess compensation in the tax-exempt sector was a real and recurring problem, not a theoretical one. The governance failures that produce compensation disputes in churches are also real and recurring: absent process, conflicted approvals, undocumented decisions, and ad hoc adjustments that no one can later explain.

The three-board model described in the companion white paper establishes the governance structure within which compensation decisions occur. The Elder Board holds the accountability relationship with the Lead Pastor. That relationship is only as strong as the processes the board uses to exercise it. A board that lacks a defined compensation process has not simply left an administrative gap. It has left the accountability relationship itself underspecified at one of its most critical points.

The same principle applies to the Lead Pastor's management of direct-report compensation. The absence of defined evaluation criteria, structured review cycles, and documented processes does not leave the organization with flexible, relationship-based management. It leaves the organization with inconsistent treatment, a record that cannot be defended, and a culture in which staff members are right to wonder whether the process is fair.

Building a defensible compensation process is not a large project. It is a deliberate one. It requires defining authority, establishing criteria, compiling data, documenting decisions, and applying the process consistently across review cycles. Organizations that do this work produce outcomes that are defensible not because they paid the right number, but because they followed the right process.

The standard is not perfection. It is defensibility: a process that a reasonable person reviewing the record would conclude was thoughtful, independent, and grounded in appropriate data.

Related Resources from Stewardship Advisors

This white paper is part of the Stewardship Advisors library on church governance and organizational health. Readers working through the compensation governance questions raised here will find additional depth in the following resources:

- The Three-Board Church (White Paper): the governance structure within which compensation authority is defined and the accountability relationship with the Lead Pastor is established
- Choosing Your Church Governance Structure (Thought Leadership Series): an overview of the three defining governance variables and six primary governance models
- The Lead Pastor (Reference Guide): the role's responsibilities, the accountability relationship with the Elder Board, and the governance disciplines required to manage it well
- The Church Constitution and Bylaws (Reference Guide): how governing documents must define compensation authority, conflict of interest, and board approval requirements
- Before You Present an Elder (Reference Guide): qualification standards and the governance responsibilities of the elder office, including the compensation oversight function

All resources are available at stewardshipadvisors.co/resources