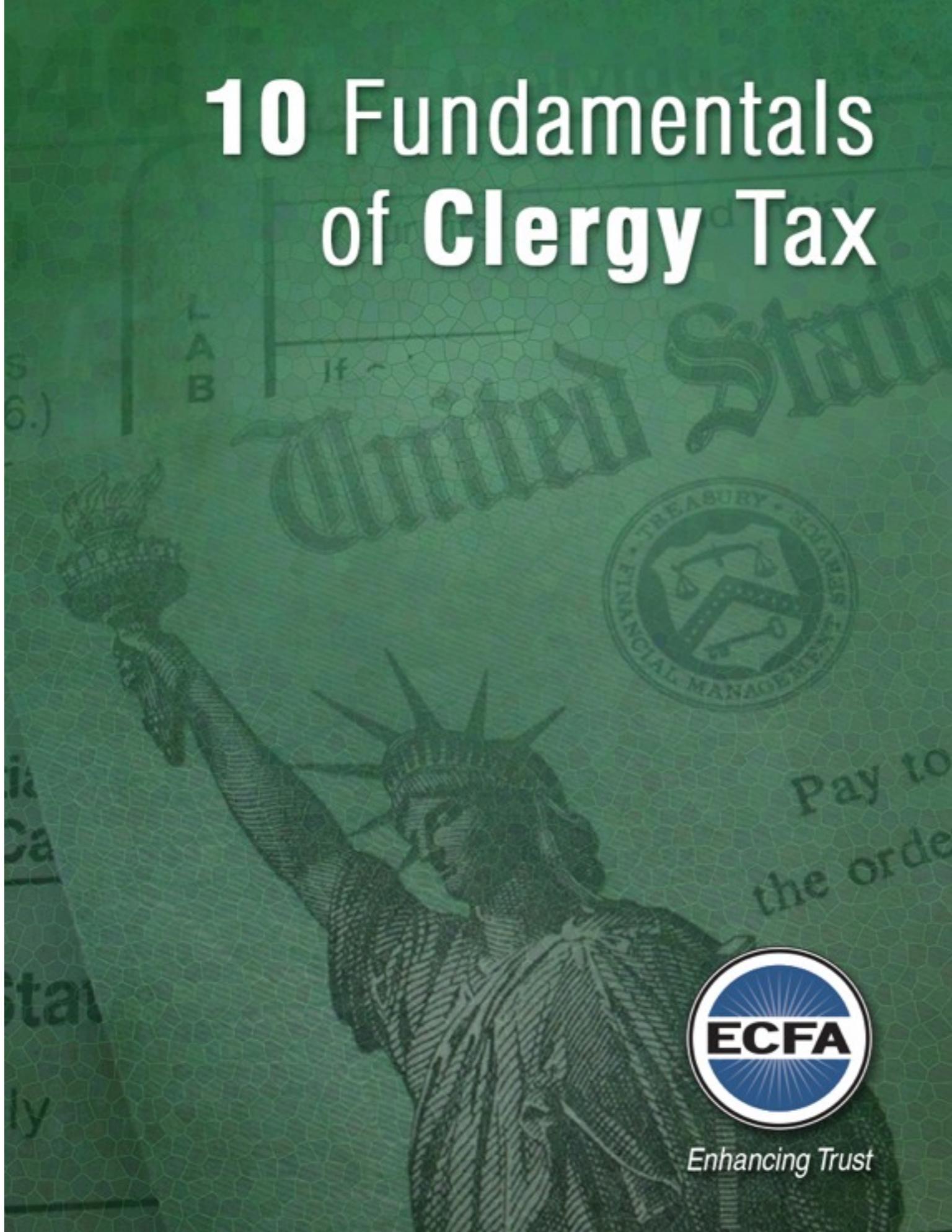


10 Fundamentals of Clergy Tax



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Introduction



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Introduction

Too often, clergy believe that the fundamentals of clergy tax are only understood by their tax preparer. While a tax preparer must understand the intricacies of clergy tax law, clergy can and should understand the basic issues. Only then will clergy be able to properly steward funds provided by the congregation.

If a minister clearly understands the *10 Fundamentals of Clergy Tax* as discussed in this book, he or she will have a working knowledge of the basic concepts of taxation for all clergy serving in the United States.

Not all clergy qualify for clergy tax treatment



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Not all clergy qualify for clergy tax treatment

There is a common myth that all clergy qualify for the special treatment afforded to clergy under the federal tax law. This is far from reality. Meeting the requirement of clergy under federal law is generally very different than how a congregation, denomination or other nonprofit organization determines who meets the requirements of clergy.

Most clergy serving congregations qualify under federal law as clergy, but certainly not all. In addition to being ordained, commissioned, or licensed, requirements may include whether or not the individual administers sacraments, conducts worship services, is considered a spiritual leader by the church, and whether or not the minister performs management services in the control, conduct, or maintenance of a religious organization. It may not be necessary for clergy to meet all of these tests to qualify for special tax treatment.

Most clergy serving religious denominations and integral agencies also qualify for clergy treatment under federal law. However, if clergy are not engaged in service performed in the exercise of the ministry of a local church, are not employed by a religious denomination or an integral agency of a church, or are not assigned by a denomination or a church to the current service, the definition of a qualifying clergy becomes much narrower. In these situations, Tax Court cases and IRS rulings suggest that an individual will qualify for the special tax treatments of clergy only if the individual's services for the employer substantially involve conducting religious worship or performing sacerdotal functions (for example, performing weddings, funerals, baptisms).

It is important for the employing organization (clergy are not in a position to decide whether or not they qualify for the special tax treatments) to decide whether or not the services of clergy qualify for special tax treatment. The special tax treatments follow:

- Exclusion for income tax purposes of the housing allowance and the fair rental value of a congregation-owned parsonage provided rent free to clergy.
- Exemption of clergy from self-employment tax, under very limited circumstances.
- Treatment of clergy who do not elect Social Security exemption as self-employed for Social Security tax purposes for income from ministerial services.
- Exemption of clergy compensation from mandatory income tax withholding.
- Eligibility for a voluntary income tax withholding arrangement between the minister-employee and a congregation.
- Potential double deduction of mortgage interest and real estate taxes as itemized deductions and excluded as housing expenses for housing allowance purposes.

Summary. The employing congregation, denomination, integral agency of a denomination or a church, or religious organization is responsible to determine whether an individual qualifies as clergy under the federal law definition. If clergy who qualify under federal law are not afforded these special tax treatments, this can create a significantly financial impairment to clergy. If clergy who do not qualify are provided the special tax treatments, the employing organization may inadvertently assist clergy in violating the tax law by affording tax-beneficial treatment for otherwise taxable dollars.

Clergy are almost always
employees for income
tax purposes



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Clergy are almost always employees for income tax purposes

Each congregation has the responsibility to determine whether clergy are employees or self-employed under the common law rules. Based on Tax Court cases, the IRS almost always considers clergy as employees for income tax purposes. This is true even though clergy are self-employed for social security tax purposes.

The income tax filing status of clergy has many ramifications for what and how a congregation and the clergy report to the IRS.

- Employees report compensation from the congregation on Form 1040, not on Schedule C or C-EZ (used by self-employed individuals). Employees receive Form W-2 each year from the congregation, not Form 1099-MISC (used to report compensation received by a self-employed individual).
- Employees deduct unreimbursed business expenses, and expenses reimbursed under a nonaccountable plan, on

Form 2106 or 2106-EZ with the amount carried forward to Schedule A as itemized deductions. The expenses are subject to a 2% of adjusted gross income limitation, and only 50% of business meals and entertainment expenses are deductible. (Those who are self-employed may only deduct these expenses on Schedule C or C-EZ.

- Health, accident, and long-term care insurance premiums paid directly by a church for an employee (or reimbursed to an employee based on substantiation provided by the clergy) are not reportable as income to the clergy (taxable to those who are self-employed).
- Employees may deduct health, accident, and long-term care insurance premiums paid personally, and not reimbursed by the church, on Schedule A as medical and dental expense, subject to a 7.5% limitation of adjusted gross income.
- Health savings accounts, health reimbursement arrangements, or flexible spending arrangements are available to employees but are not available to those who are self-employed.

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- Group-term life insurance, provided by a congregation, of \$50,000 or less is tax-free to employees but not available to those who are self-employed.
 - A voluntary arrangement to withhold income tax may be used by an employee but not available to those who are self-employed.

Summary. Clergy are almost always employees for income tax purposes (even though they are self-employed for social security tax purposes—see Principle 3).

Clergy pay social security as self-employed



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Clergy pay social security as self-employed

Determining the correct social security tax for clergy is often confusing. Self-employed clergy pay social security tax under the Self-Employment Contributions Act (SECA), not under the Federal Insurance Contributions Act (FICA). Clergy engaged in the exercise of ministry are always treated as self-employed for social security tax purposes.

A congregation should never deduct FICA-type social security tax from the pay of a qualified clergy—only SECA-type social security tax applies. Determining which type of social security tax applies is not a matter for clergy to choose. Rather, it is the responsibility of the congregation to determine the appropriate type of social security based on whether the individual qualifies as clergy in the eyes of the IRS.

If a congregation withholds and matches FICA-type social security tax for a qualified clergy, the individual is incorrectly being treated as a lay-employee. The FICA matched by the congregation for social security purposes is improperly treated as tax-free when it is taxable for both income and social security purposes.

It is possible for clergy to be exempt from SECA in only a few situations. To claim a SECA exemption, clergy must be conscientiously opposed to public insurance (including an opposition to receiving social security benefits) because of the clergy's religious beliefs or because of the position of the clergy's religious denomination regarding social security.

A clergy's earnings that are not from the exercise of ministry are generally subject to social security tax under FICA (nonclergy employment) or SECA (independent contractor earnings).

Summary. The key principle is that clergy are not subject to FICA-type social security as employees of the congregation.

The structure of clergy
compensation is evidence of the
congregation's stewardship



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The structure of clergy compensation is evidence of the congregation's stewardship

Structuring compensation to maximize the stewardship of congregational funds is often very challenging. It requires a basic understanding of tax law which applies to congregations and clergy, identifying the needs of the clergy, and an identification of congregational funds available.

Some of the key compensation stewardship planning concepts includes:

- **Consider goals and objectives.** Based on the goals of the congregation, develop a written compensation policy for clergy. For example: Based on our goal to develop three satellite congregations in the next five years and expand our international mission strategies, our compensation policy will be designed to attract, retain, reward, and motivate clergy in a fair and equitable manner, when considering the

compensation of other clergy (particularly in our community or area), the income level of citizens of our community, and the income level of members of this congregation.

- **Appoint a compensation committee.** Even though the congregation may approve the annual budget and the board may approve the compensation package, one or more board representatives should be designated to meet with clergy, talk about pay expectations, review past pay patterns, discuss the tax consequences of compensation components, and then make recommendations on a compensation plan to the congregation's board.
- **Document the current compensation.** Separately identify and document the current salary, fringe benefits, and professional expense reimbursements.
- **Maximize fringe benefits.** Structure fringe benefits to take advantage of tax laws which allow tax-free fringe benefits, such as health insurance, or tax-deferred benefits, such as 403(b) plans.
- **Reimburse expenses on a tax-free basis.** Reimbursing substantiated expenses under an accountable reimbursement plan and avoiding unsubstantiated expense "allowances" stewards congregation and clergy funds.

Summary. Stewardship of funds is often maximized for the congregation and clergy by initially focusing on fringe benefits and accountable expense reimbursements, then the housing allowance and finally cash compensation.

The housing allowance can be
the clergy's best tax friend



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The housing allowance can be a clergy's best tax friend

Clergy are eligible to receive lodging from the congregation free of income tax liability. The housing allowance is an opportunity to exclude dollars from gross income.

It is important to distinguish between a:

- **Housing allowance designation.** The designation of a portion of cash compensation as a housing allowance is done by the congregation providing the payment to clergy.
- **Housing allowance exclusion.** The mere designation of a housing allowance by a congregation is only the first step leading to the potential exclusion of dollars from income tax. The second step is the application of the housing allowance limits by clergy to determine the exclusion amount.

The housing exclusion is the lowest of these factors:

- Reasonable compensation
- The amount used from current congregation-provided compensation to provide the home
- The amount prospectively and officially designated by the congregation
- The fair rental value of the home including utilities and furnishings

Nearly every clergy should have a portion of salary designated as a housing allowance. For clergy living in congregation-provided housing, a housing allowance covering expenses such as furnishings, personal property insurance on contents, and utilities could save the clergy several hundred dollars of income taxes annually. For clergy living in their own homes or rental housing, a properly designated housing allowance may be worth thousands of dollars of income taxes saved.

Clergy who live in congregation-provided housing have a responsibility to determine and report the fair rental value of the housing for self-employment social security purposes on Schedule SE. The congregation is not responsible to set the value. The fair rental value should be based on comparable rental values of other similar residences in the immediate neighborhood or community, comparably furnished.

Summary. Nearly every qualified clergy should have a portion of cash salary designated as a housing allowance. While the most significant income tax savings are available for clergy-provided housing, there are also more modest income tax savings for many clergy living in congregation-provided housing under the housing exclusion rules.

Tax-free and tax-deferred
fringe benefits increase your
take-home compensation



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Tax-free and tax-deferred fringe benefits increase your take-home compensation

A fringe benefit is any cash, property, or service that clergy-employees receive from a congregation in addition to salary. All fringe benefits are taxable income to employees unless specifically exempted by the Internal Revenue Code.

Many fringe benefits can be provided by a congregation to clergy without any dollar limitation (health insurance is an example), while other fringe benefits are subject to annual limits (dependent care is an example).

To qualify for exclusion from income, many fringe benefits must be nondiscriminatory. In other words, the benefits must be offered to all employees or employees in certain classes. Other fringe benefits may be offered to some employees and not to others.

Some of the most important fringe benefits for ministers includes:

- **Health insurance.** If the congregation pays the medical insurance premiums directly to the insurance carrier or reimburses clergy for the premiums based on substantiation, the premiums are generally tax-free to clergy.
- **Disability insurance.** If the congregation pays the disability insurance premiums (and clergy is the beneficiary) as a part of the compensation package, the premiums are excluded from income.
- **Group-term life insurance.** If the group life coverage provided under a nondiscriminatory plan does not exceed \$50,000 for clergy, the life insurance premiums are generally tax-free to clergy.
- **Out-of-pocket medical expenses** (all of the following plans are subject to the nondiscriminatory rules):
 - **Flexible spending account (FSA).** The FSA should generally be the plan of choice for clergy and congregations. The FSA is simple to establish and easy to administer by the congregation.

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- **Health savings account (HSA).** Within limits, HSA contributions made by congregations are excludable from income tax and social security wages (HSA contributions may not be funded through salary reduction). Withdrawals from HSA's to pay medical expenses are tax-free.
 - **Health reimbursement arrangement (HRA).** The same HRA benefit must be provided to all employees. This makes this concept very limiting since out-of-pocket costs significantly vary employee-to-employee.
 - **Cafeteria plan.** Generally only very large congregations can justify establishing and maintaining a cafeteria plan. These plans can cover much more than medical expenses—for example, dependent care, life insurance, and disability insurance.

Summary. Properly focusing on tax-free and tax-deferred fringe benefits can make a significant difference in the stewarding of funds expended by a congregation on behalf of clergy. Federal tax laws help congregations and clergy by subsidizing tax-free fringe benefits and delaying the taxation of tax-deferred benefits.

Properly handling clergy business expenses starts with an accountable expense reimbursement plan



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Properly handling clergy business expenses starts with an accountable expense reimbursement plan

The starting point in considering whether clergy expenses are deductible or reimbursable is to decide whether the expenses are business (ministry) or personal. To be deductible or reimbursable, a business expense must be both ordinary and necessary. An ordinary expense is one that is common and accepted for clergy. A necessary expense is one that is helpful and appropriate for clergy.

Most clergy spend several thousands of dollars each year on congregation-related business expenses. For example, the congregation-related portion of auto expenses is often a major cost. Clergy only have two choices: try to deduct the expenses for tax purposes or have the expenses reimbursed by the congregation under an accountable expense reimbursement plan. Clergy will almost always save tax dollars if the expenses are reimbursed.

Business and professional expenses of clergy fall into three basic categories:

- expenses reimbursed under an accountable plan,
- expenses paid under a nonaccountable plan, and
- expenses not reimbursed.

Only the first category of expenses provides the maximum stewardship for the congregation and clergy, as expenses may be reimbursed on a tax-free basis. Reimbursements in the second category are treated as taxable income and expenses may be deducted, subject to limitations. Expenses in the last category may be deducted, subject to limitations. The first category results in dollar-for-dollar reimbursements, while the last two categories only provide a fractional return based on the clergy's marginal tax rates—the rate of tax on the last dollars of clergy income. This is illustrated in the following examples:

Example #1 – Expenses reimbursed under an accountable plan. Church-related business (ministry) expenses properly substantiated on a timely basis are reimbursed dollar-for-dollar on a tax-free basis to clergy. This maximizes stewardship as the expenses paid by clergy are fully returned without any reduction.

Example #2 – Expenses paid under a nonaccountable plan. Church-related business (ministry) expenses which are paid by the church in a nonaccountable fashion (inadequate substantiation, not documented on a timely basis, expenses are not business expenses, etc.) must simply be added to income. While the business expenses are deductible on Form 1040, the expenses are reduced on Schedule A, with the resulting amount only benefiting clergy based on the clergy's income tax rate.

And, if the standard deduction is used, the expenses have no benefit at all.

Example #3 – Expenses not reimbursed. Business expenses that clergy incur but are not reimbursed are deductible on Form 1040, the expenses are reduced on Schedule A, with the resulting amount only benefiting clergy based on the clergy's income tax rate. And, if the standard deduction is used, the expenses have no benefit at all.

The full reimbursement of ministry expenses is also important because if expenses are reimbursed under a nonaccountable plan or not reimbursed at all, the Internal Revenue Service will generally disallow the portion of the expenses that relates to the housing allowance of the clergy.

Summary. Most clergy spend several thousands of dollars each year on church-related business expenses. Only when the expenses are fully reimbursed by the congregation is the stewardship of funds maximized.

Fees and honoraria must be reported as business income



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Fees and honoraria must be reported as business income

Fees and honoraria received by clergy are subject to income and self-employment social security taxes (unless the clergy has properly opted out of social security related to clergy-income).

Clergy income may be reported in two ways on Form 1040:

- **Compensation paid by the congregation.** Employee compensation should always be reported on Form W-2.
- **Honoraria, fees and similar amounts not paid by the congregation.** Clergy may receive a Form 1099-MISC for payments of \$600 or more in a calendar year, but it is the clergy's responsibility for recording and reporting these amounts on Schedule C or C-EZ.

The most common types of income to be reported on Schedule C or C-EZ by clergy are:

- **Speaking honoraria.** Clergy often speak at various venues and receive honoraria for these services.
- **Fees.** Clergy often conduct weddings, funerals, and baptisms and receive honoraria for these services.

Even if clergy do not quote an amount for honoraria or fees, payments received by clergy in exchange for services provided in speaking or conducting weddings, funerals, or baptisms represent payment for services rendered and are taxable income. When clergy visit a congregation other than their "home" congregation, "love offerings" received by clergy in recognition of services rendered should be reported on Schedule C or C-EZ as income.

Expenses related to clergy income reported on Schedule C or C-EZ should be reported as expenses on this Schedule. Business expenses related to congregational compensation to clergy should not be reported on Schedule C or C-EZ. Instead, these expenses are reportable on Form 2106 and carried forward to Schedule A.

Example – Form W-2 for Clergy A reflects \$60,000 of compensation. Speaking honoraria and marriage, funeral, and baptism fees of \$2,500 are also received.

Unreimbursed business expenses of \$5,000 relate to the compensation paid by the church. Business expenses of \$800 were incurred in relation to the speaking, marriage, funeral, and baptism services performed. The \$5,000 should be deducted on Form 2106 and carry forward the amount to Schedule A as miscellaneous deductions.

The \$2,500 of honoraria and fees should be reported on Schedule C-EZ, and the \$800 of expenses should be deducted on the same form.

Summary. Distinguishing the congregational-related income and business expenses for clergy from clergy income not provided by the congregation (and the business expenses related to this income is one of the key challenges in the tax life of clergy.

Retirement planning is a function
of time and money



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Retirement planning is a function of time and money

Being financially prepared for retirement is simply a function of time and money: the less you have of one, the more you need of the other.

It is often difficult to save as much as many experts insist is needed for a comfortable retirement based on clergy compensation levels. But there is one inescapable truth: the sooner you start saving, the better. Saving for retirement isn't like climbing one great peak. It's like climbing several smaller ones.

The best advice for clergy is the simplest—put as much into your 403(b) or 401(k) plan as you can. Whether the payments are congregation-funded or funded by a salary reduction from your pay, the contributions are tax-deferred for income tax purposes and are not subject to self-employment social security taxes. When you receive benefits from your plan in retirement, the payments are not subject to self-employment social security taxes.

If your plan was sponsored by a denomination, your benefits qualify for housing allowance treatment, subject to the housing allowance limitations. If you are a good money manager, you may want to arrange your indebtedness so you have mortgage payments during at least the early years of your retirement.

Summary. Age 65 was entrenched as the finish line for our careers. But this false endpoint is rapidly disappearing. We are living longer, the social security retirement age is increasing, and stock market fluctuations have significantly impacted many retirement investments.

It is important for clergy to understand many financially-related issues, including when to file for social security, working after retirement, and when and how to withdraw money from tax-deferred retirement plans.

It is important to keep your
tax payment current



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It is important to keep your tax payment current

Lay employees are subject to federal income tax and Federal Insurance Contribution Act (FICA) type social security withholding. However, clergy are not subject to mandatory federal income tax withholding and clergy income is always subject to Self-Employment Contributions Act (SECA) type social security.

Clergy have several options to pay their federal income tax and SECA-type social security taxes:

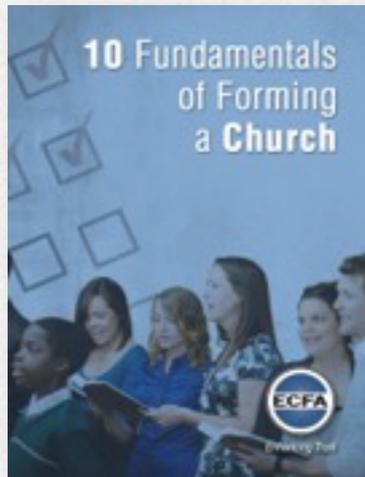
- Voluntary withholding of federal income tax. Clergy may ask the congregation to withhold federal income taxes sufficient to cover the federal income tax and self-employment social security tax obligation.
 - Congregations are not required to withhold federal income tax but the congregation and clergy may agree to federal income tax withholding.

- The amount of federal income tax withheld under this agreement may be sufficient to cover the clergy's federal income tax and SECA tax obligation.
- The withholding agreement may be based on the completion of Form W-4 and submission by clergy to the congregation, or by a simple written document.
- Paying estimated taxes using Form 1040-ES. To avoid underpayment penalties, payments with Form 1040-ES must be filed with the IRS on April 15, June 15, September 15 and January 15 for each tax year. As with a voluntary withholding agreement, the amounts of the estimated payments may be sufficient to cover the clergy's federal income tax and SECA tax obligation.
- Spousal withholding. A clergy's spouse could have sufficient federal income tax withheld to cover the clergy's federal income tax withholding and SECA tax obligation.

Summary. The federal income tax is a pay-as-you-go tax. You must pay the tax as you earn or receive income during the year. While congregations are not required to withhold income tax from clergy compensation, clergy and congregations may agree on a voluntary withholding arrangement. This is often a wise approach.

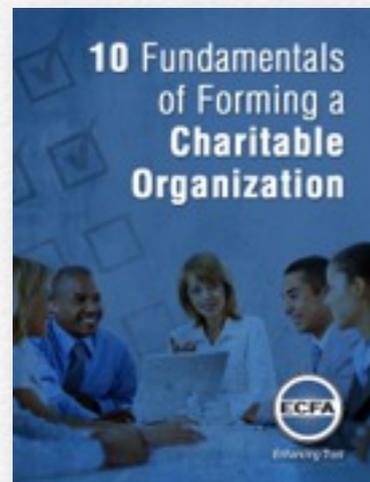


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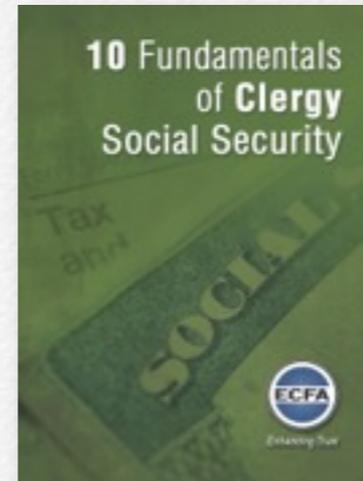
10 Fundamentals of Forming a Church

Churches form to give followers of Christ the opportunity to worship together, grow in faith, and meet the needs of the local community. Although churches are formed for spiritual purposes, there are also practical legal and financial consequences that arise when organizing a church. This book provides an overview of the ten most fundamental issues to consider when starting a new church.



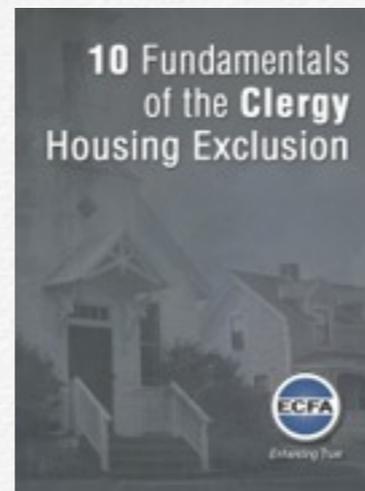
10 Fundamentals of Forming a Charitable Organization

Tens of thousands of new nonprofits are formed each year. Of those applying for tax-exempt status with the IRS, about three out of four applications are approved. When forming a new nonprofit, there are some fundamental issues to consider before starting the process. This book provides an easy-to-read guide to the ten fundamental issues related to starting a new nonprofit organization.



10 Fundamentals of Clergy Social Security

Clergy social security is one of the most complicated issues for many clergy in the U.S. It all starts with two types of social security—and a minister might be subject to both types of social security in the same tax year. The tax forms do not provide a convenient way to calculate the amount subject to social security tax—and this is just the beginning of the challenges facing clergy. If you understand the ten fundamentals discussed in this book, you will have a good grasp of the social security basics that are often puzzling to ministers.



10 Fundamentals of the Clergy Housing Exclusion

The clergy housing exclusion provides an income tax advantage to nearly every member of the clergy—in some instances ministers can save thousands of dollars per year using this tax provision. Maximizing this benefit requires coordination with the church, keeping good records of housing expenses, and applying the housing exclusion limits provided in the tax law. If you understand the ten fundamentals discussed in this book, you will have a sound understanding of the housing exclusion basics for clergy.

Watch for future books which will be published soon.

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ISBN-10: 0-9799907-5-0

ISBN-13: 978-0-9799907-5-5

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