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The Minister and His Taxes

One of the reasons for the confusion surrounding ministers and their taxes is the fact that the IRS has a different set of rules for ministers than laymen.

The purpose of the following information is to assist both ministers and church treasurers in meeting IRS regulations with regard to the proper way to report a minister's earnings, along with ways in which the minister can reduce their taxes because of the special rules that the IRS has established. Most of the rules have been in place for many years and some of them do not make sense, but Congress and the IRS seem hesitant to make any significant changes.

One of the best books dealing with ministers and their taxes is "Minister's Tax and Financial Guide" by Dan Busby, a Wesleyan CPA. The book can be ordered from Amazon.com and Dan updates the book each year. I recommend every church have a copy.

However, because the average person will not take the time to read the 180 pages of material in that book, even though it is written in easy to understand language, I have put together the following material which is a summary of the major topics found in that book, along with some other materials, that I trust will benefit both ministers and church treasurers.

What Income is Taxable to the Minister

As mentioned earlier, some of the IRS rules do not make much sense. One example is - a minister is treated as an "employee" for income tax and "self-employed" for social security taxes.

Income received by a minister that is subject to income taxes: (Exhibit A)

1. Salary paid to the minister by his church
2. Special "love offerings" given to the minister by the church
3. Amount of minister's social security tax paid for by the church either to the minister or IRS
4. Reimbursements for ministry expenses without adequate accounting, as outlined in Exhibit B

Income received by a minister that is subject to social security tax:

1. All of the above forms of income
2. A "housing allowance" paid to the minister who owns his home (Exhibit D)
3. A "parsonage allowance" paid to minister living in a parsonage (Exhibit C)
4. For a minister living in parsonage provided by the church – the fair rental value of the parsonage plus utilities, if paid by the church

What Income is NOT Taxable to the Minister

Income received by minister not subject to either income tax or social security tax:

1. Personal gifts received directly from parishioners, where no services are rendered. If given through the church, gifts to minister become taxable.
2. Fringe benefits that are offered to all full time employees of the church (nondiscriminatory) (full time is usually defined as working 30 hours a week or more)
 - Health insurance (exempt from nondiscriminatory rules)
 - Medical reimbursement plans
 - Educational assistance
 - Retirement plans
3. Reimbursements for ministry expenses with adequate accounting:
 - Ministry related miles at current mileage rate
 - Books and periodicals used in ministry
 - Seminars that benefit his ministry
 - Entertainment of parishioners at an allotted amount per person
 - Office supplies
 - Parsonage maintenance

See attached Exhibit B for a sample reporting form that a minister can provide the church treasurer for accountable reimbursement.

NOTE: It is to the pastor's advantage both financially and tax wise to be reimbursed for all ministry related expenses, as the reimbursement is tax free if reported properly, as noted in Exhibit B. If the church cannot afford to reimburse the minister for all of the above in addition to a full salary, then reimburse the pastor for all the above and then adjust his salary so the gross amount the church pays is the same in total, but the amount subject to tax is less. Exhibit B with Options 1 and 2 illustrates the above.

Housing Allowance

This is an area that has raised many questions as to how to handle it for the minister's taxes.

There are two types of housing arrangements:

1. Church provided housing – parsonage owned or rented by the church
2. Minister providing his own housing

With both types of housing, neither the value of the housing in the case of church owned nor the amount paid to the minister in the case of housing owned by him, are subject to income taxes, but both are subject to social security taxes.

Church Provided Housing

There are three issues involved here:

1. How to report the fair rental value of the parsonage, and utilities if paid by the church
2. How the fair rental value is determined
3. How the expenses of living in the parsonage are handled if paid for by the minister vs. paid for by the church

When we get to Exhibit E, on the church issuing a W-2 to the minister, we will deal with how the fair rental value is reported to the minister and the IRS.

With respect to determining the fair rental value, the IRS will accept whatever figure is used as long as there is some reasonable basis for determining such and it is documented. A simple way would be to determine what comparable houses rent for in the area and a realtor can provide this information.

As noted earlier, there is no income tax paid on the fair rental value, just social security tax. This fair rental value plus utilities, if paid by the church, are reported on the minister's Schedule SE on his personal return.

If the minister incurs expenses while living in the parsonage, any of these can be reimbursed by the church to the minister without the minister incurring either income tax or social security tax if the expenses are reported properly as noted on Exhibit B - 3.

If the church does not reimburse all the expenses incurred by the minister, such as insurance on personal items, purchase of furniture, etc., then a portion of the minister's salary can be designated as a "parsonage allowance," just as would be true if the minister owned his own home. The form for figuring this "parsonage allowance" is found on Exhibit C. This amount would reduce the minister's total taxable wages for income taxes but be subject to social security tax.

Minister Providing His Own Housing

Exhibit D is the form that a minister would use to estimate his expenses to maintain his own home. This is normally filled out at the beginning of the year. Based on this estimate the church board puts in their minutes the amount designated as a "housing allowance." The amount of the housing allowance is limited up to a maximum equal to the fair rental value of the home, including furnishings and utilities, if the minister's estimate of his expenses should go over that amount.

I recommend that between the end of the year and before the church treasurer issues the W-2, the minister let the treasurer know what his actual housing expenses were, compared to his estimate on Exhibit C or D.

If the expenses are less than estimated, the designated housing allowance can be adjusted before the W-2 is issued. If the expenses are more, then the housing allowance is limited to whatever was approved by the church board. The housing allowance can be adjusted during the year and reflected in the church minutes.

As noted above, as is true of a minister living in a parsonage, the value of the housing allowance for a minister living in his own home is not subject to income tax but is subject to social security tax.

Reporting Income on a W-2

One of the areas of churches not meeting IRS regulations is the way the minister's income is reported to the IRS or maybe not even reported at all. Some churches give a Form 1099 to the minister and may or may not file a copy with the IRS, some give a statement to the minister without anything going to the IRS and then in some cases – nothing to the minister or IRS.

The correct way is - copy B and C of a W-2 to the minister and copy A of the W-2 and a W-3 to the IRS (actually the Social Security Administration is where it is mailed). Exhibit E is a sample of a correctly filled out W-2. A W-3 is basically a repeat of the same information on a W-2 and is self explanatory.

Because the minister is treated as an employee for income tax purposes and self-employed for social security purposes, then generally only box 1 of the W-2 has a figure which is the total taxable income from Exhibit A and box 14 which reflects the parsonage allowance for either the expenses of a minister in a parsonage (Exhibit C) or a housing allowance for a minister in his own home. (Exhibit D)

In some situations a minister may have the treasurer deduct income tax from the minister's pay (in lieu of the minister paying quarterly estimated taxes) and send it in quarterly with Form 941. This type of deduction is not required, but if it is done, then the amount that has been withheld and paid in quarterly on Form 941 will go in box 2. This amount in Box 2 can be used to cover either income taxes or social security taxes on the minister's tax return.

Because the minister is treated as self-employed for social security purposes, boxes 3-6 are left blank on the W-2 as the minister pays his own social security on Schedule SE of his personal tax return.

NOTE: There are some churches who treat the minister like any other employee. They deduct income tax, deduct social security, match it and send it all in quarterly on a Form 941. At the end of the year the minister's W-2 looks like any other employee's W-2, except the minister's W-2 shows the housing allowance in box 14, or at least it should. The social security wages in box 3 and 5 will be more than the wages in box 1 because of the parsonage or housing allowance in box 14. In this situation the social security tax may have already been deducted and paid on the parsonage or housing allowance.

Even though the above way, as reflected in the NOTE, of treating a minister as an employee for both income tax and social security tax is technically not correct, the IRS will probably allow it. It does make it easier for the minister as they don't have to file quarterly estimated taxes, but causes some extra work for the treasurer as it requires filing quarterly reports. However, if QuickBooks is used, all the paperwork is created by QuickBooks with very little extra effort by the treasurer.

Other Tax Considerations

1. Another example of an IRS regulation that does not make sense, is the fact that after reducing the minister's taxable salary by the value of the housing allowance, he can deduct a second time, on Schedule A, interest on his mortgage and property taxes paid, if he has enough to itemize his deductions including medical expenses, state income or sales taxes, charitable contributions and unreimbursed ministry expenses.
2. While on the subject of contributions – if the minister gives back to the church a set amount each week/month, he can have the treasurer deduct that amount from his paycheck and in doing so he does not pay either income tax or social security on that deducted amount. The following must be done to make this deducted amount non-taxable:
 - The minister needs to sign Exhibit F stating that he is, in essence, taking a voluntary salary reduction of a stated amount, which is what he normally gives back to the church.
 - By signing Exhibit F he relinquishes all control over how that money is used.
 - The minister cannot state that he wants some of the deduction to go to missions or building fund, etc. If he does so, then in reality he has received the money and is just bypassing writing a check back to the church for missions, building fund, etc.
 - If he follows the above, the amount is not reflected as income on his W-2, and he does not get a charitable tax deduction on his tax return.
 - If, in addition to the above, he wants to give offerings through the church for missions, building fund, etc., he can write a check to the church for that amount and project and that is tax deductible if he itemizes his deductions.

3. On income earned other than directly from the church – weddings, funerals, revivals, etc., then the income would be reported on Schedule C and the expenses to make that income would also be reported there. If the expenses are more than the income the net loss can be deducted from other income reflected on the tax return and it will also reduce the amount of social security owed on Schedule SE.
4. It is critical that a minister keep good records of all income and expenses so he can take advantage of all the deductions to reduce his taxes. QuickBooks has a free software program called “Simple Start” that would be an excellent way to keep track of expenses and income so that when it comes time to file his tax return, all the information is there to make the task easier. Go to www.quickbooks.com and download a copy. If your church needs a computer program for the treasurer, QuickBooks Pro for about \$179 at an office supply store will be all they need.
5. If the minister is not reimbursed for all his ministry related expenses and he itemizes his deductions on Schedule A, he should file Form 2106 and he may be able to deduct a % of those unreimbursed expenses.
6. All of the above pages are dealing with ordained ministers. However, these same provisions would apply to a licensed minister if that minister is allowed by the ordaining body to perform all the same functions as an ordained minister.
7. One of the best retirement tools for a minister, or for anyone, is investing in a Roth IRA. The money invested is not tax deductible at the time it is contributed, but the advantage of the Roth over a regular IRA is that all the appreciation and all the dividends, if reinvested, are totally tax free if left invested for the required length of time. While the regular IRA might give a small tax deduction now, the fact that there is no tax in the future when withdrawing the Roth IRA makes it more advantageous tax wise than a regular IRA.
8. Even though the minister is treated as self employed for social security purposes, others employed by the church, for example custodians and secretaries, are to be treated as regular employees. Thus, social security taxes and federal and state income taxes, depending on income and exemptions claimed, must be withheld from their wages and a Form 941 submitted quarterly to the IRS and any forms to the states that have income taxes.
9. Churches are exempt from paying state and federal unemployment taxes on all church employees including the minister.
10. Church employees are subject to workman’s compensation insurance unless exempted by the state.
11. Ministers who draw social security benefits early, prior to full retirement age, need to be sure that the social security office does not pick up the minister’s W-2 wages twice; once on page 1 of the 1040 and again on Schedule SE where the minister reflects his W-2 wages for social security taxes. This could result in the social security office incorrectly assuming that the minister made more than the earnings limit and reducing the benefits accordingly. Include a note of explanation with the tax return so that the above does not happen, pointing out that the taxpayer is a minister and that the social security office should not add the W-2 wages twice in the total wage calculations. This only needs to be done if the minister is receiving benefits prior to full retirement age and only until the minister reaches the year of full benefits.

EXHIBIT A

Minister's Total Compensation Package

Taxable for Income Taxes *

- Salary of \$_____ per week
- Social Security reimbursement of ____% of salary
- Christmas bonus – \$_____
- Other gifts during the year – \$_____
- _____

* Definition of income subject to income taxes is – “for services rendered”

Taxable for Social Security

- All of the above are subject to social security taxes
- Housing/parsonage allowance of \$_____ per month
(based on either Exhibit C or D)
- Fair rental value of parsonage \$_____ per month

Non-taxable Fringe Benefits to be Provided

- Health insurance \$_____ per month
- Retirement plan \$_____ per month
- _____ \$_____ per month
- _____ \$_____ per month

Accountable Expenses up to \$_____ per month (Exhibit B)

EXHIBIT B

Minister's Accountable Expense Report
(Attach receipts for all expenses where applicable)

1. Auto Expenses

_____ miles x _____ per mile rate	\$_____	
Parking and tolls	_____	
Other _____	_____	
Sub Total		_____

2. Professional Expenses

Books/Periodicals	_____	
Out of town travel (actual expenses + 50% meals)	_____	
Office supplies	_____	
Entertainment in home ___meals @ \$3 each	_____	
Business meals outside home (50%)	_____	
Cell Phone	_____	
Other _____	_____	
Sub Total		_____

3. Parsonage Maintenance

Items _____	_____	
_____	_____	
_____	_____	
Sub Total		_____

Grand Total \$_____

Option 1

Church pays salary of \$700 per week plus up to \$300 per week of reimbursable expenses of minister. Treasurer gives minister salary check of \$700 which is subject to income tax plus social security tax and an expense check of \$300 which is not subject to any tax. If expenses were \$500, the minister can claim the remaining \$200 that was not reimbursed on Form 2106 if he itemizes his deductions.

Option 2

Similar to Option 1 except, instead of paying normal \$700 per week salary, the treasurer reduces the \$700 by the extra \$200 of expenses over the \$300 allotment for expenses and thus gives a \$500 salary check and a \$500 expense check. The total of \$1,000 is the same in both options but this is better for the minister tax wise as he only pays taxes on the \$500 salary and nothing on the \$500 of expenses.

EXHIBIT C

Parsonage Allowance Worksheet

Minister Living in Parsonage

Minister's name _____

For the period _____, 20____ to _____, 20____

Housing Expenses (<i>expenses paid by minister</i>)	Estimated Annual <u>Expenses</u>	<u>Actual</u>
Utilities (<i>gas, electricity, water</i>) and trash collection	\$_____	\$_____
Local telephone expense (<i>base charge</i>)	_____	_____
Pest control	_____	_____
Maintenance and repair	_____	_____
Landscaping and yard maintenance	_____	_____
Furniture/furnishings (<i>purchase, repair, replacement</i>)	_____	_____
Personal property insurance on minister-owned contents	_____	_____
Subtotal	_____	
10% allowance for unexpected expenses	_____	
TOTAL	\$_____	\$_____ (A)
Board designated Parsonage Allowance		\$_____ (B)

The amount excludable from income for federal income tax purposes is the *lower* of A or B.

In most cases the church rather than the minister would be paying for many of these expenses. The above should reflect only those expenses that are paid for by the minister.

EXHIBIT D

Housing Allowance Worksheet

Minister Owns Home

Minister's name _____


For the period _____, 20____ to _____, 20____

Housing Expenses (<i>expenses paid by minister</i>)	<u>Estimated Annual Expenses</u>	<u>Actual</u>
Down payment on purchase of house	\$_____	\$_____
Principal and interest payments on house loan	_____	_____
Property taxes	_____	_____
Homeowner's insurance	_____	_____
Maintenance and repair	_____	_____
Landscaping and yard maintenance	_____	_____
Furniture/furnishings (<i>purchase, repair, replacement</i>)	_____	_____
Utilities (<i>gas, electricity, water</i>) and trash collection	_____	_____
Local telephone expense (<i>base charge</i>)	_____	_____
Pest control	_____	_____
Sub total	_____	
10% allowance for unexpected expenses	_____	
TOTAL	\$_____	\$_____ (A)
Board designated Housing Allowance		\$_____ (B)
Fair rental value of home, including furnishings, plus utilities		\$_____ (C)

The amount excludable from income for federal income tax purposes is the *lowest* of A, B, or C.

EXHIBIT E

W-2 Correctly Filled Out

a Employee's social security number 123-45-6789		Safe, accurate, FAST! Use 		Visit the IRS website at www.irs.gov/efile .			
b Employer identification number (EIN) 59-1234567		1 Wages, tips, other compensation 23,300.00	2 Federal income tax withheld				
c Employer's name, address, and ZIP code ANY CHURCH 123 MAIN ST. ANY WHERE, OH		3 Social security wages	4 Social security tax withheld				
		5 Medicare wages and tips	6 Medicare tax withheld				
		7 Social security tips	8 Allocated tips				
d Control number		9 Advance EIC payment	10 Dependent care benefits				
e Employee's name, address, city, and ZIP code GEORGE SMITH 123 MAIN ST. ANY WHERE, OH		11 Nonqualified plans		12a See instructions for box 12			
		13 Statutory employee <input type="checkbox"/> Retirement plan <input type="checkbox"/> Third-party sick pay <input type="checkbox"/>	12b				
		14 Other HOUSING ALLOWANCE 10,000.00		12c			
				12d			
15 State OH	Employer's state ID number	16 State wages, tips, etc. 23,300.00	17 State income tax	18 Local wages, tips, etc.	19 Local income tax		
20 Locality name							

Copy A of the W-2 goes to the Social Security Administration and copies B and C go to the minister. For states with a state income tax, a copy would also go to the state and if any state income tax was withheld by the church from the minister's pay, that amount would go in Box 17.

The \$23,300 in Box 1 would be made up of:

Salary (\$30,000 less \$10,000 Housing Allowance)	=	\$20,000 (for minister in his own home)
Christmas and other gifts	=	1,000
Reimbursement for share of social security tax	=	<u>2,300</u>
Total		\$23,300

The Housing Allowance of \$10,000 is reflected in Box 14. This figure would come from Exhibit D and would be included for social security tax purposes on the minister's Schedule SE.

In the case of a minister living in a parsonage, Box 1 would be the cash salary less any designation of a Parsonage Allowance from Exhibit C. Box 14 would then reflect that same amount of Parsonage Allowance. Box 14 would not include the fair rental value of the parsonage plus utilities, if paid by the church, as that figure has no bearing on any of the \$ paid to the minister by the church. That figure can be noted in the board minutes and given to the pastor in writing or that figure can be part of Exhibit A if a copy is given to the minister, to include for social security taxes on the minister's Schedule SE, along with any amount in Box 14.

EXHIBIT F

Voluntary Salary Reduction

I, _____, am asking my church treasurer to reduce my
(Minister's name)

salary by \$_____ per _____ as a voluntary salary reduction.

I understand that I relinquish any stipulation as to what this amount of salary reduction is used for. To do otherwise is to render this salary reduction as taxable income.

This agreement is to start _____ and will continue until I state in writing to the church treasurer my desire to change or terminate this agreement.

Signed this _____ day of _____, 20____.

By _____
(Minister's signature)