



# The Ins and Outs of Minister Tax Issues

Elaine Sommerville, CPA

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# Speaker Introductions



- **Elaine Sommerville, CPA**

Elaine has almost 30 years of experience working with nonprofit organizations in areas of tax compliance. She is the sole shareholder of Sommerville & Associates, P.C. located in Arlington, Texas, and is a frequent speaker for the Texas Society of CPAs, the NACBA and an instructor for the AICPA.



# Learning Objectives

- At the end of this session, you will be able to:
  - Define ministerial duties as recognized by tax law
  - Describe what dual tax status means for ministers
  - Identify the tax implications related to compensation, allowances, and business expenses for ministers



# Who Can Be Classified as a Minister

- For federal tax purposes a minister is always credentialed - ordained, commissioned or licensed; and
- A minister is compensated for performing ministerial duties including some or all of the following:
  - Performance of sacerdotal functions
  - Conduct religious worship services
  - Have management responsibility in a local church or denomination
  - Teach or perform administrative services at a theological seminary
  - Perform duties under a valid assignment from a church





# Who is a Minister for Department of Labor & Employment Rules

- The courts have ruled that the employment laws do not apply to the relationship between a church and its ministers thus excluding them from wage and hour and nondiscrimination requirements
- While the definitions are similar, the definition of a minister for IRS purposes is not the same as the definition of a minister for DOL purposes.
  - May only be available to churches
  - Doesn't have to be the predominant portion of the duties
  - Doesn't have to have ministerial credentials



# Important Ministerial Tax Issues for IRS

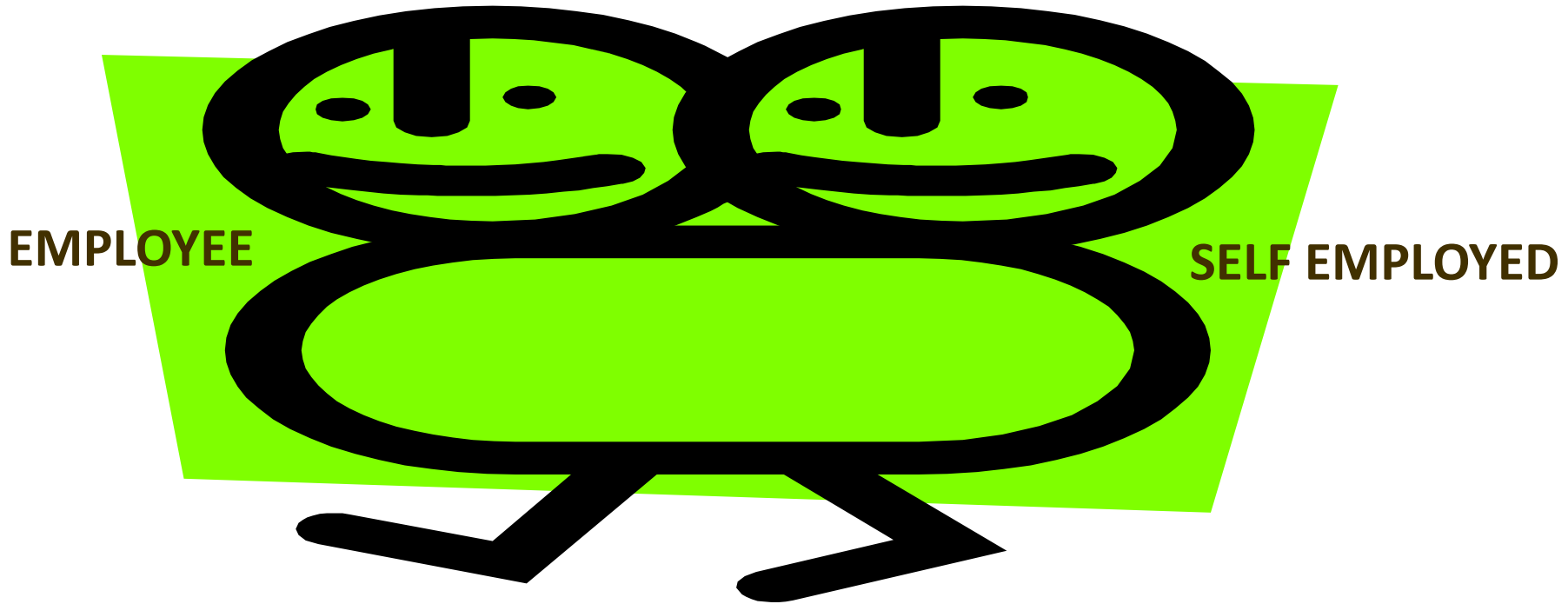
- Special rules for FICA/Medicare
- Special rules for SE tax
- Special rules for federal income tax withholding
- Special rules for housing allowance

Warning: Ministerial classification is determined by law and not by a personal decision



# The Minister & Dual Tax Status

- Classification for federal income tax purposes?
- Classification for social security tax purposes?



# Classification for Federal Income Tax

- Truly self employed, i.e, income earned outside the church such as honorariums
  - Most Instances – Self Employed Report on Schedule C
- Employee of the Church
  - Most Instances – Common Law Employee
  - This determines:
    - ◇ Participation in & taxation of Benefit Plans
    - ◇ Deduction of employee business expenses
    - ◇ The taxability of health Insurance premiums
    - ◇ The correct reporting on Form W-2
      - Special rules allow a minister to not have federal income tax withheld from his/her pay. This is not an exclusion from federal income tax overall.



# Classification for Social Security

- There are two ways to pay into the system
  - Self Employed Contributions Act (SECA)
  - Federal Insurance Contributions Act (FICA)
- The law says ministers receiving compensation from the performance of ministerial duties must pay in through SECA. There is not an option to pay in through FICA.
- Therefore, **for social security only**, ministers are self employed and required to file Schedule SE unless they have obtained an exemption by filing Form 4361.



# The Exemption from Social Security

- Ministers may opt out based on their theological beliefs against socialized insurance
- Form 4361
  - Due by the due date of the Form 1040 for the 2<sup>nd</sup> year in which the minister had self employment income of \$400 or more of which any portion is attributable to ministry work
  - Not effective until it is approved by the IRS!
  - File in triplicate and do not attach to the Form 1040
  - Only applies to ministerial income
  - **DON'T LOSE THE APPROVED FORM!**



# What is Considered as Income?

General Rule: If it benefits a person, it is probably taxable unless the Code says its not!

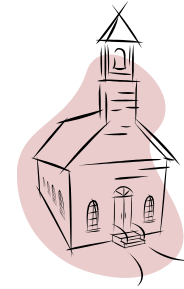
- Salary
- Housing Allowance
- Auto Allowance
- Love Gifts
- Retirement Plan Contributions
- Health and Other Benefit Plans
- Clothing
- Education

\*\*\*The above are examples of both taxable and nontaxable forms of income \*\*\*



# Housing Allowance Organizational Issues

- Must be designated by the employer/payer, i.e., the church **and**
- Must be designated in advance of being paid **and**
- Must be designated in writing





# Housing Allowance

## More Organizational Issues

- Do not report as wages on Form 941 or in Box 1 of W-2
- Do not ask the minister to account for his housing expenses at the end of the year
- Only pay to those properly classified as a minister and performing ministerial duties
- Do not pay to anyone who is having FICA/Medicare taxes withheld & matched



# Housing Allowance Minister's Issues

- A housing allowance is a portion of your compensation that is not taxable to the extent it does not to exceed the lowest of:
  - Amount actually designated by the church;
  - Amount actually spent on housing expenses; or
  - The fair rental value of the home as furnished plus utilities.



# What Are Valid Housing Expenses?

- Mortgage payments
- Utilities
- Base rate of phone – not your cell phone
- Furniture & decorating items
- Cleaning supplies and help
- Repairs & maintenance
- Payments on home equity loans where proceeds use on valid housing expenses that you have not already claimed as housing expenses
- Insurance
- Taxes



# Housing Allowance & Taxes

- Federal Income Tax – The amount that can be excluded is not taxable. Any excess housing is claimed as additional income and included on Line 7 of the Form 1040.
- Self Employment Tax – the full amount of housing allowance is taxable on Schedule SE.

Note: No accounting should be included on the 1040, but a statement indicating the situation is advisable.



# Love Gifts – The Gift That is Not A Gift

- Any amounts received for the provision of services is not a gift but is taxable income.
- Any gift received from an employer that is more than a small token item is taxable pursuant to Internal Revenue Code Sec. 102.



# Business Expenses

- The following may be considered as business expenses:
  - Books & magazines for study
  - Mileage to & from hospitals, member calls, meetings, etc.
  - Office supplies
  - Conference fees
  - Some educational expenses
  - Travel
  - Cell phones with caution
  - Gifts limited to \$25 per recipient



# Business Expenses & Deductions

- While fully deductible against SE Income, a minister's business expenses are limited by 3 different limitations for purposes of computing federal taxable income:
  - The Deason allocation to nontaxable housing allowance
  - The ability to meet the 2% threshold for itemized deductions
  - The ability to itemize deductions on Schedule A

**Warning:** Expenses are only deductible, if the employer will not reimburse the employee for the expense. If the employee is not reimbursed by his choice, it is not a deductible expense.



## Example of the Deason Rule

Pastor Helpful receives \$10,000 for his service to First Church. \$2,500 is designated as housing allowance. He has \$4,000 of out of pocket business expenses. How much of his business expenses can he deduct on Form 2106?

Nondeductible Expense:

$$\$2,500 / \$10,000 \times \$4,000 = \$1,000$$

Deductible Expense:

$$\$4,000 - \$1,000 = \$3,000$$

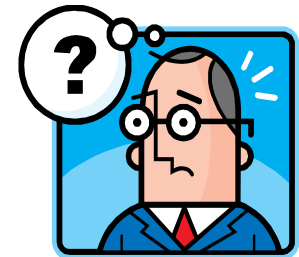
**Note:** This calculation should be included as a statement to the Form 1040





# Beware of Netting Arrangements!

- Netting arrangements are considered to be nonaccountable expense reimbursement plans and are fully taxable
- A netting arrangement
  - Pastor Bob receives \$750 each week. However, the Finance Committee tells Pastor Bob that if he turns in his business expenses each week, then he can split the payment into part business expense reimbursement and part salary.
  - How much is taxable to Pastor Bob?
  - Answer: All \$750





## Questions?

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