

Based on our experience, the following are frequent questions asked by ministers, missionaries, church treasurers, and others serving in ministry positions as licensed or ordained ministers. Our answers are not intended to be exhaustive. Accordingly, you should consult your own tax professional for assistance in applying this information to your specific tax situation.

—Corey A. Pfaffe, CPA, LLC, www.MinistryCPA.org, info@ministrycpa.org.

Top 10 Questions that Ministers, Missionaries, and Church Treasurers Ask Tax Preparers

(Updated: October 1, 2014)

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1. Am I an employee of the church or am I self-employed?

The answer is “both.” Most ministers are considered employees in every respect except for purposes of paying self-employment tax (Medicare and Social Security). This means that they are eligible for virtually all employee benefits that are given favorable tax treatment in the IRC. Many of these benefits are unavailable to the typical self-employed individual.

Ministers who have not opted out of the Medicare and social security system, however, are not permitted to have FICA withheld and matched by the church. The minister must pay the entire 15.3 percent self-employment tax. Many churches provide additional funds to assist their ministers in the payment this tax, but this additional compensation, while very helpful, is itself subject to both income and self-employment tax.

Itinerate evangelists are a common example of ministers who do not have employee status; they are entirely self-employed.

2. What can I deduct for a housing/parsonage allowance?

A minister who receives a housing allowance may exclude the allowance from gross income to the extent it is used to pay expenses in providing a home. A minister living in a parsonage qualifies for a housing allowance to the extent of his own out-of-pocket costs. The minister’s church or other qualified organization must designate the housing allowance pursuant to official action taken in advance of the payment. The IRS lists only food and servants as prohibitions to allowable housing expenses. If a minister owns a home, the amount excluded from the minister’s gross income as a housing allowance is limited to the least of the following three amounts:

- (a) The amount actually used to provide a home.
- (b) The amount officially designated as a housing allowance.
- (c) The fair rental value of the home.

Allowable Housing Expenditures can be viewed on the next page.

ALLOWABLE HOUSING EXPENDITURES

-  Total mortgage *payments* (Be careful not to duplicate amounts included below under “real estate taxes” and “homeowner’s insurance”)
-  Real estate taxes
-  Homeowner’s or renter’s insurance
-  Furniture, furnishings, appliances
-  Utilities (including heat, lights, water, sewer, telephone, water softener, cable, waste disposal, etc.)
-  Rent paid
-  Repairs paid personally
-  Loan refinancing costs
-  Other (everything except food and household employee compensation)

(Sources: IRS Publication 1828; Clergy Housing Allowance Clarification Act of 2002; IRS Regulation §1.107-1)

3. What are my retirement plan options and what are the advantages / disadvantages of each?

The best retirement plan option for each minister depends on his objectives and his current tax situation. The three most common retirement plan options used by ministers include:

- (a) IRC 403(b) plans (also called Tax Sheltered Annuities (TSAs)),
- (b) Traditional Individual Retirement Accounts (IRAs), and
- (c) Roth IRAs.

Ministers often select 403(b) plans when they want to maximize their eligible contributions, or to reduce their self-employment tax burden. For the year 2014, a minister may elect to have his employer withhold (“elective deferral”) up to \$17,500 of his compensation and contribute it, instead, to his 403(b) qualified investment account. Many ministers who are 50 and older are eligible to increase this amount by another \$5,500 to catch-up for earlier years’ smaller deferrals (source: IRS Publication 571). In addition, unlike other retirement plan choices, an employee minister is not subject to the 15.3 percent federal self-employment tax on amounts deferred into 403(b) accounts (source: IRS Revenue Rulings 68-395 and 78-6). This is also true of any amount that his employer contributes over-and-above the minister’s own elective deferral.

The situations for which Traditional IRAs are the best choice for a minister’s retirement plan are less frequent, especially since the establishment of Roth IRAs beginning with the 1998 tax year. For the year 2014, a minister and his wife may each contribute up to \$5,500 to qualified IRA accounts; an additional \$1,000 each may be contributed if they are 50 years of age. A minister who has opted out of the social security system but is still looking for additional income tax deductions may find the Traditional IRA his best choice. These contributions can often be made even if the minister participates in a 403(b). However, he

may not be able to *deduct* his full Traditional IRA contribution. For this reason and others, many ministers choose Roth IRA's instead of Traditional IRAs.

Roth IRAs enable ministers to make the same amount of contributions as do Traditional IRAs but without receiving an income tax deduction. For many ministers, especially those with young families and ample housing allowances, additional tax write-offs are not needed. Unlike Traditional IRAs, not only will future retirement (age 59½ or later) distributions of their current contributions be untaxed, the *earnings* distributed from the Roth IRA will not be taxed. Further, pre-retirement distributions may be made without penalty for:

- (a) Medical expenses (and health insurance premiums for the unemployed).*
- (b) Qualified higher education expenses.*
- (c) New home purchase costs for taxpayers who have not owned a personal residence for at least two years ("first time homebuyers").

*Also available for some Traditional IRA distributions.

Tax-saving opportunity: Many ministers who participate in retirement plans have also reduced their federal income tax by taking advantage of the retirement savings contributions credit. For 2014, the credit is equal to 50% of Traditional and Roth IRA and 403(b) plan contributions for married filing joint taxpayers with Adjusted Gross Income less than \$35,500. Reduced credits are available for those with AGI greater than \$35,500 but less than \$59,000 (IRS Form 8880). With housing allowances reducing their AGI to these levels, many ministers are eligible.

4. Do you think I should suggest that the church set up a car allowance?

Any financial assistance that a minister's employer can give is appreciated. A car allowance can be especially helpful. Car allowances, however, must be established as "accountable plans." This means that any advances given by the employer to the minister must be properly substantiated on a timely basis or the law requires the minister to refund the unspent, undocumented portion of the allowance.

It's a better idea to offer a professional expense allowance under accountable plan rules of the IRS (instead of a car allowance) that covers car expenses and any other professional expense. Documentation can then include non-auto costs such as air travel, lodging, conferences, gifts, entertainment, books, supplies, and any other legitimate ministry-related expenditure. The minister documents car expenses when he provides a record of the date, business purpose, and number of miles for each trip. The total miles submitted for reimbursement should then be multiplied by a per mile rate adopted by the church. The IRS sets maximum per mile rates each year that may be used if the church wishes without requiring inclusion of the reimbursement payments on the minister's annual Form W-2.

Even though the IRC permits the payment of advances, church funds will be managed more effectively if the church budget establishes an expense category with an annual limit and if the church only disburses funds as documentation is received.

Tax-saving opportunity: For 2014, the IRS increased the allowable mileage reimbursement/deductibility rate to 56 cents per mile.

Tax-saving opportunity: Ministers who incur unreimbursed employee business expenses may include these costs as miscellaneous itemized deductions on Schedule A. Unfortunately, these deductions often do not reduce ministers' taxable income because of required modifications for two percent of Adjusted Gross Income and for the prorated tax-free portion of their income (i.e., the housing allowance) (source: Publication 517). However, many ministers fail to also reduce their self-employment taxable income on Schedule SE by these same amounts.

5. What reports do the church need to file with the government regarding my compensation?

A church files the same reports for all employees and is subject to the same withholding rules for standard employees as any other organization. The only exceptions relate to the exemption from unemployment taxes that all churches enjoy and to an exemption from FICA tax that a few churches applied for in the 1980s. IRS Publication 15 can answer treasurers' standard questions regarding church payroll.

Reporting a minister's compensation is often confusing even to treasurers who are familiar with the rules for standard employees. Following is a sample compensation arrangement for Pastor Mike Minister of Sample Church. Quarterly amounts are presented below. Pictures of IRS Forms 941, W-2, and W-3 are provided. The forms have been prepared assuming that the church also has a part-time office worker, Susan Secretary, who works too few hours to be eligible for any benefits other than an hourly wage with 7.65 percent FICA withholding (and an equal amount of FICA matching by the church).

<u>Pastor Mike Minister's Compensation</u>	Quarterly Amount
Cash compensation	\$ 5,000
Housing allowance	5,000
Medical Benefit Assistance for Health-sharing Plan (100% taxable)	400
Other Unapproved Affordable Care Act Health Benefits	100
Elective deferral withholding from cash compensation for 403(b) plan (paid by church to Pastor Minister's qualified investment account each month)	-1,000
Federal income tax withholding from cash compensation (paid by church each quarter to the IRS)	-1,500
State income tax withholding from cash compensation (paid by church periodically to appropriate state department)	<u>-100</u>
Net checks per quarter (1/13 th paid each week)	\$ 7,900
 Professional expense <i>reimbursement</i> (disbursed only as documentation is received) or <i>allowance</i> (documentation required within 60 days of advance (source: IRS Regulation § 1.62-2(g)(2)(i)))	 *
 Approved Affordable Care Act Health Insurance, HRA, HSA, or other Health Benefits	 *
 Contributions to 403(b) plan paid by church to Pastor Minister's qualified investment account	 *

* Amounts are irrelevant for IRS reporting purposes.

This information is provided as a service of MinistryCPA.org to ministers and Christian ministries. Please contact us or your personal professional advisor to determine how this information may apply to your own situation.

<u>Susan Secretary's Compensation</u>	<u>Quarterly Amount</u>
Cash compensation	\$ 1,500
FICA Taxes	-115
Federal income tax withholding from cash compensation (paid by church each quarter to the IRS)	-100
State income tax withholding from cash compensation (paid by church periodically to appropriate state department)	-50
Net checks per quarter (1/13 th paid each week)	<u>\$ 1,235</u>

Mike Minister's 2013 Form W-2									
22222		Void		a Employee's social security number		For Official Use Only ▶ OMB No. 1545-0008			
b Employer identification number					1 Wages, tips, other comp. 18000.00		2 Federal income tax withheld 6000.00		
c Employer's name, address, and ZIP code Sample Church					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		10 Dependent care benefits		
e Employee's first name and initial Mike		Last name Minister		Suff.	11 Nonqualified plans		12a See instructions for box 12 E 4000.00		
f Employee's address and ZIP code					13 Statutory employee Retirement plan Third party sick pay X		12b		
					14 Other HouseAll 20000.00		12c		
							12d		
15 State Employer's state ID number		16 State wages, tips, etc. 18000.00		17 State income tax 400.00		18 Local wages, tips, etc.		19 Local income tax	20 Locality name
Form W-2 Wage & Tax Statement					2013		Department of the Treasury -- Internal Revenue Service		
Copy A for Social Security Administration - Send this entire page with Form W-3 to the Social Security Administration;					0 0 0 0 / 1015		For Privacy Act and Paperwork Reduction Act Notice, see the separate instructions.		

Susan Secretary's 2013 Form W-2									
22222		Void		a Employee's social security number		For Official Use Only ▶ OMB No. 1545-0008			
b Employer identification number					1 Wages, tips, other comp. 6000.00		2 Federal income tax withheld 400.00		
c Employer's name, address, and ZIP code Sample Church					3 Social security wages 6000.00		4 Social security tax withheld 372.00		
					5 Medicare wages and tips 6000.00		6 Medicare tax withheld 87.00		
					7 Social security tips		8 Allocated tips		
d Control number					9		10 Dependent care benefits		
e Employee's first name and initial Susan		Last name Secretary		Suff.	11 Nonqualified plans		12a See instructions for box 12		
f Employee's address and ZIP code					13 Statutory employee Retirement plan Third party sick pay		12b		
					14 Other		12c		
							12d		
15 State Employer's state ID number		16 State wages, tips, etc. 6000.00		17 State income tax 200.00		18 Local wages, tips, etc.		19 Local income tax	20 Locality name
Form W-2 Wage & Tax Statement					2013		Department of the Treasury -- Internal Revenue Service		
Copy A for Social Security Administration - Send this entire page					0 0 0 0 / 1015		For Privacy Act and Paperwork Reduction Act Notice, see the separate instructions.		

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Sample Church's 2013 Form W-3					
33333	a Control number	For Official Use Only OMB No. 1545-0008			
b Kind of Payer (Check one)	<input type="radio"/> 91 <input type="radio"/> CT-1 <input type="radio"/> 941 Military <input type="radio"/> Hshld. emp. <input type="radio"/> 943 <input type="radio"/> Medicare govt. emp. <input type="radio"/> 944	c Total number of Forms W-2	d Establishment number	1 Wages, tips, other compensation	2 Federal income tax withheld
		2		24000.00	6400.00
		e Employer identification number (EIN)		3 Social security wages	4 Social security tax withheld
				6000.00	372.00
f Employer's name		Sample Church		5 Medicare wages and tips	6 Medicare tax withheld
				6000.00	87.00
g Employer's address and ZIP code				7 Social security tips	8 Allocated tips
				9	10 Dependent care benefits
h Other EIN used this year				11 Nonqualified plans	12a Deferred compensation
					4000.00
15 State	Employer's state ID number	13 For third-party sick pay use only		12b	
16 State wages, tips, etc.	17 State income tax	14 Income tax withheld by payer of third-party sick pay			
24000.00	600.00				
Contact person	Telephone number	18 Local wages, tips, etc.		19 Local income tax	
Email address	Fax number				
				0000/1015	
Under penalties of perjury, I declare that I have examined this return and accompanying documents and, to the best of my knowledge and belief, they are true, correct, and complete.					
Signature		Title		Date	
Form W-3 Transmittal of Wage and Tax Statements				2013	
Department of the Treasury Internal Revenue Service					

Sample Church's Quarterly Form 941	
Form 941 for 2013: Employer's QUARTERLY Federal Tax Return	OMB No. 1545-0029 970113
(Rev. January 2013) Department of the Treasury - Internal Revenue Service	
Employer identification number (EIN) _____	Report for this Quarter of 2013 (check one.)
Name (not your trade name) <u>Sample Church</u>	<input type="checkbox"/> 1: January, February, March
Trade name (if any) _____	<input type="checkbox"/> 2: April, May, June
Address _____	<input checked="" type="checkbox"/> 3: July, August, September
	<input type="checkbox"/> 4: October, November, December
Read the separate instructions before you complete Form 941. Type or print within the boxes. Instructions and prior year forms are available at www.irs.gov/form941 .	
Part 1: Answer these questions for this quarter.	
1 Number of employees who received wages, tips, or other compensation for the pay period including: Mar. 12 (Quarter 1), June 12 (Quarter 2), Sept. 12 (Quarter 3), or Dec. 12 (Quarter 4) 1	2
2 Wages, tips, and other compensation 2	6,000.00
3 Income tax withheld from wages, tips, and other compensation 3	1,600.00
4 If no wages, tips, and other compensation are subject to social security or Medicare tax. <input type="checkbox"/> Check and go to line 6.	
5a Taxable social security wages Column 1 <u>1,500.00</u> x .124 = Column 2 <u>186.00</u>	
5b Taxable social security tips x .124 =	
5c Taxable Medicare wages & tips <u>1,500.00</u> x .029 = <u>43.50</u>	
5d Additional Medicare Tax withholding x .009 =	
5e Add Column 2 from lines 5a, 5b, 5c and 5d. 5e	229.50
5f Section 3121(q) Notice and Demand - Tax due on unreported tips (see instructions) 5f	
6 Total taxes before adjustments (add lines 3, 5e, and 5f) 6	1,829.50
7 Current quarter's adjustment for fractions of cents 7	
8 Current quarter's adjustment for sick pay 8	
9 Current quarter's adjustments for tips and group-term life insurance 9	
10 Total taxes after adjustments. Combine lines 6 through 9 10	1,829.50
11 Total deposits for this quarter, including overpayment applied from a prior quarter and overpayment applied from Form 941-X or Form 944-X filed in the current quarter. 11	
12a COBRA premium assistance payments (see instructions) 12a	
12b Number of individuals provided COBRA premium assistance	
13 Add lines 11 and 12a 13	
14 Balance due. If line 10 is more than line 13, enter the difference and see instructions 14	1,829.50
15 Overpayment. If line 13 is more than line 10, enter the difference <input type="checkbox"/> Check one: <input type="checkbox"/> Apply to next return. <input type="checkbox"/> Send a refund.	
▶ You MUST complete both pages of Form 941 and SIGN it. Next ▶	
For Privacy Act and Paperwork Reduction Act Notice, see the Payment Voucher. Form 941 (Rev. 1-2013)	

6. What ideas can a church consider to control its rising health care costs?

Many ministers and their employers are looking for alternative plans to control rising health care costs without neglecting those in need of medical services. Because of the new Affordable Care Act (ACA) requirements, the majority of churches need to re-think the medical benefits it offers to employees. If the church employs a single employee—a solo minister, the ACA has one set of requirements. (From our opinion, there is more flexibility when there is only a solo employee.) But for churches that employ two or more employees who participate in medical benefits, the ACA has stringent requirements. We suggest that you consult your own tax professional when offering medical benefits. The benefits the church offers may very well be 100 percent taxable to the employee.

Be aware that if a church covers the monthly share costs of an employee for a health-sharing plan (e.g., Samaritan Ministries International, Medi-Share, or Christian Healthcare Ministries), the amount paid by the church is subject to income tax for all employees and to FICA for all standard employees. The church needs to remember that health-sharing plans are not the same as health insurance plans.

7. Can a church give non-taxable gifts to its minister?

Any gifts paid by employers to their employees are considered taxable income and must be reported together with other earnings on Forms 941 and W-2. The only exception relates to gifts of tangible personal property valued less than \$25. Accordingly, the typical Christmas bonus collection received by many congregations and given to their employees represent fully taxable compensation. Of course, as participants in a church-sponsored collection, donors may write off their contributions as tax-deductible donations. On the other hand, personal gifts from a member to a minister are neither taxable to the minister, nor deductible by the member.

8. How can the church and I work together to sell the parsonage and to get my family into a home of our own?

The answer to this question varies greatly based on the church's and minister's specific situation. However, following are several issues that most likely will need to be addressed.

- (a) Any property transferred by the church to the minister will be considered taxable compensation at its fair market value (reduced by any payment by the minister to the church).
- (b) Because the minister will no longer be living in real estate that is tax-exempt housing, his costs of living will increase accordingly.
- (c) The tax-free nature of a housing allowance may not fully eliminate the taxability of any one-time, large bonuses to the minister, even if entirely disbursed to construct or purchase a home. This is due the requirement that a housing allowance not exceed the annual fair rental value of a minister's housing.
- (d) Interest-free (or below market rate) loans from the employer to the minister or principal forgiveness arrangements in reward for ongoing longevity can aid in the transition from a church's "parsonage era" to homeownership for its minister. Care must be taken, however, to comply with IRS income reporting rules and to establish a written agreement that reflects the true substance of a legally binding arrangement between the church and its minister.

Tax-saving opportunity: December and January "bonuses" to assist the minister in constructing or purchasing a home, if implemented properly, can spread the income and self-employment tax costs over two different tax years. Principal forgiveness arrangements established as legitimate compensation for ongoing longevity can spread these tax costs over several consecutive years.

9. Should I “opt out” of the social security system?

The IRC exempts ministers from *mandatory* federal and state income tax and Medicare and Social Security tax withholding by their employers. However, if they do not *elect* to have income tax withholding, then ministers must file and pay federal and state estimated tax vouchers. In any case, employers of ministers are not permitted to withhold and match the 7.65 percent FICA tax payments (source: IRC 3121(b)(8)). Instead, the minister (unless he opts out of the social security system) is responsible to pay the entire 15.3 percent self-employment tax himself. Many ministers elect to have additional federal income tax withheld so that the excess can be applied to their self-employment tax obligation at the time they file their annual Form 1040. Whether you should opt out of the social security system depends greatly on your specific situation. However, the following information may be useful in determining your course of action.

- (a) You may apply to opt out of the social security system only within the first two years of receiving at least \$400 of self-employment earnings when any portion of which is related to your ministry as a licensed or ordained minister.
- (b) Your social security tax-exempt status will apply only to ministerial income. FICA tax will continue to be withheld by your non-ministerial employers, if any.
- (c) Your non-ministerial income both in the past and in the future will help you gain eligibility for Medicare and Social Security benefits (10 years required for eligibility) (source: www.ssa.gov). However, your Social Security benefits are based on your wage history and, accordingly, may be severely limited.
- (d) If you choose to opt out, then you must provide for your own adequate retirement funds, long-term disability savings or insurance, life insurance or survivor savings, and retirement era health care.

Tax-saving opportunity: By opting out, you can save thousands of dollars each year in self-employment taxes, but you must have a plan to gain minimum eligibility for Medicare and Social Security benefits and to provide your own financial stewardship. Do not base your decision on rumors that the federal system might fail. In my opinion, if the economic woes of the US become so acute that the politicians are forced to deny benefits to millions of retirees, then your own investment accounts will likely be severely impacted as well.

10. What bookkeeping system should our Treasurer use to keep the church books?

The bookkeeping system used by a church must be compatible with current and future treasurers' training and experience. To adopt a system that is overly complex or suitable for only a highly qualified bookkeeper may create grave difficulty when there is turnover in the treasurer's position. Following are several solutions that small local churches have found useful:

-  Paper cash receipts and cash disbursement journals—the treasurer uses two separate columnar journals with columns for the amount of each bank deposit (in the cash receipts journal) or for the amount of each check (in the cash disbursements journal). Additional columns of the journals are used to record the amount of the bank deposit or the check into categories consistent with the accounts presented in the church budget. Each month the columns of both journals must be totaled and the totals compared with the check register that, itself has been reconciled with the monthly statement from the bank. The beginning checkbook balance, plus the total bank deposits per the cash receipts journal, less the total checks per the cash disbursements journal, must equal the ending checkbook balance. Periodic reports may be prepared based on summarizing the month-end totals of the journals.
-  Electronic cash receipts and cash disbursement journals—the treasurer follows the same procedures described above using spreadsheet software.
-  Accounting software—the treasurer uses QuickBooks, Peachtree, or other low-cost software. While generally around \$250 per year (not including a payroll add-on) will be incurred to maintain software, either previous formal training in bookkeeping or considerable on-the-job training will be required.

11. How do you respond to my fellow minister's comment: "I do _____ and the IRS has never questioned me"?

Oh, you hear this one too? :^) My typical response—"just because you haven't been caught yet, doesn't mean the IRS will excuse your ignorance, nor will the Lord excuse your willful neglect for God's command to pay tribute to whom tribute is due." Of course, the basis for the tax actions you take must be the Internal Revenue Code established by the Congress and the decisions that courts have handed down. The IRS gives its opinions, as well, in Revenue Rulings, Regulations, and other documents. In addition to your professional tax preparer, the following resources may be helpful:

-  Church and Clergy Tax Guide, by Richard R. Hammar (www.churchlawtoday.com)
-  Worth's Income Tax Guide for Ministers, by B.J. Worth (www.worthfinancial.com)
-  Zondervan's Minister's Tax and Financial Guide, by Dan Busby (www.zondervan.com)