Minister Tax Law

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Topics Unique to Ministers

• Income Issue:
  – Parsonage/Housing Allowance
  – Gift or Compensation

• SE Issue:
  – Members of Religious Orders and Vow of Poverty
  – Exemption
  – Computing SE Income
  – Employee or Independent Contractor
  – Business Expenses: Operation of Section 265

Important Tax Cases and IRS Rulings

• Salkov v. Commissioner, 46 T.C. 190, 197 (1966)
• Silverman v. Commissioner, 57 T.C. 727, 732 (1972)
• In Rev. Rul. 78-301, 1978-2 C.B. 103
• Knight v. Commissioner, 92 T.C. 199, 205 (1989)
• Lawrence v. Commissioner, 50 T.C. 494, 499-500 (1968)
• Charles E Banks and Rose M Banks v. Commissioner, T.C. Memo. 1991-641
• Commissioner v. Duberstein, 363 U.S. 278, 4 L. Ed. 2d 1218, 80 S. Ct. 1190 (1960)
• Potito v. Commissioner, T.C. Memo 1975-187, aff’d 534 F2d 49 (5th Cir. 1976)
## Freedom from Religion Foundation, Inc. v. Lew

- The case is Freedom from Religion Foundation, Inc. v. Lew on appeal from the United States District Court for the Western District of Wisconsin.
- The issue is Section 107(2) of the Internal Revenue Code, which states that for a “minister of the gospel” the income received as a housing allowance is exempt from federal income tax, to the extent used to provide a home, including furnishings and utilities.
- In 1966, the Tax Court of the United States interpreted the exemption to reach “the equivalent of ministers in other religions” and it has since been applied to clergy of all faiths.

## Legal Challenge

- The Freedom from Religion Foundation voted a housing allowance to two of its officers of $15,000.
- They brought suit in the United States District Court for the Western District of Wisconsin.
- The housing allowance is not considered tax exempt for its officers, while it was considered tax exempt for ministers.
- Judge Barbara Crabb, stated the tax exemption for the housing allowance unconstitutional in that it favors religious organizations over secular non-profit organizations.
- She cited the Supreme Court’s 1989 ruling in Texas Monthly, Inc. v. Bullock.

## Lack of Standing

- The Government appealed Judge Crabb’s decision to the Seventh Circuit.
- The case was reversed and dismissed.
- It never addressed the issue before the court stated that the organization did not have standing to bring the suit and challenge the law.
Ministerial Services

- Ministerial services, in general, are the services performed in the exercise of the ministry, in the exercise of the duties as required by the religious order, or in the exercise of a profession as a Christian Science practitioner or reader.
- Income receive for performing ministerial services is subject to SE tax unless the client has an exemption.
- Even with the exemption, only the income receive for performing ministerial services is exempt.
- The exemption does not apply to any other income.

Ministers

- Most services you perform as a minister, priest, rabbi, etc., are ministerial services and include:
  - Performing sacerdotal functions,
  - Conducting religious worship, and
  - Controlling, conducting, and maintaining religious organizations (including the religious boards, societies, and other integral agencies of such organizations) that are under the authority of a religious body that is a church or denomination.
- You are considered to control, conduct, and maintain a religious organization if you direct, manage, or promote the organization’s activities.

Employment Status for other Tax Purposes

- Even though all of your income from performing ministerial services is subject to self-employment tax for social security tax purposes, the client may be an employee for income tax or retirement plan purposes in performing those same services.
- For income tax or retirement plan purposes, the income earned as an employee will be considered wages.
Common-Law Employee

- Under the common law rules, a client is considered either an employee or a self-employed person.
- Generally, the individual is an employee if they perform services for someone who has the legal right to control both what you do and how they do it, even if you have considerable discretion and freedom of action.
- If a congregation employs them and pays them a salary, they are generally a common-law employee and income from the exercise of the ministry is wages for income tax purposes.
- However, amounts received directly from members of the congregation, such as fees for performing marriages, baptisms, or other personal services, are not wages; such amounts are self-employment income for both income tax purposes and social security tax purposes.

Example

- A church hires and pays the client a salary to perform ministerial services subject to its control.
- Under the common-law rules, they are an employee of the church while performing those services.
- Form SS-8
  - If you are not certain whether the client is an employee or a self-employed person, they can request a determination from the IRS by filing Form SS-8.
  - Generally the process takes about 6 months for a response.

Members of Religious Orders

- If your client is a member of a religious order who has not taken a vow of poverty, the earnings for ministerial services performed as a member of the order are subject to SE tax.
- However, the client can request that the IRS grant an exemption.
- Vow of poverty
  - If your client is a member of a religious order and have taken a vow of poverty, they are already exempt from paying SE tax on their earnings for ministerial services performed as an agent of your church or its agencies.
  - No separate exemption is needed.
  - For income tax purposes, the earnings are tax free to the client and are considered the income of the religious order.
Services Covered under FICA at the Election of the Order

- Even if your client has taken a vow of poverty, the services they perform for their church or its agencies may be covered under social security.
- The services are covered if their order, or an autonomous subdivision of the order, elects social security coverage for its current and future vow of poverty members.
- The order or subdivision elects coverage by filing Form SS-16.
- The election may cover certain vow of poverty members for a retroactive period of up to 20 calendar quarters before the quarter in which it files the certificate.
- If the election is made, the order or subdivision pays both the employer’s and employee’s share of the tax.
- The client does not pay any of the FICA tax.

SS-16

Services Performed Outside the Order

- Even if your client is a member of a religious order who has taken a vow of poverty and the order requires them to turn over amounts they earned, these earnings are subject to federal income tax and either SE tax or FICA tax (including estimated tax payments and/or withholding) if:
  - The client is self-employed or an employee of an organization outside your religious community, and perform work not required by, or done on behalf of, the order.
  - In these cases, the income from self-employment or as an employee of that outside organization is taxable to them directly.
  - They may be able to take a charitable deduction for the amount they turn over to the order.
### Christian Science Practitioners and Readers

- Earnings from services performed in the profession as a Christian Science practitioner or reader are subject to SE tax.
- However, the client can request an exemption.
- Christian Science practitioners are members in good standing of the Mother Church, The First Church of Christ, Scientist, in Boston, Massachusetts, who practice healing according to the teachings of Christian Science.
- State law specifically exempts Christian Science practitioners from licensing requirements.
- Some Christian Science practitioners also are Christian Science teachers or lecturers.
- Income from teaching or lecturing is considered the same as income from their work as practitioners.

### Election by Certain Church Employees Who Are Opposed to Social Security and Medicare

- Your client may be able to choose to be exempt from social security and Medicare taxes, including the SE tax, if they are a member of a recognized religious sect or division and work for a church (or church controlled nonprofit division) that does not pay the employer’s part of the social security tax on wages.
- This exemption does not apply to their service, if any, as a minister of a church or as a member of a religious order.
- Make this choice by filing Form 4029.

### Handy Table from Pub 517
Form 4029
Eligibility requirements

• To claim this exemption from SE tax, all the following requirements must be met
  1. The client must file Form 4029
  2. As a follower of the established teachings of the sect or division, you must conscientiously oppose accepting benefits of any private or public insurance that makes payments for death, disability, old age, retirement, or medical care, or provides services for medical care.
  3. The client must waive all rights to receive any social security payment or benefit and agree that no benefits or payments will be made to anyone else based on their wages and self-employment income.
  4. The Commissioner of Social Security must determine that:
     a. The client’s sect or division has the established teachings as described in (2) above,
     b. It is the practice, and has been for a substantial period of time, for members of the sect or division to provide for their dependent members in a manner that is reasonable in view of the members’ general level of living, and
     c. The sect or division has existed at all times since December 31, 1950.
Form 4029
Certification.

- In order to complete the certification portion under Part I, the client needs to enter their religious group (on the first line) followed by the religious district or congregation (on the second line).
- For example, they would enter “Old Order Amish” as the religious group, then would enter “Conewango Valley North District,” “Conewango Valley West District,” etc., on the second line as the district.
- However, if they are Anabaptist or Mennonite, enter the name of the religious group as “Unaffiliated Mennonite Churches” or “Eastern Pennsylvania Mennonite Church,” etc., and the congregation as “Antrim Mennonite Church (Anabaptist)” or “Bethel Mennonite Church (Mennonite),” on the second line.

When and Where to File

- File Form 4029 when applying for exemption from social security and Medicare taxes.
- This is a one-time election.
- The client should keep an approved copy of Form 4029 for your permanent records.
- Send the original and two copies of Form 4029 to:
  Social Security Administration
  Security Records Branch,
  Attn: Religious Exemption Unit
  P.O. Box 7
  Boyers, PA 16020
- If the client is no longer a member or no longer follow the teachings of the religious group, their exemption is no longer effective.
- Notify the Internal Revenue Service by sending a letter to:
  Department of the Treasury
  Internal Revenue Service Center
  Philadelphia, PA 19255-0733

Effective Period of Exemption

- An approved exemption granted to employers and employees is effective on the first day of the first quarter after the quarter in which Form 4029 is filed.
- An approved exemption granted to self-employed individuals is effective when granted and applies for all years for which the client satisfy the requirements.
- The exemption will continue as long as the client, or in the case of wage payments, both the employee and employer continue to meet the exemption requirements.
### Employees without Form 4029 approval

- If you have a client who has employees who do not have an approved Form 4029, they must withhold the employee’s share of social security and Medicare taxes and pay the employer’s share.

### Reporting Exempt Wages

- If your client is a qualifying employer with one or more qualifying employees, they are not required to report wages that are exempt under section 3127.
- Do not include these wages for social security and Medicare tax purposes on:
  - Form 941, Employer’s QUARTERLY Federal Tax Return,
  - Form 943, Employer’s Annual Tax Return for Agricultural Employees, or
  - Form 944, Employer’s Annual Federal Tax Return.
- If your client has received an approved Form 4029, check the box on line 4 of Form 941 (line 3 of Form 944) and write “Form 4029” in the empty space below the check box.
- If you file Form 943 and have received an approved Form 4029, write “Form 4029” to the left of the wage entry spaces for total wages subject to social security taxes and total wages subject to Medicare taxes.

### Preparation of Form W-2

- When you prepare Form W-2 for a qualifying employee, enter “Form 4029” in the box marked “Other”.
- Do not make any entries in the boxes for Social security wages, Medicare wages and tips, Social security tax withheld, or Medicare.
- tax withheld for these employees.
Form 4361
Application for Exemption From Self-Employment Tax for Use by Ministers, Members of Religious Orders and Christian Science Practitioners

- File Form 4361 by the date the income tax return is due, including extensions, for the second tax year in which both of the following are true:
  - 1. The client has net earnings from self-employment of at least $400
  - 2. Any part of those net earnings was from ministerial services you performed as a:
    - a. Minister,
    - b. Member of a religious order, or
    - c. Christian Science practitioner or reader

Example 1

- He must file his application for exemption by the due date, including extensions, for his 2015 income tax return.
- However, if Rev. Jaeger does not receive IRS approval for an exemption by April 18, 2016, his SE tax for 2015 is due by that date.
Example 2

- Rev. Louise Wolfe has only $300 in net self-employment earnings as a minister in 2014, but earned more than $400 in 2013 and expects to earn more than $400 in 2015.
- She must file her application for exemption by the due date, including extensions, for her 2015 income tax return.
- However, if she does not receive IRS approval for an exemption by April 18, 2016, her SE tax for 2015 is due by that date.

Table 2. The Self-Employment Tax Exemption Application and Approval Process

<table>
<thead>
<tr>
<th>Who Can Apply</th>
<th>Members of the Clergy</th>
<th>Members of Recognized Religious Seals</th>
</tr>
</thead>
<tbody>
<tr>
<td>How</td>
<td>File Form 4361</td>
<td>File Form 4029</td>
</tr>
<tr>
<td>When</td>
<td>File by the due date (including extensions) of your income tax return for the second tax year in which you had at least $400 of net earnings from self-employment, any of which came from ministerial services.</td>
<td>File anytime</td>
</tr>
<tr>
<td>Approval</td>
<td>If approved, you will receive an approved copy of Form 4361</td>
<td>If approved, you will receive an approved copy of Form 4029</td>
</tr>
<tr>
<td>Effective Date</td>
<td>For all tax years after 1987 in which you have at least $400 of net earnings from self-employment, any of which came from ministerial services.</td>
<td>For all tax years beginning with the first year you meet the eligibility requirements discussed later</td>
</tr>
</tbody>
</table>

Special Rules for Compensation of Ministers

- Unlike other exempt organizations or businesses, a church is not required to withhold income tax from the compensation that it pays to its duly ordained, commissioned, or licensed ministers for performing services in the exercise of their ministry.
- An employee minister may, however, enter into a voluntary withholding agreement with the church by completing IRS Form W-4, Employee’s Withholding Allowance Certificate.
- A church should report compensation paid to a minister on Form W-2, Wage and Tax Statement, if the minister is an employee, or on IRS Form 1099-MISC, Miscellaneous Income, if the minister is an independent contractor.
Self-Employment Contributions Act (SECA)

- Although a minister is considered an employee under the common law rules, payments for services as a minister are considered income from self employment pursuant to IRC §§ 1402(c) and 3121(b)(8).
- A minister, unless exempt, pays social security and Medicare taxes under the Self-Employment Contributions Act (SECA) and is not subject to Federal Insurance Compensation Act (FICA) taxes or income tax withholding.

Payments for Services

- Payment for services as a minister, unless statutorily exempt, is subject to income tax, therefore the minister should make estimated tax payments to avoid potential penalties for not paying enough tax as the minister earns the income.
- If the employer and employee agree, an election can be made to have income taxes withheld IRC § 3402(p)(3).
- Even though a minister may receive a Form 1099-MISC for the performance of services, he or she may be a common law employee and should in fact be receiving a Form W-2.

Employee vs. Independent Contractor

- The determination of whether a minister is an employee or an independent contractor follows the same rules as any other industry determination.
- The challenge with a minister is the same as with any professional.
- The control test must be applied only after taking into account the nature of the work to be performed.
- How a minister is classified for income tax purposes affects how they treat their expenses.
- A minister that is a common law employee must claim their trade or business expenses incurred while working as an employee as an itemized deduction on Form 1040 Schedule A, which is subject to the 2% of adjusted gross-income (AGI) limitation and alternative minimum tax.
Parsonage or Housing Allowances

- A minister is frequently provided a parsonage or is paid a housing allowance, which is exempt from income tax under IRC § 107
- The “allowable” allowance is subject to self employment tax under SECA and IRC § 1402(a)(8)
- The “allowable” allowance is computed subject to limitations imposed by law as to the amount and the required designation by the employing church
- There are special rules for retired ministers 42 U.S.C. § 411(a)(7)

Parsonage or Housing Allowances

- Generally, a minister’s gross income does not include the fair rental value of a home (parsonage) provided, or a housing allowance paid, as part of the minister’s compensation for services performed that are ordinarily the duties of a minister
- A minister who is furnished a parsonage may exclude from income the fair rental value of the parsonage, including rent, mortgage payments, utilities, repairs, and other expenses directly relating to providing a home
- However, the amount excluded cannot be more than the reasonable pay for the minister’s services

Parsonage or Housing Allowances

- 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:
  - (a) the amount actually used to provide a home;
  - (b) the amount officially designated as a housing allowance; or
  - (c) the fair rental value of the home
Parsonage or Housing Allowances

- The minister’s church or other qualified organization must designate the housing allowance pursuant to official action taken in advance of the payment
- If a minister is employed and paid by a local congregation, a designation by a national church agency will not be effective
- The local congregation must make the designation
- A national church agency may make an effective designation for ministers it directly employs
- If none of the minister’s salary has been officially designated as a housing allowance, the full salary must be included in gross income

Parsonage or Housing Allowances

- The fair rental value of a parsonage or housing allowance is excludable from income only for income tax purposes
- These amounts are not excluded in determining the minister’s net earnings from self-employment for Self-Employment Contributions Act (SECA) tax purposes
- Retired ministers who receive either a parsonage or housing allowance are not required to include such amounts for SECA tax purpose

Parsonage or Housing Allowances

- A minister who receives a parsonage or rental allowance excludes that amount from his income
- The portion of expenses allocable to the excludable amount is not deductible
- This limitation, however, does not apply to interest on a home mortgage or real estate taxes, nor to the calculation of net earnings from self-employment for SECA tax purposes
Example 1

- Alice is an ordained minister
- She receives an annual salary of $36,000 and use of a parsonage which has a FRV of $800 a month, including utilities
- She has an accountable plan for other business expenses such as travel
- Alice’s gross income for arriving at taxable income for Federal income tax purposes is $36,000
- For self-employment tax purposes it is $45,600 ($36,000 salary + $9,600 FRV of parsonage)

Example 2

- Bruce, an ordained minister, is vice president of academic affairs at Holy Bible Seminary
- His compensation package includes a salary of $80,000 per year and a $30,000 housing allowance
- His housing costs for the year included mortgage payments of $15,000, utilities of $3,000, and $3,600 for home maintenance and new furniture
- The fair rental value of the home, as furnished, is $18,000 per year

Allocation of Business Expenses

- Because of the exemption from income tax for the “allowable” parsonage or housing allowance, the operation of IRC § 265 requires business expenses to be allocated between taxable and non-taxable income
Other Issues Identified in the ATG

- Some other issues of ministers you may see in a smaller number of cases are:
  - The earnings for qualified services a member of an exempt religious order, who has taken a vow of poverty, performs as an “agent” of their church or its agencies, may be exempt from income tax and self employment tax.
- Gifts given to a minister, other than retired ministers, may actually be compensation for services, hence includible in gross income under IRC § 61

Comparison

- The three amounts for comparison are:
  - a. Actual expenses of $21,600 ($15,000 mortgage payments + $3,000 utilities + $3,600 other costs)
  - b. Designated housing allowance of $30,000
  - c. FRV plus utilities of $21,000 ($18,000 + $3,000 utilities)
- Bruce may exclude $21,000 from gross income but must include in income the other $9,000 of the housing allowance
- The entire $30,000 will be considered in arriving at net self-employment income

Example 3

- Cedar is an ordained minister and has been in his church’s employ for the last 20 years
- His salary is $40,000 and his designated parsonage allowance is $15,000
- Cedar’s mortgage was paid off last year
- During the tax year he spent $2,000 on utilities, and $3,000 on real estate taxes and insurance
- The FRV of his home, as furnished, is $750 a month
**Cedar Comparison**

- The three amounts for comparison are:
  - a. Actual housing costs of $5,000 ($2,000 utilities + $3,000 taxes and insurance)
  - b. Designated housing allowance of $15,000
  - c. FRV + utilities of $11,000 ($9,000 FRV + $2,000 utilities)

- Cedar may only exclude his actual expenses of $5,000 for Federal income tax purposes
- He may not exclude the FRV of his home even though he has paid for it in previous years
- Swaggart v. Commissioner, T.C. Memo. 1984-409
- $15,000 will be included in the computation of net self-employment income

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**Example 4 – Change the Facts in Cedar**

- Cedar takes out a home equity loan and uses the proceeds to pay for his daughter’s college tuition
- The payments are $300 per month
- Even though he has a loan secured by his home, the money was not used to “provide a home” and can’t be used to compute the excludible portion of the parsonage allowance
- The interest on the home equity loan may be deducted as an itemized deduction subject to the limitations, if any, of IRC § 163

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**Example 5**

- Dean is an ordained minister who received $40,000 in salary plus a designated housing allowance of $12,000
- He spent $12,000 on mortgage payments, $2,400 on utilities, and $2,000 on new furniture
- The FRV of his home as furnished is $16,000
- Dean’s exclusion is limited to $12,000 even though his actual cost ($16,400) and FRV and utilities ($18,400) are more
- He may not deduct his housing costs in excess of the designated allowance
Example 6

- Ellen’s designated housing allowance is $20,000
- She and her husband live in one half of a duplex which they own
- The other half is rented
- Mortgage payments for the duplex are $1,500 per month
- Ellen’s utilities run $1,800 per year, and her tenant pays his own from a separate meter
- During the year Ellen replaced carpeting throughout the structure at a cost of $6,500 and did minor repairs of $500
- Ellen must allocate her mortgage costs, carpeting, and repairs between her own unit and the rental unit in determining the amount of the excludible parsonage allowance

Example 6 - Continued

- Amounts allocable to the rented portion for mortgage interest, taxes, etc., would be reported on Schedule E as usual
- Her actual costs to provide a home were $14,300 ($9,000 mortgage payments, $1,800 utilities, and $3,500 for half the carpeting and repairs)
- The FRV for her unit is the same as the rent she charges for the other half, which is $750 a month, and she estimates that her furnishings add another $150 per month to the FRV
- Her FRV plus utilities is $12,600 ($10,800 FRV + $1,800 utilities)
- Ellen may exclude $12,600 for Federal income tax purposes

Ellen’s Property

<table>
<thead>
<tr>
<th></th>
<th>Full Year</th>
<th>Ellen’s 1/2</th>
<th>Fair Rental Value (FRV)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mortgage</td>
<td>$18,000</td>
<td>$9,000</td>
<td>$750 + 150= 900 x 12 = $10,800</td>
</tr>
<tr>
<td>Utilities</td>
<td>$1,800 (half of unit)</td>
<td>$1,800</td>
<td>$1,800</td>
</tr>
<tr>
<td>Carpet</td>
<td>$6,500</td>
<td>$3,250</td>
<td>$3,250</td>
</tr>
<tr>
<td>Repairs</td>
<td>$500</td>
<td>$250</td>
<td>$250</td>
</tr>
<tr>
<td></td>
<td>$14,300</td>
<td>Parsonage or Housing Allowances</td>
<td>$12,600</td>
</tr>
</tbody>
</table>
**Itemized Deductions and Sale of Home**

- Pursuant to IRC § 265(a)(6) and Rev. Rul. 87 - 32, 1987 - 1 C.B. 131 even though a minister’s home mortgage interest and real estate taxes have been paid with money excluded from income as a housing allowance, he or she may still claim itemized deductions for these items.
- The sale of the residence is treated the same as that of other taxpayers, even though it may have been completely purchased with funds excluded under IRC § 107.

**Retired Ministers**

- A retired minister may receive part of his or her pension benefits as a designated parsonage allowance based on past services.
- The "least of" rules should be applied to determine the amount excludible from gross income.
- The retired minister may exclude from his/her net earnings from self-employment the rental value of the parsonage or the parsonage allowance received after retirement.
- The entire amount of parsonage allowance received is excludible from net earnings from self-employment, even if a portion of it is not excludible for income tax purposes.
- In addition, the retired minister may exclude from net earnings from self-employment any retirement benefits received from a church plan.

**Employee Business Expenses**

- Ministers who are employees may deduct the following expenses on Schedule A as miscellaneous expenses subject to the 2 percent floor:
  - 1. Unreimbursed employee business expenses (that is, expenses for which the minister is not reimbursed under an IRC § 62(a)(2)(A) accountable plan) and
  - 2."Nonaccountable" reimbursed business expenses.
Accountable Plan

- The limitations on deductibility of employee business expenses may be avoided if the church adopts an “accountable plan”
- An accountable plan is an arrangement that meets all the requirements of Treas. Reg. § 1.62-2, that is:
  - Business connection (deductibility under IRC § 162),
  - Substantiation within a reasonable period of time
  - Return of amounts in excess of substantiated expenses within a reasonable period of time
- The regulations provide two safe harbor methods under the reasonable period of time requirement:
  - If an arrangement meets all the requirements for an accountable plan, the amounts paid under the arrangement are excluded from the minister’s gross income and are not required to be reported on his or her Form W-2
  - If, however, the arrangement does not meet one or more of the requirements, all payments under the arrangement are included in the minister’s gross income and are reported as wages on the Form W-2, even though no withholding at the source is required

Typical business expenses for ministers include the following:

- Transportation
- Many ministers receive a non-accountable auto allowance, which is includible in income
- Transportation costs which may be deductible include trips for hospital and nursing home visits, attendance at conferences, or other church business
- However trips between the minister’s personal residence and the church are considered nondeductible commuting expenses

Typical business expenses for ministers include the following:

- Travel
- A minister may incur travel away from home occasionally for special conferences or other duties out of the area
- The same rules regarding the deductibility of meals, entertainment, and lodging apply as for other taxpayers
Typical business expenses for ministers include the following:

- **Business Use of Home**
  - In order for a home to qualify as a principal place of business under IRC § 280A(c)(1)(A), the functions performed and the time spent at each location where the trade or business is conducted are the primary considerations and must be compared to determine the relative importance of each.
  - The church often provides an office on the premises for the minister, so the necessity of an office in the home will be questioned in an IRS audit
  - Furthermore, since the total cost to provide the home is used in computing the exempt housing allowance, home office deductions for taxes, insurance, mortgage interest, etc. would be duplications.
  - (Note that itemized deductions are allowable for mortgage interest and taxes. IRC § 265(a)(6), and Rev. Rul. 87-32, 1987-1 C.B. 131)

Typical business expenses for ministers include the following:

- **Supplies, Publications**
  - Ministers may incur some out-of-pocket costs for office supplies and job-related books and periodicals for which they are not reimbursed.
  - This may be more common in small churches.
  - Increasingly, ministers are using computers for writing sermons, correspondence, and recordkeeping.
  - Personal use should be determined.

Typical business expenses for ministers include the following:

- **Dues versus Contributions**
  - Ministers often pay a small annual renewal fee to maintain their credentials, which constitutes a deductible expense.
  - However, ministers’ contributions to the church are not deductible as business expenses.
  - They may argue that they are expected to donate generously to the church as part of their employment.
  - This is not sufficient to convert charitable contributions to business expenses.
  - The distinction is that charitable contributions are given to a qualifying organization (such as a church) for the furtherance of its charitable activities.
  - Dues, on the other hand, are usually paid with the expectation that a financial benefit will result to the individual, as in a realtor’s multi-list dues or an electrician’s union dues.
  - A minister’s salary and benefits are not likely to directly depend on the donations made to the church.
  - They may still be deducted as contributions on Schedule A but may not be used as a business expense to reduce self-employment tax.
Typical business expenses for ministers include the following:

- **Other Expenses**
  - A minister may incur expenses for special vestments that would qualify as “uniforms”
  - Their reasonable cost and care would be deductible
  - Ordinary street clothes or suits for church are not deductible
  - Cell Phones – new audit issue

**Determination of Deductible Expenses Where Some Income is Tax Exempt**

- Once total business expenses have been determined, the nondeductible portion can be computed using the following formula
- **Step 1**
  - Divide the allowable housing allowance or fair rental value (FRV) of parsonage by the total ministry income to get the nontaxable income percentage
  - Total ministry income includes salary, fees, expense allowances under non-accountable plans plus the allowable housing allowance or FRV of the parsonage
- **Step 2**
  - Multiply the total business expenses times the nontaxable income percentage from step 1 to get the expenses allocable to nontaxable income which is not deductible

**Example 7**

- Frank receives a salary of $36,000, an exempt housing allowance of $18,000 and an auto expense allowance of $6,000 for his services as an ordained minister
- Frank incurs business expenses as follows:
  - Auto $7,150
  - Vestments $350
  - Dues, $120
  - Publications and supplies, $300
  - Total $7,920
Frank Step 1

- Step 1:
- $18,000 housing allowance/Nontaxable Income divided by $60,000 total ministry income ($36,000 salary, $18,000 housing and $6,000 car allowance) equals 30% nontaxable income percentage

Frank Step 2

- Step 2:
- Total business expenses of $7,920 times 30%, the non taxable income percentage equals
- $2,376 the nondeductible expenses

Frank's Deductible Expenses

- Total expenses $7,920 less the nondeductible expenses of $2,376 equals the deductible expenses of $5,544
- Frank's deductible expenses are reported as Schedule A miscellaneous deductions since his church considers him an employee and issues a W-2
- These expenses, along with any other miscellaneous deductions are subject to a further reduction of 2 percent of his adjusted gross income
Computing Self-Employment Tax

• If an exemption from self-employment tax is not applied for, or is not granted, self-employment tax must be computed on ministerial earnings
• To compute self-employment tax, allowable trade or business expenses are subtracted from gross ministerial earnings, then the appropriate rate is applied

Computing Self-Employment Tax

• Include the following items in gross income for self-employment tax:
  1. Salaries and fees for services, including offerings and honoraria received for marriages, funerals, baptisms, etc. Include gifts which are considered income
  2. Any housing allowance or utility allowances
  3. Fair Rental Value (FRV) of a parsonage, if provided, including the cost of utilities and furnishings provided
  4. Any amounts received for business expenses treated as paid under a nonaccountable plan, such as an auto allowance
  5. Income tax or self-employment tax obligation of the minister which is paid by the Church

Computing Self-Employment Tax

• Mark receives a salary from the church of $20,000
• His parsonage/housing allowance is $12,000
• The church withholds Federal income tax (by mutual agreement) and issues him a Form W-2
• He has unreimbursed employee business expenses (before excluding nondeductible amounts attributable to his exempt income) of $5,200
• His net earnings for self-employment tax are $26,800 ($20,000 + $12,000 - $5,200). Note that all of Mark’s unreimbursed business expenses are deductible for self-employment tax purposes, although the portion attributable to the exempt housing allowance is not deductible for Federal income tax purposes
• IRC § 265 regarding the allocation of business expenses related to exempt income relates to income tax computations but not self-employment tax computations
Job Aid #1
Exclusion of Parsonage Allowance under Internal Revenue Code § 107
Home Owned Or Rented/ Housing Allowance Received

• The exclusion is limited to the least of:
  1. Amount designated as housing allowance
  2. Amount actually used to provide a home which is composed of the following items:
    - Rent
    - House payments
    - Furnishing
    - Repairs
    - Insurance, Taxes
    - Utilities
    - Other Expenses
  3. Fair rental value of home, including furniture, utilities, garage
• Amount excludible from income tax liability is the least of 1, 2, or 3 above
• If Parsonage provided, you can deduct only the fair rental value
• The entire designated housing allowance is subject to self‐employment tax unless you have been approved for exemption or are retired

Job Aid #2
Computation of Allowable Expenses When Tax‐Exempt Income Is Received

• Step 1 Enter amount of tax‐exempt income (housing allowance or fair rental value of parsonage provided)
• Step 2 Total income from ministry computed by adding the following:
  - Salary
  - Fees
  - Allowances
• Step 2 Total of items above to derive total income from ministry
• Step 3: Divide step 1 amount by total step 2 amount to obtain the non taxable income %
• Step 4 Compute total business expenses substantiated by adding the following items
  - Auto
  - Travel
  - M&E
  - Other
• Step 5 Multiply step 4 total by step 3 percentage to obtain nondeductible expenses allocable to tax exempt income
• Step 6 Subtract step 5 amount from step 4 amount to obtain the deductible expenses for Federal Income tax purposes

Earned Income Credit

• Earned income includes the clients:
  • 1. Wages, salaries, tips, and other taxable employee compensation (even if these amounts are exempt from FICA or SECA under an approved Form 4029 or 4361), and
  • 2. Net earnings from self‐employment that are not exempt from SECA (you do not have an approved Form 4029 or 4361) that you report on Schedule SE, line 3, with the following adjustment
    - a. Subtract the amount you claimed (or should have claimed) on Form 1040, line 27, for the deductible part of your SE tax.
    - b. Add any amount from Schedule SE, Section B, line 4b and line 5a
Comprehensive Example

- Rev. John White is the minister of the First United Church. He is married and has one child
- The child is considered a qualifying child for the child tax credit
- Mrs. Susan White is not employed outside the home
- Rev. White is a common law employee of the church, and he has not applied for an exemption from SE tax
- The church paid Rev. White a salary of $31,000
- In addition, as a self-employed person, he earned $4,000 during the year for weddings, baptisms, and honoraria
- He made estimated tax payments during the year totaling $7,000
- The local community college paid him $3,400 for teaching a course

Comprehensive Example

- Rev. and Mrs. White own a home next to the church
- They make a $650 per month mortgage payment of principal and interest only
- They paid $1,800 in real estate taxes for the year on the home
- The church paid Rev. White $800 per month as his parsonage allowance (excluding utilities)
- The home’s fair rental value for the year (excluding utilities) is $9,840
- The utility bills for the year totaled $960
- The church paid him $100 per month designated as an allowance for utility costs

House Paid by Minister

<table>
<thead>
<tr>
<th></th>
<th>Minister</th>
<th>Housing Allowance</th>
<th>Fair Rental Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mortgage</td>
<td>$650 x 12 = $7,800</td>
<td>$800 x 12 = $9,600</td>
<td>$9,840</td>
</tr>
<tr>
<td>Real Estate Taxes</td>
<td>$1,800</td>
<td>$1,800 + $1,800</td>
<td>$9,840</td>
</tr>
<tr>
<td>Utilities</td>
<td>$960</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>$10,560</td>
<td>$10,800</td>
<td></td>
</tr>
</tbody>
</table>
First United Church W-2

Hometown College W-2

Schedule C - EZ

- Line 1. Rev. White reports the $4,000 from weddings, baptisms, and honoraria
- Line 2. Rev. White reports his expenses, however, he cannot deduct the part of his expenses allocable to his tax-free parsonage allowance
Worksheet 1

- First, Rev. White uses Worksheet 1 to figure his percentage of tax-free income.

Deductible Schedule C Expenses

<table>
<thead>
<tr>
<th>Schedule C Expenses</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Marital and Family Booklets</td>
<td>$ 87.00</td>
</tr>
<tr>
<td>400 Miles @ $6 per mile</td>
<td>$74.00</td>
</tr>
<tr>
<td>Total</td>
<td>$361.00</td>
</tr>
<tr>
<td>Worksheet 1 - 23%</td>
<td>($ 83.00)</td>
</tr>
<tr>
<td>Adjusted Expenses</td>
<td>$778.00</td>
</tr>
</tbody>
</table>

Tax Free % applied to Expenses

Attachment 1—John L. White 01-01-2022 (continued)

Worksheet 1. Figuring the Allowable Deduction for Schedule C or C-1Z Expenses

1. Percentage of expenses that are not deductible (Worksheet 1, line 6) = 23%  2 = 23%
2. Business use of car for entire year = 100% - income figures (line 8.00) = 23%
3. Meals and entertainment = 23% x (23) =
4. Other expenses (line 10 and amount)
5. Office and family booklets
6. Wages
7. Adjusted expenses (worksheet 1, line 6) = $1,000.00
8. Deduction allowed = Subtract line 7 from line 6. Enter the result here and on Schedule C, line 2, or Schedule L, line 2.

* Some of the other deductions claimed in the return are allowable to tax-free income.
Worksheet 1

• He subtracts the $83 from the $361, enters the $278 difference on line 2, and adds a note at the bottom of the schedule to see the attached statement
• Rev. White attaches Worksheets 1 to his return
• This is part of his required statement
• Rev. White enters his net profit of $3,722 ($4,000 – $278) on line 3 and on Form 1040, line 12

Schedule C - EZ

Form 2106 EZ

• Rev. White fills out Form 2106EZ to report the unreimbursed business expenses he had as a common-law employee of First United Church
• Before completing line 1, Rev. White fills out Part II because he used his car for church business
• His records show that he drove 2,774 business miles, which he reports in Part II
• Then, he figures his car expense for his line 1 entry
• 2,774 miles × 56 cents ($0.56) = $1,553
• He enters $231 for his professional publications and booklets
• Before entering the total expenses on line 6, Rev. White must reduce them by the amount allocable to his tax-free parsonage allowance
Worksheet 3

Form 2106 EZ Calculation

- After completing Worksheet 3, he finds that $410 \times 23\% \times 23\%$ of his employee business expenses are not deductible
- He subtracts $410 from $1,784 and enters the result, $1,374, on line 6, adding a note at the bottom of the page about the attached statement
- He also enters $1,374 on Schedule A (Form 1040), line 21

Form 2106-EZ
Schedule A

- Rev. White fills out Schedule A
- He deducts $1,800 in real estate taxes paid in 2014
- Line 10. He deducts $5,572 of home mortgage interest paid in 2014
- Line 16. Rev. and Mrs. White contributed $4,800 in cash during the year to various qualifying charities
- Each individual contribution was less than $250 and they have the required records for all donations
- Line 21. Rev. White enters his $1,374 of unreimbursed employee business expenses from Form 2106EZ, line 6
- Lines 25, 26, and 27. He can deduct only the part of his employee business expenses that exceeds 2% of his adjusted gross income
- After he completes page 1 of Form 1040, he fills out these lines to figure the amount he can deduct
- Line 29. The total of all the Whites’ itemized deductions is $12,840, which he enters here and on Form 1040, line 40

Schedule SE

- After Rev. White prepares Schedule CEZ and Form 2106EZ, he fills out Schedule SE (Form 1040)
- He can use Section A—Short Schedule SE to figure his self-employment tax
Schedule SE

- Rev. White is a minister, so his salary from the church is not considered church employee income.
- Thus, he does not have to use Section B—Long Schedule SE.
- He fills out the following lines in Section A:
  - Line 2: Rev. White attaches a statement that explains how he figures the amount ($43,655) to enter on line 2, and adds a note at the bottom of the page to see the attached statement.
  - Line 4: He multiplies $43,655 by 92.35% (.9235) to get his net earnings from self-employment ($40,315).
  - Line 5: The amount on line 4 is less than $117,000, so Rev. White multiplies the amount on line 4 ($40,315) by 15.3% (.153) to get his self-employment tax of $6,168.
  - He enters that amount here and on Form 1040, line 57.
  - Line 6: Rev. White multiplies the amount on line 5 by 50% (.50) to get his deduction for the employer equivalent portion of self-employment tax of $3,084.
  - He enters that amount here and on Form 1040, line 27.
August Webinars

- August 6 - Form 941 and Matching with Form W-2 - IRS match Forms W-2 to information to amounts reported on Form 941. When the numbers don’t add up IRS issues a Combined Annual Withholding Report Notice (CAWR) and it’s up to you to assist your client in resolving the discrepancies. Tips on how to resolve the issues and prevent the notices from being issued will be discussed.

- August 10 - Fringe Benefits - An overview of fringe benefits that employees enjoy and whether or not they are taxable income or exempt from tax will be discussed. Publication 5137 will be used for this class.

August Webinars

- Registration: To register: https://goo.gl/35tM78
- (registration ends at 10 AM CST on the day of the scheduled webinar)
- Cost: $35 per webinar
- Registration fee is non-refundable. If you are unable to attend a webinar, we can transfer you to another webinar we are offering. Please contact us at 515-294-5217 for questions.

ACA Week 2015
Get ready for the 2016 filing season and ACA

- ACA Week October 19, 2015 – October 23, 2015
  - The Marketplace and Affordability: October 19, 2015 - Noon to 1 pm (CST) – 1 hour of CPE
  - Exemptions and Shared Responsibility Payment: October 20, 2015 - Noon to 1 pm (CST) – 1 hour of CPE
  - Premium Tax Credit: October 21, 2015 - Noon to 1 pm (CST) - 1 hour of CPE
  - Shared Allocations: October 22, 2015 – Noon to 2 pm (CST) - 2 hours of CPE
  - Employer Issues and Cadillac Tax: October 23, 2015 – Noon to 2 pm (CST) – 2 hours of CPE
ACA Week 2015

- Registration:
  - To register: https://goqrl/Rw5nG
- Special Discount!! (must be pre-registered for all 5 classes): $200 (7 hours of CPE)
- The Marketplace and Affordability: October 19, 2015 - Noon to 1 pm (CST) – 1 hour of CPE - $35
- Exemptions and Shared Responsibility Payment: October 20, 2015 - Noon to 1 pm (CST) – 1 hour of CPE - $35
- Premium Tax Credit: October 21, 2015 - Noon to 1 pm (CST) – 1 hour of CPE - $35
- Shared Allocations: October 22, 2015 – Noon to 2 pm (CST) – 2 hours of CPE - $70
- Employer Issues and Cadillac Tax: October 23, 2015 – Noon to 2 pm (CST) – 2 hours of CPE - $70

Repair Regulation Week
October 26-30, 2015

- The full series of classes will build on current knowledge as well as provide in-depth, more complex issues you may face in your practice. Time for questions will be available at each seminar.
- All sessions will be conducted from Noon – 1:00 Central Time and at a cost of $35.00 each for one hour of CPE.
- A special rate of $150.00 will be available if you register for all five webinars, a savings of $25.00. Otherwise the cost will be $35.00 each if you are only interested in certain aspects.
- October 26, 2015 Buildings: Renovation
  - What is an Improvement? An improvement occurs if the unit of property (UOP) undergoes, other than through routine maintenance: (1) betterment, (2) restoration, or (3) adaptation to another use. This revision will cover the new regulations and provide examples that will assist in the process where the improvement is: (1) to enhance the safety, health, or comfort of the property, (2) to repair or replace the property's structural, mechanical, or electrical components, or (3) is expected to materially increase the property's productivity, efficiency, strength, quality, or utility. Discussion on how to identify and examples will be shared. Also a discussion on the safe harbor will be demonstrated.
- October 27, 2015 Buildings: Restoration
  - What is an improvement? Does that improvement: (1) It returns a non-functional unit of property to operating condition; (2) It replaces a major component or substantial structural part or set of parts; or (3) It renders property after the end of its class life to a like-new condition (as defined in other Federal regulatory guidance or the manufacturer's specifications). Discussion on how to identify and examples will be shared.
- October 28, 2015 Buildings: Adaptation
  - Does the improvement return the property to its use? Are improvements subject to capitalization or can they be expensed under the safe harbor? Examples will be demonstrated. The treatment under the new rule applies to all direct costs of the improvement plus all indirect costs that either directly benefit from, or are incurred by reason of, the improvement. Discussion on how to identify and examples will be shared.
- October 29, 2015 Dispositions
  - What happens when the property is disposed of or sold, how is that handled under the new repair regulations? What are the new procedures? Discussion on how to apply the new regulations and examples will be shared.
- October 30, 2015 Other Remaining Issues of Importance
  - The IRC repair regulations cover a wide array of topics, this session will cover a plethora of issues that will assist in the completion of the homework. We will review some of the key definitions necessary to fully understand the new regulations. We will also cover as time allowed topics we were unable to fully address in other sessions.
  - Registration fee is non-refundable. If you are unable to attend a webinar, we can transfer you to another webinar we are offering. Please contact us at 515-294-0217 for questions.

Repair Regulation Week
October 26-30, 2015
Scoop Dates for Post Filing Season

- September 23, 2015
- October 21, 2015
- November 4, 2015
- November 18, 2015
- December 16, 2015
- December 30, 2015

2015 Farm Tax Schools

- November 9, 2015 to December 15, 2015
- 8 Locations in Iowa
- Registration and the Fall Brochure will be out in August
- The program is intended for tax professionals and is designed to provide up-to-date training on current tax law and regulations.
- The program stresses practical information to facilitate the filing of individual and small business returns, in addition to farm returns.

2015 Farm Tax Schools- Dates and Locations

- Waterloo: Nov 9-10
- Sheldon: Nov. 10-11
- Red Oak: Nov. 11-12
- Ottumwa: Nov. 12-13
- Mason City: Nov. 16-17
- Maquoketa: Nov. 23-24
- Denison: Dec. 7-8
- Ames: Dec. 14-15 – live as well as attendance via webinar available
CALT Website

http://www.calt.iastate.edu/

Tour of the CALT Website

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<th>Fax</th>
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