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TAX PLANNING FOR CLERGY-2021

CURRENT STATUS OF CLERGY HOUSING ALLOWANCE:

On March 15, 2019, the Court of Appeals for the Seventh Circuit, reversing a district court, held that the exclusion for clergy housing ("parsonage") allowance is constitutional. It determined that the clergy housing allowance does not violate the First Amendment Establishment Clause of the U.S. Constitution

CLERGY TAXATION UNDER CURRENT LAW:

Following is a brief explanation of the taxability of compensation and other payments made by a church (or other qualifying organization) to clergy employees, the related responsibilities of the employer, and certain other related matters. There are several categories of payments and fringe benefits, each with different tax implications. All of this material assumes that the individual is ordained, licensed, or the equivalent, and carries out the usual pastoral duties.

These rules also usually apply to clergy employed to perform ministerial duties for nonprofit organizations other than churches. However, there are special rules governing who is eligible for the tax benefits which usually apply to clergy. For any clergy person functioning as anything other than a pastor in a church or a teacher in a seminary or Bible college, it is wise to verify the applicability of the clergy tax rules to your situation. We are equipped to assist in this area.

EMPLOYMENT STATUS:

Pastors and other clergy are almost always required by the Internal Revenue Service to be treated as employees, not independent contractors. However, see the explanation of self-employment tax for special treatment of income for social security tax purposes. Only in those cases where the person meets the criteria for independent contractors is a person to be treated as self-employed. There is a lengthy list of these criteria. One should not attempt to classify clergy as self-employed without a thorough knowledge of the subject.

SALARY and RELATED COMPENSATION:

Salary is a portion of gross compensation. It is fully taxable and is to be reported by the employer on Form W-2 at year-end. The value of personal use of an employer provided vehicle is treated as additional taxable compensation. No withholding taxes are required, including Social Security (FICA) and Medicare taxes, but see "Self-Employment Taxes" on the next page. The pastor/employee may request to have income taxes withheld (but not FICA or Medicare taxes). If such a request is made, it should be submitted in writing to the employer on IRS Form W-4.

HOUSING ALLOWANCE:

Housing allowance is an allocation from gross compensation for income tax purposes only. It reduces the amount that would otherwise be treated as salary. Housing allowance may be up to the full amount paid to the employee, but must be reasonable in amount, both in relation to services performed and actual cost of housing. There are no additional rules restricting housing allowances for part-time clergy.

Housing allowance is excludable from taxable income to the extent that it is actually expended for housing and related expenses. However, the excludable amount is limited to no more than the fair rental value of the home, furnishings and appurtenances, plus the cost of utilities. Any excess allowance is taxable as ordinary income. Housing allowances must be officially designated as such prior to payment. Such designation can take a variety of forms, according to the way the employer keeps its records. For instance, it might be in the form of a specific Board of Directors resolution, or it might be part of the budget adopted by the board. The form is unimportant, so long as the amount, purpose, date of adoption, and any other relevant matters are clear in the employer records. Housing allowance is not reported on Forms W-2, except as a memo item in box 14.

PARSONAGE USE:

The value of the use of a parsonage by a pastor and his/her family is not included in taxable income for income tax purposes. However, it is includible in self-employment income for calculation of self-employment taxes.

SELF-EMPLOYMENT TAXES (Social Security and Medicare):

For Self-Employment (SE) tax purposes only, members of the clergy are treated as self-employed under a special provision of the Internal Revenue Code even though they are treated as employees for income tax purposes. Unless the individual has elected to be exempt by filing Form 4361 with the Internal Revenue Service, salaries and housing allowances and the value of use of a parsonage are fully taxable for SE tax purposes (but there may be deductions for unreimbursed employee business expenses). The person is required to report SE income and to pay the SE tax with his/her individual income tax return. If income taxes withheld exceed actual income tax, the excess may be applied to Self-Employment tax. Therefore, a clergy employee may wish to request on Form W-4 that the employer withhold enough to cover both income tax and SE tax.

BUSINESS EXPENSE REIMBURSEMENT OR ALLOWANCE:

Beginning January 1, 2018, business expenses were no longer deductible on Schedule A of Form 1040. Therefore, we strongly recommend that all business expenses are reimbursed by the employer using an accountable plan. This method will generally produce the lowest tax for the employee.

Accountable plan

Under an accountable plan, the employee is required to submit a record of actual expenses to the employer. The report must include dates, purpose of expenditures, persons visited or entertained, auto mileage, etc., and the employer reimburses for the reported expenses.

Auto expenses may be reimbursed on a cents per mile basis at 56 cents for 2021 and 57.5 cents for 2020. If the standard mileage rate is used instead of actual auto expenses, there is no need to keep records of actual vehicle expenses unless the taxpayer wants to compare actual expenses to amounts reimbursed. If actual expenses or the standard mileage rates are higher than reimbursements, the excess may be deducted by the taxpayer to the extent that it relates to business mileage. Expense allowances for which an employee does not account to the employer for actual expenses must be added to salary and reported as compensation on Form W-2. Expense allowances or reimbursements which exceed the employee's actual expenses and mileage allowance are fully taxable and must be reported as income. We recommend that the employer keep employee expense records for at least seven years.

Business expenses not reimbursed

Unless they are self employed, ministers may typically not deduct unreimbursed business expenses from their taxable income. Unreimbursed businesses expenses may be used to calculate income for self-employment (social security) tax purposes. Calculation of these amounts is explained in IRS Publication 517 (available at www.irs.ustreas.gov/). If you have your tax returns prepared by a CPA firm knowledgeable about clergy taxation, they should handle this adjustment for you. However, be aware that this does complicate the preparation of your income tax returns, and many tax preparers are not familiar with this rule.

OTHER FRINGE BENEFITS:

A nonprofit employer can provide a number of fringe benefits on a pretax basis. These include health insurance, disability insurance, group term life insurance, tax sheltered annuities, and several others. For most of these it is very important that the employer treat the individual as an employee in order to ensure the tax free status of the fringe benefit.

EARNED INCOME CREDIT:

Most members of the clergy are not eligible for the earned income credit even though their taxable income may be quite small. Eligibility depends upon the total amount of income. The eligibility amount varies with the number of people in the family. Housing allowance or the rental value of a parsonage must be included in earned income for purposes of determining eligibility for this credit. In most cases, inclusion of these items will cause the amount of earned income to exceed the cutoff point for this credit.

ESTIMATED TAX PAYMENTS:

People who expect to owe either income or Self-Employment taxes are required to make quarterly estimated tax payments to the Internal Revenue Service if they do not expect to have enough withholdings to cover the actual taxes due.

Please contact us for specific guidance regarding your tax situation.