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How To Pay Your Minister

The Rev. Deb Oskin, Enrolled Agent
Annual Conference Insight Session
Sponsored by Brethren Benefit Trust

Saturday
July 3
2021

Outline

- Independent Contractors vs. Employees
- Clergy Income, Clergy Taxes, & Checking the W-2
- Designated Housing Exclusion
- Health Insurance: Section 105 & QSEHRAs
- Business Expenses & Employer Reimbursements: Non-Accountable & Accountable Plans
- Publications

But First, About Me

- 1989: Adventures with Clergy taxes begin! (husband was ordained; I was ordained in 2004).
- 2000-2011: H&R Block Master Tax Advisor & Certified Advanced Instructor at a Premium Office; On my own since 2011: @ 75% Clergy Clients.
- 2004: Started Teaching & Presenting on Clergy Taxes!
- 2007: Earned Enrolled Agent License from Department of Treasury; 2011: NTPI Fellow: 3-yr. course in Advanced Audit Representation.

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Independent Contractors vs. Common-Law Employees

Why Does It Matter?

- Employers are required to treat Independent Contractors & Common-Law Employees differently:
  - Employers <u>are not</u> required to withhold or pay any taxes on their payments to Independent Contractors.
  - Employers <u>are</u> required to withhold & pay Income, Social Security, Medicare, & Unemployment Taxes on wages paid to an Employee.

Why Does It Matter?

- Employers will be held liable for Employment Taxes, plus interest & penalties, if a worker is incorrectly classified as an Independent Contractor.
- All evidence of control & independence in the relationship between employer & worker will be considered.
- This evidence falls into 3 categories: Behavioral Control, Financial Control, & Type of Relationship.

How IRS Decides

- Behavioral Control
  - How the work is to be done (is this communicated via instructions, training, or other means).
- Financial Control
  - Financial & business aspects of the job (can the worker have unreimbursed business expenses; realize a profit or incur a loss; invest in the facilities used in performing services, etc.).

How the IRS Decides

- Type of Relationship
  - How the parties perceive their relationship (what does their contract say; can the worker receive employee-type benefits; is the worker available to work for other similar businesses; etc.).
- Within these 3 broad categories, IRS applies the "20-Factor Test" (listed on IRS Form SS-8) to each situation individually.

Clergy: "Hybrid" Employees

- Pastors are Common-Law Employees of the Congregation:
  - for Federal Income Tax & Benefit Plans
  - but <u>not</u> for FICA or Unemployment Taxes
  - but who must pay Self-Employment Taxes on their total ministerial income
- So: Pastors are Employees of the Congregation who are exempt from FICA but subject to SECA (but who are NOT independent contractors).

Clergy Income, Taxes, & Checking the W-2

Clergy Income

- There are actually 3 types of Clergy income. The first two are reported by the Congregation:
  - Salary . . .
    reported on the W-2 in Box 1
  - Housing Exclusion . . .
    reported on the W-2 in Box 14
- The third is reported by the Pastor:
  - Self-Employment or Honoraria . . .
    reported on Schedule C (Form 1040)

Clergy Income

- The following income is subject to Clergy Tax Rules:
  - Salaries & fees for ministry services (not including royalties from publishing).
  - Offerings received for marriages, baptisms, funerals, masses, etc.
  - Any "gross-up" amount the Congregation pays the Pastor toward their federal income tax or self-employment tax (not including amounts withheld from the Pastor's salary).

Clergy Income

- The following income is subject to Clergy Tax Rules:
  - Fair Rental Value of a Parsonage provided for the Pastor (including furnished utilities) &/or any Parsonage Adjustment (in lieu of parsonage) paid to the Pastor.
  - Value of Meals & Lodging provided for the Pastor & family for the Congregation's convenience.

"Gifts" vs. Salary

- "Gifts" vs. Salary:
  - While the Pastor continues to serve, Courts have decided that most "Gifts" or special offerings are actually compensation for services.
  - "Retirement Gifts" to departing Pastor are usually gifts (per the Courts), as there's no expectation of services in the future.
  - "Gifts" from individual members of the Congregation to the Pastor <u>might</u> be gifts; each situation could be different.

"Free Ministers"

- "Free Minister" with no compensation from the Congregation:
  - If not reimbursed under an Accountable Plan, Clergy expenses are cash charitable contributions (regular Schedule A rules apply).
- "Free Minister" with no compensation from the Congregation, but living in the Parsonage:
  - FRV of Parsonage = Clergy compensation. Letter from Congregation with FRV amount can substitute for $0 (Box 1) W-2.

Not Clergy Income

- The following income is <u>not</u> subject to Clergy Tax Rules:
  - Offerings made to the Congregation by others.
  - Contributions by the Congregation to a tax-sheltered annuity plan (403(b)) set up for the Pastor, including salary reduction contributions made by the Pastor (usually found on the W-2 Box 12 Code E).

Clergy Taxes

- Pastors are <u>not</u> subject to taxes that most employees are subject to:
  - FICA: Social Security & Medicare Taxes
  - Payroll Taxes: Unemployment
- Pastors are, however, subject to 2 other taxes:
  - Federal Income Tax
  - Self-Employment Tax: this is usually the largest tax balance-due affecting Pastors.

Clergy Tax Rules: Employers

- Congregations are prohibited by law from withholding FICA taxes for their Pastor.
- Congregations may withhold Federal Income Taxes for their Pastor if requested.
- Congregations must issue a W-2 to their Pastor.
- Congregations can only issue a 1099-MISC to non-employee Clergy (e.g., Supply Preachers).

Clergy Tax Rules: Clergy

- All Clergy income is subject to Self-Employment Tax.
- All Clergy income is subject to Federal Income Tax – unless properly excluded by an officially designated Housing Exclusion.

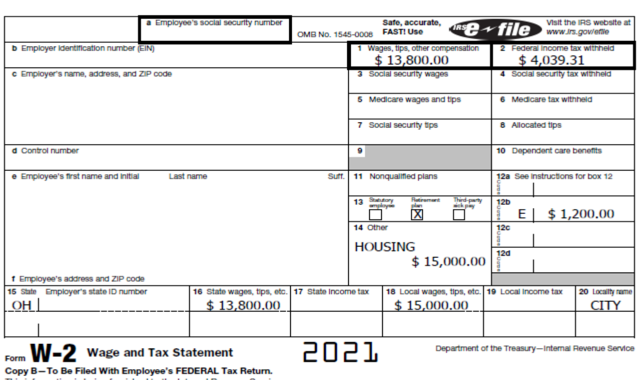
Clergy Income & Tax Table

Types/Sources of Clergy Income:	Income Tax?	Self-Employment Tax?	FICA Tax?
Self-Employment Income (Honoraria)	**Yes**	**Yes**	**No**
Employee Salary	**Yes**	**Yes**	**No**
Housing Exclusion Fair Rental Value of Parsonage	**Maybe** **No**	**Yes**	**No**

Employer "Gross-Up"

- "Gross-Up"
  - Congregation can pay their Pastor extra to help pay Pastor's self-employment tax bill.
  - IRS Pub. 15-A Ch. 4 gives a formula for "grossing-up" these payments to Pastors, so that when federal income taxes are taken on the increased amount, the Pastor still receives the amount the Congregation intended.
  - Gross-Up amount is added to W-2 Box 1.

Clergy W-2



Clergy W-2

- The Pastor's W-2 only shows payments to the Pastor which are subject to Federal Income Tax.
- The W-2 prepared by the Congregation shows the Pastor's non-Housing Exclusion compensation in Box 1, & notes the amount of the officially designated Housing Exclusion in Box 14.

Clergy W-2

- Congregations are required by the IRS to issue W-2s (not 1099-NECs) to their Pastors. This is true even if there is no federal income tax withholding.
- Another benefit of using a W-2 (over a 1099-NEC) is that the Housing Exclusion appears in Box 14.
- However, if the Pastor has $0 (zero) in Box 1, no W-2 is required. In this case, the Congregation issues a letter on their letterhead detailing the compensation paid to the Pastor.

Clergy W-2

- Finally, since Pastors are exempt from FICA & unemployment tax withholding, no payroll returns need to be filed for them unless income tax is being withheld.
- If income tax is being withheld for other employees, this option should be offered to Pastors as well. Otherwise, Pastors are required to make estimated tax payments totaling thousands of dollars each year.

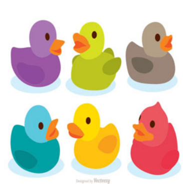
Checking the Clergy W-2

- Total Pastor's Compensation as reported on W-2 = Box 1 (salary) + Box 12 (pension Code E) + Box 14 (officially designated housing exclusion).
- Confirm that the Housing Exclusion amount listed in Box 14 is correct (check contract & payment records).
- Confirm that there are no entries for Boxes 3-6 (FICA wages & FICA withholding).

Designated Housing Exclusion

Housing Exclusion

- The Housing Exclusion is called by many names, yet they all represent the same thing: the mechanism by which Pastors are permitted to exclude some of their income from being subject to (or taxed by) federal income tax.
  - Housing allowance or exclusion
  - Rental allowance or exclusion
  - Parsonage allowance or exclusion
  - Utilities allowance or exclusion



Housing Exclusion

- Ordained, Commissioned, or Licensed Ministers performing ministerial services **should** designate **all or part** of their total compensation from their Congregation as Housing Exclusion.
- This allows the amount so designated to be excluded from their income for federal income tax purposes (subject to certain rules).

Housing Exclusion

- However, remember that <u>all ministry income</u> is subject to self-employment tax, including both the designated Housing Exclusion &/or the Fair Rental Value (FRV) of a provided Parsonage & the cost of all Utilities paid by the congregation.

Typical Housing Expenses

<u>HOUSING EXPENSES</u>:	<u>UTILITIES</u>:
rent/mortgage payments (in full)	electricity
real estate taxes (in full)	heating oil
renter's/homeowner's insurance	natural gas
homeowner's assn./condo fees	pest control
repairs & maintenance	water/sewer/trash
furnishings & decorations	security systems
lawn care & snow removal	internet/cable/tv
cleaning services	land-line phone OR
(26 CFR §1.107-1(c)(3))	personal use cell phone

(etc.)

Housing Expenses

- 26 CFR § 1.107-1 Rental value of parsonages
- (c) . . . "Circumstances under which a rental allowance will be deemed to have been used to rent or provide a home will include cases in which the allowance is expended (1) for rent of a home, (2) for purchase of a home, and (3) for expenses directly related to providing a home. **Expenses for <u>food</u> and <u>servants</u> are not considered for this purpose to be directly related to providing a home."**

Parsonages

- Rules for Pastors <u>Living in Parsonages</u>:
  - The FRV of the Parsonage (including utilities) is automatically <u>excluded</u> from income before federal income tax is calculated
  - The FRV of the Parsonage (including utilities) is automatically <u>included</u> in income before self-employment tax is calculated

Parsonages

- Rules for Pastors <u>Living in Parsonages</u>:
  - The FRV must be reasonable for its location, but it benefits the Pastor's taxes if it is on the low end of the range of rentals in the area.
    - Ask a realtor for up-to-date FRV comps.
  - Pastors should designate an additional Housing Exclusion to cover the **stuff** that goes inside the parsonage.

Housing Exclusion Rules

- The amount officially designated as Housing Exclusion must be specified <u>in writing</u>, in an official document of the Congregation, <u>before</u> any Housing Exclusion payment is made.
  - *It can be a dollar amount or a percentage.*
  - *It can be time limited ("for calendar year 2021") or in perpetuity ("until further notice").*

Housing Exclusion Rules

- The amount must be used to provide or rent the home (IRC: "provide a dwelling for the minister").
- The amount cannot be more than reasonable pay for Clergy services.
  - *It can be 100% of the Pastor's compensation. In this case, no W-2 is issued. A letter on congregational letterhead details the date the officially designated housing exclusion was approved & total payments to the Pastor.*

Calculating the Exclusion

- The amount that can be excluded from income before federal income tax is calculated is the <u>smallest</u> of the following 3 amounts:
  - The amount <u>officially designated</u> in writing as the Housing Exclusion (always start here)
  - The amount <u>actually spent</u> to provide a home
  - The <u>Fair Rental Value</u> (FRV) of the home, including utilities, furnishings, etc. (basically, everything in the home except food & clothing!)

Supply Preachers

- Rules for Clergy <u>Serving as Supply Preachers</u>:
  - The official designation of a Housing Exclusion amount can be made by the Congregation who holds the minister's membership.
  - This is also true for pension payments if not designated by the pension plan.
  - Language can include something similar to: "100% of all income received from Ministerial Services is designated as Housing Exclusion, until further notice."

Moving Expenses

- Due to the "Tax Cuts & Jobs Act," moving expenses are no longer deductible for anyone outside the U.S. Armed Forces. In fact, those expenses paid by the employer become taxable income to the employee & are reported in Box 1.
- I strongly recommend that the costs of moving the Pastor's household **stuff** (not the people) be designated as a special Housing Exclusion before the move occurs & payments are made. That moves these expenses from Box 1 to Box 14.

Health Insurance

Affordable Care Act

- Before the ACA, "Applicable Small Employers" (fewer than 50 FTE [Full Time Equivalent] employees) used medical insurance premium reimbursements to help their employees afford medical insurance.
- However, the 2010 Affordable Care Act changed that practice. Many congregations could no longer provide a pre-tax health insurance reimbursement to their employees.

aca exceptions / sec. 105

- There are two exceptions to the prohibition against Medical Insurance Premium Reimbursement under the Affordable Care Act (post June 30, 2015, & without the excise tax penalty of $100 per day per employee).
- These "one person plans" are now called "Section 105 Plans" & can be implemented with or without plan administration documents.

aca exceptions / sec. 105

- If the Congregation has only one employee ("fewer than two employees") in the plan;
- If the Congregation has only Retirees in the plan.

aca exceptions / sec. 105

- One-Employee Plans
  - If the Congregation has only one employee who works more than 25 hours per week, on average;
  - Then the Congregation can reimburse that employee's health insurance under a medical reimbursement plan, pre-tax.

aca exceptions / sec. 105

- Retirees-Only Plans
  - The Congregation can reimburse their retired employees' health insurance under a medical reimbursement plan, pre-tax.
  - There can be any number of retirees in the plan.
  - However: Assume that having a One-Employee Plan means the Congregation cannot also have a Retirees-Only Plan, & vice versa.

QSEHRA

- If Congregations are unable to take advantage of a Section 105 Plan, there is another option.
- In December 2016, The 21st Century Cures Act created the QSEHRA (Qualified Small Employer Health Reimbursement Arrangement).
- A QSEHRA allows certain small employers to give their employees pre-tax dollars to pay for premiums & other medical expenses, so long as the QSEHRA meets certain standards.

QSEHRA

- Small employers can offer HRAs on a stand-alone basis to employees, & employees may use funds in qualifying HRAs to buy individual health insurance.
- Maximum annual employer contribution for 2021 (must be prorated per month of coverage):
  - $5,300 per year for an HRA covering only the employee
  - $10,700 for an HRA covering the employee & their family

QSEHRA

- Employees cannot contribute to the HRA.
- Employer must provide payment or reimbursement for medical expenses, which can include copays & premiums for individual health insurance, Medicare Supplemental insurance, & Medicare Parts A, B, C, & D.
- Employees must provide documentation in the form of receipts for medical expenses or health insurance premiums paid.

QSEHRA

- 2021 pre-tax reimbursements from a QSEHRA cannot exceed $5,300 per year for single coverage, or $10,700 a year for family coverage.
- Amounts above this limit become taxable income to the employee.

- Setting up a QSEHRA requires specific plan documents addressing particular requirements of the law. A professional benefits advisor should be consulted when setting up a QSEHRA.

Business Expenses & Employer Reimbursements

Business Expenses

- In IRS Publication 463, "Travel, Entertainment, Gift, and Car Expenses" (p. 2), IRS defines business expenses as "ordinary & necessary business-related expenses."
- An ordinary expense is one that is common & accepted in the trade or business.
- A necessary expense is one that is helpful & appropriate for the business. An expense doesn't have to be required to be considered necessary.

Typical Clergy Expenses

- Business Mileage
- **Books !** & Subscriptions
- Computer & Internet
- Religious Material; Anointing Oil
- Education (Seminars & Conferences)
- Robes, Vestments, Collars, etc. (& dry cleaning)
- Office Supplies
- **Portion of Cell Phone Bill Used for Ministry**

Employer Reimbursement

- Due to the changes to unreimbursed employee business expenses, Congregations should immediately set up a method by which "ordinary & necessary" expenses incurred by Pastors for the benefit of the Congregation are reimbursed to the Pastor.
- It's not an enormous amount to the Congregation, but it's certainly helpful to the Pastor!

Employer Reimbursement

- There are many ways Congregations can reimburse Pastors for these expenses. They tend to end up in two categories with vastly different tax consequences for the Pastors:
  - Non-Accountable (bAD) Reimbursement Plans
  - Accountable (good) Reimbursement Plans

Non-Accountable Plans

- Congregations prepare budgets which often include their Pastors' anticipated expenses. Budgets are an essential financial management tool.
- "Allowances" (e.g., car allowance, education allowance, travel allowance, etc.) are based on the Congregation's budget for these expenses.
- Once the expenses are budgeted for, it seems simple enough just to pay it to the Pastor as part of their regular paycheck.

Non-Accountable Plans

- Allowances are "Non-Accountable Plans." Here are some of their characteristics:
  - Employee is not required to give the employer receipts or other documentation
  - Employee is not required to return any amount of an advance not used for business expenses
  - Employer pays the employee regardless of whether the employer reasonably expects the employee to have business expenses.

Non-Accountable Plans

- Payments from an Non-Accountable Plan are <u>income to the employee</u>.
- These payments <u>are wages</u> & are subject to withholding & payment of Income, Social Security, Medicare, & Unemployment Taxes.
- Non-Accountable Plans hit Pastors especially hard!
- When Allowances show up on the Pastor's W-2 in Box 1 as salary, that income becomes subject to <u>both</u> federal income tax & self-employment tax.

Accountable Plans

- "Accountable Plans" are easy to set up. Here are the requirements:
  - Expenses must be business-related
  - Employee expenses must be adequately accounted to employer (receipts provided) in a reasonable & timely fashion (within 120 days)
  - Any excess reimbursement must be returned to employer within a reasonable amount of time (within 120 days)

Accountable Plans

- Payments from an Accountable Plan are <u>not income to the employee</u>.
- Which means these payments <u>are not</u> wages & are not subject to withholding & payment of Income, Social Security, Medicare, & Unemployment Taxes.
- And they are not taxable income to Pastors!

Accountable Plans

- However, be careful:
  - If, at the end of the year, there is still money left in the budget in any of these expense categories, & the Congregation decides to give the balance to the Pastor without documented expenses . . .
  - The entire plan for the entire year becomes a Non-Accountable Plan, turning all Accountable Plan reimbursements for the entire year into taxable wages for **every** employee. *Nooooooooo!!!*

Publications

Publications

- Batts, Michael E. 2019. Church Finance: The Church Leader's Guide to Financial Operations. 2nd ed. Carol Stream IL: Christianity Today Intl. www.ChurchLawAndTaxStore.com
- Church Finance Update Newsletter. ChurchLawAndTax.com
- Church Law & Tax Update Newsletter. ChurchLawAndTax.com

Publications

- Pub 517, Social Security & Other Information For Members Of The Clergy & Religious Workers
- Pub 15-A, Employer's Supplemental Tax Guide, Ch. 4, "Religious Exemptions & Special Rules For Ministers"
- Pub 1828, Tax Guide For Churches & Religious Organizations
- Ministers Audit Techniques Guide (04/2009)

All pubs & forms can be found at www.irs.gov

Publications

- Pub 15 (Circular E), Employer's Tax Guide
- Pub 463, Travel, Entertainment, Gift, & Car Expenses
- Pub 526, Charitable Contributions
- Pub 535, Business Expenses
- Pub 15-B, Employer's Tax Guide To Fringe Benefits

All pubs & forms can be found at www.irs.gov

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Clergy Housing Allowance Exclusion Items

- Home:
  - mortgage or rent payments in full (including principal, interest, escrow, & fees)
  - home equity loans or lines of credit (to the extent used for housing)
  - appraisals, closing costs, title insurance, points paid on mortgage or refinance
  - homeowners or renters insurance, personal umbrella insurance
  - real estate or property taxes related to housing
  - homeowners or condo association fees
  - home assessments or fees

- Maintenance:
  - brooms, mops, vacuum cleaners, swiffers, steam cleaners, spot cleaners, etc.
  - cleaning supplies, floor cleaners, surface cleaners, window cleaners, etc.
  - professional cleaning service — 26 CFR §1.107-1(c)(3) prohibits "expenses for food & servants"
  - dish & dishwasher detergent, sponges, scrubbers, etc.
  - paper towels, paper plates, paper napkins, plastic silverware, etc.
  - laundry supplies, hampers, baskets, detergent, dryer sheets, etc.
  - plants, seeds, gardening tools, etc.
  - professional lawn care, landscaping, gutter cleaning, winter snow removal, etc.

- Repairs:
  - tools, miscellaneous hardware, etc.
  - batteries, light bulbs, etc.
  - interior & exterior painting, painting supplies, etc.
  - replacing flooring, drywall, windows & screens, siding, roof, etc.

- Furnishings & Appliances:
  - furniture & artwork; appraisal fees
  - carpets & rugs; appraisal fees
  - decorative wall & shelf items
  - electronics (tv, entertainment media & players, computer, printer, supplies, etc.)
  - appliances, supplies, warranties, repairs (refrigerator, stove, microwave, slow cooker, dishwasher, washer/dryer, portable a/c, portable heaters, etc.)
  - kitchenware, pots & pans, baking sheets, cooking implements, etc.
  - dishes, glassware, table settings, silverware, etc.
  - curtains, window coverings, wall coverings, etc.
  - linens: for dining room (tablecloths, table runners, place mats, etc.); bathroom (towels, hand towels, washcloths, etc.); bedroom (sheets, blankets, comforters, quilts, etc.)
  - infant, toddler, children's furniture; appliances; kitchenware; dishware (bottles, sanitizing equipment, nursing equipment); linens (not clothing); toys; etc.

- Utilities:
  - electric, natural gas, heating oil, propane, kerosene, water, sewer, trash, pest control, firewood (including cost of delivery or hauling), etc.
  - cable or satellite tv, streaming services, internet, etc.
  - land-line phone bill, cost of purchasing or leasing land-line telephone equipment . . .
  - . . . OR personal-use percent of total cost of cell phone bill & equipment–
    but only if there is NO land-line (calculation instructions follow)

- How to calculate the personal-use amount of your cell phone bill:

  - If you do not share your plan with anyone else:
    (1) add up your voice minutes used for personal calls
    (2) divide into the total minutes used
    (3) multiply that percentage by the total bill
    (4) this is the dollar value for your personal use of the cell phone & can be used as a housing allowance exclusion item.

  - If you share your plan with others:
    (1) divide the "shared" portion of the plan that is in addition to each individual's usage by the number of people sharing the plan
    (2) add that dollar amount to the cost attributed to your usage alone
    (3) then add up your voice minutes used for personal calls
    (4) divide by the total minutes you used
    (5) multiply that percentage to the cost attributed to your usage alone PLUS your portion of the shared cost
    (6) this is the dollar value for your personal use of the cell phone & can be used as a housing allowance exclusion item
    (7) repeat individually for each person on your plan who resides in your household; be aware that other adults in the household may have business- or work-related calls that do not qualify as personal-use for the purposes of the housing allowance exclusion.

  - Note: the remaining amount of your cell phone bill that does not relate to personal use <u>might</u> be deductible as business use of your cell phone.

Calculating the Housing Exclusion

The amount of income that can be excluded from federal income before federal income tax is calculated (but not from federal self-employment income) is the <u>smallest</u> of the following three amounts:
(1) the amount properly designated in writing as the <u>housing exclusion</u> before payments to clergy begin;
(2) the amount <u>actually spent</u> to provide the home during the calendar year (see list above); &
(3) the <u>Fair Rental Value</u> of the home during the calendar year:

- <u>Fair Rental Value of the Home</u> means something different if it's a Parsonage or owned Home:

  - <u>If you live in a congregation-owned Parsonage</u>:
    - The Fair Rental Value of a congregation-owned Parsonage (plus any Congregation-paid Utilities) is/are added to your income for the purposes of Self-Employment Tax, so the lower, the better.
    - It should be accurate for its location & condition.
    - A realtor can give an accurate value for the building.

  - <u>If you live in a home that is not owned by the congregation</u>:
    - The Fair Rental Value of your own home is the amount it would cost someone else to rent the home you live in, fully furnished, if you walked out the door & left almost everything behind (except food, clothes, toiletries).
    - This value includes the FRV of the building itself (a realtor can give an accurate number for this), plus the cost of all utilities, & THE FRV OF EACH INDIVIDUAL ITEM INSIDE!
    - Because the total FRV of your home is impossible to calculate accurately, <u>it should not be the smallest of the three amounts</u> that determine the amount of income that can be excluded from federal income before federal income tax is calculated.