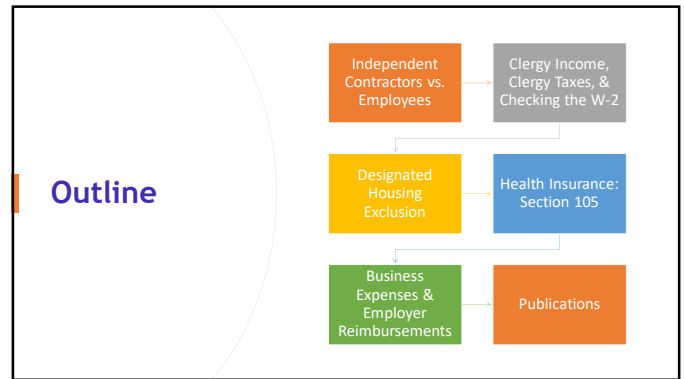




1



2



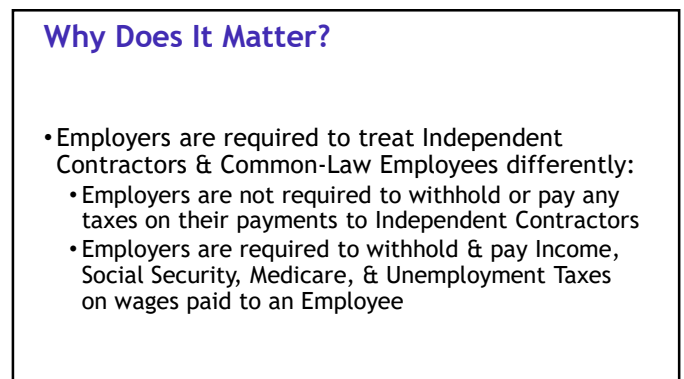
3



4



5



6

### 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.

7

### 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 the services?

8

### How IRS Decides

- Type of Relationship
  - How the parties perceive their relationship: what does the contract say? Can the worker receive employee benefits? Is the worker available to do the same work for other businesses?
- Within these 3 broad categories, IRS applies the “20 Factor Test” (listed on IRS Form SS-8) to each situation individually.

9

### Clergy Are “Hybrid” Employees

- Pastors are Common-Law Employees of the Congregation:
  - For Income Tax and Benefit Plans
  - But not for FICA (Social Security & Medicare) or Unemployment Taxes
  - And who are subject to SECA (Self-Employment Contributions Act) on their total ministerial income


10

### Clergy Are “Hybrid” Employees

- So: Pastors are Employees of the Congregation, who are exempt from FICA, and must pay Self-Employment Taxes (that’s how they pay into Social Security & Medicare), but who are NOT Independent Contractors.

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**CLERGY INCOME,  
CLERGY TAXES,  
& CHECKING  
THE W-2**



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### Types of Clergy Income

- Pastors have 3 types of income.
- The first 2 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 3<sup>rd</sup> is reported by the Pastor:
  - Self-employment or honoraria . . .
    - Reported on Schedule C (Form 1040)

13

### Clergy Income Subject to Clergy Tax Rules

- 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, etc.
  - Any “gross-up” amount the Congregation pays the Pastor toward their Income or Self-Employment tax

14

### Clergy Income 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

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### “Gifts” vs. Salary

- Any compensation given by an employer to an employee is, by definition, compensation for services, unless it is “de minimis” by nature
  - IRS defines “de minimis” as a benefit for which, considering its value & the frequency with which it is provided is so small as to make accounting for it unreasonable or impractical.
- For example: on Father’s Day, all the fathers in the congregation receive a Father’s Day mug filled with snack-size candy bars. The Pastor also receives one. This is a “de minimis” gift.

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### “Gifts” vs. Salary

- Calling payments to the Pastor “special offerings” or “love offerings” does not change the fact that they are compensation to the Pastor.
  - For example, the congregation holds special offerings for the Pastor on the Pastor’s anniversaries at the congregation & at Christmas. In addition, once or twice during the Pastor’s tenure, there has been a special offering for the Pastor’s birthday.
- Regardless of whether the special offerings are regular & expected or unusual & unexpected, the fact that they are payments from the congregational employer means they are compensation for services.

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### “Free Ministers”

- “Free Minister” with no cash compensation from the Congregation:
  - If not reimbursed for expenses under an Accountable Plan, professional expenses are Cash Charitable Contributions (regular Schedule A rules apply)
- “Free Minister” with no cash compensation from the Congregation, but living in the Parsonage:
  - The Fair Rental Value (FRV) of the Parsonage is compensation! A letter from the Congregation with the FRV amount is all that’s necessary.

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### Clergy Income NOT Subject to Clergy Tax Rules

- The following income is NOT subject to Clergy Tax Rules:
  - Offerings made to the Congregation by others
  - Contributions by the Congregation to a tax-sheltered annuity plan (403(b)9) set up for the Pastor
    - Including salary reduction contributions made by the Pastor, found on the W-2 in Box 12, Code E

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### Clergy Taxes

- Pastors are not subject to FICA, the system of Social Security & Medicare withholding that most employees are subject to. In this system, the employer pays half, and withholds the other half from the employee.
- Pastors are, however, subject to Self-Employment Tax instead. This is how Pastors pay their Social Security & Medicare taxes. In this system, the worker pays both the employer and employee halves. This is usually the largest tax balance due affecting Pastors.

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### Clergy Tax Rules for Congregations

- Congregations are prohibited by law from withholding FICA taxes for their Pastor.
- Congregations may withhold Income taxes for their Pastor if requested.
- Congregations must issue a W-2 to their Pastor.
- Congregations can only issue a 1099-NEC to non-employee clergy (e.g., supply or revival preachers)

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### Clergy Tax Rules for Pastors

- All ministry income is subject to Self-Employment tax.
- All ministry income is subject to income tax – unless properly excluded by an officially designated Housing Exclusion.

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Table: Active Pastor

	Subject to Income Tax?	Subject to Self-Employment Tax?	Subject to FICA Taxes?
SE Income (Honoraria)	Yes	Yes	No
Employee Salary	Yes	Yes	No
Housing Exclusion FRV of Parsonage	Maybe No	Yes	No

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### Employer “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 all taxes are taken on the increased amount, the Pastor still receives the amount the congregation intended (this includes all income taxes & self-employment taxes as well)
- The gross-up amount is added to Pastor’s W-2 in Box 1

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### Employer “Gross-Up”

- To calculate gross-up, follow these 4 steps:
  - 1. Add up all federal, state, & local tax rates
  - 2. Subtract the total tax rates from the number 1.00 (one):  $1.00 - \text{tax} = \text{net percent}$
  - 3. Divide the net payment by the net percent:  $\text{net payment} / \text{net percent} = \text{gross payment}$
  - 4. Check your answer by multiplying gross payment by net percent

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### Employer “Gross-Up” Example

- A Pastor has compensation of \$50,000 from the congregation, who would like to also give her their half of FICA (7.65%, or \$3,825).
  - 1. Add up all federal, state, & local tax rates:
    - Federal income tax: 0.12
    - Self-employment tax: 0.1413 ( $0.9235 \times 0.153$ )
    - Ohio income tax: 0.03226
    - Columbus City income tax: 0.025
    - Total taxes: 0.31856

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### Employer “Gross-Up” Example

- A Pastor has compensation of \$50,000 from the congregation, who would like to also give her their half of FICA (7.65%, or \$3,825).
  - 2. Subtract the total tax rates from the number 1.00 (one):  $1.00 - 0.31856 = 0.68144$
  - 3. Divide the net payment by the net percent:  $\$3,825.00 / 0.68144 = \$5,613.11$
  - 4. Check your answer by multiplying gross payment by net percent:  $\$5,613.11 \times 0.68144 = \$3,825.00$

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### 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 salary in Box 1, & notes the amount of the officially designated Housing Exclusion & the Fair Rental Value of a provided Parsonage or the amount of the Parsonage Adjustment in Box 14

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### 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 amounts appear 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 official letterhead detailing the compensation paid to the Pastor during the calendar year.

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### 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

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## Clergy W-2

a. Employer's social security number 000-00-0000		Safe, accurate, FAST! Use  Visit the IRS website at www.irs.gov/efile	
b. Employer identification number (EIN) 00-0000000		1. Wages, tips, other compensation \$18,000.00	2. Federal income tax withheld \$7,065.78
c. Employer's name, address, and ZIP code Happy Valley Congregation 1 Happy Drive Happy Valley, STATE 00000		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 Last name Happy Valley Minister 50 Valley Avenue Happy Valley, STATE 00000		11. Nonqualified plans	12a. See instructions for box 12 E   \$2,000.00
		13. Insurance (Health) <input checked="" type="checkbox"/> (Life) <input type="checkbox"/> (Disability) <input type="checkbox"/> (Other) <input type="checkbox"/>	12b. <input type="checkbox"/>
		14. Other HOUS EXCL \$13,692 PARS ADJ \$16,308 TOTAL HOUS \$30,000	12c. <input type="checkbox"/>
f. Employee's address and ZIP code		15. State income tax	16. Local income tax
15. State income tax ST \$18,000.00		16. Local income tax \$18,000.00	17. Local income tax HAPVAL

Form **W-2** Wage and Tax Statement **2022** Department of the Treasury—Internal Revenue Service  
Copy B—To Be Filed With Employee's FEDERAL Tax Return.  
This information is being furnished to the Internal Revenue Service.

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## 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 and payment records)
- Confirm that there are no entries in Boxes 3, 4, 5, or 6 (Social Security & Medicare wages & withholding)

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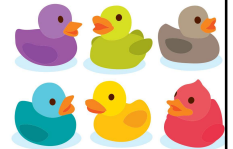
## DESIGNATED HOUSING EXCLUSION



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## Designated Housing Exclusion

- The Designated Housing Exclusion is called by many names, yet each represents 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



34

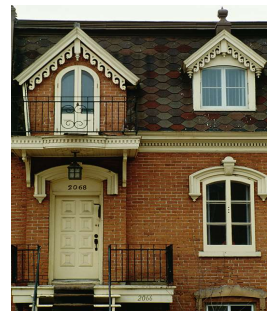
## Designated Housing Exclusion

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

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## Designated Housing Exclusion

- However, remember that all ministry income is subject to self-employment tax, including the designated housing exclusion & parsonage adjustment amount or the fair rental value (FRV) of a provided parsonage & the cost of all utilities paid by the congregation.



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### Typical Housing Expenses

HOUSING EXPENSES	UTILITIES EXPENSES
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/Supplies . . .	Landline Phone OR . . .
. . . (26 CFR §1.107-1(c)(3))	. . . Personal Use Cell Phone
etc.	

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### What The Code Says: 26 CFR § 1.107-1

- (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 food and servants are not considered for this purpose to be directly related to providing a home.**” (emphasis added)

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### Rules for Pastors Living In Parsonages

- The FRV of the Parsonage (including utilities if paid by the congregation) is automatically **EXCLUDED** from income before federal income tax is calculated
- The FRV of the Parsonage (including utilities if paid by the congregation) is automatically **INCLUDED** in income before federal self-employment tax is calculated

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### Rules for Pastors Living In Parsonages

- The FRV must be reasonable for its location
- Ask a realtor for up-to-date FRV comps
  - The low end of the range benefits the Pastor's tax bill now
  - The high end of the range benefits the Pastor's social security benefits later
- Pastors should also designate a housing exclusion to cover the **stuff** that goes inside the parsonage!

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### Housing Exclusion Rules

- The amount officially designated as housing exclusion must be specified in writing, in an official document of the congregation, before that housing exclusion payment is made.
  - *It can be a dollar amount or a percentage*
  - *It can be time limited (“for calendar year 2023”) or in perpetuity (“until further notice”)*

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### Housing Exclusion Rules

- The amount must be used to provide or rent the home (Internal Revenue Code: “provide a dwelling for the minister”)
- The amount cannot be more than reasonable pay for the Pastor's services
  - *It can be 100% of the Pastor's unspent compensation*

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### Housing Exclusion Rules

- If the designated housing exclusion is 100% of the Pastor's "unspent" compensation, a few other items must be taken out first:
  - Any tax withholding to federal, state, or local
  - Pastor's pension contributions\*
  - Pastor's payments for Eder insurances
  - Pastor's payments for non-Eder insurances
- The remaining cash salary amount can then be designated as the housing exclusion amount

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### Housing Exclusion Rules

- If there was no tax withholding & there were no pension contributions by the Pastor, then no W-2 is issued
- A letter on congregational letterhead details the date the officially designated housing exclusion was approved and the total housing exclusion payments to the Pastor

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### Housing Exclusion Rules

- \* There is a pension contribution issue that can occur when Pastors designate most of their cash salary as housing exclusion.
- If the amount the congregation is contributing to the Pastor's pension, added to the amount the Pastor is contributing, is more than the W-2 Box 1 salary amount, contact **Jeremiah Thompson (847.622.3368)** at Eder Financial for assistance.

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### Calculating The Exclusion

- The amount that can be excluded from income before federal income tax is calculated is the smallest of the following 3 amounts:
  - The amount officially designated in writing as the housing exclusion (always start here)
  - The amount actually spent to provide the home
  - The fair rental value (FRV) of the home, including utilities, furnishings, decorations—basically everything in the home except food & clothing!

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### Rules for Supply Preachers

- The official designation of a housing exclusion amount can be made by the congregation who holds the minister's membership & to whom the minister is accountable
- Language can include something similar to: "100% of all income received from ministerial services is designated as housing exclusion, until further notice."

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### 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 became taxable income to the employee & are reported on the W-2 in Box 1.

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### Moving Expenses

- 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 payments from Box 1 to Box 14.

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### HEALTH INSURANCE



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### Affordable Care Act

- Before the Affordable Care Act (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 ACA made that practice illegal until the 2016 "21st Century Cures Act" created 2 (two) exceptions.

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### Section 105 Plans: ACA Exceptions

- The two exceptions are:
  - If the congregation has only one employee ("fewer than two employees") in the plan; or
  - If the congregation has only retirees in the plan
- These are now called "Section 105 Plans" and these particular plans can be implemented with or without plan documents.

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### Section 105 Plans: ACA Exceptions

- One-Employee Plans
  - Congregation can only have 1 (one) employee who works more than 25 hours per week, on average
  - This is why worker classification is so important. Determining who is an employee vs. an independent contractor is crucial for this test.
- Congregation cannot have both a one-employee plan & a retirees-only plan

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### Section 105 Plans

- The following Section 105 plans require specific plan administration documents, & a professional benefits advisor should be consulted when setting one up.

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### Section 105 Plans: QSEHRA

- Qualified Small Employer Health Reimbursement Arrangement
- Allows certain small employers to give their employees pre-tax dollars to pay medical premiums & other medical expenses
- Employers can contribute \$5,850 (in 2023) for an HRA covering an individual employee; & \$11,800 (in 2023) for an HRA covering an employee & their family

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### Section 105 Plans: ICHRA

- Individual Coverage Health Reimbursement Arrangement
- Allows employers who don't offer medical coverage to give their employees pre-tax dollars to pay medical premiums & other medical expenses
- Employers can contribute differing amounts to older workers & workers with larger families; these amounts cannot exceed 3 times that available to other employees

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### Section 105 Plans: EBHRA

- Excepted Benefit Health Reimbursement Arrangement
- Allows employers who do offer medical coverage to give their employees pre-tax dollars to cover dental, vision, & medical costs not covered by their primary plan
- Employers can contribute \$1,950 (in 2023) per employee

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## BUSINESS EXPENSES & EMPLOYER REIMBURSEMENTS



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### Business Expenses

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



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### Typical Clergy Expenses

- BOOKS, Subscriptions
- Business Mileage
- Business Use of Cell Phone
- Computer, Internet
- Education (Seminars, Conferences)
- Office Supplies
- Religious Material (Anointing Oil)
- Robes, Vestments, Collars, Stoles, Albs, etc.
  - Cost of Dry Cleaning these "Clerical Uniforms"

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### 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 😊

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### Non-Accountable Plans 😞

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

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### 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 purposes.
  - Employer pays the employee regardless of whether the employer reasonably expects the employee to have business expenses.

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### Non-Accountable Plans 😞

- Payments from a Non-Accountable Plan are income to the employee.
- These payments are wages & are subject to withholding and payment of income, social security, medicare, & all payroll 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 both income tax & self-employment tax.

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### 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)

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### Accountable Plans 😊

- Payments from an Accountable Plan are not income to the employee.
- Which means these payments are not wages & are not subject to withholding and payment of income, social security, medicare, & all payroll taxes.
- And they are not taxable income to Pastors!

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## 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 IRS could disqualify the accountable plan, meaning all accountable plan reimbursements for every year would become taxable wages for every employee, plus amendments, taxes, & penalties.

67

## PUBLICATIONS



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## Publications

- Batts, Michael E. 2019. Church Finance: The Church Leader's Guide to Financial Operations. 2<sup>nd</sup> ed. Carol Stream IL: Christianity Today Intl. [www.ChurchLawAndTaxStore.com](http://www.ChurchLawAndTaxStore.com)
- Laue, Vonna. 2013. Essential Guide to Church Financial Health. Ver. 1.0. Carol Stream IL: Christianity Today. [www.ChristianityToday.org](http://www.ChristianityToday.org)

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## Publications

- Newsletters from ChurchLawAndTax.com:
  - Church Finance Update Newsletter
  - Church Law & Tax Update Newsletter

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## 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](http://www.irs.gov)

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## Publications

- Pub 15 (Circular E), Employer's Tax Guide
- Pub 463, Travel, 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](http://www.irs.gov)

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