

CONGREGATIONAL/MINISTERIAL INCOME TAX GUIDELINES

Updated For 2016 Tax Returns

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The new year brings a reminder that tax season is also here and deserves our attention. This document is to be used as a "practical, how-to" guideline. Information was gathered from various publications and accountants. Although we believe it is accurate, you may find variations under some circumstances and differences of accountants' interpretations. This represents the basics:

1. PASTOR'S STATUS

According to IRS regulations, ordained, licensed, or commissioned persons who perform ministerial/religious duties of a church have dual-status. This means that the minister is an **EMPLOYEE** for income reporting, fringe benefits and expense deducting purposes and is **SELF-EMPLOYED** for social security purposes.

2. INCOME

- A. ANY INCOME is taxable that is received because you performed a service or assignment. This includes all regular income from the congregation, such as salary (less designated housing allowance discussed in Section #4), love offerings, and congregational gifts and taxable fringe benefits. In addition, honorariums for services rendered such as weddings, funerals, evangelistic meetings, seminars, etc., are to be included, whether received from local congregation or from other sources.
- B. REPORTING OF INCOME should be done by the church on a W-2 form. Total wages, EXCLUDING housing allowance, are reported on Box 1. Boxes 3, 4, 5, and 6 should have a zero (0) entered.
- C. ALL WAGES, INCLUDING housing allowance and taxable fringe benefits, are subject to self-employment taxes. Don't overlook the tax deduction described in section #7.
- D. DO NOT INCLUDE as income, payments made by the church for medical/disability insurance, qualified pension/retirement plans, or accountable reimbursed expenses according to the church's written policy. To be eligible for these "tax free" fringe benefits, pastors must be considered church employees (receive a W-2) and not self-employed (receive a 1099)—see details in Section #1 and Section #6.
- 5. GIFTS RECEIVED by the pastor at birthdays, anniversaries, holidays, etc. are generally considered non-taxable. Usually these gifts are "small and nominal," and are not deductible on the donor's tax return.

Gifts usually "larger and special occasion" are taxable when they are channeled through the church treasury and a tax deductible receipt is given.

NOTE: An IRS "rule of thumb" to remember about what taxable income is:

- If donor receives a tax deduction for a contribution, the amount is taxable income to the pastor.
- If donor does not receive a tax deduction, a gift is usually considered non-taxable to the pastor.

3. FORMS FOR CHURCHES TO USE

Churches should report pastor's salaries on W-2 forms rather than 1099's. Continued use of a 1099 by churches will increase a pastor's chance for an audit and result in the loss of fringe benefits. See note at #2D and item #6. W-2 forms are given to pastors by January 31. The church files with IRS a W-3 Yearly Summary with copies of each W-2 also by **January 31**. Churches DO NOT withhold Social Security (FICA) from pastors (they file as self-employed) ALSO income is not subject to income tax withholding. However, by a written agreement of the church and pastor, income tax may be withheld by the church and sent to the IRS for the pastor. See Section 10D for tax payment options.

Churches are required to withhold Federal Income Tax and Social Security (FICA) from ALL other employees paid regular wages. This includes janitors, secretaries, or any paid staff persons. Churches file a quarterly 941 tax form and keep on file a W-4 and an I-9 form for each employee.

NOTE: If your church is new or does NOT have an Employer Identification Number (EIN) apply on Form SS-4. This will give the church a valid number needed on bank accounts, and will provide the needed number for W-2's and other tax forms. This will be a federal NINE digit number. Do not confuse this number with a state EIGHT digit sales tax exemption number.

4. HOUSING ALLOWANCE

Housing allowance (sometimes called parsonage exclusion) remains a very important benefit IRS provides to those who perform ministerial services (bishops, ministers, deacons and deaconesses; ordained or licensed; part-time or full-time) an exclusion from gross income the amount used to provide a house. This is tax free income for federal taxes only, and must be reported as income for social security and to Pennsylvania state. Pastors in other states should check their state laws. County taxing of housing allowance varies. Currently, Lancaster County uses the same guidelines as federal, excluding housing allowance from earned income. We recommend that you write "clergy" on the W2 that you send to Lancaster County. Check with your local tax office for information. Pennsylvania passed Act #166 in early 2003 that forbids local authorities from taxing housing allowance from 2003 on. Be sure to check with your local tax preparer or authority on this when doing your taxes.

These guidelines apply to housing allowance:

- A. The congregation must record a minute annually that designates a dollar amount BEFORE the amount is paid. An amendment can be made to increase the amount during the year but that increase is never retroactive to the beginning of the year.

- B. The amount designated should be the estimated total needed to provide housing, including cost of rent or mortgage payments, mortgage interest, real estate taxes, insurance costs, utilities, furnishings, repairs and maintenance. Figures must be within normal housing rental costs for your community (including furnishings and maintenance).
- C. Adequate records need to be kept by the recipient. All accountability or substantiating of amounts used is the pastor's responsibility. Any amount NOT used for actual housing expenses must be added to total income and be shown on Line 21 of Form 1040.
- D. The "double deduction" clause continues to provide a favorable tax break. This allows itemized deductions of mortgage interest and real estate taxes on Schedule A even though they are also included in the housing allowance figure.

NOTE: The Housing Allowance figure is **NEVER** included with total wages on Form W-2, Box 1. Some tax publications recommend not reporting the housing allowance on any IRS wage forms. Pastors must remember to include it on their Schedule SE and State form as income. Other tax publications recommend using Form W-2, Box 14, stating the dollar amount and a note "parsonage allowance." Either way seems to be used by churches and accepted by IRS.

5. REIMBURSEMENT OF EXPENSES

It is very important for churches to FULLY REIMBURSE pastors for all actual expenses of ministry, since pastors cannot deduct full costs on Schedule A. This plan must be IN WRITING and be part of the church's official minutes. This includes costs of travel, telephone, office supplies, professional and educational costs, and car mileage. IRS recognizes a standard mileage reimbursement rate of 54 cents per mile for 2016. Expenses should be paid by the treasurer on a regular basis (not longer than 60 days), and are NOT included in taxable income. If older than 60 days mileage reimbursements ARE taxable income.

Mileage is usually calculated from the church office as the starting place or base for counting miles (commuting expenses are not deductible). For overseers or bishops who use their home as the designated office when working with several churches, the base from which miles are calculated could be their home office if the church district designates the home office as the base of operation.

If the church does NOT reimburse expenses, pastors receiving a W-2 can claim deductions for expenses on Form 2106 and Schedule A, although these amounts will be reduced by percentages of adjusted gross income.

NOTE: For the year 2017, the standard mileage allowance is 53.5 cents per mile.

6. SCHEDULE C (OR C-EZ)

DO NOT USE Schedule C for reporting of any regular income or expenses as a dual status minister. See Section 1. Pastors should use Schedule C (Profit or Loss From Business) only to

record income and deduct expenses for amounts not directly related to the congregational salary. This includes honorariums from, and expenses related to outside services, such as weddings, funerals, evangelistic meetings, speaking at retreats, etc.

NOTE: IRS is targeting more audits of clergy returns that show income on 1099's, and prepared with salaries and expenses listed on Schedule C. Clergy with 1099's and Schedule C's will not fare well in an IRS audit

NOTE: For income/expenses not related to local congregation, most pastors can use Schedule C-EZ instead of the longer Schedule C. The Schedule C-EZ has only three lines to list income, expenses (of \$2,500 or less), and net profit.

7. SELF-EMPLOYMENT TAXES

Pastors are considered self-employed for social security purposes and must pay tax at the rate of 15.3% (.153) on all income INCLUDING housing allowance. This is calculated on Schedule SE.

This is a significantly high cost to pastors, since employees only have 7.65% withheld from their paychecks, with employers matching this amount to Social Security. CHURCHES ARE ENCOURAGED to pay 1/2 of this self-employment amount to the pastor so the pastor's tax liabilities are more equitable with other persons who are employees. Any amount added must be included in taxable income.

NOTE: Don't overlook the self-employment tax deduction available on Schedule SE. You may deduct, as an adjustment to income, ONE-HALF of your self-employment tax from schedule SE. This is calculated on Line 6. This deduction is entered on Form 1040, line 27.

All pastors are subject to self-employment taxes, unless they file a Form 4361, claiming exemption because of religious principles that are conscientiously opposed to accepting government insurance. IRS is clear that exemption must be based on religious conviction and not economic reasons. This exemption is irrevocable and must be filed by April 15th of the second year in which pastor receives \$400 or more for services as a minister.

8. RETIREMENT PLANNING

It is important for pastors and church workers to establish good retirement plans to supplement social security income during retirement years. Since there are many plans and options available with varying tax implications (such as mutual funds, annuities, tax sheltered and individual retirement accounts), be sure to consult your accountant and/or Everence representative for reputable counsel.

In recent years, IRS clarified that retired ministers “are not subject to self-employment taxes on housing allowances or any other retirement benefits received from a church plan.” Those who are retired need to work closely with their accountants, since IRS rulings and regulations about retirement plans continue to be updated.

9. CHURCH AND TREASURER'S ACCOUNTING

It is important that all congregations do careful accounting, keep accurate records, practice sound financial management, and stay informed about tax regulations and reporting.

This includes having:

1. An accounting system that is approved by general non-profit accounting standards.
2. Providing clear and adequate reports to the leadership and congregation on a regular basis.
3. Independent auditors (either from within or outside the congregation) review and report on treasurer's work annually.

Two other areas should be highlighted:

1. Donors need written receipts from the congregation to be able to deduct any individual contributions of \$250 or more, also for ANY AMOUNT if contribution is in CASH. The receipt (most congregational numbered offering envelope plans are sufficient) must include the donors name, church name, and be signed by an authorized signature. Individual donations must be a dated and listed separately, rather than showing only an annual grand total given.
2. A statement MUST be included on the receipt indicating whether or not the church provided any goods or services to the donor in return for the contribution. If the donor receives goods or services in return, the receipt must show the value of the goods and services. On any size donation, the donor can only count as a charitable contribution the difference between the amount of the gift and the value of goods and services received.

10. RELATED TAX/FINANCIAL INFORMATION

- A. PENNSYLVANIA STATE TAX RATE for 2016, on all income, continues at 3.07% (0.0307). The rate for 2017 is the same. If outside of PA, check your state rates and laws.
- B. COUNTY TAX: Don't forget to file county taxes especially if you are filing as self employed. Tax rates vary by township or boro of residence but are usually withheld by employer location. You may be due a refund or need to pay in extra if these rates are not the same. In Pennsylvania local taxing authorities are forbidden to tax housing allowances (see paragraph #4).
- C. LOCAL SERVICES TAX: LST can be levied up to a maximum of \$52 a year. The LST replaces the occupational privilege tax (OPT). This annual tax is based on the place of employment rather than where employee lives. Some districts and cities exempt clergy (Lancaster County does). Other areas include clergy. This is a Pennsylvania local tax levy.
- D. SEVERAL OPTIONS are available for payment of federal taxes. Quarterly deposits of estimated taxes can be reported on Form 1040ES. If the pastor or spouse has another wage, that employer can withhold extra amounts to cover taxes due. Or if the pastor and church agree, income taxes may be withheld by the church and paid to IRS on Form 941. There is an

“underpayment penalty” at filing time if you have not deposited or withheld 90% of total tax due for the current year, or 100% of the tax total of your previous year.

- E. SOCIAL SECURITY provides taxpayers with information on their account: total earnings reported, amount paid in, and estimated amounts of disability, retirement income, and death benefits. These annual mailed reports were discontinued in mid 2011 to save money. You can use their web site to access some of this same information: www.ssa.gov/mystatement/.
- F. The IMPORTANCE OF PERSONAL RECORD KEEPING cannot be over emphasized. Tax filers must keep adequate records and sufficient evidence to support all tax forms. Estimates and approximations are not enough for IRS inquiries and audits. A year-round system of careful record keeping will make your end of year tax reporting much easier.
- G. KEEP YOUR CONGREGATION'S LIABILITY POLICIES CURRENT. Many states and local municipalities are requiring churches to provide more and more insurance coverage. In addition, churches and church leaders are facing increasing risks of lawsuits and legal action from the public. These areas include workers compensation for all employees, including pastors; liability coverage for church property, vehicles and special events; counseling and liability coverage for pastoral and other paid professional staff; and coverage for sexual harassment and abuse situations. I believe we need to do all we can to eliminate and lower the risks. Churches should regularly review insurance coverage and needs with a reputable insurance agent.

11. RESOURCES AVAILABLE

The following helpful publications are available for review at the Lancaster Mennonite Conference Office or for purchase either online or at a local bookstore.

- Church Law & Tax Report/Church and Clergy Tax Guide, 2016 Edition, by Richard Hammar, (Christian Ministry Resources)
- Income Tax Guide for Ministers and Religious Workers, 2012 Edition, by B. J. Worth (Appalachian, Inc.)
- The Tax Confusion Solution, 60 minute video about church accounting & clergy taxes, by Kenneth Shirk, Son-Set Ministry, Lebanon, PA (www.sonrise.biz).
- The Ernst & Young Tax Guide 2012, by Ernst & Young, LLP (John Wiley & Sons, Inc.)
- The Minister and His Taxes by Randall E. Rhoads Tax practitioner from Cerran Enterprises of 65 Willow Mill Park Road, Mechanicsburg, Pa. 17050. Phone (717) 790- 0697
- The IRS web site (www.irs.gov) is written in a user-friendly format, and offers tax forms, publications, and complete tax information. The following IRS Publications may be helpful: #517; #1828. Or call IRS at 1-800-829-3676 (1-800-TAX-FORM).
- PA tax information can be found at www.revenue.state.pa.us/

Any questions/comments/suggestions contact:



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