

Fifty-Seventh Annual Edition

**MINISTER'S GUIDE
for
2012 Income Tax**

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MINISTER'S GUIDE FOR 2012 INCOME TAX

by Conrad Teitell

This guide assists ministers in preparing their 2012 federal income tax returns, due April 15, 2013. In Internal Revenue Service ("IRS") Publication 517, "Social Security and Other Information for Members of the Clergy and Religious Workers," for use in preparing 2012 returns, *Rev. Rul. 80-110*, 1980-1 C.B. 190, and instructions to its agents, the IRS requires that a minister: (1) report salary from his or her church (and related expenses) on Form 1040, the same way that other employee wages are reported; and (2) use Schedule C or Schedule C-EZ (Form 1040) to report income and expenses relating to marriages, funerals, baptisms and other services as a self-employed minister. This booklet is based on filing that way. Consult your adviser.

Since 2001, there have been several laws that affect the income, gift, estate and generation-skipping taxes, as well as pension plan rules. These laws include: *Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA '01)*; *The Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA)*; the *Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA)*; *The American Recovery and Reinvestment Act of 2009 (ARRA)*; the *Worker, Homeownership and Business Assistance Act of 2009 (WHBAA)*; the *Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (Tax Relief Act of 2010)*, and the *American Taxpayer Relief Act of 2012*, which extended many of the laws that expired at the end of 2011 and 2012 through 2013. The provisions of these laws are discussed where appropriate in this booklet.

I. Are You a Church Employee or a Self-Employed Minister?

The distinction between church employees and self-employed ministers is important for several reasons. It determines on which income tax form income is reported and business expenses are deducted and whether certain fringe benefits are excludable from income. Most ministers are employees for federal *income tax* purposes. They're all self-employed for *Social Security* purposes (with respect to services they perform in the exercise of their ministry).

Whether you're an employee or self-employed depends on all the relevant facts and circumstances in your case. Courts generally apply the following factors to determine whether a minister is an employee or is self-employed: (1) the degree of control exercised by the employer over the details of the work; (2) which party invests in the facilities used in the work; (3) the opportunity of the individual for profit and loss; (4) whether the employer has the right to discharge the individual; (5) whether the work is part of the employer's regular business; (6) the permanency of the relationship; and (7) the relationship the parties believe they are creating. Although no single factor is dispositive, the degree to which a congregation has the right to control your actions is often the most important factor.

A decision by the Eighth Circuit U.S. Court of Appeals is of interest. The court ruled that Rev. Alford, an Assemblies of God pastor, was self-employed—rather than an employee—for federal income tax purposes.¹ Except for regularly scheduled church services, the pastor set his own schedule and wasn't required to remit his fees for weddings and funerals to the church. The court examined the factors discussed above but concluded they were less relevant because most of them pertain to "services the individual in question actually rendered, and the pastor clearly did no work for the regional or national [churches]." The court concluded that the churches' right to control the pastor primarily concerned awarding him credentials. The churches couldn't control the "manner and means" he used to carry out his duties. The churches didn't find the pastor his job, didn't negotiate his salary or benefits, couldn't guarantee him a job or remove him and didn't regularly evaluate his work. The court concluded that the relationship between the local church and the regional and national denominational agencies didn't show the control needed to make the pastor an employee for federal income tax purposes. It rejected the IRS's claim that the authority of the local, regional and national church bodies over the pastor should be combined. *Note:* The IRS only has to accept this decision for other taxpayers residing in the Eighth Circuit—Arkansas, Iowa, Minnesota, Missouri, Nebraska, North Dakota and South Dakota—and the facts in your case must be similar. Check with your adviser to see which rules apply to you.

Several other court cases are also of interest. In one test case, the Fourth Circuit U.S. Court of Appeals upheld the U.S. Tax Court's ruling that due to the organizational structure of the United Methodist Church, a Methodist minister was an employee.² In the other case, the U.S. Tax Court found that a Pentecostal minister—who had a large degree of control over his own activities—was not an employee, even though he had to account to and could be fired by the congregation.³ From the cases it is unclear what degree of control is necessary for a court to find employee status. But if you receive regular wages from the church and the congregation defines and directs your duties, you're probably (definitely in the IRS's eyes) an employee and should receive a Form W-2 from the church. If, on the other hand, as an itinerant minister you arrange for and provide services to a number of churches, you may be self-employed. In that case, you should expect to receive Form 1099s from the churches.

It is difficult for ministers to be classified as self-employed rather than as employees for income tax purposes. An increasing number of ministers who claim Schedule C (Form 1040) deductions for church-related expenses are being audited. The IRS's audit guidelines state that ministers "are generally considered employees." Thus a minister will generally have to prevail in court to prove otherwise.

¹ *Alford*, 116 F.3d 334 (CA-8, 1997)

² *Weber*, 60 F.3d 1104 (CA-4, 1995); see also *Radde*, T.C. Memo 1997-490

³ *Shelley*, T.C. Memo 1994-432

You can have the IRS determine your status by filing Form SS-8. As always, consult your adviser. *Note:* Even if you are considered an employee for income received from your church, fees you receive from individuals for marriages, funerals and other services are paid to you as a self-employed minister. (See section IV.B. for how to report those fees.)

A. **Form W-2.** Internal Revenue Code (IRC) §6051 and its regulations indicate that an employer need not issue a Form W-2 to employees for whom it is not required to withhold income taxes. But in instructions to revenue agents, the IRS has stated: "The church is required to issue a Form W-2 *whether income tax was withheld or not withheld.*" (Emphasis added.) Therefore, I believe it's best that churches issue a Form W-2 to their ministers for salary paid to them, and that ministers file the form with their income tax returns.

If a church issues a Form W-2 to its minister, all salary and wages, taxable fringe benefits, such as the personal use value of employer-provided vehicles, expense reimbursements under a nonaccountable plan, per diem and mileage allowances that exceed the IRS or federal amounts, the taxable portion of moving expenses paid or reimbursed by the employer, and all other taxable compensation or allowances should be included in Box 1—Wages, tips, other compensation.

Box 2—Federal income tax withheld—normally isn't used for ministers. If the minister elects voluntary withholding, the amount withheld, whether intended to cover federal income tax or SECA tax, should be reported in Box 2.

Boxes 3 through 7 apply only to employees who are subject to FICA tax and withholding. In Boxes 3-7 (and in Box 2, if voluntary withholding has not been provided) I suggest a note saying "see attached statement." The statement should say "Taxpayer is a minister not subject to FICA tax or withholding requirements."

B. **Form 1099.** Income and benefits paid to the truly self-employed minister by the church or other sources must be reported to the minister on Form 1099-Misc if the total amount paid by the payor during the year is \$600 or more.

II. Filing Your Income Tax Return

A. **Income Levels.** The income levels at which ministers must file income tax returns for 2012 are:

Age and category	Gross income
Single minister (under 65)	\$ 9,750 or more
Single minister (65 or over)	\$11,200 or more
Married—filing jointly (both under 65)	\$19,500 or more
Married—filing jointly (one spouse 65 or over)	\$20,650 or more
Married—filing jointly (both 65 or over)	\$21,800 or more
Married—filing separately (any age)	\$3,800 or more
Head of household (under 65)	\$12,500 or more

Head of household (65 or over)	\$13,950 or more
Surviving spouse using joint return rates (under 65)	\$15,700 or more
Surviving spouse using joint return rates (65 or over)	\$16,850 or more

Different dollar amounts may apply if you can be claimed as a dependent on someone else's return. See the instructions to Form 1040.

IMPORTANT. Even if your income doesn't exceed the applicable level, you *must* file a return if you aren't exempt from self-employment tax (see section XI.) and your net self-employment earnings exceeded \$400 in 2012, or if you received wages of \$108.28 or more from a church or church-controlled organization that is exempt from employer FICA taxes. See the instructions to Schedule SE (Form 1040). You *should* file (even if you don't have to) to get a refund of any federal income tax withheld. Also, state filing requirements may be different.

B. **When and How to File.** Be sure to sign your return. If you're filing a joint return, your spouse must also sign. If you receive a Form W-2 from your church (and from any other employer), attach it to Form 1040. If no tax has been withheld, the Form W-2 should say so and state that this is because you are a minister. If there was voluntary withholding, the Form W-2 should show the amount of tax withheld. (See section I.A. regarding Form W-2, and section XII. for more on voluntary withholding.) If your spouse also has wage income and you file a joint return, be sure to attach your spouse's Form W-2 to Form 1040.

You must file the return with a check for the full tax due by April 15, 2013. If you file and pay the tax due by January 31, 2013, you need not pay the fourth installment of your 2012 estimated tax (otherwise due on January 15, 2013).

Make your check payable to the United States Treasury. Enclose your check and Form 1040-V, "Payment Voucher" (recommended by the IRS but not required). Deliver or mail your return, check and payment voucher to the appropriate IRS Center at the address specified in the instructions to Form 1040.

If you can't pay the full amount due with your return, you may ask to make monthly installment payments by filing Form 9465. If you owe \$50,000 or less in combined tax, penalties and interest, you can use the Online Payment Agreement at www.irs.gov and set up a payment plan.

If you mail your return, be sure to mail it in ample time to be postmarked before midnight, April 15, 2013. (While not required, it's a good idea to send your return by registered or certified mail, return receipt requested.) Make sure you keep a copy of your tax return, all supporting evidence, and the canceled checks for your 2012 tax payments for at least three years.

Private delivery services. Tax returns and other documents filed with the IRS and documents filed with the U.S. Tax Court are considered timely filed if they're mailed on or before their due date. For many years, that "delivered when mailed rule" only applied to U.S. mail, not to private delivery services. But the IRS has designated private delivery companies that you may use to file tax returns and make installment payments (also for filing documents with the U.S. Tax Court) and you'll be covered

by the timely when mailed rule. The designated companies and types of private delivery services that qualify are: (1) Federal Express (FedEx): FedEx Priority Overnight, FedEx Standard Overnight, FedEx 2Day, FedEx International Priority, and FedEx International First; (2) United Parcel Service (UPS): UPS Next Day Air, UPS Next Day Air Saver, UPS 2nd Day Air, UPS 2nd Day Air A.M., UPS Worldwide Express Plus, and UPS Worldwide Express; and (3) DHL Express (DHL): DHL Same Day Service. However, currently, other than direct proof of actual delivery, the IRS accepts only a registered or certified mail receipt to establish a presumption of delivery. *Caution:* The U.S. Postal Service advises that private delivery services cannot deliver items to P.O. boxes. You must use the U.S. Postal Service to mail any item to an IRS P.O. box address.

If you cannot file your return on time, you can get an automatic six-month filing extension by filing Form 4868 by April 15, 2013. The extension gives you until October 15, 2013 to file your return. *An extension of time to file is not an extension of time to pay.* You must make an accurate estimate of your 2012 tax and send any necessary payment with your Form 4868. If you get an extension and you don't pay all the tax due, you'll be subject to interest charges and possible penalties on taxes paid after April 15, 2013.

C. **Which Form You Should Use.** You report your income on Form 1040. At the bottom of page 2 of that form, state your occupation as "Ordained Minister," "Licensed Minister" or "Commissioned Minister." Where a church ordains some ministers and licenses or commissions others, the IRS has ruled that the latter two must be recognized by your denomination as the equivalent of ordination. If you aren't ordained, check with your denomination headquarters.

Some ministers can use the simpler Form 1040EZ. That form may be used by single people and married people filing jointly. To qualify you (and your spouse, if married and filing jointly) must be under 65 and not blind at the end of 2012. You can't use that form if, for example, you had taxable income of \$100,000 or more, sold or exchanged a capital asset, had taxable interest over \$1,500, had self-employment income on Schedule C, claim dependents or credits other than the Earned Income Credit, or itemize your deductions. Check with your adviser.

D. **Filing Jointly.** If you are married, a joint return will generally result in less tax. To be sure which way is best for you, compute your tax both ways before filing: as "married filing joint return" and "married filing separate return." *EGTRRA* enacted several changes intended to eliminate the "marriage penalty." One change phased-in an increase of the standard deduction for married couples filing jointly so that beginning in 2009 the standard deduction is twice that of single taxpayers. Another change gradually increased the 15% tax bracket so that in 2012 the highest taxable amount in the 15% bracket is twice that for single taxpayers.

When filing a joint return, use the two separate lines provided on Form 1040 to enter both spouses' full names. Put a check in the box next to "Married filing joint

return." Be sure to include your spouse's income and deductions. For tax purposes, your marital status is determined on the last day of the year.

You can file a joint return if your spouse died in 2012 and you didn't remarry before the end of the year. (If you've remarried, you can file jointly with your new spouse.) You can also file as a surviving spouse and use joint tax rates if your spouse died in 2010 or 2011, you haven't remarried, you keep your home as the principal home of your dependent child, and you meet certain other residency and support requirements. Check with your adviser.

You can file as a head of household if you're unmarried at the end of the year, do not qualify as a surviving spouse, and furnish over half the cost of maintaining a household for more than half the year for at least one relative or dependent. See section VIII.A. for a discussion of who are dependents.

III. Church-Provided Parsonage or Parsonage Allowance

Housing or a housing allowance provided by your church or synagogue does not get reported as income for income tax purposes (subject to certain limitations, discussed later).

In 2012, the exclusion from tax is the lowest of: (1) the fair rental value of a home (furnished or unfurnished) plus the cost of utilities (whether you rent or own the home); (2) the amount officially designated as a housing allowance; or (3) the actual expenses of operating the home to the extent they're used to pay parsonage-related expenses such as mortgage, taxes, utilities, furnishings and repairs.

Fair rental value rule. In 2000, the U.S. Tax Court held there was no fair rental value limit to a housing allowance provided to a minister.⁴ IRS disagreed and appealed to the Ninth Circuit U.S. Court of Appeals. The Ninth Circuit raised the question whether the parsonage allowance was unconstitutional as a violation of the Establishment Clause of the U.S. Constitution. In response, Congress enacted the "*Clergy Housing Allowance Clarification Act of 2002*," which provides that for tax years beginning in 2002, the parsonage allowance is limited to the fair rental value of the home, including furnishings and appurtenances such as a garage, plus the cost of utilities. On the stipulation of the parties, the Ninth Circuit dismissed the *Warren* case.⁵

Caution: The 2002 law settled the amount of the exclusion for the parsonage allowance for years after 2001 and, with the dismissal of *Warren*, the issue of its constitutionality was also then dismissed.⁶

⁴ *Warren*, 114 T.C. 343 (2000)

⁵ 303 F.3d 1012 (CA-9 2002)

⁶ The constitutionality of the parsonage allowance was again raised in *Freedom From Religion Foundation, Inc. v. Geithner*. 715 F. Supp.2d 1051 (E.D. CA. 2010). The action survived a motion to dismiss; however, the parties later agreed to dismissal of the action without prejudice after the decision on which the district court relied for

You can exclude the allowance only if it's *officially designated in advance of payment* by your employer.⁷ The designation doesn't have to be made before the calendar year, but it is only effective from the date of the official designation. A resolution, minutes, or a budget identification by your employer is sufficient. In two cases, the U.S. Tax Court allowed a minister to exclude his housing allowance even though the designation wasn't in writing.⁸ However, the cases were decided on unique facts and should not be relied upon. (Knowing about the cases could be helpful if your church didn't make a written designation in advance and you can show that church matters are generally taken care of in an informal manner. Still, play it safe and get the designation in writing.)

Note: If you don't use the full allowance, the excess over what you spend to rent or provide a home is taxable. (See discussion in section IV.G. for details.)

Note: The fair rental value of a church-provided parsonage or parsonage allowance must be included in your self-employment earnings on Schedule SE (Form 1040) when computing your Social Security tax liability. (See section XI.B.)

Your housing allowance qualifies for exclusion from income tax when it is spent for:

1. Rental of a home;
2. Purchase of a home, including: down payment, legal fees, fees for searching title, mortgage payments, interest, taxes, fire and home liability insurance premiums, and repairs. Real estate taxes and mortgage interest may also be deductible on Schedule A (Form 1040) if you itemize. (See section VI.N.); or
3. Expenses of running a home, such as utilities, house furnishings, appliances, maintaining a garage, sidewalk, or yard.

A minister may exclude from gross income the parsonage allowance used to provide only one home.⁹

Church-supplied housing. A minister who receives housing from his or her church may exclude from income the fair rental value of a home furnished as part of his or her compensation.

Note: Costs for food and domestic help don't qualify for the allowance.

its ruling on taxpayer standing was reversed. Another challenge has been filed in the District Court of the Western District of Wisconsin, *Freedom from Religion Foundation, Inc. v. U.S., et al.*, 11-CV-626. The court denied the defendant's motion to dismiss, finding that the plaintiffs have standing to challenge a statute before it has been applied to them, when the injury to their First Amendment rights is clear from the face of the statute. As always, check with your adviser.

⁷ *Logie*, T.C. Memo 1998-387

⁸ *Libman*, T.C. Memo 1982-377; *Kizer*, T.C. Memo 1992-584

⁹ *Driscoll*, 669 F.3d 1309 (CA-11 2012), *cert. denied*, — U.S. — (2012).

Ceiling on allowance. A Tax Court case held that the allowance is excludable *only to the extent you actually spend it to provide a home or to the extent of the fair rental value of your home plus the cost of utilities, if less.*¹⁰ For example, if your parsonage allowance is \$12,000 but you only spend \$1,000, only \$1,000 may be excluded. If you own your home free and clear, the fair rental value cannot be excluded as parsonage allowance if you don't actually spend that amount. But you can exclude the amount used for utilities, furnishings, running expenses, improvements to the property and real estate taxes—to the extent that amount doesn't exceed the fair rental value plus utilities.

A minister who owns a home free and clear might consider mortgaging the house or taking out a home equity loan and using the financing to provide housing (*i.e.*, repairs, capital improvements, or other expenses mentioned above). An argument could be made that the loan payments can be included in the minister's parsonage allowance.¹¹ (However, the tax laws impose limits on deducting home mortgage interest for all taxpayers. See section VI.N.) But if the financing is not used to provide housing, the loan payments can't be included in the parsonage allowance. There are situations where the law isn't clear. For example, if you are planning to purchase a home, the safest route is to take out a mortgage to pay part of the purchase price, rather than placing the mortgage on the home after the purchase. You should consult your adviser on how the law applies to your situation.

To qualify for excludable housing or a housing allowance, you must perform "duties of a minister of the gospel." These include:

1. Performing ministerial services for a religious or non-religious organization;
2. Performing ministerial or non-ministerial services for a religious or a non-religious organization pursuant to an assignment or designation by your church; or
3. Performing ministerial or non-ministerial services for a religious organization that is an integral agency of your church. Check with your adviser.

Note: Ministerial services include: (a) the conduct of religious worship or the ministration of sacerdotal functions as determined by the practices of your church or church denomination; and (b) participation in the control, conduct and maintenance of religious organizations under the authority of a church or church denomination (such as directing, managing or promoting the activities of the organizations). A religious organization is deemed to be under the authority of a church or church denomination if it is organized and dedicated to carrying out the tenets and principles

¹⁰ *Reed*, 82 T.C. 208 (1984)

¹¹ *Rasmussen*, T.C. Memo 1994-311; *Private Letter Ruling 9115051*. *Caution:* Private letter rulings are not precedents.

of a faith in accordance with either the requirements or sanctions governing the creation of the institutions of the faith.¹²

Rabbis and cantors qualify for synagogue-provided housing or a housing allowance.¹³

A retired temple employee was held not entitled to exclude pension income as a housing allowance because he was not a "minister of the gospel." The employee was not an ordained rabbi or a cantor and was not considered a religious leader by his temple. He was an executive director and his duties were mostly administrative. His honorary title—Fellow in Synagogue Administration—was irrelevant, especially since it was conferred after his retirement.¹⁴ The IRS has ruled that "ordained deacons" of a worldwide Christian denomination were "ministers of the gospel" and were eligible to have a portion of their salary designated as a parsonage allowance and exclude such allowance from gross income.¹⁵

The way the parsonage allowance is reported to the minister may vary from church to church. The church should give the minister a breakdown between salary and parsonage allowance. Make sure that items excluded from gross income, such as the parsonage allowance, are not reported on Form W-2 in such a way as to cause confusion when the IRS reviews the minister's return.

In IRS Publication 517, a sample Form W-2 shows the parsonage allowance in Box 14. A church that reports the allowance on Form W-2 should set forth that amount separately in Box 14 with a notation that properly describes the allowance. Otherwise, churches may provide their ministers with parsonage allowance information in one of these ways: (1) show the amount of parsonage allowance in a separate written statement that is attached to Form W-2; (2) show the allowance on Form W-2 in any of the boxes designated for state or local income tax and withholdings if those boxes aren't filled in; or (3) where all of those items are filled in, don't show the parsonage allowance on Copy A of Form W-2, but rather show the parsonage allowance in any empty box (except those showing FICA wages and withholding) on Copies B, C and D. (In the limited cases where the minister is truly self-employed, similar principles and guidelines apply to Form 1099.)

¹² See e.g., *Private Letter Ruling 200803008* (where University was an integral agency of the religious denomination, rental allowances paid to ministers who were faculty, managers, executives, or administrators were excludable from gross income.); *Private Letter Ruling 201023008* (Organization providing foster care residential program was integral agency of church; ministers performing control, conduct or maintenance services could exclude rental allowances from gross income.) *Caution*: Private letter rulings are not precedents.

¹³ *Salkov*, 46 T.C. 190 (1966)

¹⁴ *Haimowitz*, T.C. Memo 1997-40

¹⁵ *Private Letter Ruling 199910055*. *Caution*: Private letter rulings are not precedents.

Retired ministers. If all or a portion of an annuity paid to you by your church denomination has been properly designated as parsonage allowance, it is suggested that Form 1099-R show how much of the annuity has been designated as a parsonage allowance.¹⁶ (The amount that's ultimately tax-free depends on how much of the parsonage allowance portion you actually *use* to provide a home. The excludable amount is the lesser of what you spend or the fair rental value of the house, including utilities.) Next to line 16b of Form 1040, write "See attached statement," and attach a statement that shows the total amount of the annuity (line 16a), minus the lesser of the amount designated or the amount actually spent (line 16b).

Caution: In 1989, the IRS announced that it would no longer rule on whether distributions to a retired minister from a pension or annuity plan were excludable from gross income as parsonage allowance.¹⁷ In audit guidelines issued in 1995, IRS stated that retired ministers may exclude a portion of pension income as a parsonage allowance. But those guidelines are for IRS agents.

The fair rental value of a parsonage supplied to a retired minister as compensation for prior ministerial services is excludable from the minister's income for income tax purposes.¹⁸

Spouses of deceased ministers. There is no exclusion for a parsonage (or housing) allowance paid to the surviving spouse of a deceased minister. The entire allowance is includable in the spouse's gross income.

IV. How to Report Your Income

A. **Church Salary.** Report your church salary on Form 1040, line 7. If any expense allowance received from your church for your automobile and travel or other business expenses was reimbursed under a nonaccountable plan and wasn't reported in Box 1 of your Form W-2, report it as income on Form 1040, line 7. Reimbursements under an Accountable Plan (I call it an AP and discuss it in detail in section VI.C.), including reimbursements reported under Code L (substantiated employee business expense reimbursements) in Box 12 of your Form W-2, not included in Box 1 of your Form W-2, should be reported on Form 2106, Part I, Line 7.

If your church (or other employer) pays any part of your income or self-employment tax to the IRS or to you, the amount paid is additional income to you and must be included in your gross income and in your self-employment income for computing your self-employment tax.

B. **Fees for Marriages, Funerals, etc.** If fees for marriages, funerals, baptisms, etc., don't appear on your Form W-2 as part of church salary, report them on Schedule

¹⁶ *Rev. Rul. 75-22*, 1975-1 C.B. 49

¹⁷ *Rev. Proc. 89-54*, 1989-2 C.B. 633; this item is included in the current IRS no-rule list. *Rev. Proc. 2012-3*, 2012-1 IRB 113 (Jan. 3, 2012)

¹⁸ *Rev. Rul. 63-156*, 1963-2 C.B. 79

C (Form 1040), "Profit or Loss From Business," Part I, line 1, or on Schedule C-EZ (Form 1040), "Net Profit From Business," Part II, line 1. If those fees are paid directly to your church, don't report them on your tax return. See section VI.D.

C. **Social Security Benefits.** If you receive Social Security benefits, your other income can affect those benefits in two ways: (1) your benefits may be taxable; or (2) your benefits may be reduced. You should receive Form SSA-1099 (Social Security Benefit Statement) by January 31 of the tax filing year.

To determine if part of your benefit is taxable, complete the worksheet included in the instructions to Form 1040. You add half of your net benefits (half of the amount in Box 5, Form SSA-1099) plus other taxable income, plus tax-exempt interest, minus adjustments to income from lines 23 through 32 plus any write in adjustments entered on the dotted line next to line 36 of Form 1040. If you use your entire parsonage allowance to provide a home, no part of the allowance is includable in your taxable income for purposes of determining the taxability of your Social Security benefits. That's also true for a retired minister's annuity or pension—as long as the entire annuity or pension has been designated as parsonage allowance and expended by the minister to rent or provide a home. Whether the minister is working or retired, any portion of a parsonage allowance not excluded as a housing allowance is included in the minister's taxable income when determining if Social Security benefits are subject to tax. Spouses who file a joint return must consider net benefits, income, etc., of both spouses when making the determination.

Fifty percent of your Social Security benefits will be taxed if the amount resulting from your calculation on the worksheet is more than \$25,000 (\$32,000 for married persons filing joint returns; \$0 for married persons filing separately if the spouses lived together at any time during the year). If the amount is more than \$34,000 (\$44,000 for married persons filing joint returns; \$0 for married persons filing separately if the spouses lived together at any time during the year), 85% of your Social Security benefits is subject to tax.

Persons who have reached normal retirement age (66 years in 2012, increasing to age 67 by 2027) and continue to work will not have their Social Security benefits reduced, no matter how much they earn. An earnings test is imposed for Social Security recipients aged 62 to full retirement age. The maximum amount such recipients may earn without reduction of benefits is \$14,640 in 2012. If you earn more than that, \$1 in benefits is withheld for every \$2 you earn over \$14,640. In the year you reach retirement age, \$1 in benefits will be deducted for every \$3 above \$38,880, but only counting earnings before the month you reach full retirement age. Starting with that month, you can receive full benefits with no limit on earnings. If you are receiving Social Security benefits and your earnings exceed the allowable limit, you should file an annual report of earnings. SSA accepts W-2 information reported by an employer and self-employment tax information filed with IRS as a report of earnings. You may also report earnings by making either a written statement or by telephone (call 1-800-772-1213). The failure to report excess earnings can result in high penalties.

Caution: If you're a working minister under full retirement age and you receive Social Security benefits and a parsonage allowance, your eligibility for Social Security or the amount of your benefits may be affected. Check with your adviser.

D. **The Sale of Your Home at a Profit.** If you sell your home at a profit, you must report any amount exceeding the exclusion amount on Schedule D (Form 1040). The total capital gain amount is entered on Form 1040, line 13. *JGTRRA*, as extended by the *Tax Relief Act of 2010*, reduced the top rate on most long-term capital gains to 15% through 2012 (0% for taxpayers in the 10% and 15% income tax brackets in 2012) (see section X.). Generally, you can't deduct any loss on the sale of your home. Capital gain on the sale of a principal residence (house, cooperative apartment, condominium) can be excluded if certain tests are met.

In 2012 joint filers can exclude up to \$500,000 (\$250,000 for single taxpayers) of gain from the sale of a home used as a principal residence for at least two of the last five years if they have not sold another principal residence for the two year period preceding the sale of their home. IRC §121. The exclusion may be claimed once every two years. A surviving spouse, whose spouse is deceased on the date of the sale or exchange of the personal residence, may be eligible for the \$500,000 exclusion if the residence is sold no later than two years after the death of the spouse and either spouse met the ownership and use requirements immediately before the date of death. A pro rata exclusion is available for taxpayers who fail the two-year test because of job relocation, health reasons or certain unforeseen circumstances, such as, death of the taxpayer's spouse, natural or man-made disasters, and acts of war or terrorism resulting in a casualty to the residence. Check with your adviser.

E. **Retirement Gifts.** In 1955, the IRS ruled that retirement gifts made by a congregation as a token of affection and esteem were excludable from income if: (1) the minister wasn't expected to perform any further services for the congregation; (2) the payments were based on the minister's financial position and the congregation's financial capacity; and (3) there was neither an enforceable agreement nor an established plan or practice for the church to provide pensions.¹⁹ However, the *Tax Reform Act of 1986* provided that no amount transferred by an employer to an employee will be treated as a gift. Caution dictates that the minister report the amount received as taxable compensation. Check with your adviser.

F. **Prizes and Awards.** Prizes and awards received for charitable, religious, scientific, educational, artistic, literary, or civic achievement are included in your gross income. They may be excluded, however, if you assign them to a governmental unit or a tax-exempt charitable, educational, etc., organization that's eligible to receive tax-deductible contributions. IRC § 74. You should make the assignment *before* the

¹⁹ *Rev. Rul. 55-422*, 1955-1 C.B. 14

prize or award is actually presented to you. You don't get a charitable deduction, but the award won't be included in your gross income.

G. **Miscellaneous Income.** Interest income is considered received by you when the bank credits your account with the interest in its records. Your bank should send you a Form 1099-INT with your annual interest income information. Report it on Form 1040, line 8a. If your interest income is over \$1,500 you must list it separately on Schedule B (Form 1040), Part I, and also complete Part III.

Reporting tax-exempt income. Although it isn't added to your gross income, tax-exempt interest must be reported on line 8b of Form 1040.

You can choose when to report interest on Series EE or Series I U.S. Savings Bonds. Either report the interest each year or report the full accumulation when you cash the bond or when it matures.²⁰ If you've been reporting interest annually on these bonds and want to change to deferred reporting, attach Form 3115, "Application for Change in Accounting Method," to your Form 1040. If you wish to switch from deferred to annual reporting, report the accumulated interest in the year of change and the annual interest thereafter on your Form 1040. No Form 3115 is necessary. Check with your adviser for more information.

If you received any dividends from stock or mutual fund investments, you should receive a Form 1099-DIV from the corporation or mutual fund containing the annual dividend or distribution information. The total ordinary dividends are shown in Box 1a; qualified dividends are shown in Box 1b. Under *JGTRRA*, as extended by *TIPRA* and the *Tax Relief Act of 2010*, through 2012, qualified dividends are taxed at a 15% rate (in 2012, there is no tax on dividends for taxpayers in the 10% and 15% income tax brackets). Qualified dividend income means dividends paid during the tax year by domestic corporations and qualified foreign corporations. Total ordinary dividends are entered on Form 1040, Line 9a; qualified dividends are entered on Line 9b. If you report qualified dividend income, you must use either the Schedule D Tax

²⁰ You may be able to exclude interest on Series EE and Series I bonds that you redeem to pay qualified higher education expenses. Qualified higher education expenses include payment for tuition and similar education fees as well as contributions to a Coverdell Education Savings Account or a qualified tuition program. Use Form 8815 to report the redemption of Series EE and Series I bonds bought to fund tuition costs. The amount excluded must be reported on Form 1040, Schedule B, Part I, line 3. The rule applies for bonds issued after 1989 to a holder who has attained the age of 24 before the issue date (so you should buy the bonds in your own name, not a child's). Tuition and fees must be for a college, university or vocational school that meets federal financial aid standards. Room and board are not eligible expenses. In 2012, the interest exclusion is phased out for taxpayers whose income is between \$72,850 and \$87,850 if single or head of household, or between \$109,250 and \$139,250, if married filing jointly. Check with your adviser for other limitations.

Worksheet (Form 1040) or the Qualified Dividends and Capital Gain Tax Worksheet (in the instructions to Form 1040) to figure your tax. If you use either of these forms you cannot use the Tax Table or Tax Rate Schedules to figure your tax. For details, see IRS Publication 550, "Investment Income and Expenses." If your gross dividends are over \$1,500, you must list them separately on Schedule B (Form 1040), Part II, and complete Part III. Check with your adviser.

Income from other sources: Report IRA distributions and rollovers on Form 1040, line 15a; pensions and annuities on line 16a. Taxable amounts are entered on lines 15b and 16b, respectively. A distribution from a Roth IRA is not usually taxable. Pension and annuity income is fully taxable if you paid no part of the cost. Report pension income by following the information your pension board gives you.

Any part of your designated parsonage allowance you don't actually spend to provide a home is includable in your gross income. Report any taxable portion of your parsonage allowance on Form 1040, line 7.

Rents, royalties, S corporation and partnership income and estate and trust income are reported on Schedule E (Form 1040) and entered on Form 1040, line 17.

Bonuses paid to you are included in income.

"Special occasion gifts" such as those made on birthdays, anniversaries or Christmas are included in income if they consist of substantial cash gifts collected from members by congregation leaders in a routine, structured program. But individual gifts from members of your congregation aren't income to you.²¹

Premiums an employer pays to purchase more than \$50,000 of group-term life insurance for you are includable in your gross income for income and self-employment tax purposes. For 2012, the value of "excess" coverage is computed using the following table:

Your Age on 12/31/2012	Cost Per \$1,000 of Protection for One-Month Period
Under 25	5¢
25-29	6¢
30-34	8¢
35-39	9¢
40-44	10¢
45-49	15¢
50-54	23¢
55-59	43¢
60-64	66¢
65-69	\$1.27
70 & over	\$2.06

²¹ *Goodwin*, 67 F.3d 149 (CA-8, 1995)

If you receive a Form W-2 from the church, the value of coverage in excess of \$50,000 that is includable in gross income should be reported in Box 12—preceded by the letter "C"—and included as part of your total compensation in Box 1. The amount should also be included in Boxes 3 (up to the Social Security wage base) and 5. Otherwise compute the amount includable in your gross income based on the above table and include that amount on Form 1040, line 7, along with an attached schedule, and as part of your net income from self-employment on Schedule SE (Form 1040).

A dependent child under age 18 who has net unearned income exceeding \$1,900 (adjusted for inflation) is taxed at the parents' marginal rate.²² This tax provision is called the "kiddie tax." Instead of the child filing a tax return, the parents may elect to report the child's interest and dividend income between \$951 and \$9,500 on their own tax return by filing Form 8814. The child's first \$950 is tax-free; any amount between \$951 and \$1,900 is taxed to the parents at the 10% rate. Income over \$1,900 is taxed at the parents' highest rate. A separate Form 8814 must be filed for each child. *Note:* A combined parent/child return increases adjusted gross income and could decrease the deductibility of some itemized deductions.

V. Income You Should Not Report

Do not report:

- Payments made by your employer to purchase:
 1. An annuity for you by paying your pension fund dues.
 2. A tax-sheltered (Section 403(b)) annuity. *Note:* You may wish to have an additional annuity above that provided by your denomination, which you can obtain through joint action with your employer. It will decrease taxable income during your working years (for both federal income tax and self-employment tax purposes) and increase income in retirement, when your tax rate may be lower. Distributions from those annuities won't be subject to self-employment tax when received. (See IRS Publication 571, "Tax-Sheltered Annuity Plans (403(b) Plans) For Employees of Public Schools and Certain Tax-Exempt Organizations," and section VII.) Check with your denomination.
- Accident and health plan premiums paid directly to the insurer.

²² Beginning in 2006, *TIPRA* increased the age to which the "kiddie tax" is applicable from 14 to 18. The *Small Business and Work Opportunity Tax Act of 2007* provides that beginning January 1, 2008, the kiddie tax applies to children who are 18 years old or who are full-time students over age 18 but under age 24, whose earned income does not exceed one-half of the amount of their support for the taxable year.

- Personal gifts not related to ministerial activities.
- Damages received on account of personal physical injuries or sickness (except punitive damages) whether by suit or agreement and whether as lump sums or as periodic payments.
- Reimbursement from health or accident insurance.
- Reimbursement for your spouse's travel expenses if your spouse's presence on the trip had a legitimate business purpose, your employer doesn't treat those amounts as compensation, and the expenses are reimbursed under an AP. See section VI.G.
- Amounts paid to you as an employee by your employer for tuition, fees and related expenses under a qualified educational assistance program. The excludable amount is limited to \$5,250 per individual each year. Expenses paid for graduate-level courses are eligible for the exclusion in 2012.
- Qualified distributions from Roth IRAs. See section VII.

Some churches offer a benefit plan (called a "flexible spending account," "Section 125 plan" or "cafeteria plan") where ministers and all other church employees can elect to set aside a portion of their compensation that would otherwise be fully taxable. The non-taxable funds are then used to pay certain types of expenses such as medical expenses and dependent or child care expenses. When the church plan pays those expenses to you or to the service provider with before-tax dollars, your compensation is effectively reduced for purposes of federal income tax, self-employment tax and state income tax (in most states). Check with your church and tax adviser for more information.

VI. How to Calculate and Report Your Deductions²³

A. **In General.** List itemized deductions on Schedule A (Form 1040). If your allowable deductions are larger than your standard deduction, it's to your advantage to itemize. The standard deduction is an alternative to itemizing; it allows you to deduct a minimum amount from your adjusted gross income in determining your taxable income. You can take the standard deduction *or* itemize, *but not both*. When married taxpayers file separate returns, both must itemize or take the standard deduction.

List deductions such as medical and dental expenses, taxes, mortgage interest and gifts to charity on Schedule A (Form 1040). If you don't have enough room on the return for all of the details of those expenses, list them on separate sheets and attach them to the form. But be sure to write "See attached schedule" in the appropriate section on Schedule A. *Pointer:* If your deductions are near the minimum amount

²³ The taxpayer bears the burden of proving entitlement to any claimed exemptions or deductions; this includes the burden of substantiation. See *Welch v. Helvering*, 290 U.S. 111 (1933); *Mandeville*, T.C. Memo 2007-332.

required to itemize, try to bunch your deductions by timing deductible payments so that the total exceeds the standard deduction every other year. *Note:* In 2012, the phaseout for itemized deductions is eliminated. No matter how high your income is in 2012, there is no reduction of itemized deductions.

B. Professional Expenses Allocable to Your Parsonage Allowance. IRC §265 provides that a taxpayer can't deduct expenses allocable to earning tax-exempt income. In the 1964 *Deason* case,²⁴ the U.S. Tax Court held that because a minister's parsonage allowance wasn't taxable, he couldn't deduct his professional expenses attributable to earning the tax-free parsonage. The same reasoning applies to the rental value of a home furnished to a minister rent-free.

In the *Dalan* case,²⁵ the U.S. Tax Court agreed with the IRS that professional expenses allocable to a minister's tax-exempt parsonage allowance weren't deductible. In the *McFarland* case,²⁶ the U.S. Tax Court followed the *Deason* and *Dalan* decisions and held that a minister whose taxable ministerial earnings far exceeded expenses attributable to his ministerial earnings still had to allocate those expenses between his taxable and exempt income. And IRS Publication 517, *requires that ministers who receive a parsonage allowance allocate the expenses of operating their ministries*. Those expenses attributable to the tax-free parsonage allowance are not deductible. Publication 517 provides, however, that the reduction rule does not apply to a minister's deductions for home mortgage interest and real estate taxes.

To calculate the non-deductible portion of your expenses related to ministerial earnings, multiply them by a fraction, the numerator of which is the tax-free rental or parsonage allowance and the denominator of which is all income (taxable and non-taxable) earned from your ministry. This *Deason* allocation rule is applicable to both: (1) expenses related to earning your church salary; and (2) expenses related to weddings, baptisms, funerals, etc. The *Deason* allocation rule is applied only to determine deductions used in figuring your income tax, not in figuring your self-employment tax.

Example: A minister receives \$30,000 salary from the church, of which \$10,000 is a parsonage allowance used to provide a home, and earns \$2,000 in fees from performing weddings. The minister has \$1,800 of unreimbursed employee expenses attributable to earning his church salary and \$200 of expenses related to earning his wedding fees. To determine the non-deductible part of his expenses, the minister calculates the fraction: the numerator is \$10,000 (the tax-free parsonage allowance) and the denominator is \$32,000 (the total of taxable and non-taxable compensation). The

²⁴ 41 T.C. 465 (1964)

²⁵ T.C. Memo 1988-106

²⁶ T.C. Memo 1992-440

result is 31%. The minister multiplies $\$1,800 \times 31\%$ and gets \$558. Therefore, \$558 of the \$1,800 salary-related expenses is not deductible. The minister multiplies $\$200 \times 31\%$ and gets \$62. Therefore, \$62 of the \$200 self-employment-related expenses is not deductible. Because approximately 1/3 of the minister's compensation is exempt from tax (the parsonage allowance), approximately 1/3 of the expenses attributable to that income are not deductible.

IRS Publication 517 requires a minister who receives a parsonage allowance and who is deducting ministerial expenses (either related to church salary or to income from weddings, baptisms, funerals, etc.), to attach to his or her tax return a statement that contains:

1. A description and the amount of each item of taxable ministerial income by source (such as wages, salary, fees from weddings, funerals, etc.);
2. A description and the amount of each item of tax-free ministerial income by source (parsonage allowance);
3. A description and the amount of each item of otherwise deductible ministerial expense;
4. A calculation showing how the non-deductible portion of expenses was determined; and
5. A statement that the balance of deductions on the tax return is not allocable to tax-free income.

Even without the allocation rule, deducting professional expenses is complicated. A minister must: (1) report income and deduct expenses relating to marriages, funerals, etc., on Schedule C or Schedule C-EZ (Form 1040); (2) report church salary on Form 1040, the same way other wages are reported; and (3) report expenses attributable to church salary not reimbursed under an Accountable Plan ("AP") as "Job Expenses and Certain Miscellaneous Deductions" on Schedule A (Form 1040), deductible only by ministers who itemize—and only to the extent those expenses exceed 2% of adjusted gross income. See section VI.R.

Remember, you can avoid the *Deason* allocation rule if your ministerial expenses are paid under an AP. If you have an AP, reimbursements or advances paid to you by the church are not included in your income. Therefore, because you do not claim deductions for those expenses, you need not worry about making the allocation. See section VI.C., below.

C. **Expenses Related to Earning Your Church Salary.** Expenses incurred in earning your church salary—travel and automobile expenses, meals (to the extent allowable) and lodging when away from home overnight, allowable educational expenses, professional expenses—can be deducted only by itemizers. *Those expenses are subject to a 2% floor on miscellaneous itemized deductions, which means that*

your benefit from those deductions may be significantly reduced or eliminated. This can be avoided if the church reimburses you under an Accountable Plan.

Under an AP, the church requires you to account (with an account book, expense report, diary or similar statement) for expenses paid or incurred in connection with the performance of services as its employee. You must also provide the church with receipts to substantiate all lodging regardless of amount and other expenses of \$75 or more. You must then return any unspent or unsubstantiated allowance to the church. If the church advances funds to you, the advances must be made within a *reasonable time* of when the expense is paid or incurred. You must substantiate expenses to the church and return any excess within a *reasonable time*. Under the Treasury regulations, an advance made within 30 days of the anticipated expense is automatically deemed reasonable. Substantiation of the expense within 60 days of the time it was paid or incurred is deemed reasonable, as is return of excess or unsubstantiated payments within 120 days. Alternatively, the church may provide you with a statement at least quarterly of amounts paid to you in excess of expenses that you've substantiated for that period. If you then substantiate those expenses (and return any amounts that you can't substantiate) within 120 days of the statement date, you'll satisfy the reasonable time requirement.

The regulations prohibit the church from making regular payments to you and characterizing a portion of them as AP reimbursements after the fact. For example, if the church regularly pays you a salary of \$2,400 a month and in a given month you substantiate \$400 of expenses, the church may not report \$2,000 of wages on your Form W-2 for that month and exclude the \$400 as reimbursement. The monthly payment of \$2,400 would have been made to you in any event, so no part of it can be considered to be made for expenses paid or incurred in connection with your services under the AP rules.

Amounts paid to you under an AP are completely excludable from your income; they don't appear on your Form W-2 as income. Thus, you pay no tax on them and do not deduct them on your tax return. But "excess" amounts paid to you under an AP are included in your income. See sections VI.F. and VI.H.

What if you had an AP, but the church reported the reimbursements as income on your Form W-2? There's no way for you to deduct those expenses fully on the 2012 tax forms, so it's best to have the church amend your Form W-2. It will be easier explaining the discrepancy to your church than to the IRS. If need be, file Form 4868, "Application for Automatic Extension of Time to File U.S. Individual Income Tax Return," by April 15, 2013. (See section II.B.)

If you don't have an AP with your church, all advances or reimbursements must be included in gross income and all employee business expenses—reimbursed and unreimbursed—after making the *Deason* allocation, are deducted on Form 2106, "Employee Business Expenses." You may be able to use Form 2106-EZ if the expenses are unreimbursed and you don't depreciate an automobile (see section VI.H.). Expenses that don't meet the AP requirements, whether or not your church has an AP, are also deducted on Form 2106 or Form 2106-EZ. (Meal and entertainment expenses must be reduced by 50% in 2012. See section VI.E.) When transferred to

Form 1040, Schedule A, line 21, employee expenses are miscellaneous itemized deductions, deductible only to the extent they exceed 2% of adjusted gross income (Form 1040, line 37).

D. **Expenses Related to Earning Fees for Marriages, Funerals, etc.**²⁷ After reporting fees and reimbursed expenses attributable to those items on Schedule C (Form 1040), make the *Deason* allocation, then deduct your actual expenses in the appropriate places on Schedule C (Form 1040), Part II. If your expenses attributable to those fees were less than \$5,000, you can likely use the simpler Schedule C-EZ. However, there are many conditions on the use of Schedule C-EZ. See Part I of the schedule for the details. If you are eligible to use Schedule C-EZ, report your fees and expenses on Part II. If any part of your expenses are for the business use of your car, complete Part III of Schedule C-EZ as well.

E. **Meal & Entertainment Expenses.** Meal and entertainment expenses aren't deductible unless you establish that they're directly related to your professional activities and are "ordinary and necessary." A business meal expense generally isn't deductible unless there's a substantial bona fide business discussion *during* the meal. If the meal directly precedes or follows a substantial and bona fide business discussion, then you must establish that the expense is associated with your professional activities to properly substantiate the deduction. No deduction is allowed for any food or beverage expense that's lavish or extravagant under the circumstances.

You can use the actual amount of meal expenses for business trips away from home to figure your deduction. Or if your church's AP gives you a per diem allowance that does not exceed the IRS or federal per diem rates (see section VI.F.), your meal expense deductions will be deemed properly substantiated as long as you describe the time, place and business purpose of your expenses.²⁸

Any deduction for the cost of food, beverages, entertainment, amusement or the use of a recreational facility, is reduced by 50%. Thus, only 50% of otherwise allowable business meal and entertainment expenses are deductible. The *Deason* allocation rule also applies to those expenses. Where an employer reimburses an employee for meal or entertainment expenses and hasn't treated the expenses as wages subject to withholding (*i.e.*, the employer has an AP), the 50% reduction rule applies to the employer making the reimbursement, not the employee. That won't affect tax-exempt employers, *e.g.*, churches. There are other limited exceptions to the 50% reduction rule. Check with your adviser to see if any apply to you.

F. **Meal, Incidental & Lodging Expenses; Using a Per Diem Allowance Under an Accountable Plan.** Instead of reimbursing an employee's actual meal,

²⁷ To qualify as a trade or business, the dominant purpose of the ministerial activities must be to earn a profit. *Oswandel*, T.C. Memo 2007-183.

²⁸ *Rev. Proc. 83-71*, 1983-2 C.B. 590

incidental and lodging expenses under an AP, a church may provide its minister with a per diem allowance. The minister need not verify the *amount* spent (although the time, place and business purpose of each expense must still be documented). Nor must the minister return any unspent per diem to the church. If the allowance is no more than the federal government's per diem rate for the travel destination and is paid under an AP, it won't be reported on the minister's Form W-2 as income.

Note: Self-employed ministers may use the per diem rates to substantiate expenses for meals and incidentals, but not for lodging.

Federal per diem rates vs. IRS high-low method. U.S. government employees are reimbursed for travel expenses at a number of different per diem rates, depending on the destination. Your church can base travel reimbursements on those rates, or it can use IRS's simpler "high-low" method for travel in the continental U.S. There are limitations on the high-low method: (1) if you use the high-low method to determine any travel expenses, you cannot use the federal per diem rate to determine other travel expenses incurred in the same year in the continental U.S.; and (2) the high-low method cannot be used with a meals-only per diem where actual lodging costs are reimbursed. (A meals-only per diem can be used with the federal per diem rates.) The IRS "high-low" per diem rate for meals, incidental and lodging expenses through September 30, 2012 is \$242 for high-cost areas and \$163 for all others. Pursuant to IRS Notice 2012-63,²⁹ the high-low rates remain the same for October 1, 2012 through September 30, 2013.

Both federal per diem rates and IRS high-low rates must be prorated for partial travel days. (See IRS Publication 463, "Travel, Entertainment, Gift, and Car Expenses," and check with your adviser for details.)

If your allowance exceeds the IRS high-low rates or federal per diem rates, part can still be excluded under an AP as long as the other requirements are met: you give the church documentary evidence showing the amount, time, place and business purpose of each expense, and return any excess. (See section VI.C.) If you don't return any excess allowance, the portion that doesn't exceed the IRS or federal rates is reported on your Form W-2, Box 12 preceded by the letter "L" and isn't taxed; the portion that does exceed those rates is included as gross income in Box 1. If the documentation requirements for a per diem allowance under an AP plan are not met, the entire amount of the allowance must be included as gross income in Box 1 of your Form W-2; it's subject to income and self-employment taxes.

If your actual expenses exceed both the church allowance and the IRS or federal rates, you will be able to deduct the excess only by reporting your total expenses on lines 1-5 of Form 2106. Amounts reimbursed by the church (as shown

²⁹ 2012-42 IRB 496 (Oct. 15, 2012). The IRS has announced that effective for 2012 and later, it will no longer update Publication 1542, Per Diem Rates." Current per diem rates may be found on the U.S. General Services Administration (GSA) website, www.gsa.gov, or in IRS Publication 463, "Travel, Entertainment, Gift, and Car Expenses."

in Box 12 of Form W-2) are entered on line 7 of Form 2106. Any excess can be claimed as itemized deductions on Schedule A of Form 1040. You must be prepared to substantiate the amount, time, place and business purpose of each expense to the IRS. Moreover, those deductions will be subject first to the 50% limitation on meal and entertainment expenses, then to the *Deason* allocation rule and finally to the 2% of adjusted gross income floor on miscellaneous itemized deductions.

G. **Travel Expenses.** A deduction is permitted for ordinary and necessary travel expenses incurred while "away from home" overnight in connection with your professional activities. Travel allowances paid by your employer without an AP and unreimbursed church travel expenses are miscellaneous itemized deductions subject to the *Deason* allocation rule and the 2% floor (see section VI.R.). If paid under an AP (see section VI.C.), reimbursements attributable to church employment aren't includable as income or deductible as business expenses.

Allocate your travel expenses between: Schedule C (Form 1040), line 24a (expenses attributable to marriages, funerals, etc.) or Schedule C-EZ; and Form 2106, line 3 or Form 2106-EZ, line 3 (employee expenses attributable to church salary).

Travel expenses away from home overnight include: train, plane and bus fares; automobile expenses, including car rental; taxi fares; food costs while away from home overnight; hotel, motel, etc.; tips (included in above); baggage charges. They do not include the cost of laundry; cleaning and pressing clothing; telephone calls; transportation between your place of lodging and place of business at a temporary post of duty.

You can deduct actual substantiated expenses *away from home overnight* when your trip: (1) is in connection with your professional activities; (2) takes you away from your city, community, or area of professional activity; and (3) takes you away overnight or for a period substantially longer than an ordinary day's work, provided that the trip requires sleep or rest. Alternatively, your church can use the per diem rates discussed in section VI.F. above.

If your spouse, dependent or other individual accompanies you on your business trip, his or her travel expenses are deductible only if: (1) he or she is employed by the person or entity paying the expenses; (2) there is a business purpose for his or her presence; and (3) the expenses are otherwise deductible. If those expenses aren't deductible, reimbursements from your employer may be included in income. See section V.

You can't deduct expenses for travel as a form of education. However, those expenses may be deductible if they're necessary for an activity that gives rise to a *business* deduction relating to education.

No deduction is allowed for costs of attending a convention, seminar, or similar meeting (*e.g.*, travel to the site; registration or other fees for attending the convention; personal living expenses such as meals, lodging and local travel while there) unless the expenses are deductible as ordinary and necessary business expenses.

You can deduct expenses incurred traveling to see parishioners in your community (in their homes or in the hospital, for example), even if it's the first trip

after leaving home (or the last). Those expenses usually include auto costs, taxis, bus or train fares and tips. But you can't deduct the cost of commuting between your home and your church or office.

H. **Transportation Expenses.** Transportation expenses are the ordinary and necessary expenses of getting from one work site to another when you're not traveling away from home. Deduct transportation expenses attributable to fees for marriages, funerals, baptisms, etc., on Schedule C (Form 1040), Part II, lines 9, 13 (if the vehicle is depreciated), 16b and 24a or on Schedule C-EZ, Part II, line 2, whether or not you itemize your deductions. Part IV of Schedule C, "Information on Your Vehicle," eliminates the requirement that you file Form 4562 if you are using the standard mileage rate, you lease your automobile or if you are not claiming depreciation on your automobile. Otherwise, you must attach Form 4562 to your Form 1040.

If you are reimbursed for travel and transportation expenses and don't account to your church under an AP, the entire reimbursement should be included in your income. You compute the allowable deduction for the expenses attributable to your church salary on Form 2106, reduce the expenses by the percentage determined under the *Deason* allocation rule, then deduct them on Schedule A (Form 1040), line 21. (See section VI.R.) Unreimbursed transportation expenses may be reported on Form 2106-EZ if you don't depreciate an automobile (see this section below).

If you are reimbursed for expenses and account to your church under an AP, the reimbursement should not be included in income, so you don't deduct the expenses against your salary. If your reimbursement exceeds actual expenses (or the standard mileage rate for business use) you must return the excess. As noted above, an AP must require that excess reimbursements be repaid. Even though an AP has that requirement and excess reimbursements are generally repaid, if you fail to repay an excess reimbursement, that excess will be taxable to you.

Expenses that exceed your AP reimbursement may be deducted as follows:

1. List your documented travel and actual automobile costs on Form 2106; list the AP reimbursements not reported to you as income on Form W-2 on line 7 of Form 2106; apply the *Deason* allocation rule to the excess and deduct the resulting portion on Schedule A (Form 1040), line 21; or
2. List your documented travel expenses and use the standard mileage rate to calculate your automobile expenses on Form 2106 (see limitations on use of the standard mileage rate discussed below); list the AP reimbursements not reported to you as income on line 7 of Form 2106; apply the *Deason* allocation rule to the unreimbursed excess, then deduct the resulting portion on Schedule A (Form 1040), line 21. For 2012, the standard mileage rate for business travel is 55.5¢ per mile. If your church allowance is less than the standard mileage rate, you can deduct the difference; e.g., if your church allows you only 18¢ per mile, you may deduct 37.5¢ per mile as an unreimbursed expense.

Automobile costs also include depreciation on the car. There are many ways to depreciate a car, depending on when the car was placed in service and other variables. (The instructions to Form 2106 give a helpful summary.) IRS Publication 463, "Travel, Entertainment, Gift, and Car Expenses," spells out the depreciation rules as simply as possible. Check with your adviser to see which method is best for you. Suffice it to say here that you can't depreciate a car for which you claim a standard business mileage deduction, and depreciation must be prorated when you use a car both for business and personal activities. If, for instance, you have depreciation of \$2,200 and you use the car 80% for church activities, your depreciation deduction is \$1,760 (80% × \$2,200). Note also that if you depreciate a car and later sell it, some depreciation may be "recaptured" and constitute taxable income.

Automobile Owned by You. The cost of operating your car, as well as other travel costs and similar expenses incurred in performing church-related duties, are appropriate costs of your church-employer that may be reimbursed under an AP. But if you're required to bear those costs, or if you're given an automobile allowance included in your income, you can deduct auto expenses using one³⁰ of the three methods discussed below.

Method I—Standard Mileage Rate. The standard mileage rate is a simpler method to calculate the cost of using your car for professional activities. You keep track of how many miles you travel for business by keeping a log, diary, trip sheets or similar records. The taxpayer must establish the amount (i.e., business mileage), the time, and the business purpose of each use.³¹ Then you compute your deductible car costs by using a standard rate of 55.5¢ per mile for all business miles traveled. In addition, you can deduct tolls and parking fees that you've documented.

If you use your car to earn self-employment income (i.e., for weddings, funerals, etc.) and use the standard mileage rate, you can also deduct a portion of state and local taxes, along with interest on a car loan, attributable to that use on Schedule C or Schedule C-EZ (Form 1040). You must also answer the questions in Part IV of Schedule C or Part III of Schedule C-EZ. A minister who itemizes may deduct the balance of allowable taxes (i.e., the part attributable to personal or employee use) on Schedule A (Form 1040).³² See discussion of personal interest in section VI.N.

To use the standard mileage rate, you must own or lease the vehicle. If you want to use the standard mileage rate, you must choose that method in the first year

³⁰ See *Larson*, T.C. Memo 2008-187

³¹ *Id.* Taxpayer is entitled to only one deduction; using one method precludes use of any other method.

³² The minister who doesn't itemize cannot deduct reimbursed automobile expenses that aren't substantiated to the church under an AP (see section VI.C.), even if the reimbursements are included in his or her taxable income. Both itemizers and non-itemizers can deduct (on Schedule C or Schedule C-EZ (Form 1040)) automobile expenses attributable to Schedule C income.

the car is placed in service or not at all. By using the standard mileage rate, you make an election not to depreciate the car by any method other than the straight-line depreciation method, if you change to the actual expenses method in later years. Nor can you "expense" the car under IRC §179. If you used the standard mileage rate in the first year, you can keep using it in subsequent years. Or you can switch to claiming actual expenses, using the required straight-line method of depreciation. If you lease the car and choose the standard mileage rate, you must use it for the entire lease period. This is a complicated area. Check with your adviser.

You can use Form 2106-EZ to report unreimbursed business expenses attributable to earning your church salary if you use the standard mileage rate.

Method II—Actual Expenses. Total these actual automobile costs on Form 2106, line 26: gas, oil, lubrication, tires and batteries; repairs; "summerizing" and "winterizing;" engine tune-ups; car washes; car insurance and automobile club dues; auto rental or leasing expenses; garage rental; parking fees and tolls; driver's license and car registration. Then compute how much was attributable to your business use as a church employee and transfer that amount to Form 2106, line 1. (Tolls and parking fees go separately on line 2.) Actual costs attributable to weddings, funerals, baptisms, etc. (including car loan interest allocable to this income) are deducted on Part II, line 9, of Schedule C (Form 1040) or on Schedule C-EZ, Part II, line 2. You must also answer the questions in Part IV of Schedule C or Part III of Schedule C-EZ.

Remember, if you deduct actual expenses using accelerated or straight-line depreciation for the first year the car is placed in service, you can't switch to the standard mileage rate method in later years.

In 2012, you may use either the actual expense method or the standard mileage rate if you lease your car.

The actual expense method is not available to a minister who cannot substantiate both the total number of miles driven during the year *and* the percentage of those miles that were for business purposes. In one U.S. Tax Court case, a minister was required to use the standard mileage rate method because he could not substantiate, by log or other documentation, the actual number of miles he drove the car during the year for business purposes.³³ The substantiation requirements for the actual expenses method do not allow for estimation. Make sure you have documentation for the actual number of miles driven for business purposes. The fact that even without such documentation, the court allowed the minister to use the standard rate method to deduct such expenses doesn't mean that estimates will satisfy the substantiation requirements. You should maintain detailed records no matter which method you use.

³³ *Parker*, T.C. Memo 1993-15; see also *Oswandel*, T.C. Memo 2007-183; *Brown*, T.C. Summary Opinion 2005-155 (weekly activity reports submitted to employer that did not reflect the number of miles driven or other details of specific business activities were not sufficient to satisfy the substantiation requirements). *Caution:* Tax Court summary opinions are not precedents.

Method III—Fixed and Variable Rate (FAVR). Instead of reimbursing an employee for actual costs or at the standard mileage rate, an employer may use a FAVR allowance to reimburse an employee's automobile expenses. The allowance consists of two components. Part of the allowance represents fixed costs, such as insurance, depreciation, registration and license fees, and personal property taxes. The other part is for variable costs—gas, oil, tires, and routine maintenance and repairs. Parking fees and tolls aren't part of the allowance and are deducted separately. There are many limitations and eligibility requirements that apply to the FAVR method. Check with your adviser to determine if this method is available to you.

Whichever way you compute your automobile expenses, reduce them by the percentage determined under the *Deason* allocation rule and allocate them between Schedule C or Schedule C-EZ (Form 1040) (expenses attributable to marriages, funerals, etc.) and Form 2106 or Form 2106-EZ (expenses attributable to earning your church salary).

Automobile Provided by the Church. The value of an automobile furnished to you by the church is not included in your income provided that, had you paid for the use of the automobile yourself, you'd be entitled to a business deduction for the expenses (*i.e.*, the car is used to perform church duties and you're required to substantiate your use of the car to the church). Also not included in your income is the value of an automobile furnished to you by the church if the church board has adopted a resolution limiting use of the automobile to business use, and the automobile is in fact used only for business use. Generally, business use does not include commuting.

If the church provides you with an automobile for your *personal* use, that benefit is taxable to you. The value of personal automobile use is also considered to be "wages" for the purposes of self-employment and any federal income tax withholding. (For some purposes, ministers are considered to be self-employed individuals whose wages aren't subject to employee income tax withholding. But for other purposes, ministers are treated as employees of the religious denomination to which they belong. It isn't clear whether the IRS considers ministers "employees" for the purpose of wage withholding on fringe benefits. However, as discussed in section I., it is becoming more difficult for a minister to be classified as self-employed.)

The church may elect not to withhold income taxes on the value of the personal use of a car that is included in your income. It must give you advance written notice that the non-withholding election will be implemented, and must include the taxable amount of the benefit in your income as reported on Form W-2. The notice generally must be provided to you by the later of January 31 of the year to which the election is to apply or within 30 days after you are first provided with the car.

Before including any amount in your gross income, the church must request that you furnish records showing the number of miles driven for church-related business and the number of total miles driven. The church has to report your income after taking into account the business and total use shown by those records.

You can compute the value of your personal use with one of three special methods—but only if your employer uses the same method. However, you can always use a fourth method—the general valuation rule, to determine the amount included in income—even if your employer uses one of the special methods.

Annual Lease Value Rule. First, determine the fair market value of the automobile when it was made available to you. Then, consult the annual lease value table in IRS Publication 15-B, "Employer's Tax Guide to Fringe Benefits." Find the fair market value of the car in Column 1 and the corresponding annual lease value in Column 2. That value is used for up to four full years if the same car is provided to you. For any later four-year period, figure the fair market value of the automobile as of January 1 of the first year of the later period and then refer to the table.

The annual lease value includes the church's maintenance and insurance of an automobile that you use, but not fuel. Fuel provided by a church for your personal use is valued separately at the greater of fair market value or 5.5¢ per mile and included in your income. If a car is made available to you for a continuous period of 30 days or more (but less than an entire year), the value of the car is determined by multiplying the annual lease value by a fraction: the numerator is the number of days of availability and the denominator is 365.

Example: You received a church-provided automobile on November 1, 2012. During 2012, you drove a total of 2,000 miles; 500 miles, or 25% for personal use, and 1,500 miles, or 75% for business use, supplying your own gas. The fair market value of the car as of 11/1/12 was \$8,000. The annual lease value is \$2,600. To determine the amount includable in income, first determine the partial year lease value by multiplying the annual lease value by a fraction, the numerator of which is 61 (number of days of availability in 2012) and the denominator of which is 365 ($\$2,600 \times 61/365 = \434.52). The amount includable in income in 2012 is 25% of the partial year lease value, or \$108.63 ($\$434.52 \times 25\%$). If you use the same car for all of 2012, and 3,000 miles of the total 12,000 miles driven are for personal use, the amount you must include in income is the annual lease value multiplied by the percentage of personal use, or \$650 ($\$2,600 \times 25\%$).

An automobile made available to you for less than 30 days is valued by multiplying the annual lease value by a fraction: the numerator is 4 times the number of days of availability and the denominator is 365. However, if the 30-day value is less, then you can elect to use the value for the full 30 days instead.

When using the annual lease value method, the church has the option to include 100% of the car's fair rental value on your Form W-2, then let you offset the value of your business use on Form 2106, line 25. (In effect, that results in an "above the line" deduction for your business mileage, not subject to the 2% floor on most employee business expenses.) See the instructions to Form 2106.

Commuting Value Rule. The value of an automobile furnished by an employer to an employee to be used exclusively for commuting to and from work is

considered to be \$3.00 per day if: (1) the employer requires the employee to commute in the car for bona fide noncompensatory business reasons (this requirement is met if the vehicle is generally used each workday to carry at least three employees to and from work); (2) the employer has a written policy prohibiting personal use of the car other than commuting or *de minimis* personal use; (3) the employee doesn't use the car for personal purposes, except for commuting or *de minimis* use; and (4) the commuting employee is not a "control employee." (Ministers and church employees are generally not control employees. See IRS Publication 15-B.)

Cents-Per-Mile Rule. This method is simpler because you just keep track of your miles traveled and tell the church how many miles were for business and how many for personal use. In 2012 the church multiplies your personal use miles by the standard mileage rate of 55.5¢ per mile for all personal miles traveled; if you supply your own gas for personal use, the rate may be reduced by 5.5¢ per mile. That determines the value of the personal use, which is then included in your income.

The mileage method is not available for a car that has a fair market value of more than \$15,900. Also, this method is only available for an automobile reasonably expected to be regularly used in the employer's business—that is, at least 50% of annual mileage is for church business. This method is automatically available if the car is driven at least 10,000 miles per year by employees (personal use included).

General Valuation Principles. When the special rules discussed above aren't used to determine the amount includable in the minister's gross income for church-provided automobiles, or if the car is used outside the U.S., general valuation principles are used. The cost of leasing a comparable automobile on similar terms for a comparable period is includable in the minister's gross income. If you're entitled to use the automobile for personal purposes, part of its use value—the personal use—is included in your gross income, though the business part is excluded. Determine the amount included by multiplying the use value by a fraction: the numerator is the number of non-business miles driven, and the denominator is your total mileage.

I. **Educational Expenses.** Generally, you can deduct expenses you've paid for education to maintain or improve skills required in your employment, or to meet the express requirements of your employer. Thus, you can deduct the costs of keeping current in your profession or, if you teach, of improving or maintaining your teaching skills. You may deduct the cost of courses, food and lodging "away from home overnight," and travel to and from home.

You cannot deduct educational expenses incurred primarily for the purpose of meeting the minimum standards for qualification in your profession or qualifying for a new profession. Nor can you deduct educational expenses incurred primarily for your general educational aspirations or for other personal reasons. See IRS Publication 970, "Tax Benefits for Education," for the educational expense rules.

Report educational expenses (including travel and transportation) attributable to your church salary on Form 2106, Part I, line 4, whether or not reimbursed by your employer. Unreimbursed educational expenses may be reported on Form 2106-EZ, Part I, line 4. Don't report amounts up to \$5,250 paid to you by your employer under

a qualified educational assistance program. (See section V.) (*Note:* Don't include meal and entertainment expenses, which are subject to a 50% limitation and are listed separately on Form 2106, Part I, line 5 or on Form 2106-EZ, Part I, line 5. See the instructions to Form 2106.) All educational expenses attributable to salary must be reported on Form 2106 or Form 2106-EZ and are deductible on Schedule A (Form 1040), line 21 *only* if you itemize deductions. Remember, like most expenses, educational expenses are subject to the 2% of adjusted gross income floor.

Whether or not you itemize, you can deduct educational expenses attributable to earning fees for marriages, funerals, etc., on Schedule C or Schedule C-EZ (Form 1040). Meal or entertainment expenses are subject to a 50% limitation and are listed separately on line 24b (Schedule C) or line 2 of Part II (Schedule C-EZ). If your educational expenses are attributable to operating your ministry, you must reduce your deduction for those expenses under the *Deason* allocation rule.

J. **Moving Expenses Incurred Because of a Job Change.** Employer reimbursements of deductible moving expenses are not included in income, and unreimbursed deductible moving expenses of employees and self-employed are claimed as an "above-the-line" deduction. That means that both itemizers and non-itemizers can claim a deduction for moving expenses.

You deduct unreimbursed moving expenses on Form 1040, line 26, as an adjustment to income. Fill out Form 3903, "Moving Expenses," and attach it to your return if the move is within the United States or its possessions, or outside the United States or its possessions if you are a U.S. citizen or resident alien. The IRS eliminated Form 4782 for employers to report moving expense reimbursements to employees. Employers may continue to give employees similar information, in any format they wish, if they consider it helpful to the employees.

Deductible moving expenses include: (1) transporting household and personal effects, furnishings, etc.; packing and "in transit" storage; and (2) travel and lodging for you and your family while in transit. If you use a car in making the move, in 2012, you can deduct either your actual out-of-pocket expenses (gas, oil, parking, tolls, etc.) or a standard mileage allowance of 23¢ per mile, plus parking and tolls. Non-deductible expenses include the cost of travel incurred for domestic help, forfeited tuition, mortgage penalties, expenses for trips to sell your old house and the cost of pre-move house-hunting trips. Reimbursement of non-deductible moving expenses must be included in income. *Note:* There is no limit on the amount of a moving expense deduction.

The distance between your new place of work and your former home has to be at least 50 miles greater than the distance from your former primary place of work to your former home. If you had no former principal place of work, your new place of work must be at least 50 miles from your former home.

You must be a full-time employee in your new place of work for at least 39 weeks out of the 12 months immediately following your move. If you're a self-employed minister, you must work full-time in your new location for at least 39 weeks of the first 12 months following your move **and** for at least 78 weeks out of the 24

months immediately following your move. If you are married and file a joint return and both you and your spouse work full-time, either of you may meet the full-time work test. But you can't combine your weeks of work. The full-time work restrictions are waived for death, disability, involuntary termination or transfer to another location for the benefit of the employer.

Even if you don't meet the 39-week or 78-week requirements by the time your tax return is due, you may take the deduction if you'll probably meet the residence requirement in the future. *Note:* If you later fail to meet the residence requirements, you must either amend your return or include as gross income (on a later year's return—when the 12-month or 24-month period ends) the amount deducted as expenses.

K. Other Professional Expenses. The professional expenses described in this section attributable to your church salary may be deducted *only* if you itemize. Make the *Deason* allocation and take the deduction on Schedule A (Form 1040), line 21.

All employee business expenses—other than reimbursed expenses that weren't included in your income because of an AP, and a special exception for handicapped employees and certain performing artists—are miscellaneous itemized deductions, deductible only to the extent the total exceeds 2% of adjusted gross income. For example, if you had an adjusted gross income of \$20,000 and \$500 of miscellaneous itemized deductions, \$100 is deductible ($\$20,000 \times 2\% = \400 ; $\$500 - \$400 = \$100$). If you use an AP, you can avoid this limitation on your deductions.

There are limited exceptions to the 2% floor on miscellaneous itemized deductions. Report those deductions on Line 28 of Schedule A (Form 1040). Check Form 1040, Schedule A instructions to see if they apply to you.

Whether or not you itemize, the professional expenses described in this section attributable to fees for marriages, funerals, baptisms, etc., after applying the *Deason* allocation rule, are deductible on Schedule C (Form 1040), Part II or Schedule C-EZ, Part II, line 2.

To determine your miscellaneous itemized deductions, which are not properly allocated to Schedule C, total the following expenses:

- Magazines, books, office furnishings, etc., that have an expected useful life of one year or less. (See below for treatment where useful life is more than one year.)
- Office supplies, stationery, postage, secretarial expenses and office machine rentals (or depreciation if you own the machines).
- Religious supplies and materials.
- Registration fees and other expenses of attending religious conferences and conventions for business purposes only. (There are limitations on deducting expenses for conventions held abroad. See IRS Publication 463, "Travel, Entertainment, Gift, and Car Expenses.")
- Special-purpose garments, such as a pulpit robe. Include cleaning costs.

- Telephone expenses for professional calls. Don't include the cost of personal calls. You cannot deduct any charge—including sales or excise taxes—that you pay for local telephone service for the *first* telephone line in your home. You may deduct charges for long-distance calls, equipment rental, services such as call waiting or call forwarding, or additional telephone lines in your home used for business.
- Dues to professional societies, such as ministerial alliances, and to business leagues and civic or public service organizations, such as Kiwanis, Lions and Rotary clubs.
- Entertainment of church groups or visiting speakers.
- Cost of tax return preparation.
- Maintenance of an office or study in your home, but only if you don't receive a parsonage or rental allowance or housing from the church and you don't have an office furnished by your church employer. Assuming that you meet those requirements for a home office deduction, you can't deduct any expenses of using your home for professional purposes except to the extent that those costs are attributable to a portion of your home that is used *exclusively*³⁴ and on a regular basis: (1) as your principal place of business; (2) as a place to meet clients or parishioners in the normal course of professional activities for the convenience of your employer; or (3) in connection with your professional activities (in the case of a separate structure). In 2012, a home office will qualify as the principal place of business (1) if it is used regularly and exclusively to administer or manage a business and (2) there is no other fixed location where substantial administrative or management activities are performed. IRC §280A(c)(1). In IRS Publication 587, "Business Use of Your Home," the IRS sets forth several examples of administrative or managerial activities, such as: (1) billing customers, clients or patients; (2) keeping books and records; (3) ordering supplies; (4) setting up appointments; and (5) forwarding orders or writing reports. The rules are complicated, so consult your adviser.

Pointer. If you can deduct your home office expenses you may also be able to deduct your transportation costs of going from home to your church.

If you do qualify, deduct only a pro rata part of the home expenses.³⁵ For example, you use 200 square feet of your 2,000 square-foot house exclusively and on a regular basis as a study and office (and you don't receive a parsonage or rental

³⁴ A professor met the "exclusive use" test by maintaining an office in part of his bedroom, but the court disallowed the deduction because that office wasn't his principal place of business. *Weightman*, T.C. Memo 1981-301. See your adviser before taking the deduction.

³⁵ See *Rayden*, T.C. Memo 2011-1, discussing the allocation of taxpayers' exclusive use of their residence for business purposes.

allowance). Your out-of-pocket expenses to maintain your home total \$3,000. You deduct 1/10 of that, or \$300. Include: rent, electricity, heat, maid and cleaning services, painting, insurance (part of your home, fire, liability and theft insurance) and depreciation.

Deductions allowed for the business use of your home are limited. The total of your deductions for otherwise non-deductible expenses, such as utilities, insurance and depreciation (with depreciation taken last) cannot be more than your gross income from the business use of your home minus: (1) the business percentage of the otherwise deductible mortgage interest, real estate taxes, and casualty and theft losses; and (2) the business expenses that are not attributable to the business use of your home (for example, salaries or supplies). Any deductions disallowed because they exceed the amount of gross income received from your professional activity for the year may be carried forward to the next year and will be limited to the amount of income received from the professional activity in which it arose, whether or not your home is used as a residence during that year.

If you claim deductions for the business use of your home, you must attach Form 8829 to your return.

The cost of office and study equipment, reference books, furniture, rugs, air conditioners, etc., that have useful lives of more than one year must be depreciated over the useful life or expensed under special rules. See IRS Publication 587, "Business Use of Your Home."

Dues, fees or other expenses incurred for any club organized for pleasure, recreation, or other social purpose—such as country, golf or athletic clubs—are not deductible.

Pointer for non-itemizers: Although you can't deduct certain unreimbursed professional expenses, the problem can be mitigated if your church adopts an AP (see section VI.C.) to reimburse you for expenses that aren't being reimbursed. That way, you won't have to pay tax on the expenses that you can't deduct against church salary.

Example: In earning her church salary for 2012, a minister incurs \$1,000 of unreimbursed expenses. She takes the standard deduction and cannot deduct those expenses. Suppose, instead, her church has an AP. After incurring those expenses, she can account to the church and be reimbursed under its AP. That way, although her expenses still are not deductible at least the reimbursement is not includable in her income. See section VI.C.

L. **Standard Deductions.** Except for elderly or blind individuals, the basic standard deduction amounts for 2012 are: \$11,900 for married couples filing jointly or a surviving spouse; \$8,700 for heads of household; \$5,950 for single individuals; and \$5,950 for married couples filing separately.

If you or your spouse (or both) are 65 or older or blind, you get a larger standard deduction. If you're married (whether filing jointly or not) or a surviving spouse, your standard deduction is increased by \$1,150 if elderly or blind, \$2,300 if both. Similarly, your spouse's standard deduction is also increased by \$1,150 if

elderly or blind; \$2,300 if both. If you're single or a head of household, your standard deduction is increased by \$1,450 if elderly or blind, \$2,900 if both. Check the boxes that apply to you on Form 1040, line 39a and enter the total number of boxes checked.

Report the standard deduction on Form 1040, line 40. *Note:* Compare your standard deduction to your itemized deductions from Schedule A (Form 1040), then use the *larger figure* to minimize your tax liability. If you receive a parsonage allowance you do not have to make the *Deason* allocation for the standard deduction. (See section VI.B.) But you do have to make that allocation on Schedule C (Form 1040) for expenses relating to fees for marriages, funerals, etc.

M. **Charitable Contributions.** If you itemize, deduct charitable contributions made to churches, schools, universities, hospitals, publicly supported health organizations (*e.g.*, The Salvation Army), publicly supported social welfare organizations (*e.g.*, YMCA), community foundations and other "public charities."

Cash contributions to those charities are generally deductible up to 50% of adjusted gross income as reported on Form 1040, line 38. But contributions exceeding 50% may be deducted over the five following years³⁶ until exhausted (up to 50% of adjusted gross income in each year).

You may also deduct:

- Charitable gifts of long-term (held more than one year) appreciated securities, real estate and "related use" tangible personal property at their fair market value. The deductibility ceiling for those gifts is 30% of adjusted gross income. However, you can increase the ceiling to 50% of adjusted gross income by electing to reduce the value of all appreciated property gifts claimed on your return (including those carried over from earlier years) by all of the appreciation. The five-year carryover is available for both "excess" 30% gifts and "excess" 50% gifts. Substantiation requirements are described briefly below.
- Unreimbursed expenses in connection with services you've volunteered to charitable organizations, including transportation from your home to the place of rendering services; meals and lodging while away from home overnight; incidental expenses for phones, postage, etc. The mileage rate for charitable purposes is 14¢ per mile.³⁷ Those gifts are deductible up to 50%

³⁶ *Maddux*, T.C. Summary Opinion 2009-30 (When the amount of the contribution made to a charity exceeds 50% of a taxpayer's adjusted gross income, any excess contribution is treated as a charitable contribution paid in each of the five succeeding taxable years in order of time. Some portion of the deduction expires each year whether used or not.) *Caution:* Tax Court summary opinions are not precedents.

³⁷ The mileage rate for charitable purposes is set by statute and has not been increased in many years.

of adjusted gross income, with a five-year carryover for any "excess." No charitable deduction is allowed for transportation and other charitable travel expenses—including meals and lodging when performing services away from home for a charitable organization—when there's a significant element of personal pleasure, recreation or vacation in the travel. If your unreimbursed expenses on any one day are \$250 or over, you'll need a statement from the charity describing your volunteer services and estimating the value of any goods or services you received or explicitly stating that you received none. You must have the letter from the charity *before* filing your income tax return.

- Contributions to private foundations. Those gifts are generally deductible only up to 20% or 30% of adjusted gross income, depending on the type of property contributed. A five-year carryover for those gifts is allowed. Other limits apply.
- In 2012 an individual age 70½ or older could make direct charitable gifts from a traditional or Roth IRA (including the minimum required distribution) of up to \$100,000 per year to public charities (other than donor advised funds and supporting organizations) and not have to report the IRA distribution as taxable income on his or her federal income tax return. There is no charitable deduction for the distribution. However, not paying tax on otherwise taxable income is the equivalent of a charitable deduction. This benefit was extended by the *American Taxpayer Relief Act of 2012* through 2013. A donor may elect to treat a direct transfer to charity made in January 2013 as being made on December 31, 2012. Check with your adviser.

Caution: Generally, if you made a charitable gift and received a benefit (goods or services) in return, such as food, entertainment or merchandise, you may deduct only the amount by which the gift exceeds the benefit. For example, if you paid \$100 to a charitable organization to attend a fund-raising dinner and the value of the dinner was \$30, you may deduct only \$70. If the benefit is an intangible religious benefit or is a low-cost or "token" item such as a T-shirt, mug or key chain, you need not reduce your deduction. The allowable amount of these items is adjusted annually for inflation. *More caution:* Receiving any benefit for a charitable gift from an IRA will cause the donor to lose the entire benefit of the transfer.

The charitable deduction is available only to individuals who itemize. Report your total cash contributions on Schedule A (Form 1040), line 16, under "Gifts to Charity." Any donations other than cash are reported on Schedule A (Form 1040), line 17. Report any carryover from prior years on Schedule A (Form 1040), line 18, and total your contributions on line 19 of Schedule A (Form 1040). (See IRS Publication 526, "Charitable Contributions.")

For cash gifts, *regardless of the amount*, recordkeeping requirements are satisfied only if the donor maintains as a record of the contribution, a bank record or a written communication from the donee showing the name of the donee and the date and amount of the contribution. A bank record includes canceled checks, bank or

credit union statements and credit card statements. Bank or credit union statements should show the name of the charity and the date and amount paid. Credit card statements should show the name of the charity and the transaction posting date. The recordkeeping requirements will not be satisfied by maintaining other written records.

Special substantiation rules apply to all charitable gifts of \$250 or more. You must have a contemporaneous written acknowledgment of the contribution from the charity by the earlier of filing your tax return or the due date of the return, including extensions.³⁸ Get the receipt *before* filing your return. The written record can be a receipt, postcard, letter, etc. It must show the date and amount of a cash gift or a description (but not value) of items donated for a non-cash gift. The receipt must state whether any benefit was received by the donor and, if so, include a good faith estimate of the benefit's value. If you received no benefit in exchange for your gift, the receipt must say so. For purposes of the \$250 threshold, separate payments are generally considered separate gifts. Keep the written record in your file; do not attach it to your tax return.

If your non-cash contributions are over \$500, you must fill out Form 8283—giving details of the donation—and attach it to your return. If your contribution is not of cash or marketable securities and exceeds \$5,000, you must get an appraisal for the property, complete Section B of Form 8283 and attach it to your return.³⁹ See the instructions to Form 8283 for all the requirements.

N. **Mortgage Interest and Real Estate and Other Taxes.** Ministers who itemize their deductions may also deduct their mortgage interest and real estate taxes—even though those items are paid with an excludable parsonage allowance.

Mortgage interest is deductible—with some limits—on both a principal residence and a second home, and is not subject to the *Deason* allocation.

A "qualified principal residence" is your main residence. It can be a house, cooperative apartment, condominium, trailer home or houseboat.

A "qualified second residence" can be an unused residence, a residence that you use for part of the year, or a residence that is rented. *Note:* If you rent the residence to another, it's subject to the use requirements for vacation homes. (See IRS Publication 527, "Residential Rental Property.")

The rules for deducting mortgage interest depend on when you took out the loan. They also depend on whether the loan is an acquisition mortgage (one used to buy, build or substantially improve a home) or a home equity loan.

For acquisition mortgages and home equity loans taken out *before October 14, 1987*, interest on any loan secured by a personal residence is fully deductible. It doesn't matter how big the loan is, nor how you use the proceeds.

³⁸ *Gomez*, T.C. Summary Opinion 2008-93. *Caution:* Tax Court summary opinions are not precedents.

³⁹ *Obiakor*, T.C. Summary Opinion 2007-185. *Caution:* Tax Court summary opinions are not precedents.

For home mortgages taken out *on or after October 14, 1987*, the following rules apply:

1. For the interest to be fully deductible, an acquisition mortgage can't be more than \$1 million. That limit applies to refinancings, as long as the new debt isn't bigger than the old debt just before refinancing.
2. Interest on home equity loans up to \$100,000 is fully deductible—and the proceeds can be used for any purpose.
3. Overall limits:
 - The total debt can't be more than \$1,100,000 (\$1 million for an acquisition mortgage plus \$100,000 for a home equity loan).⁴⁰
 - If you have two homes, the combined ceiling on your mortgage debt can't exceed the \$1 million ceiling for acquisition mortgages and the \$100,000 ceiling on home equity loans.
 - For married individuals who file separate returns, the \$1 million ceiling is reduced to \$500,000 and the \$100,000 ceiling is reduced to \$50,000 for each individual.
 - Home equity debt can't be more than the lesser of \$100,000 or the home's fair market value minus your acquisition debt.

The rules are complicated. See IRS Publication 936, "Home Mortgage Interest Deduction," and the instructions to Schedule A (Form 1040) for the details.

Deduct your state and local income taxes or general sales taxes, real estate taxes and any personal property taxes on Schedule A (Form 1040), lines 5-9, "Taxes You Paid." Do not deduct federal income taxes or self-employment taxes.

Note: "Personal interest" is not deductible. Personal interest is any interest other than interest on a home mortgage, interest incurred in connection with a trade or business, investment interest or interest taken into account in computing the taxpayer's income or loss from passive activities for the year. Personal interest includes interest on car loans, credit card balances for personal expenditures and interest on underpayments of income tax. As a result, interest payments on a minister's automobile—other than for self-employment business use—are not deductible.

O. **Self-Employment Tax ("SECA")**. Ministers employed by a church as well as ministers who are self-employed (see section I.) are treated as self-employed for SECA purposes. They may deduct a portion of the self-employment tax that they

⁴⁰ See *Rev. Rul. 2010-25*, 2010-44 IRB 572 (Nov. 1, 2010) (Indebtedness incurred by a taxpayer to acquire, construct, or substantially improve a qualified residence can constitute home equity indebtedness to the extent it exceeds \$1 million (subject to applicable dollar and fair market value limitations imposed on home equity indebtedness).)

calculated on Form 1040, Schedule SE. (See section XI.B. for details.) Enter the deductible portion of your self-employment tax on line 27 of Form 1040.

P. **Unreimbursed Medical Expenses.** You can only deduct unreimbursed medical and health insurance expenses that exceed 7.5% of adjusted gross income (Form 1040, line 38).

As an itemizer, follow the instructions to lines 1-4 of Schedule A (Form 1040), "Medical and Dental Expenses."

If part of your medical expense is covered by insurance, you may deduct only the portion that isn't covered.

You may deduct (above the 7.5% floor): fees paid to doctors, dentists, nurses, podiatrists and similar professionals; hospital costs; costs of prescription drugs and insulin. Medical expenses include any amount paid for:

1. The diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body.
2. Transportation costs on trips primarily for and essential to medical care. The cost of traveling to and from a doctor or dentist, a hospital or a pharmacy is a deductible medical expense. You may deduct actual costs, such as taxis, plane or train fares. If you drive your car, you can deduct actual expenses (gas, oil, parking, tolls, etc.) or use a standard mileage allowance of 23¢ per mile, plus parking and tolls.
3. Insurance premiums you've paid for policies that cover medical care and, up to the prescribed limits (adjusted annually for inflation), premiums paid for long-term care insurance (see Instructions to Schedule A, Form 1040). See IRS Publication 502, Medical and Dental Expenses.
4. Lodging expenses while you are away from home primarily for, and essential to, medical care provided by a physician in a licensed hospital or similar medical facility. You can't include meals that are not part of inpatient care. The deduction may also be claimed for a person required to accompany the individual seeking medical care. You can't deduct lodging expenses if there's any significant element of personal pleasure, recreation or vacation in the travel. The deduction for lodging is limited to \$50 each night per person. For example, the limit is \$100 if a parent travels with a sick child.
5. Accommodating a home to the needs of a physically handicapped individual (such as building entrance ramps or widening doorways to allow the use of a wheelchair).

Other deductible medical expenses include: the cost of medical or surgical appliances such as a surgical belt, elastic hosiery, special sleeping equipment, hearing aid, wheelchair, arches, orthopedic shoes, eyeglasses, dentures.

If your church, as your employer, contributes to your health and accident plan, the contribution is not taxable income to you. Benefits you receive are also tax-exempt, provided that the amounts are paid: (1) to reimburse you for medical

expenses incurred by you or your dependents; or (2) to compensate you for disfigurement, loss of a limb or other permanent injury to you, your spouse or dependents.

The part of self-employment tax that covers Medicare (hospital insurance) is not considered a medical expense and is not deductible. Similarly, the basic cost of Medicare insurance (Medicare A) isn't deductible unless voluntarily paid by an individual 65 or older who isn't entitled to Social Security benefits. However, the additional amounts paid for Medicare Part B (supplemental medical insurance) and Medicare Part D (prescription drug insurance program) qualify as medical expenses, and thus are deductible. For most, the monthly Medicare Part B premium rate for each covered individual is \$99.90 for 2012. Upper income individuals pay higher premiums based on their modified AGI. If your church-employer paid the premium, it isn't taxable income to you, so you can't deduct it as a medical expense.

Q. Health Insurance Costs for the Self-Employed. In 2012, self-employed individuals who had a net profit for the year may deduct 100% of the health insurance costs incurred during the year for themselves, their spouses and their dependents.

In 2012, the *Small Business Jobs Act of 2010* allows a deduction for self-employed health insurance costs in computing net earnings from self-employment. Therefore, for purposes of calculating the self-employment tax and the self-employment tax deduction, a self-employed individual may deduct health insurance costs incurred for himself, their spouse, dependents and children who have not attained age 27 as of the end of the tax year.

The deduction is not available for a taxpayer who is eligible to participate in a subsidized health plan maintained by the taxpayer's employer or that of his or her spouse. Costs taken into account in computing this deduction cannot be claimed as a medical expense deduction on Form 1040, Schedule A (see section VI.P.). However, health insurance costs not taken into account in computing this deduction may be claimed as a medical expense deduction on Form 1040, Schedule A.

If the self-employed health insurance deduction can be claimed, use the worksheet contained in the instructions to Form 1040 to figure the deduction, then enter the deduction on Form 1040, line 29, as an adjustment to income.

R. Job Expenses & Miscellaneous Itemized Deductions. Certain deductions, called "miscellaneous itemized deductions," are split into two categories. The first category includes miscellaneous itemized deductions that are deductible only to the extent they exceed 2% of adjusted gross income. Those deductions include: employee business expenses; union dues; job education expenses; investment expenses (office rent, investment counsel fees, legal fees, accounting fees, secretarial services, safe deposit box rental, subscriptions, statistical services, travel); and the cost of preparing your income tax return.

If any part of the costs listed above are attributable to fees earned for marriages, funerals and other services you performed as a self-employed minister, deduct the allocable portion of those costs, after applying the *Deason* allocation rule

to those expenses incurred in operating your ministry, on Schedule C or Schedule C-EZ (Form 1040).

Again, apply the *Deason* allocation rule to those expenses incurred in operating your ministry and report your unreimbursed employee business expenses—or those not reimbursed under an AP—on Form 2106 or Form 2106-EZ and deduct them on Schedule A (Form 1040), line 21. Report your tax preparation fees on line 22, and your other miscellaneous itemized deductions on line 23; if you need more room, list them on a separate attached schedule and enter the total on line 24.

The second category of miscellaneous itemized deductions are expenses *not* subject to the 2% of adjusted gross income floor. Those deductions, reported on line 28 of Schedule A (Form 1040), include impairment-related work expenses for handicapped persons. Other deductions are exempt from the 2% floor, but they generally don't apply to ministers. Check with your adviser to determine if any of them apply to you.

S. **Casualty Losses.** Losses attributable to stolen or vandalized property and property destroyed or damaged by fire, storm, flood and similar natural catastrophes and terrorist attacks are deductible to the extent not covered by insurance. Individuals who have suffered losses who are in a “Presidentially declared disaster area” may claim such losses on their return for the year of the loss or on the prior year’s return. For a 2012 loss, the 2011 return may be amended by the due date for the 2012 return, that is, April 15, 2013. Check with your adviser for the details of claiming such losses. To deduct a theft loss, be prepared to show that a theft occurred. The fact that property is missing is not sufficient evidence of a theft. If you suspect a theft, report it to the police. Damage to your automobile not compensated by insurance is also deductible unless the accident is the result of your willful negligence or another willful act.

Further, a casualty or theft loss of insured property requires a timely filed insurance claim in order to deduct any portion of the loss not covered by insurance.

Amount of deduction: In 2012, the deduction for personal-use property or a theft loss is allowed only to taxpayers who itemize and only to the extent the total losses for the year (after reducing *each loss* by \$100) exceed personal casualty gains (where an insurance or other recovery exceeds the basis of the property). *If personal casualty losses exceed personal casualty gains, you can claim a loss deduction to the extent that the excess is greater than 10% of adjusted gross income* (Form 1040, line 37). The amount of a loss is the lesser of: (1) the difference between the property's value immediately before the casualty and immediately after the casualty; or (2) the property's adjusted basis immediately before the casualty reduced by \$100 and any insurance compensation. If you repair damaged property, the cost of repairs minus \$100 may be permitted as the measure of loss. Exceptions to these limitations may apply to losses in certain disaster areas. See instructions to Schedule A. See the instructions to Form 4684.

Disaster losses: A disaster loss is one that occurred in a “Presidentially declared disaster area.” The net disaster loss is deductible as an itemized deduction

on Schedule A (Form 1040), Line 20. See IRS Publication 547, "Casualties, Disasters, and Thefts."

Itemizers deduct any allowable personal casualty loss on Schedule A (Form 1040), line 20, "Casualty and Theft Losses." Attach Form 4684. The itemized deduction claimed for personal use property is not subject to the 2% reduction rule which is applicable to employee property. Appraisal fees and other incidental costs are claimed as miscellaneous itemized deductions on line 23 of Schedule A.

The \$100/10% limits don't apply when the property was used exclusively in the practice of your ministry. Deducting business casualty losses or losses on income-producing property can be complicated. See IRS Publication 547, "Casualties, Disasters, and Thefts" and check with your adviser.

T. **Student Loan Interest.** Some parents and students may claim a deduction for student loan interest paid during the year whether or not they itemize. The maximum deduction is \$2,500 in 2012. The deduction is allowed only for interest paid on a qualified education loan. The deduction is phased out for single taxpayers with adjusted gross incomes between \$60,000 and \$75,000 and for joint filers with adjusted gross incomes between \$125,000 and \$155,000. The deduction is not available to married persons filing separately. The deduction is claimed on line 33 of Form 1040. Check with your adviser.

VII. Planning for Your Retirement

There are a number of ways a minister can plan for retirement and save taxes.

For certain tax purposes a minister is treated as a self-employed individual. For example, a minister's salary isn't subject to federal income tax withholding, and ministers pay self-employment tax. (The self-employment tax, or SECA, is the counterpart of the FICA tax imposed on employees.) However, a minister who is considered a "common-law employee" and not self-employed for federal income tax purposes may not qualify for an H.R. 10 self-employed retirement plan ("Keogh" or "qualified" plan) with respect to church compensation. Still, a minister should be able to have a Keogh plan for fees from weddings, funerals, baptisms, etc. In 2012, the maximum deduction for contributions to a minister's defined contribution Keogh plan is \$50,000 or 100% of self-employment income, whichever is less. Keogh plans are available to itemizers and non-itemizers. A minister may be eligible for a simplified employee pension (SEP) plan or a Savings Incentive Match Plan for Employees (SIMPLE) plan. The rules are complicated but may allow contributions without getting involved in the more complicated rules for a qualified plan. See IRS Publication 560, "Retirement Plans for Small Business." Check with your adviser which is the best plan for you.

Ministers and other employees of a church may participate in a tax-sheltered annuity (section 403(b)) plan. The largest amount that the church can contribute towards the annuity without causing the excess contribution to be taxable to the minister, that is, the maximum amount contributable, is the lesser of the limit on

annual additions or the limit on elective deferrals. The limit on annual additions, which is the limit on total contributions, i.e., elective deferrals, nonelective contributions and after-tax contributions, in any given year, may not exceed the lesser of \$50,000 or 100% of includable compensation in 2012. Amounts paid as a tax-free housing allowance are not compensation for the purpose of determining the limits on contributions.⁴¹

A minister who is considered a "common-law" employee and other church employees may also elect to defer up to \$17,000 in 2012 (indexed for inflation) through a voluntary salary reduction arrangement with the church, though in many situations a lower limit may apply. See IRS Publication 571, "Tax-Sheltered Annuity Plans (403(b) Plans)."

A minister who will be age 50 or older by the end of 2012 may also be able to make an additional catch-up contribution of \$5,500.

Note: Tax-exempt organizations may sponsor 401(k) plans.

Traditional IRA. A minister may contribute to an Individual Retirement Account (IRA), whether a church employee or self-employed. Contributions to a traditional IRA of up to \$5,000 are fully deductible for 2012 if neither you nor your spouse is covered by an employer's retirement plan. If you are an active plan participant or if you are considered a participant because your spouse actively participates in a plan, the \$5,000 deduction limit is phased out when your 2012 modified adjusted gross income exceeds the phase-out threshold: \$58,000 if you are single, a head of household, or married filing separately and considered single because you lived apart from your spouse for all of 2012; \$92,000 if you are married filing jointly or a qualifying widow or widower; and \$0 if you are married filing separately and lived with your spouse during 2012. If your modified adjusted gross income exceeds the threshold by \$10,000 (\$20,000 if married filing jointly) or more, you are not allowed an IRA deduction. If the phaseout rule prevents you from making deductible IRA contributions for 2012, you may make nondeductible contributions of up to \$5,000 or \$10,000 if married filing jointly, provided you have compensation of at least that much. If you are age 50 or older in 2012, the maximum contribution increases by \$1,000. Contributions for 2012 may be made up to the filing deadline of April 15, 2013; that is the deadline even if you get a filing extension. See IRS Publication 590, "Individual Retirement Arrangements (IRAs)."

Spousal IRA deduction for non-working or low-earning spouse. A spouse who is not an active participant in an employer's retirement plan is not considered an active participant merely because his or her spouse is a participant. The deduction for a nonparticipant spouse filing jointly is phased out if modified adjusted gross income is between \$173,000 and \$183,000.

Whether or not your annual contribution to your traditional IRA is deductible, the income earned on the IRA will not be taxed until it is distributed to you. Distributions to you from a traditional IRA must begin by April 1 of the year

⁴¹ *Private Letter Ruling 200135045. Caution:* Private letter rulings are not precedents.

after the year you reach age 70½ and cannot be made without penalty before you are age 59½, become disabled or die. Penalty-free withdrawals from an IRA to pay for medical expenses exceeding 7.5% of adjusted gross income are allowed. The early distribution penalty does not apply to early IRA withdrawals by first-time home buyers, up to \$10,000, and to amounts used for qualified higher education expenses⁴² (including graduate courses) of the taxpayer, his or her spouse, child or grandchild. But there are many limitations so see your adviser for the details.

Roth IRA. In 2012, a nondeductible contribution of up to \$5,000 may be made to a Roth IRA if modified adjusted gross income is below \$110,000 for single taxpayers or below \$173,000 if married filing jointly. The allowable contribution to the Roth IRA is phased out over these amounts and eliminated when income is \$125,000 or more for single taxpayers and \$183,000 or more for married persons filing jointly. If you are age 50 or older in 2012, the maximum contribution increases by \$1,000. Tax-free withdrawals are possible after five years if you're at least 59½, or disabled or you have up to \$10,000 of qualifying "first-time" home-buyer expenses. In 2012, existing traditional IRAs may be rolled over to Roth IRAs regardless of your income or filing status. The amount rolled over must be included in taxable income for the year of the rollover. Check with your adviser.

In 2012, the maximum IRA contribution to either the traditional IRA, Roth IRA, or combined, cannot exceed \$5,000 (\$6,000 if you are age 50 or older).

In 2012, you may be able to make nondeductible annual contributions of up to \$2,000 per child to a Coverdell Education Savings Account. The \$2,000 contribution limit is phased out starting at modified adjusted gross income of \$95,000 for single filers and \$190,000 for joint filers and is completely phased out at \$110,000 for single filers and \$220,000 for joint filers. Contributions to a Coverdell Education Savings Account do not count against contributions to IRAs. Check with your adviser.

If a minister participates in a church-sponsored retirement plan, Keogh plan, 401(k) plan adopted by the church prior to July 2, 1986, or tax-sheltered annuity plan, he or she can still have an IRA. Contributions made by a minister to an IRA aren't deductible for purposes of computing self-employment tax.

Note: Self-employed ministers and chaplains can participate in church pension plans.

Churches may establish retirement income accounts to provide benefits to their employees. Those accounts generally provide benefits similar to tax-sheltered annuity (section 403(b)) plans. Self-employed ministers and chaplains may participate in retirement income accounts.

The rules for retirement plans are complicated. Consult your adviser for further information.

⁴² To qualify for the higher education expense exception, the expenses must be paid for in the same year as the withdrawal from the IRA. *Duronio*, T.C. Memo 2007-90.

VIII. How to Determine Your Credits & Exemptions⁴³

A. **Exemption for Yourself, Spouse and Dependents.** The exemption for you, your spouse and dependents is \$3,800 each. You claim exemptions on Form 1040, lines 6a, 6b and 6c. Total your exemptions on line 6d. *EGTRRA* repealed the phaseout of the personal exemption through 2010; the *Tax Relief Act of 2010* extended this repeal through 2012.

Check the boxes alongside line 6a for yourself and line 6b for your spouse. On line 6c(1) enter the first and last name of any dependent who lives with you. On line 6c(2) report the dependent's Social Security number. You may not take an exemption for any person who does not have a Social Security number. If your dependent will not have a Social Security number by April 15, 2013, you may have to apply for an extension to file your tax return. Report the dependent's relationship to you on line 6c(3). On line 6c(4) check the box if the dependent is a child qualifying for the child tax credit (see section VIII.F.). Enter the appropriate figures in the boxes provided in this section and total the number of exemptions claimed on line 6d.

To claim a dependent as an exemption, you must meet **all** of the five following tests:

1. *Financial support test.* You either: (a) contribute more than half of the dependent's support for the year; or (b) contribute more than 10% and, together with others, contribute more than half (*i.e.*, no *one* individual contributed over half of that support). Only one taxpayer can claim the exemption. For example, you and your sister jointly contribute more than half of your father's support. Each of you contributed more than 10%. You and your sister decide who'll have the exemption. If you're to have it, your sister should sign a declaration on Form 2120, "Multiple Support Declaration," that she won't take the exemption. Then you attach that form to your tax return.

If you're a divorced parent, your entitlement to claim dependency exemptions for your children does not depend on the relative contributions you and your former spouse make to the children's support (although your combined contributions must meet the general support requirement applicable to all dependents). Generally, the parent who has custody of a child for most of the year is entitled to the exemption unless he or she relinquishes it to the other parent by executing Form 8332,⁴⁴ which the non-custodial parent attaches to his or her tax return.

⁴³ The taxpayer bears the burden of proving entitlement to any claimed exemptions or deductions. See *Welch v. Helvering*, 290 U.S. 111 (1933); *Mandeville*, T.C. Memo 2007-332.

⁴⁴ See *Chief Counsel Advice 200925041*. *Caution:* Chief Counsel Advice may not be cited as precedent.

Pointer: If you're a divorced parent, consider which parent would most benefit by the dependency exemption and any effect it would have on child support payments.

2. *Close relative or household member.* Your dependent must be a child (a legally adopted child, eligible foster child, or a child born alive, but who died shortly after birth in 2012, may be claimed), parent, grandparent, grandchild, great-grandchild, brother or sister (including a brother or sister by the half-blood), parent-in-law, child-in-law, brother- or sister-in-law, nephew, niece, uncle or aunt. Stepchildren and stepparents but not foster parents also qualify under the relationship test. An individual related to you in one of those ways need not live with you in order to qualify as a dependent, provided the other four tests are met. A dependent who isn't a relative can be claimed if your home is his or her principal home for the full year, and the dependent is a member of your household. For example, you may claim a foster parent who lives with you and whom you support. The household test is met even if you or a dependent who lives with you is temporarily absent because of illness, education, vacation, business or military service.
3. *Income earned by dependent.* Your dependent may not have gross income for the year of more than \$3,800. However, that test doesn't apply to your child or foster child who is under 19 at the end of 2012 or is under age 24 and a full-time student. He or she may earn over \$3,800 and be claimed as an exemption, provided you support him or her. (Note, however, that a taxpayer can't claim a dependency exemption for a student who has attained the age of 24 years before the end of the year, unless the child's gross income for the year is less than the exemption amount.) If you can't claim the exemption under that rule, your child may claim an exemption on his or her own return.

Social Security benefits generally don't count as income under that test. But if your dependent uses those benefits for support, they are included as the dependent's contribution to his or her own support (see the "financial support" test above). The income of a permanently and totally disabled dependent doesn't include amounts received from a sheltered workshop operated by an exempt organization that provides training designed to alleviate the disability.

4. *Citizenship or residency.* Your dependent must be a U.S. citizen or a resident of the U.S., Canada, or Mexico. A citizen may claim a legally adopted child who isn't a U.S. citizen or resident if the child makes the citizen's home his or her principal home for the entire year and is a member of the citizen's household.
5. *Married child.* You may claim your married child as a dependent only if the child doesn't file a joint return and if the child otherwise qualifies as a dependent. If the "financial support" test above is met, you may claim a married child and his or her spouse as dependents, even though they file a

joint return, if neither is *required* to file a return for the year (the filing was merely for the purpose of claiming a refund).

B. Child and Dependent Care Credit. If you maintain a household, you may claim a tax credit for the expenses you incurred if they enable you to be gainfully employed (or to look for employment) and they're for the care of: (1) a child under age 13 whom you can claim as a dependent; (2) a dependent (or anyone else you could list as a dependent except for the fact that the individual had at least \$3,800 of income) regardless of age, and who is physically or mentally incapable of caring for himself or herself; and (3) your spouse, if incapable of self-care due to physical or mental illness. Include the care provider's name, address and taxpayer identification number on Form 2441 to claim the credit.

You get the credit whether or not you itemize your deductions. If your adjusted gross income is \$15,000 or less, the credit is equal to 35% of your employment-related expenses. For adjusted gross incomes between \$15,000 and \$43,000, the credit is 34% of employment-related expenses, reduced by 1% for each \$2,000 (or fraction of \$2,000) above \$15,000. For adjusted gross incomes greater than \$43,000, the credit is 20% of employment-related expenses.

The limit on qualifying employment-related expenses is \$3,000 if you have one qualifying child or dependent; \$6,000 for two or more.

Also, the qualifying employment-related expenses taken into account in computing your credit can't exceed your earned income (wages, salary, net self-employment income, etc.). For married individuals, the lower-earning spouse's earned income sets the limit for qualifying expenses. (*Note:* Generally, you must file a joint return to claim the credit if you're married.) Special rules apply if your spouse is disabled or a full-time student. See the instructions for Form 2441.

Allowable employment-related expenses are: (1) expenses incurred to care for a qualifying person; (2) expenses for household services necessary to run your home if the expenses are partly for the benefit of the qualifying person; and (3) expenses for services provided outside the household if the qualifying person regularly spends at least eight hours each day in your home.

The rules are complicated, so read the instructions to Form 2441 carefully. Use Form 2441 to calculate the credit and enter it on Form 1040, line 48.

If your employer has a dependent care assistance program, the expenses paid or incurred for assistance are excluded from your gross income. (Benefits received from an employer program may reduce or eliminate your dependent care credit.) The exclusion is limited to your earned income or, if married, the earned income of the lower-earning spouse—with a maximum exclusion of \$5,000 (\$2,500 for married individuals filing separately). Any excess must be included in your income for the year the services are provided, no matter when the employer pays the expenses.

Example: In 2012, a widowed minister incurred and paid \$6,000 of dependent care expenses for her two children. In 2013 she incurs and pays \$5,000 of dependent care expenses. The minister's church-employer main-

tained a qualified dependent care assistance program allowing the minister full reimbursement for her expenses. The church reimbursed the minister \$3,000 in 2012. However, it reimburses an additional \$8,000 in 2013.

The minister exceeded the \$5,000 annual ceiling for dependent care assistance by \$1,000 in 2012, and that amount is includable in her income for 2012 (even though she wasn't fully reimbursed by her employer until the following year). In 2013, the minister is deemed to receive \$5,000 of assistance, so she's within the limit for that year. Thus, the minister will have no includable income from dependent care assistance for 2013.

C. **Credit for the Elderly and the Disabled.** Use Schedule R (Form 1040) to claim the credit for the elderly and the permanently and totally disabled. An individual may qualify for the credit if, by the end of 2012, he or she was age 65 or was permanently and totally disabled when he or she retired on disability. All taxable income, including earned income, can qualify for the credit.

Your eligibility for the credit depends on your filing status, age and income—and, if you're married, on your spouse's age and income. Other limitations apply.

Generally, though, you **can't** take the credit if:

- You're single, head of household or qualifying widow(er) and had an adjusted gross income of more than \$17,500, or you received \$5,000 or more of non-taxable Social Security benefits or other pension benefits;
- You're married filing a separate return and lived with your spouse at *any* time during 2012;
- You're married filing a separate return, didn't live with your spouse during 2012, but had an adjusted gross income of \$12,500 or more, or you received \$3,750 or more of non-taxable Social Security or other pension benefits;
- You're married filing jointly, only one spouse meets the age/disability requirements and your combined adjusted gross income was \$20,000 or more, or you received \$5,000 or more of non-taxable Social Security or other pension benefits; or
- You're married filing jointly, both spouses meet the age/disability requirements and your combined adjusted gross income was \$25,000 or more, or you received \$7,500 or more of non-taxable Social Security or other pension benefits.

Read the separate instructions for Schedule R (Form 1040) for more details. The credit is computed on Schedule R and transferred to Form 1040, line 53 (check box “c” and enter “Sch R” in the space next to that box).

D. **Earned Income Credit.** The earned income credit may be claimed by taxpayers of any filing status (other than married filing a separate return). Because the

earned income credit is a refundable tax credit, if the credit exceeds the amount of taxes you owe, you get a refund equal to the difference.

The credit is available to eligible individuals with qualifying children and eligible individuals without qualifying children who meet additional requirements.

A "qualifying child" must meet three tests: (1) a relationship test; (2) a residency test; and (3) an age test. A natural child, adopted child, grandchild, stepchild or eligible foster child as well as a sister, brother, half-sister, half-brother, stepbrother, stepsister or descendant of any of them, meets the relationship test. The residency requirement is satisfied if a qualifying child lives with the taxpayer in the taxpayer's principal residence (within the U.S.) for more than half of the tax year. Certain temporary absences for education or illness are disregarded for purposes of the residency test. Members of the military on extended active duty outside the United States are considered to be living in the United States. A qualifying child meets the age test if he or she is younger than you and: (1) is under age 19 at the end of the tax year; (2) is a full-time student under age 24 at the end of the tax year; or (3) is permanently and totally disabled. (See Schedule EIC (Form 1040)) and its instructions for exceptions and further information on the eligibility requirements.)

If you don't have a qualifying child, you must meet these tests to be eligible to claim the earned income credit: (1) a residency test; (2) an age test; and (3) a dependency test. You satisfy the residency test if you had a principal residence in the U.S. for more than half of the tax year. As above, certain temporary absences for education or illness are disregarded. You meet the age test if you (or your spouse) are at least 25 years old and not over the age of 64 at the end of 2012. The dependency test is met if you cannot be claimed as a dependent of another person. You cannot be the qualifying child of another person.

For 2012, the maximum credit you may claim if you have one qualifying child is \$3,169; if you have two qualifying children, the maximum credit is \$5,236; if you have three or more qualifying children, the maximum credit is \$5,891. If you don't have a qualifying child, the maximum credit is \$475. The credit is gradually phased out when you have one or more qualifying children and your adjusted gross income ("AGI") exceeds \$17,000 if filing as a single or head of household, or \$22,300 if married filing jointly, or you don't have qualifying children and your AGI exceeds \$7,800 if filing as a single or head of household, or \$13,000 if married filing jointly. The phaseout amounts are adjusted annually for inflation.

No credit is available to you when: you have no qualifying children and your AGI exceeds \$13,980 if single or head of household, or \$19,190 if married filing jointly; you have one qualifying child and your AGI exceeds \$36,920 if filing as a single or head of household, or \$42,130 if married filing jointly; you have two qualifying children and your AGI exceeds \$41,952 if filing as a single or head of household, or \$47,162 if married filing jointly; or you have three or more qualifying children and your AGI exceeds \$45,060 if filing as a single or head of household, or \$50,270 if married filing jointly.

Further, no credit is available to you when your "disqualified income" exceeds \$3,200. Disqualified income includes interest, dividends, net rental and royalty income, net capital gain income and net passive income.

Use the worksheet contained in the Form 1040 instructions to figure your earned income credit. If you can take the earned income credit and have one or more qualifying children, use Schedule EIC (Form 1040) to give information about that child or those children.

For purposes of the credit, "earned income" consists of wages, salaries, tips and other compensation, plus net earnings from self-employment. (Net earnings from self-employment count even if they're under \$400, and thus aren't subject to self-employment tax.) The minister's parsonage allowance and meals provided for the convenience of an employer are also considered earned income for purposes of the credit even though they're excluded from gross income for income tax purposes. Inclusion of the parsonage allowance may be affected by whether you have filed a Form 4361. Check with your adviser. Earned income doesn't include Social Security benefits or amounts received as a pension or annuity.

The 2012 Form 1040 instructions for line 64a, "Earned Income Credit," specify that if you are filing Schedule SE (Form 1040) because you are a member of the clergy, see the instructions for "Clergy" which appear under "Definitions and Special Rules." Clergy are also required to use Worksheet B to determine earned income. Check with your adviser.

E. **Adoption Credit.** A tax credit of up to \$12,650 is available for the qualifying costs of adopting a child under 18, or a person who is physically and mentally incapable of self-care. The credit is phased out for those with modified adjusted gross incomes between \$189,710 and \$229,710.⁴⁵ The taxpayer must also attach certain adoption-related documents with the tax return to substantiate the adoption. The credit is claimed on Form 8839 and on line 71 of Form 1040.

F. **Child Tax Credit.** Taxpayers with "qualifying children" may be entitled to a child tax credit. The credit is \$1,000 per child in 2012. The credit is phased out if modified adjusted gross income is more than \$110,000 for married couples filing jointly, \$75,000 for single filers, heads of households or qualified widow(er)s, and \$55,000 for married persons filing separately. A qualifying child is a child, grandchild, stepchild or eligible foster child for whom the taxpayer can claim a

⁴⁵ For 2012, the adoption credit is not refundable. Because the adoption credit is not refundable after 2011, you may be able to carryforward any unused credit amounts to future tax years. The 2013 Form 8839 and its instructions will have information on the credit carryforward. See 2012 Instructions to Form 8839. The *American Taxpayer Relief Act of 2012* made the adoption credit, including the carryforward provision, permanent.

dependency exemption and who is less than 17 years old as of the close of the tax year. The child must also be a U.S. citizen or resident.

An additional child tax credit may be available to taxpayers who get less than the full amount of the child tax credit because their tax is too low. The additional child tax credit may be partly refundable. The additional child tax credit is claimed by filing Form 8812 and entered on line 65 (Form 1040). The refund may be available to the extent of 15% of earned income that exceeds \$3,000 or you have three or more qualifying children and the Social Security taxes you paid exceed the earned income credit.

G. **Higher Education Tax Credits.** Two higher education tax credits—the HOPE scholarship credit and the lifetime learning credit became available beginning in 1998. As a result of *ARRA*, the Hope credit applies to 2008 and earlier tax years. For 2009 through 2017, *ARRA* enacted the American Opportunity Credit,⁴⁶ which modifies the existing Hope credit, making it available to a broader range of taxpayers, including many with higher incomes and those who owe no tax. The credits are limited to expenses paid for the education of the taxpayer, his or her spouse, or a dependent for whom a personal exemption is allowed.

The maximum American Opportunity Credit is \$2,500. The credit begins to phase out for taxpayers with a modified adjusted gross income above \$80,000 for single taxpayers and \$160,000 for joint filers. A single taxpayer whose modified adjusted gross income is greater than \$90,000 (\$180,000 for joint filers) cannot benefit from this credit. The maximum Lifetime Learning Credit is \$2,000. The credit starts to phase out at modified adjusted gross income of \$52,000 for single taxpayers and \$104,000 for joint filers. No credit is allowable for taxpayers with incomes above \$124,000 on a joint return or \$62,000 on a single return. See Form 8863, “Education Credits,” for details. Check with your adviser.

H. **First-Time Homebuyer Credit.** The first-time homebuyer credit is no longer available. There are repayment provisions that may apply for homes purchased between 2008 and 2011. Check with your adviser.

IX. Record Keeping

To substantiate deductions for business use of a car or other travel expenses (including meals and lodging while away from home), a minister must keep adequate records indicating the amount of the expense, the time and place of travel and the business purpose of the expenditure.

IRS regulations define adequate records as an account book, diary, log, statement of expenses, trip sheets or similar written receipts containing the required

⁴⁶ The *American Taxpayer Relief Act of 2012* extended the American Opportunity Credit through 2017.

information to substantiate the expenditure.⁴⁷ All lodging expenses and any expenses over \$75 must be substantiated with receipts, except for transportation charges if such documentation is unavailable. It's better to make written records at or near the time the expense is incurred. Contemporaneous records have more value than records recreated some time after the expenditure. The more detailed and accurate your records, the easier it is to compute and substantiate federal tax deductions.

Keep track of your business and personal mileage. The proportion spent on church activities fixes the auto costs that you can deduct. For example, your auto costs for 2012 are \$2,000. You use the car 80% for church activities. You deduct \$1,600.

Keep a record of your expenses even if you receive a car allowance. If you don't account to your employer for expenses under an AP (see section VI.C.), the allowance is includable in your income—and you must be able to substantiate the expenses reported on Form 2106.

X. 2012 Tax Rates

In 2012, there are six progressive tax rates—10%, 15%, 25%, 28%, 33% and 35%. In 2012, the 10% bracket applies to the first \$8,700 of taxable income for single taxpayers, \$12,400 for heads of households, and \$17,400 for married couples filing joint returns. For married taxpayers filing jointly and surviving spouses, taxable income over \$17,400 and up to \$70,700 is taxed at the 15% bracket; over that amount and up to \$142,700 it's taxed at the 25% bracket; over that amount and up to \$217,450 it's taxed at the 28% bracket; over that amount and up to \$388,350 it's taxed at the 33% bracket. For heads of households, the ceilings are: \$47,350 (15%); \$122,300 (25%); \$198,050 (28%); and \$388,350 (33%). For single taxpayers (other than surviving spouses and heads of households), the ceilings are: \$35,350 (15%); \$85,650 (25%); \$178,650 (28%); and \$388,350 (33%). In all the above categories, the 35% rate applies to taxable income over \$388,350. For married, filing separately, the ceilings are: \$8,700 (10%); \$35,350 (15%); \$71,350 (25%); \$108,725 (28%); \$194,175 (33%); and over \$194,175 (35%).

Property held more than one year qualifies for the long-term capital gains rate. *JGTRRA* reduced the capital gains rate for long-term assets to 15% (0 for taxpayers in the 10% and 15% income tax brackets in 2012) for assets sold after May 6, 2003. For long-term capital assets sold prior to May 6, 2003, the long-term capital gains rate is 20% (10% for taxpayers in the 10% and 15% income tax brackets). There are, however, exceptions to the maximum 15% rate.

⁴⁷ See *Oswandel*, T.C. Memo 2007-183; see also *Brown*, T.C. Summary Opinion 2005-155 (weekly activity reports submitted to employer that did not reflect the number of miles driven or other details of specific business activities were not sufficient to satisfy the substantiation requirements). *Caution*: Tax Court summary opinions are not precedents.

Long-term gain from the sale of real property attributable to depreciation—but not already recaptured—is taxed at 25%. Only gains exceeding depreciation are eligible for the 15% rate. The "recapture" of accelerated depreciation is taxable at ordinary income rates, subject to the 25% maximum rate. Long-term gain on the sale of collectibles (e.g., artworks, gems, antiques, stamps, etc.) is taxed at 28%. Gain from the sale of capital assets held one year or less is taxed at ordinary income rates—up to 35%.

Capital losses are allowed in full against capital gains and \$3,000 of other income (\$1,500 for married persons filing separate returns). Net capital losses may be carried over until exhausted.

Alternative Minimum Tax. A small percentage of ministers may be subject to the alternative minimum tax. The rules are complicated; check the instructions to Form 1040—and, if need be, Form 6251—carefully.

Household employment tax. Use Schedule H (Form 1040) to compute household employment taxes for 2012. You may need to complete that schedule if you paid wages over \$1,800 to a household employee in 2012. See the instructions to Schedule H.

XI. How to Calculate and Report Your Self-Employment Tax

A. **Social Security Coverage.** Since 1968, Social Security coverage is automatic for ordained, commissioned, or licensed ministers of churches. Your earnings from your ministerial services are, therefore, automatically subject to self-employment tax. In other words, you must pay self-employment tax to receive future Social Security benefits. You may opt out of Social Security coverage by filing Form 4361, on the grounds of conscientious or religious opposition to Social Security benefits (or other insurance providing similar protection) based on services as a minister. If the IRS approves your application, your earnings from your ministerial services will not be subject to self-employment tax and you will not be entitled to receive any future Social Security benefits based on those earnings.

Grounds for exemption. Form 4361 requires you to certify that you're opposed—on conscientious or religious grounds—to accepting public insurance for services as a member of the clergy. Opposition based on general conscience won't do, says the IRS; nor will seeking exemption on purely economic grounds. You have to certify that you've expressed your opposition to the ordaining, commissioning or licensing body of your church or order. Upon receiving your Form 4361, the IRS will verify that you understand the grounds on which the exemption will be granted.

How to file for exemption. Form 4361 must be filed early in your career as a minister. File it with your District Director by the due date (including extensions) of your income tax return for the second tax year in which you have at least \$400 in self-employment earnings, any part of which came from services as a minister, member of a religious order, or Christian Science practitioner. *Note:* An extension of time to file your income tax return also applies to Form 4361.

Failure to file your application for exemption by this deadline will most likely preclude you from opting out of Social Security coverage. The IRS rigorously enforces the filing procedures. In one case, even though an individual was not an ordained minister, but could officiate at marriages, funerals, and baptisms, conduct religious services, and participate in the maintenance of his local church, the U.S. Tax Court found him liable for self-employment tax because he didn't timely file an exemption.⁴⁸ **Caution:** In another case, the IRS incorrectly told a minister that his Form 4361, although untimely filed, was accepted and the minister was exempt from self-employment tax. The minister did not report self-employment tax and was assessed deficiencies and penalties by the IRS. The U.S. Tax Court held that because the minister's application was not timely filed, he was not exempt from self-employment tax. The minister was not allowed to rely on the misstatement of law made by the IRS.⁴⁹

In another case, a duly ordained minister who had not applied for an exemption from self-employment tax, because his faith did not oppose Social Security coverage, left the church and the ministry. After five years, he was reordained with another church that opposed public insurance. He began a new ministry and applied for and was denied an exemption from self-employment tax. The Tenth Circuit U.S. Court of Appeals held that the minister was entitled to an exemption from self-employment tax. The court held that when a minister enters a new church and ministry, having adopted a new opposition to public insurance, that minister is eligible to seek the exemption from self-employment tax.⁵⁰ The IRS has ruled on several situations in which a minister changes faith and belief.⁵¹ In one situation, a duly ordained minister who was not opposed to acceptance of public insurance had a change of faith and was ordained as a minister of another church, which opposed acceptance of public insurance. Adopting the reasoning of *Hall*, the IRS ruled that when an individual enters the ministry anew in a new church and adopts a new set of beliefs, the individual is a “new” minister for the purposes of seeking an exemption. In another situation, the minister was ordained in a church that opposed acceptance of public insurance. However, the IRS did not approve his Form 4361 because of late filing. The minister subsequently changed faith and was ordained as a minister in another church but had no change in belief regarding public insurance. This minister did not have a second opportunity to file a Form 4361 due only to a change in faith and entering the ministry in a new church. The ruling requires that there be both a

⁴⁸ *Reeder*, T.C. Memo 1993-287; see also *McGaffin*, 112 F.3d 311 (CA-8, 1997); *Bennett*, T.C. Memo 2007-355 (petitioner not exempt because he failed to establish timely filing of Form 4361 to qualify for ministerial exemption); *Vigil*, T.C. Summary Opinion 2008-6. **Caution:** Tax Court summary opinions are not precedents.

⁴⁹ *Keaton*, T.C. Memo 1993-365

⁵⁰ *Hall*, 30 F.3d 1304 (CA-10, 1994)

⁵¹ *Chief Counsel Advice 200404048*. **Caution:** Chief Counsel Advice may not be cited as precedent.

change in faith *and* a change in belief based on the new faith, reordination and a timely filing of Form 4361. Check with your adviser to see which rule applies to you.

Revocation of exemption. For a brief time, beginning in 2000 and until April 15, 2002, a minister who had opted out of Social Security coverage by timely filing Form 4361, had the opportunity to revoke the exemption and opt back in and obtain Social Security and Medicare coverage, by filing Form 2031, "Revocation of Exemption From Self-Employment Tax for Use by Ministers, Members of Religious Orders, and Christian Science Practitioners."

Effect of Form 2031. Once Form 2031 was timely filed and your exemption revoked, you can never again elect exemption from self-employment tax.

If you were ever exempt from Social Security coverage but later revoked your exemption, you can't re-apply for exemption. (Before 1968, services performed by a minister were automatically exempt; you had to opt **into** the Social Security system by filing a prior version of Form 2031 certifying that you elected coverage. If you elected Social Security coverage with respect to your ministerial services for tax years before 1968, you're still covered and need not file any new forms. However, you aren't eligible for an exemption.)

Social Security has suspended issuing Social Security Statements. You may be able to estimate your retirement benefit using the Social Security online Retirement Estimator, www.socialsecurity.gov/estimator. The Retirement Estimator gives estimates based on a person's actual earnings record. However, Social Security warns that these are just estimates and it can't provide the actual benefit amount until a person applies for benefits. For more information, call or visit a local Social Security office; call Social Security's toll-free number, 1-800-772-1213; or visit Social Security's website, www.socialsecurity.gov.

B. Self-Employment Tax ("SECA Tax"). If you haven't received an exemption from self-employment tax, have revoked your exemption, or are not automatically exempt, your net earnings from self-employment include the gross income earned from your ministerial services, minus the deductions related to that income, and are taxed at the rate of 13.3% in 2012. This rate consists of two components: 10.4% (in 2012) for old age, survivor and disability insurance (Social Security [OASDI] tax) and 2.9% for health insurance (Medicare tax). (The FICA tax, imposed on non-self-employed individuals, consists of the same rate and the same components.) The ceiling on net earnings subject to tax at the 10.4% rate is \$110,100 for 2012. All of your 2012 self-employment income is subject to Medicare tax.

If you perform ministerial services as an employee of a church, you may deduct all your unreimbursed ministerial trade and business expenses when figuring your net earnings for purposes of the self-employment tax. (Unreimbursed meal and entertainment expenses are limited to 50% of the otherwise deductible amount.)

Although the amount of your parsonage allowance (or the fair rental value of a home furnished to you) isn't included in your gross income for income tax purposes, it is includable for self-employment tax purposes. The *Deason* allocation is not required when calculating self-employment taxes. In defining net earnings from

self-employment, the Internal Revenue Code specifically provides that you must include the parsonage allowance. (See instructions to Schedule SE (Form 1040).)

Example: An ordained minister received \$30,000 compensation, plus a \$6,000 parsonage allowance. She had expenses of \$3,500 attributable to that income. The minister reports \$32,500 (\$36,000 - \$3,500) on Schedule SE (Form 1040) as net earnings from services as a minister.

Retirement benefits received from a church retirement plan after a minister retires, and the fair rental value or allowance of a parsonage (including utilities) furnished to a minister after retirement, aren't subject to self-employment taxes. Check with your adviser.

However, if a parsonage allowance is provided to you during your retirement in return for your current services to the church, then the allowance is considered part of your compensation and must be considered in filing Schedule SE (Form 1040) and in computing the self-employment tax. Also, it will probably be considered compensation for purposes of the Social Security earnings test. Check with your adviser.

Your net earnings from self-employment include fees for marriages, funerals, baptisms, etc., minus the deductions for unreimbursed business expenses that are related to that income (before making the *Deason* allocation). The *Deason* allocation rule does not apply to the deduction of business expenses on Schedule SE. You must include the value of meals and lodging provided for the church's convenience, even though those amounts are excluded from gross income for *income tax* purposes. Amounts reimbursed under an AP (see section VI.C.) aren't included.

Income earned from employment, even after retirement, must be reported for both income tax and self-employment tax purposes.

Amounts excluded from your income because they are contributions to a qualified tax-sheltered annuity aren't taken into account in computing your self-employment tax. After you retire, any amounts you receive for past services from your section 403(b) annuity are likewise not subject to self-employment taxes. If part of your annuity is designated as parsonage allowance, you need not consider the amount of the annuity that has been designated as parsonage allowance for the Social Security earnings test in determining whether you're eligible for Social Security benefits before attaining retirement age. If you use the entire amount of the annuity designated as parsonage allowance to provide a home, no part of that amount will be considered in determining the federal taxability of your Social Security benefits.

There is no law on whether a minister may exclude moving expense reimbursements from wages subject to self-employment tax. Rules for "common-law employees" provide that moving expense reimbursements are not subject to FICA tax. On the other hand, truly self-employed individuals may not exclude moving expenses from income for SECA tax purposes. I believe that a minister who receives a moving expense reimbursement from his church should treat it for self-employment tax purposes similarly to an employee subject to FICA taxes. Therefore, I believe that the

minister may exclude moving expense reimbursements from his SECA wage base. As always, consult your adviser.

You are entitled to deduct a portion of your earnings from self-employment. In 2012, the self-employment tax deduction is revised to reflect the employer's equivalent portion of the tax. In prior years, the deduction was one-half of the self-employment tax. To compute the deduction, Schedule SE (Form 1040) directs you to multiply your net earnings by .9235 to arrive at the net earnings subject to the self-employment tax. In 2012, the tax is arrived at as follows: *If you use the Short Schedule SE:* if income is \$110,100 or less, multiply the amount by 13.3% (.133); if income is more than \$110,100, multiply the entire amount by 2.9% (.029) and add \$11,450.40 to the result. To arrive at the deduction for the self-employment tax, if the tax is \$14,643.30 or less, multiply the amount by 57.51% (.5751); if the amount of the tax is more than \$14,643.30, multiply the amount by 50% (.50) and add \$1,100 to the result. Enter the result on line 6 of Short Schedule SE, and on line 27 of Form 1040. *If you use the Long Schedule SE:* multiply the first \$110,100 by 10.4% (.104) (OASDI) and all net earnings by 2.9% (.029) (Medicare) and add these two amounts for the self-employment tax. To arrive at the deduction for the self-employment tax, the OASDI tax is multiplied by 59.6% (.596) and the Medicare tax by 50% (.50). The total of these amounts is the self-employment tax deduction which is entered on line 13 of the Long Schedule SE and on line 27 of Form 1040.

C. **Schedule SE.** To report your self-employment tax, complete Schedule SE (Form 1040). You must file Schedule SE if your net earnings from self-employment were \$400 or more, or you had wages of \$108.28 or more from an electing church or church organization. When a minister files jointly with a spouse and both have self-employment income, each must file a separate Schedule SE.

Note: If your only self-employment income was from earnings as a minister and you filed Form 4361 (and the IRS has approved you as exempt from self-employment tax), and you did not revoke the exemption, don't file Schedule SE. Instead write: "Exempt—Form 4361" on Form 1040, line 56. If you filed Form 4361, but have \$400 or more of other earnings subject to self-employment tax, fill out the long Schedule SE.

Both a long and short Schedule SE (Form 1040) exist. You *must* file long Schedule SE (Form 1040) if you fall into any of the following categories:

- You are a minister, member of a religious order, or Christian Science practitioner and received IRS approval not to be taxed on your earnings from those sources, but you owe self-employment tax on other earnings, or you revoked your exemption.
- The total of your combined wages and net earnings from self-employment subject to Social Security and Medicare tax is more than \$110,100.
- You are an employee of a church or church organization that paid you wages in excess of \$108.28 and that chose by law not to pay employer Social Security and Medicare taxes.

- You choose an "optional method" to figure your net earnings from self-employment. (See long Schedule SE (Form 1040), Part II.)
- You have tip income that's subject to Social Security or Medicare tax, but you didn't report those tips to your employer.

If you don't fall into any of those categories, you may use short Schedule SE (Form 1040). Both the long (Section B) and the short (Section A) schedule options are located on the same Schedule SE.

XII. Declaring Your Estimated Taxes for 2013

Because ministers normally don't have tax withheld from their income, they must file a declaration of estimated tax using Form 1040-ES. Estimated taxes are payable in four periodic installments. Your Form 1040-ES package contains four payment vouchers, each indicating the due date of the estimated payment. Enter your name, address and Social Security number in the spaces provided on each voucher. Include the same information for your spouse if you file jointly. Enter the net amount of your payment in the space provided on the voucher. If you overpaid your 2012 taxes, you may apply all or part of the overpayment on any voucher—but only send a voucher to the IRS when you are making a payment.

Your first declaration of estimated tax for 2013 is due by April 15, 2013. The remaining payments are due June 17 and September 16 of 2013, and January 15, 2014. Your 2013 estimated tax will generally be the total of your expected income tax and self-employment tax, minus your expected withholding and credits. By including your self-employment tax with your estimated income tax liability, you pay your combined self-employment tax and your income tax periodically.

Taxpayers are subject to a penalty for underpayments of estimated taxes. But there's no penalty if a taxpayer makes timely estimated tax payments at least equal to: (1) 100% of the previous year's tax liability, or (2) 90% of the current year's tax liability. In 2013, the 100%-of-last-year's-tax-liability exception increases to 110% for individuals with adjusted gross income of more than \$150,000 (more than \$75,000 if married filing separately) for the prior year. If you don't make your periodic payments on time, you may be charged a penalty for certain quarters—even if the government ends up owing you a refund on your 2013 tax return. In addition to federal tax, most states have their own requirements and/or penalties regarding the underpayment of taxes. Check with your adviser.

Although a minister's remuneration isn't subject to withholding, you can voluntarily agree with your church to cover any income and self-employment tax due. Filing a completed Form W-4 with the church constitutes a request for withholding. (Note that voluntary withholding doesn't subject your church income to FICA). Commencement of withholding by the church in effect constitutes an agreement between the minister and the church. If you wish the withholding to terminate on a specific date or the church compensates you for non-ministerial services that are

subject to mandatory withholding, you must furnish the following written request along with a completed Form W-4.

To: Employer's Name
Address

In accordance with Reg. §31.3402(p)-1, please withhold federal income tax from the _____ [describe type or kind of payment being made] payments you are making to me. This agreement is to terminate on _____, 20 ____.

Employee's name: _____

Address: _____

Social Security Number: _____

Employee's signature

Date

If you elect voluntary withholding in the appropriate amount for your income and self-employment taxes, you should not have to pay estimated taxes unless you have other income not related to the ministry and not subject to withholding.

XIII. Specimen Forms

As discussed at the beginning of this booklet, the IRS generally requires a minister to report church salary as specified in *Rev. Rul. 80-110* and IRS Publication 517. Although the specimen forms and statements on the following pages are for an employee-minister who itemizes deductions, many of the forms are also applicable to the minister who does not itemize.

The minister who takes the standard deduction won't be able to deduct professional expenses allocable to church salary. Apart from not completing Schedule A (Form 1040) and Form 2106 or Form 2106-EZ, a minister who takes the standard deduction prepares Form 1040 in the same way as a minister who itemizes. The specimen forms take into account \$27,000 earned by the minister's wife. In our example, neither the minister nor his wife participated in an employer's retirement plan. Although he can use the short Schedule SE (Form 1040), the long version is used for illustrative purposes.

Our hypothetical minister didn't have an Accountable Plan (AP) with his church for 2012, so his \$2,500 automobile expense allowance was simply included in his compensation. (Note that the 2% floor on miscellaneous deductions kept him from deducting \$1,179 in expenses on line 26 of Schedule A. Also, he didn't have any meal or entertainment expenses; they would have been reduced by 50% on Form 2106 and **then** subjected to the *Deason* allocation rule and the 2% floor on miscellaneous deductions on Schedule A.)

If the minister had an AP, no part of the allowance would be reported as income on his Form W-2. (If his total automobile expenses exceeded his AP reimbursements, he'd have to complete Form 2106 to claim a deduction for the excess.)

Notice: The tax forms used in this booklet are the latest available at press time. If there are any changes in the law enacted later, the IRS may issue new tax forms or instructions. Check with your adviser.

1040

Individual Income Tax Return

Name: JAMES JOHNSON, Address: 585 CLAY STREET, AUNTOWM, FLORIDA 32638

Dependent: MAINE JOHNSON, ALEX JOHNSON, ALEX JOHNSON

Exemptions: 1 Single, 2 Married filing jointly, 4 Head of household

Income: 7a Wages, salaries, tips, etc. 18,500; 7b Tax-exempt interest 500; 7c Ordinary dividends 1,797

Adjusted Gross Income: 23 Educator expenses 29; 24 State and local taxes 24; 25 Health savings account deduction 25

Other income: 21 Other income 220; 22 Combine the amounts in the far right column for lines 7 through 21

Form 1040 2012, Cat. No. 13259

Page 2

Tax and Credits: 30a Amount from line 97 (qualified gross income) 53,843; 30b Check if you were born before January 2, 1948

Other Taxes: 47 Foreign tax credit 47; 48 Credit for child and dependent care expenses 47; 49 Education credits 49

Payments: 65 Federal income tax withheld from Forms W-2 and 1099 6,000; 66 Amount applied from 2011 return 5,000

Refund: 73 If line 72 is more than line 61, subtracted tax 72; 74 Amount you owe 74a

Amount You Owe: 74a Amount you owe 74b; 75 Estimated tax payments 75

Sign Here: Your signature, Date, Preparer's signature, Date

Form 1040 2012, Cat. No. 13259

* You decide whether you have the \$5,129 refunded to you (line 74b) sent to your bank (line 71b-d), or applied to your 2013 estimated tax (line 75).

Itemized Deductions
▶ Information about Schedule A and its separate instructions is at www.irs.gov/form1040.
▶ Attach to Form 1040.

1 Medical and dental expenses (see instructions)	2,500
2 Enter amount from Form 1040, line 38	58,845
3 Multiply line 2 by 7.5% (0.075)	4,421
4 Subtract line 3 from line 2. If the result is less than line 1, enter 0	0
5 State and local (check only one box): <input type="checkbox"/> Income taxes, or <input type="checkbox"/> General sales taxes <input type="checkbox"/> Real estate taxes (see instructions)	792
6 Other taxes. List type and amount ▶	2,500
7 Add lines 5 and 6	3,292
8 Add lines 5 through 8	0
9 Add lines 5 through 8	3,292
10 Home mortgage interest and points reported to you on Form 1098 (see instructions)	7,455
11 Investment interest. Attach Form 4952 if required. (See instructions)	0
12 Charitable contributions (see instructions)	0
13 Mortgage insurance premiums (see instructions)	0
14 Investment interest. Attach Form 4952 if required. (See instructions)	0
15 Add lines 10 through 14	7,455
16 Gifts to charity. If you made a gift of \$250 or more, see instructions. Attach Form 2850 or 2106-IC, if required. (See instructions) ▶	4,000
17 Other than by cash or check. If any gift of \$250 or more, see instructions. You must attach Form 8883 if over \$500	0
18 Add lines 16 and 17	4,000
19 Add lines 15 through 18	11,455
20 Casualty or theft losses. Attach Form 4684. (See instructions)	0
21 Unreimbursed employee expenses—job travel, union dues, and dues and fees. Attach Form 2106 or 2106-IC, if required. (See instructions) ▶	3,926
22 Tax preparation fees	0
23 Other expenses—investment, safe deposit box, etc. List type and amount ▶	0
24 Add lines 21 through 23	3,926
25 Enter amount from Form 1040, line 38	58,845
26 Multiply line 25 by 2% (0.02)	1,177
27 Subtract line 26 from line 25. If line 26 is more than line 25, enter 0	3,179
28 Other—form as in instructions. List type and amount ▶	2,752
29 Add the amounts in the far right column for lines 4 through 28. Also, enter this amount on Form 1040, line 40	17,654
30 Total itemized deductions. Enter the amount from line 29, but only if it is more than your standard deduction. Check here	17,654

Profit or Loss From Business
▶ Information on Schedule C and its instructions, go to www.irs.gov/schedulec.
▶ Attach to Form 1040, 1040NR, or 1041; partnerships generally must file Form 1065.

A Principal business or profession, including product or service (see instructions)	ORDINANCE MINISTER
B Enter code 172, 48, 517, or 520	172
C Business name. If no separate business name, leave blank. City, town or post office, state, and ZIP code	New World Church New York, NY 10018
D Employer ID number (EIN, see instructions)	00-0000000
E Business address (including suite or room no.)	New York, NY 10018
F Accounting method: <input type="checkbox"/> Cash <input type="checkbox"/> Accrual <input type="checkbox"/> Other (specify) ▶	Cash
G Did you "materially participate" in the operation of this business during 2012? If "No," see instructions for limit on losses	Yes <input type="checkbox"/> No <input type="checkbox"/>
H If you started or acquired this business during 2012, check here	Yes <input type="checkbox"/> No <input type="checkbox"/>
I If you sold or otherwise disposed of this business during 2012, check here	Yes <input type="checkbox"/> No <input type="checkbox"/>
J If you, did you or will you file required Form 1099?	Yes <input type="checkbox"/> No <input type="checkbox"/>

Part I Income	Enter expenses for business use of your home only on line 30.
1 Gross receipts or sales. See instructions for line 1 and check the box if this income was reported to you on Form 1042 and the "Statutory employee" box on that form was checked	18
2 Form 1042 and the "Statutory employee" box on that form was checked	19
3 Subtract line 2 from line 1	18
4 Cost of goods sold (from line 42)	0
5 Gross profit. Subtract line 4 from line 3	18
6 Other income, including interest and state gasoline or fuel tax credit or refund (see instructions)	0
7 Add lines 5 and 6	18
Part II Expenses	Enter expenses for business use of your home only on line 30.
8 Advertising	18
9 Car and truck expenses (see instructions)	19
10 Commissions	19
11 Contract labor fees (see instructions)	20b
12 Depreciation	21
13 Repairs and maintenance	22
14 Supplies (not included in Part III)	22
15 Taxes and licenses	23
16 Travel, including lodging and entertainment	24a
17 Entertainment (see instructions)	24b
18 Mortgage (for banks, etc.)	25
19 Other (see instructions)	27a
20 Loan and professional services	27b
21 Total expenses before expenses for business use of home. Add lines 8 through 20	28
22 Expenses for business use of home. Attach Form 8829. Do not report such expenses elsewhere	29
23 Net profit or (loss). Subtract line 21 from line 20	1,707
24 If you checked the box on line 1, see instructions. Estates and trusts, enter on Form 1041, line 3	0
25 If you have a loss, check the box that describes your investment in this activity (see instructions). <input type="checkbox"/> All investment is at risk. <input type="checkbox"/> Investment is not at risk.	31

Department of the Treasury, Internal Revenue Service (IRS)
2012
Employer's identification number: 123

Employer's name: JAMES L. JOHNSON
Occupation in which you incurred expenses: OPERATIONS MANAGER
Social security number: 123 45 6789

Part I Employee Business Expenses and Reimbursements

Table with 2 columns: Column A (Out-of-pocket costs and entertainment) and Column B (Meals and entertainment). Rows 1-6 detailing travel, meals, and entertainment expenses.

Note: If you were not reimbursed for any expenses in Step 1, skip line 7 and enter the amount from line 6 on line 8.

Step 2 Enter Reimbursements Received From Your Employer for Expenses Listed in Step 1

Table for Step 2 with 2 columns: (a) Reimbursement received from employer and (b) Amount not reimbursed.

Step 3 Figure Expenses To Deduct on Schedule A (Form 1040 or Form 1040NR)

Table for Step 3 with 2 columns: (a) Vehicle 1 and (b) Vehicle 2. Rows 7-10 detailing vehicle expenses and depreciation.

Note: If both columns of line 8 are zero, you cannot deduct employee business expenses. See here and attach Form 2106 to your return.

11 Enter the date the vehicle was placed in service: 11/07/2010
12 Enter the number of miles during 2012: 15,000
13 Business miles included on line 12: 13,000
14 Percent of business use: 86.67%

Part II Vehicle Expenses

Table for Part II with 2 columns: (a) Vehicle 1 and (b) Vehicle 2. Rows 11-29 detailing vehicle expenses, depreciation, and other costs.

Section C - Actual Expenses

Table for Section C with 2 columns: (a) Vehicle 1 and (b) Vehicle 2. Rows 30-38 detailing actual expenses, depreciation, and other costs.

Note: 450 of the miles included on Line 11 are attributable to Schedule G.
2,170 of the miles included on Line 11 are attributable to Schedule G.
\$1,500 reduced by 22% Reason allocation
\$325 reduced by 22% Reason allocation

XIV. Specimen Statements Filed With Your Return

James J. Johnson (123-45-67XX) and Janet J. Johnson (187-65-43XX)
525 Clay Street, Anytown, Florida 335XX

**STATEMENT 1— AUTOMOBILE EXPENSES IN PERFORMING
MINISTERIAL DUTIES—Schedule C (Form 1040)
and Form 2106**

[*Note:* In our example, the automobile expenses are greater if Method II is elected, but that may not be so in your case. You're free to use either method (but see limits on the standard mileage rate in section VI.H.). The following example uses the standard mileage rate of 55.5¢ per mile for 2012. The example assumes an equal number of miles driven each month.]

Method I—Standard Mileage (See section VI.H.)

In 2012, I drove my automobile 7,680 miles in the exercise of my ministry. [*Note to minister:* Do not count miles driven for non-professional use or commuting mileage.] I elect to compute my deductible automobile costs by using the standard mileage rate of 55.5¢ per mile for 2012. [*Note to minister:* Even though you elect the mileage method, you can also deduct tolls, parking and certain other expenses.]

I drove 480 miles and spent \$55 on tolls and parking for functions such as weddings and funerals (for which I earned separate fees). My total, \$266 (480 miles × 55.5¢ per mile) plus \$55, is \$321 and is reduced by 22% under the IRS Publication 517 allocation rule (see Statement 4). Therefore, \$250 (\$321 - \$71) is allocable to Schedule C (Form 1040) income.

I drove 7,200 miles and spent \$220 on tolls and parking in earning my church salary. My total, \$3,996 (7,200 miles × 55.5¢ per mile) plus \$220 is \$4,216 and is reduced by 22% (under the IRS Publication 517 allocation rule). Therefore, \$3,288 (\$4,216 - \$928) is allocable to church salary and reported on Form 2106 as an employee business expense.

-OR-

Method II—Detailed Itemization of Actual Expenses (See section VI.H.)

My total mileage for 2012 was 12,000. I drove 480 miles (or 4% of total mileage) for functions such as weddings and funerals for which I earned separate fees, and drove 7,200 miles (or 60% of total mileage) in earning my church salary.

Insurance	\$1,500
License plates	42
Gas and oil	2,500
Repairs and maintenance	<u>+ 460</u>
Total	\$4,502

4% allocable to Schedule C (Form 1040) income	\$ 180
60% allocable to church salary	\$2,701

Depreciation on 2010 Ford purchased February 20, 2010 for \$15,000 (based on assumed annual depreciation of \$3,000):

4% × \$15,000 over five years (Schedule C)	\$ 120
60% × \$15,000 over five years	\$1,800

Parking and tolls allocable to Schedule C (Form 1040) income	\$ 55
Parking and tolls allocable to church salary	\$ 220

Auto expenses allocable to Schedule C (Form 1040) total \$355 (\$180 + \$120 + \$55) and are reduced by 22% (IRS Publication 517 allocation rule). Therefore, \$277 (\$355 - \$78) is allocable to Schedule C. Expenses allocable to church salary total \$4,721 (\$2,701 + \$1,800 + \$220) and are reduced by 22% (IRS Publication 517 allocation rule). Only \$3,682 (\$4,721 - \$1,039) can be reported on Form 2106 as an employee business expense.

**STATEMENT 2— UNREIMBURSED PROFESSIONAL EXPENSES
(OTHER THAN AUTOMOBILE)—Form 2106**

Dues to professional organizations	\$155
Religious conference fees	130
Subscriptions to professional journals	<u>60</u>
Total professional expenses (other than automobile)	\$345

I received a salary of \$30,000 and an automobile expense allowance of \$2,500 from my church, and earned \$2,000 in fees from weddings, baptisms, etc. Therefore, 5.8% [\$2,000 in fees from weddings and baptisms divided by \$34,500 (total of \$30,000 church salary, \$2,500 expense allowance from church and \$2,000 in fees from weddings and baptisms)], or \$20 less 22%, or \$16, is attributable to Schedule C (Form 1040) income. The balance of \$325 less 22%, or \$253 is reported on Form 2106, Line 4.

STATEMENT 3— INCOME COMPUTED FOR SELF-EMPLOYMENT TAX—Schedule SE (Form 1040), Line 2

	Example	Your Case
1. Salary from New World Church	\$ 30,000	\$ _____
2. Fees for ministerial service	2,000	\$ _____
3. Automobile expense allowance	2,500	\$ _____
4. Parsonage allowance	10,000	\$ _____
5. Total [add lines 1, 2, 3 and 4]	\$ 44,500	\$ _____
6. Total automobile expense (See Statement 1, disregard <i>Deason</i> allocation rules)	\$ 5,076	\$ _____
7. Total professional expenses other than automobile (See Statement 2, disregard <i>Deason</i> allocation rules)	\$ 345	\$ _____
8. Total professional expenses [add lines 6 and 7]	\$ 5,421	\$ _____
9. Net earnings from self-employment [subtract line 8 from line 5—enter on Schedule SE, line 2]	\$ 39,079	\$ _____

STATEMENT 4— EXPENSE ALLOCATION STATEMENT

1. Taxable Ministerial Income		
Church salary (See Form W-2)		\$30,000
Wedding and baptism fees		2,000
Auto expense allowance		2,500
2. Tax-Free Ministerial Income		
Church-provided parsonage allowance		\$10,000
3. Ministerial Expenses		
A. Attributable to Schedule C		
Automobile expenses @ 4%		\$ 180
See Statement 1		
Automobile depreciation @ 4%		120
See Statement 1		
Parking & tolls		55
See Statement 1		
Other professional expenses		20
Total		\$ 375

B. Attributable to Form 2106 and Schedule A	
Automobile expenses @ 60%	\$ 2,701
See Statement 1	
Automobile depreciation @ 60%	1,800
See Statement 1	
Parking & tolls	220
See Statement 1	
Other professional expenses	<u>325</u>
Total	\$ 5,046

4. Calculation

A. Non-deductible percentage:

$$\frac{\text{tax-free ministerial income}/\$10,000}{\text{taxable and tax-free ministerial income}/\$44,500} = 22\%$$

B. Non-deductible Schedule C expenses:

$$22\% \times \$375 = \$83$$

C. Non-deductible Schedule A expenses:

$$22\% \times \$5,046 = \$1,110$$

5. All other deductions that I am claiming on my 2012 income tax return are not allocable to my tax-free income.

IMPORTANT: In all cases, check with your adviser on how all the rules regarding federal income tax apply to you. Also check with your adviser concerning state and local income taxes.

Other IRS publications mentioned in the text provide details on topics beyond the scope of this booklet. If applicable, order them from the IRS as early as possible to allow for delivery time. The 2012 Form 1040 instructions tell how to order additional IRS forms and publications. IRS publications, forms and instructions are also available on the IRS website at www.irs.gov.

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