Ministers Audit Techniques Guide

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Introduction: Overview of Issues

Under the Internal Revenue Code of 1986, as amended, (hereinafter referred to as 'IRC'), ministers are accorded some unique tax benefits for income, social security and Medicare taxes, which present several potential examination issues on ministers' tax returns in addition to income and expenses issues found in most examinations.

As follows is a brief description of the topics which will be discussed in further detail in this guide:

Although a minister is considered an employee under the common law rules, payments for services as a minister are considered income from self employment pursuant to IRC §§ 1402(c) and 3121(b)(8). A minister, unless exempt, pays social security and Medicare taxes under the Self-Employment Contributions Act (SECA) and is not subject to Federal Insurance Compensation Act (FICA) taxes or income tax withholding.

Payment for services as a minister, unless statutorily exempt, is subject to income tax, therefore the minister should make estimated tax payments to avoid potential penalties for not paying enough tax as the minister earns the income. If the employer and employee agree, an election can be made to have income taxes withheld. IRC § 3402(p)(3). Even though a minister may receive a Form 1099-MISC for the performance of services, he or she may be a common law employee and should in fact be receiving a Form W-2.

The determination of whether a minister is an employee or an independent contractor follows the same rules as any other industry determination. The challenge with a minister is the same as with any professional. The control test must be applied only after taking into account the nature of the work to be performed.

How a minister is classified for income tax purposes effects how they treat their expenses. A minister that is a common law employee must claim their trade or business expenses incurred while working as an employee as an itemized deduction on Form 1040 Schedule A, which is subject to the 2% -of-adjusted-gross-income (AGI) limitation and alternative minimum tax.

A minister is frequently provided a parsonage or is paid a housing allowance, which is exempt from income tax under IRC § 107. The "allowable" allowance is subject to self employment tax under SECA and IRC § 1402(a)(8). The "allowable" allowance is computed subject to limitations imposed by law as to the amount and the required designation by the employing church which is discussed in detail under the section on the parsonage allowance. Please be aware of the special rules for retired ministers. See 42 U.S.C. § 411(a)(7).

Because of the exemption from income tax for the "allowable" parsonage or housing allowance, the operation of IRC § 265 requires business expenses to be allocated between taxable and non taxable income. Other business expenses discussed in this guide are common to all other professionals.

Some other issues of ministers you may see in a smaller number of cases are:

- The earnings for qualified services a member of an exempt religious order, who has taken a vow of poverty, performs as an "agent" of their church or its agencies, may be exempt from income tax and self employment tax.
- Gifts given to a minister, other than retired ministers, may actually be compensation for services, hence includible in gross income under IRC § 61.

To summarize the topics unique to ministers are:

- Income Issue: Parsonage/Housing Allowance
- Income Issue: Gift or Compensation
- Income/SE Issue: Members of Religious Orders and Vow of Poverty
- SE Issue: Exemption
- SE Issue: Computing SE Income
- Employee or Independent Contractor
- Business Expenses: Operation of Section 265

Please refer to the table of contents for the location of each issue.

Who Qualifies For Special Tax Treatment As A Minister

To qualify for the special tax provisions available to ministers, an individual must be a "minister" and must perform services "in the exercise of his ministry." Treas. Reg. § 1.107-1(a) incorporates the rules of Treas. Reg. § 1.1402(c)-5 in determining whether the individual is performing the duties of a "minister of the gospel."

Treas. Reg. § 1.1402(c)-5 requires that an individual be a "duly ordained, commissioned, or licensed minister of a church." The Tax Court has interpreted this phrase to be disjunctive, finding the purpose is not to limit benefits to the ordained, but is to prevent self appointed ministers from benefiting. *Salkov v. Commissioner*, 46 T.C. 190, 197 (1966). The Tax Court in *Salkov* held that a Jewish cantor was a minister eligible for the IRC § 107 housing allowance. Id. at 198-99. It concluded that the petitioner qualified because he was commissioned by, and was a duly qualified member of the Cantors Assembly of America, which functions as the official cantorial body for the Conservative branch of the Jewish religion in America, and because he was selected by a representative Conservative congregation to perform the functions of cantor. Id. at 197.

Treas. Reg. § 1.1402(c)-5(b)(2) provides that service performed by a minister in the exercise of the ministry includes:

a. Ministration of sacerdotal functions;
b. Conduct of religious worship;
c. Control, conduct, and maintenance of religious organizations (including the religious boards, societies, and other integral agencies of such organizations), under the authority of a religious body constituting a church or denomination.

Treas. Reg. § 1.1402(c)-5(b)(2) also provides that whether service performed by a minister constitutes conduct of religious worship or ministration of sacerdotal functions depends on the tenets and practices of the particular religious body constituting the church or denomination.

Treas. Reg. § 1.107-1(a) also provides examples of specific services considered duties of a minister, including:

a. Performance of sacerdotal functions;
b. Conduct of religious worship;
c. Administration and maintenance of religious organizations and their integral agencies;
d. Performance of teaching and administrative duties at theological seminaries.

The duties performed by the individual are also important to the initial determination whether he or she is a duly ordained, commissioned, or licensed minister. Because religious disciplines vary in their formal procedures for these designations, whether an individual is "duly ordained, commissioned, or licensed" depends on these facts and circumstances.

a. In *Salkov v. Commissioner*, 46 T.C. 190, 197 (1966), and *Silverman v. Commissioner*, 57 T.C. 727, 732 (1972), the Tax Court, in holding that a cantor of the Jewish faith was a duly ordained, commissioned, or licensed minister, looked, in each case, to the systematic manner the cantor was called to his ministry and the ecclesiastical functions he carried out in concluding that he was a minister within the meaning of IRC § 107.
b. In Rev. Rul. 78-301, 1978-2 C.B. 103, the IRS followed the Tax Court decisions in *Salkov* and *Silverman* and held that a Jewish cantor who is not ordained but has a bona fide commission and is employed by a congregation on a full-time basis to perform substantially all the religious worship, sacerdotal, training, and educational functions of the Jewish denomination's religious tenets and practices is a minister of the gospel within the meaning of IRC § 107. Revenue Ruling 78-301 revoked and modified prior revenue rulings to the extent that they required that an individual must be invested with the status and authority of an ordained minister fully qualified to exercise all of the ecclesiastical duties of a church denomination to be considered ministers under IRC §§ 107 and 1402.
c. In *Knight v. Commissioner*, 92 T.C. 199, 205 (1989), the Tax Court considered whether a licentiate of the Cumberland Presbyterian Church (a status that was less than full ordination), who had not filed a timely exemption from self-employment tax, was a duly ordained, commissioned, or licensed minister in the exercise of required duties who was thus liable for self-employment tax. The petitioner argued that he was not formally ordained as a minister and could not administer church sacraments or participate in church government. Thus, he could not be a minister subject to IRC § 1402(c). The court rejected this view, and looked at all the facts. In concluding that he was a licensed minister, it cited the facts that he was licensed by the church, he conducted worship services, and he was considered by the church to be a spiritual leader. The court also noted the petitioner preached, performed funerals, visited the sick, and ministered to the needy within the context of his duties for the church.
d. In contrast, the Tax Court held in *Lawrence v. Commissioner*, 50 T.C. 494, 499-500 (1968), that a “minister of education” in a Baptist church was not a “duly ordained, commissioned, or licensed” minister for purposes of IRC § 107. The petitioner held a Master's Degree in Religious Education from a Baptist Theological Seminary, but was not ordained. Although his church “commissioned” him after he assumed the position, the court interpreted the commissioning to be for tax purposes, as it did not result in any change in duties. Most significant, however, was the court's analysis of petitioner's duties or rather, the duties he did not perform. He did not officiate at Baptisms or the Lord's Supper, two Ordinances that closely resembled sacraments, nor did he preside over or preach at worship services. The court concluded that the evidence did not establish that the prescribed duties of a minister of education were equivalent to the duties of a Baptist minister.

Income Issues:

Audit techniques required are in IRM 4.10.4 and summarized on the Examiner's Mandatory Lead Sheet Work Paper #400 &quotMinimum Income Probe Lead Sheet&quot. The following provides information specific to this industry to assist in performing the various income analyses. (Note: Under IRC § 7602(e), the Service may not use indirect methods to reconstruct income unless it &quothas a reasonable indication that there is a likelihood of…unreported income.&quot See IRM 4.10.4 for the techniques that should be employed to determine whether there is a likelihood of unreported income.)

Income To Be Reported

A minister usually receives compensation from the employing church or church agency for personal services but may also receive bonuses or "special gifts." In addition, the minister may receive fees paid directly from parishioners for performing weddings, funerals, baptisms, masses and other contributions received for services. Under Treas. Reg. § 1.61-2(a)(1), all are includible in gross income, along with expense allowances for travel, transportation, or other business expenses received under a nonaccountable plan. If the church or church agency pays amounts in addition to salary to cover the minister's self-employment tax or income tax, these are also includible in gross income. Rev. Rul. 68-507, 1968-2 C.B. 485.

Fees for weddings, funerals, etc., given directly to the church rather than to the minister are not considered compensation to the minister. Contributions made to or for the support of individual missionaries to further the objectives of their missions are includible in gross income. Rev. Rul. 68-67, 1968-1 C.B. 38.

A minister's compensation package often includes a designated parsonage allowance, that is, the use of church owned housing, a housing allowance, or a rental allowance. This is treated differently for income tax and self-employment tax purposes, and is discussed in detail below in the section on Parsonage allowance.

Gift or Compensation for Services

You need to look at the facts and circumstances of each transfer. Some transfers are obvious gifts while others might actually be compensation for services.

IRC § 61(a) provides that gross income includes all income from whatever source derived unless specifically excluded by the Code. Compensation for services in whatever form received is definitely included in income. IRC § 102(a) excluded from gross income the value of property acquired by gift. Whether an item is a gift is a factual question and the taxpayer bears the burden of proof. The most significant fact is the intention of the taxpayer. The Supreme Court provided guidance in this area in two key cases which were summarized in *Charles E Banks and Rose M Banks v. Commissioner*, T.C. Memo. 1991-641 as follows:

"In *Commissioner v. Duberstein*, 363 U.S. 278, 4 L. Ed. 2d 1218, 80 S. Ct. 1190 (1960); at 285-286, the Supreme Court stated the governing principles in this area: the mere absence of a legal or moral obligation to make such a payment does not establish that it is a gift. And, importantly, if the payment proceeds primarily from "the constraining force of any moral or legal duty," or from "the incentive of anticipated benefit" of an economic nature, it is not a gift. And, conversely, "where the payment is in return for services rendered, it is irrelevant that the donor derives no economic benefit from it." A gift in the statutory sense, on the other hand, proceeds from a "detached and disinterested generosity," "out of affection, respect, admiration, charity or like impulses." And in this regard, the most critical consideration, is the transferor's "intention." "What controls is the intention with which payment, however voluntary, has been made."

The intention of the transferor is a question of fact to be determined by "the application of the fact-finding tribunal's experience with the mainsprings of human conduct to the totality of the facts of each case." *Commissioner v. Duberstein*, supra at 289. We must make an objective inquiry into the circumstances surrounding the transfer rather than relying on the transferor's subjective characterization of the transfer. *Commissioner v. Duberstein*,supra at 286; *Bogardus v. Commissioner*, 302 U.S. 34, 43 (1937).

In the *Charles E Banks and Rose M Banks v. Commissioner*, T.C. Memo. 1991-641, case a structured and organized transfer of cash from members of the church took place on four special days of each year. Prior to making the transfers, members of the Church met amongst themselves to discuss the transfers. The amounts of the transfers were significant. Several members testified in Court. Their testimony indicated "the primary reason for the transfers at issue was not detached and disinterested generosity, but rather, the church members' desire to reward petitioner for her services as a pastor and their desire that she remain in that capacity." The Court ruled the transfers were compensation for services hence included in gross income.

In *Lloyd L. Goodwin v. U.S.*, 870 F. Supp 265, 269 (S.D. Iowa 1994), aff'd 67 F. 3d 149 (8th Cir. 1995), a similar situation existed. Cash was collected from the congregation as a whole on established special occasion days. The collection was done by the congregation leaders in a structured manner. The fact was revealed that the congregation knew that it probably could not retain the pastor's service at his relatively low salary without the additional payments. The Court ruled the funds as compensation for services, not gifts.

There are numerous court cases that ruled the organized authorization of funds to be paid to a retired minister at or near the time of retirement were gifts and not compensation for past services. Rev. Rul. 55-422, 1955-1 C.B. 14, discusses the fact pattern of those cases which would render the payments as gifts and not compensation.

The Tax Court had ruled in *Potito v. Commissioner*, T.C. Memo 1975-187, aff'd 534 F2d 49 (5th Cir. 1976), that the value of a boat, motor and boat trailer was included in gross income as payment for services. The taxpayer, a minister, had not produced any evidence regarding the intention of the donors that the transfer of the property was out of "detached and disinterested generosity".

The Parsonage Allowance

IRC § 107 provides an exclusion from gross income for a “parsonage allowance,” housing specifically provided as part of the compensation for the services performed as a minister of the gospel. This includes the rental value of a home furnished to him or her as part of compensation or a housing allowance, to the extent that the payment is used to rent or provide a home and to the extent such allowance does not exceed the fair rental value (FRV) of the home, including furnishings and appurtenances such as a garage and the cost of utilities. IRC § 107(2). The term “parsonage allowance” includes church provided parsonages, rental allowances with which the minister may rent a home and housing allowances with which the minister may purchase a home. A minister can receive a parsonage allowance for only one home.

A housing allowance must be included in the minister's gross income in the taxable year in which it is received to the extent that such allowance is not used by him during the taxable year to rent or otherwise provide a home or exceeds the FRV of the home including furnishings and appurtenances such as a garage and the cost of utilities. Treas. Reg. § 1.107-1(c) and IRC § 107(2). The value of the "allowed" parsonage allowance is not included in computing the minister's income subject to income tax and should not be included in W-2 wages. However, the parsonage allowance is subject to self-employment tax along with other earnings. IRC § 1402(a)(8). (See special rules for retired ministers below). If a church-owned parsonage is provided to the minister, instead of a housing allowance, the fair rental value of the housing must be determined. Determining the fair rental value is a question of all facts and circumstances based on the local market, but the church and minister have often already agreed on a figure and can provide documentary evidence.

The exclusion under IRC § 107 only applies if the employing church designates the amount of the parsonage allowance in advance of the tax year. The designation may appear in the minister's employment contract, the church minutes, the church budget, or any other document indicating official action. Treas. Reg. § 1.107-1(b).

An additional requirement for purposes of IRC § 107 is that the fair rental value of the parsonage or parsonage allowance is not more than reasonable pay for the ministerial services performed.

The amount of the parsonage allowance excludible from gross income is the LEAST of:

1. The amount actually used to provide a home,
2. The amount officially designated as a housing allowance, or
3. The fair rental value (FRV) of the home, including furnishings and appurtenances such as a garage plus the cost of utilities. IRC § 107(2).

The following examples illustrate the application of these rules. For simplification, assume that mortgage payments include property taxes and insurance.

Example 1

A is an ordained minister. She receives an annual salary of $36,000 and use of a parsonage which has a FRV of $800 a month, including utilities. She has an accountable plan for other business expenses such as travel. A's gross income for arriving at taxable income for Federal income tax purposes is $36,000, but for self-employment tax purposes it is $45,600 ($36,000 salary + $9,600 FRV of parsonage).

Example 2

B, an ordained minister, is vice president of academic affairs at Holy Bible Seminary. His compensation package includes a salary of $80,000 per year and a $30,000 housing allowance. His housing costs for the year included mortgage payments of $15,000, utilities of $3,000, and $3,600 for home maintenance and new furniture. The fair rental value of the home, as furnished, is $18,000 per year.

The three amounts for comparison are:

a. Actual expenses of $21,600 ($15,000 mortgage payments + $3,000 utilities + $3,600 other costs)
b. Designated housing allowance of $30,000
c. FRV plus utilities of $21,000 ($18,000 + $3,000 utilities)

B may exclude $21,000 from gross income but must include in income the other $9,000 of the housing allowance. The entire $30,000 will be considered in arriving at net self-employment income.

Example 3

C is an ordained minister and has been in his church's employ for the last 20 years. His salary is $40,000 and his designated parsonage allowance is $15,000. C's mortgage was paid off last year. During the tax year he spent $2,000 on utilities, and $3,000 on real estate taxes and insurance. The FRV of his home, as furnished, is $750 a month.

The three amounts for comparison are:

a. Actual housing costs of $5,000 ($2,000 utilities + $3,000 taxes and insurance)
b. Designated housing allowance of $15,000
c. FRV + utilities of $11,000 ($9,000 FRV + $2,000 utilities)

C may only exclude his actual expenses of $5,000 for Federal income tax purposes. He may not exclude the FRV of his home even though he has paid for it in previous years. *Swaggart v. Commissioner*, T.C. Memo. 1984-409. $15,000 will be included in the computation of net self-employment income.

Example 4

Assume the same facts as in Example 3, except that C takes out a home equity loan and uses the proceeds to pay for his daughter's college tuition. The payments are $300 per month. Even though he has a loan secured by his home, the money was not used to “provide a home” and can't be used to compute the excludible portion of the parsonage allowance. The results are the same as for Example 3. The interest on the home equity loan may be deducted as an itemized deduction subject to the limitations, if any, of IRC § 163.

Example 5

D is an ordained minister who received $40,000 in salary plus a designated housing allowance of $12,000. He spent $12,000 on mortgage payments, $2,400 on utilities, and $2,000 on new furniture. The FRV of his home as furnished is $16,000. D's exclusion is limited to $12,000 even though his actual cost ($16,400) and FRV and utilities ($18,400) are more. He may not deduct his housing costs in excess of the designated allowance.

Example 6

E's designated housing allowance is $20,000. She and her husband live in one half of a duplex which they own. The other half is rented. Mortgage payments for the duplex are $1,500 per month. E's utilities run $1,800 per year, and her tenant pays his own from a separate meter. During the year E replaced carpeting throughout the structure at a cost of $6,500 and did minor repairs of $500. E must allocate her mortgage costs, carpeting, and repairs between her own unit and the rental unit in determining the amount of the excludible parsonage allowance. Amounts allocable to the rented portion for mortgage interest, taxes, etc., would be reported on Schedule E as usual. Her actual costs to provide a home were $14,300 ($9,000 mortgage payments, $1,800 utilities, and $3,500 for half the carpeting and repairs). The FRV for her unit is the same as the rent she charges for the other half, which is $750 a month, and she estimates that her furnishings add another $150 per month to the FRV. Her FRV plus utilities is $12,600 ($10,800 FRV + $1,800 utilities). E may exclude $12,600 for Federal income tax purposes.

Pursuant to IRC § 265(a)(6) and Rev. Rul. 87-32, 1987-1 C.B. 131 even though a minister's home mortgage interest and real estate taxes have been paid with money excluded from income as a housing allowance, he or she may still claim itemized deductions for these items. The sale of the residence is treated the same as that of other taxpayers, even though it may have been completely purchased with funds excluded under IRC § 107.

Because expenses attributable to earned income which is exempt from tax are not ordinarily deductible, a minister's business expenses related to his or her earnings must be allocated and become partially nondeductible pursuant to IRC § 265 This is discussed in detail in the section on Business Expenses.

Exhibit 1 provides a worksheet for the computation of the amount that is excludible as a parsonage allowance

Retired Ministers

A retired minister may receive part of his or her pension benefits as a designated parsonage allowance based on past services. Trustees of a minister’s retirement plan may designate a portion of each pension distribution as a parsonage allowance excludible under IRC § 107. (Rev. Rul. 63-156, 1963-2 C.B. 79, and Rev. Rul. 75-22, 1975-1, C.B. 49) The “least of” rules should be applied to determine the amount excludible from gross income.

The retired minister may exclude from his/her net earnings from self-employment the rental value of the parsonage or the parsonage allowance received after retirement. The entire amount of parsonage allowance received is excludible from net earnings from self employment, even if a portion of it is not excludible for income tax purposes. In addition, the retired minister may exclude from net earnings from self-employment any retirement benefits received from a church plan. Rev. Rul. 58-359, 1958-2 C.B. 422.

Members of Religious Orders and Vow of Poverty

If you are a member of an exempt religious order who has taken a vow of poverty, you are exempt from income tax and self employment tax on your earnings for qualified services you

perform as an "agent" of your church or its agencies. The religious order must be an organization described in IRC § 170(c)(2). Rev. Rul. 76-323, 1976-2 C.B. 18, stated "Amounts received by members of an exempt religious order, not acting as agents of the order, for work performed outside the religious community and paid over, in full or part, to the order at its direction, are includible in the gross incomes of the members and are wages subject to the FICA and income tax withholding. However, the individual members are entitled to charitable contribution deductions under IRC § 170 for amounts donated to the order." The ruling stated in reference to performance as an "agent" that "ordinarily a member is performing services as the agent of the religious order only if the order is engaged in the performance of the services as a principal. Ordinarily an order is not engaged in the performance of services as a principal where the legal relationship of employer and employee exists between the member and the third party with respect to the performance of such services."

The United States Court of Appeals for the Federal Circuit in *Reverend Gerald P Fogarty, S.J. v the United States*, 780 F.2d 1005, 1012 (Fed. Cir. 1986), provided a flexible facts and circumstance test for determining if the member is acting as an agent for the order or in their individual capacity. The Court stated the relevant facts to consider are:

"The presence of unique facts in each case will inevitably lead the court to place more emphasis on one or more factors and less on others. The relationship between the order and the member gives rise to a number of factors. Relevant considerations there will include the degree of control exercised by the order over the member as well as the ownership rights between member and order, *Kelley v. Commissioner*, 62 T.C. 131 (1974), the purposes or mission of the order, and the type of work performed by the member vis-a-vis those purposes or mission, ...

Other factors will include the dealings between the member and the third-party employer (circumstances surrounding job inquiries and interviews, and control or supervision exercised by the employer), and dealings between the employer and order." Id. The outcome of the case was that the Appeals Court ruled that the income earned by Reverend Fogarty, a member of the Society of Jesus religious order, as a professor at the University of Virginia, Department of Religious Studies, was taxable to him. He was not acting as an agent of the order.

The U.S. Court of Appeals for the Seventh Circuit, in *Francince Schuster v. Commissioner*, 800 F.2d 672, 678-79 (7th Cir. 1986), ruled the earned income of a nun, a member of a religious order who worked as a nurse in a clinic in the employment of the National Health Services Corps, was taxable to her as an individual and not as an agent of the order. The Court applied the six factors above to the facts of the case in making its determination.

Likewise the U.S. States Court of Appeals for the Federal Circuit in *Jerome G. Kircher, O.F.M. and Valens Waldschmidt, O.F.M. v. The United States*, 872 F.2d 1014, 1018-20 (Fed. Cir. 1989), applied the six factors above to the facts of the case in making its determination that the taxpayers, priests who were members of a religious order who worked as chaplains in a leper hospital and a mental hospital, earned income was taxable to them and not as an agent for the order.

In Rev. Rul. 77-290, 1977-2 C.B. 26, the earned income of an attorney who was a member of a religious order who has taken a vow of poverty, was taxable to him and not the order even though the income was directly deposited in the order's bank account. It also determined that a secretary, who was also a member of the same order, who worked on the direction of the order at the business office of the church that supervises the order, was acting as an agent for the order and the earned income was not taxable to the secretary.

In Rev. Rul. 79-132, 1979-1 C.B. 62, the earned income a military chaplain who was a member of a religious order who has taken a vow of poverty, was taxable to him and not the order even though he turned over the remuneration to the order.

Business Expenses

Employee business expenses:

Ministers who are employees may deduct the following expenses on Schedule A as miscellaneous expenses subject to the 2 percent floor:

1. Unreimbursed employee business expenses (that is, expenses for which the minister is not reimbursed under an IRC § 62(a)(2)(A) accountable plan) and
2. "Nonaccountable" reimbursed business expenses

The limitations on deductibility of employee business expenses may be avoided if the church adopts an "accountable plan." An accountable plan is an arrangement that meets all the requirements of Treas. Reg. § 1.62-2, that is, business connection (deductibility under IRC § 162), substantiation within a reasonable period of time, and return of amounts in excess of substantiated expenses within a reasonable period of time. The regulations provide two safe harbor methods under the reasonable period of time requirement.

If an arrangement meets all the requirements for an accountable plan, the amounts paid under the arrangement are excluded from the minister's gross income and are not required to be reported on his or her Form W-2. If, however, the arrangement does not meet one or more of the requirements, all payments under the arrangement are included in the minister's gross income and are reported as wages on the Form W-2, even though no withholding at the source is required.

If the church has a salary reduction arrangement which "reimburses" the minister for employee business expenses by reducing his or her salary, the arrangement will be treated as a nonaccountable plan because it does not meet the reimbursement requirement of Treas. Reg. § 1.62-2(d). See Treas. Reg. § 1.62-2(j), Example 2. This is the result regardless of whether a specific portion of the minister's compensation is designated for employee expenses or whether the portion of the compensation to be treated as the expense allowance varies from pay period to pay period depending on the minister's expenses. As long as the minister is entitled to receive the full amount of annual compensation, regardless of whether or not any employee business expenses are incurred during the taxable year, the arrangement does not meet the reimbursement requirement.

A minister may deduct ordinary and necessary business expenses. However, if a minister's compensation includes a parsonage or housing allowance which is exempt from income under IRC § 107, the prorated portion of the expenses allocable to the tax exempt income is not deductible, per IRC § 265, *Deason v. Commissioner*, 41 T.C. 465 (1964), *Dalan v. Commissioner*, T.C. Memo. 1988-106, and *McFarland v. Commissioner* , T.C. Memo. 1992-440.

Before this allocation is made, the total amount of business expenses must be determined. Ministers are subject to the same substantiation requirements as other taxpayers.

Typical business expenses for ministers include the following:

Transportation

Many ministers receive a non-accountable auto allowance, which is includible in income. Transportation costs which may be deductible include trips for hospital and nursing home visits, attendance at conferences, or other church business. However trips between the minister's personal residence and the church are considered nondeductible commuting expenses. *Hamblen v. Commissioner* , 78 T.C. 53 (1982).

Travel

A minister may incur travel away from home occasionally for special conferences or other duties out of the area. The same rules regarding the deductibility of meals, entertainment, and lodging apply as for other taxpayers.

Business Use of Home

In order for a home to qualify as a principal place of business under IRC § 280A(c)(1)(A), the functions performed and the time spent at each location where the trade or business is conducted are the primary considerations and must be compared to determine the relative importance of each. *Sohman v. Commissioner* , 506 U.S. 168, 177113 S. Ct. 701, 707 (1993)

The church often provides an office on the premises for the minister, so the necessity of an office in the home should be questioned closely. Furthermore, since the total cost to provide the home is used in computing the exempt housing allowance, home office deductions for taxes, insurance, mortgage interest, etc. would be duplications. (Note that itemized deductions are allowable for mortgage interest and taxes. IRC § 265(a)(6), and Rev. Rul. 87-32, 1987-1 C.B. 131).

Supplies, Publications

Ministers may incur some out-of-pocket costs for office supplies and job-related books and periodicals for which they are not reimbursed. This may be more common in small churches. Increasingly, ministers are using computers for writing sermons, correspondence, and record-keeping. Personal use should be determined.

Dues versus Contributions

Ministers often pay a small annual renewal fee to maintain their credentials, which constitutes a deductible expense. However, ministers' contributions to the church are not deductible as business expenses. They may argue that they are expected to donate generously to the church as part of their employment. This is not sufficient to convert charitable contributions to business expenses. The distinction is that charitable contributions are given to a qualifying organization (such as a church) for the furtherance of its charitable activities. Dues, on the other hand, are usually paid with the expectation that a financial benefit will result to the individual, as in a realtor's multi-list dues or an electrician's union dues. A minister's salary and benefits are not likely to directly depend on the donations made to the church. They may still be deducted as contributions on Schedule A but may not be used as a business expense to reduce self-employment tax.

Other Expenses

A minister may incur expenses for special vestments that would qualify as “uniforms.” Their reasonable cost and care would be deductible. Ordinary street clothes or suits for church are not deductible. Unreimbursed long distance phone calls made for business purposes are deductible.

Determination of Deductible Expenses Where Some Income is Tax Exempt

Once total business expenses have been determined, the nondeductible portion can be computed using the following formula. Exhibit 2 provides a computation worksheet.

Step 1
Divide the allowable housing allowance or fair rental value (FRV) of parsonage by the total ministry income to get the nontaxable income percentage

Total ministry income includes salary, fees, expense allowances under nonaccountable plans plus the allowable housing allowance or FRV of the parsonage.

Step 2
Multiply the total business expenses times the nontaxable income percentage from step 1 to get the expenses allocable to nontaxable income which is not deductible.

These examples illustrate the computation:

Example 7

F receives a salary of $36,000, an exempt housing allowance of $18,000 and an auto expense allowance of $6,000 for his services as an ordained minister. F incurs business expenses as follows: auto, $7,150; vestments, $350; dues, $120; publications and supplies, $300; totaling $7,920. His nondeductible expenses are computed as follows:

Step 1: $18,000 housing allowance/Nontaxable Income divided by $60,000 total ministry income ($36,000 salary, $18,000 housing and $6,000 car allowance) equals 30% nontaxable income percentage

Step 2: Total business expenses of $7,920 times 30%, the non taxable income percentage equals $2,376 the nondeductible expenses

Total expenses $7,920 less the nondeductible expenses of $2,376 equals the deductible expenses of $5,544.

F's deductible expenses are reported as Schedule A miscellaneous deductions since his church considers him an employee and issues a W-2. These expenses, along with any other miscellaneous deductions are subject to a further reduction of 2 percent of his adjusted gross income.

Example 8

G received a salary of $12,000, a housing allowance of $9,000, and earned $3,000 for various speaking engagements, weddings, funerals, etc., all related to her ministry. She reports her salary as "wages" on page 1 of her Form 1040 and her fees on Schedule C. Because her actual housing costs ($6,000) were less than her housing allowance and the FRV of her home for the year, she must include $3,000 of her housing allowance as "other income" for income tax purposes. Her total business expenses are $4,500. The computation of deductible expenses is shown below:

Step 1: $6,000 (housing allowance actually exempt from income tax) divided by $24,000 total ministry income ($12,000 salary + $9,000 housing + $3,000 fees) equals 25% Nontaxable income percentage.

Step 2: Total expenses $4,500 times 25% non taxable income percentage equals
$1,125 nondeductible expenses
Total expenses $4,500 less $1,125 equals $3,375 deductible expenses.

Note that this $3375 would further be allocable between Schedule A miscellaneous deductions (related to salary) and Schedule C (related to other fees).

However, as you will see in the next section, this allocation will not change G's self-employment tax, since all ministry income and ministry expenses are included in the computation, regardless of where they are reported on the return for income tax purposes. The allocation between Schedule A and Schedule C will also affect any AGI-dependent computations.

Charitable Deduction:

Occasionally a minister may receive no compensation for services. In this case, any actual out-of-pocket costs are deductible as charitable contributions. Revenue Ruling 69-645, 1969-2 C.B. 37; *Gibson v. Commissioner* , T.C. Memo. 1981-668 (note: IRS non acquiescence on part with respect to food contributions valuation- AOD 1982-083, 1982 WL 212507 (1982))

Self-Employment Tax: Exemption

Ministerial services are covered by social security and Medicare provisions under the Self Employment Contributions Act (SECA). Earnings for these services are subject to self-employment tax unless one of the following applies under IRC § 1402(e):

1. The minister is a member of a religious order whose members have taken a vow of poverty, or
2. The minister has requested, and the IRS has approved, an exemption from self-employment tax, or
3. The minister is subject only to the social security laws of a foreign country under the provisions of a social security agreement between the United States and that country (see Publication 54 for more information)

To claim exemption from self-employment tax, a minister must:

1. Be an ordained, commissioned, or licensed minister of a church or denomination. Treas. Reg.§ 1.1402(c)-5
2. File Form 4361. This is an application for exemption from self-employment tax for use by ministers, members of religious orders, and Christian Science practitioners. Treas. Reg. § 1.1402(e)-2A(a)(1).
3. Be conscientiously opposed to public insurance (Medicare/Medicaid and Social Security benefits) because of religious beliefs. Treas. Reg. § 1.402(e)-2A(a)(2).
4. File for exemption for reasons other than economic
5. Notify the church or order that he or she is opposed to public insurance. Treas. Reg. § 1.402(e)-5A(b).
6. Establish that the organization that ordained, licensed, or commissioned the minister is a tax-exempt religious organization.
7. Establish that the organization is a church or a convention or association of churches.

Form 4361 must be filed by the due date of the Form 1040 (including extensions) for the second tax year in which at least $400 in self-employment ministerial earnings was received. The 2 years do not have to be consecutive.

An approved Form 4361 is effective for all tax years after 1967 for which a minister received $400 or more of self-employed income for ministerial services.

The exemption from self-employment tax applies only to services performed as a minister. The exemption does not apply to other self-employment income.

To determine if a minister is exempt from self-employment tax, request that he or she furnish a copy of the approved Form 4361 if it is not attached to the return. If the taxpayer cannot provide a copy, order a transcript for the year under examination. The ADP and IDRS Information handbook shows where the ministers' self-employment exemption codes are located on the transcripts and what the codes mean. Transcripts will not show exemption status prior to 1988.

If the transcript does not show a MIN SE indicator and the taxpayer still claims that he or she is exempt from self-employment tax, the Taxpayer Relations Branch at the Service Center where the Form 4361 was filed can research this information and provide the taxpayer with a copy. The Social Security Administration in Baltimore also can provide the information on exemption for an individual.

Example 9

H has ministerial earnings of $400 in 2007 and $1800 in 2008. He has until April 15, 2009 (if no extension has been filed) to file Form 4361. If the approved Form 4361 is not received by the due date for the 2007 return, the self-employment tax for 2007 is still due by that date. If he later receives the approved 4361, he may amend his 2007 return.

Example 10

J earned $500 in 2006, $300 in 2007, and $6,000 in 2008 from her ministry. She has until April 15, 2009 (if no extension has been filed) to file Form 4361. If the approval of the exemption is not be received by April 15, 2007, J must pay the self-employment tax with her 2006 return, but may amend it after the exemption is approved. J may file a claim for refund (an amended tax return) within 3 years from the time the return was filed or within 2 years from the time the tax was paid, whichever is later.

Example 11

K, ordained in 2007, has $7,500 in net earnings as a minister in both 2007 and 2008. He files Form 4361 on March 5, 2009. If the exemption is granted, it is effective for 2007 and all following years.

Example 12

L, an ordained minister, has applied for and received exemption from self-employment tax for his services as a minister. In 2008 he has ministerial income of $12,000 and income from his shoe repair business, a sole proprietorship, of $9,000. He must compute self-employment tax on the $9,000.

Computing Self-Employment Tax

If an exemption from self-employment tax is not applied for, or is not granted, self-employment tax must be computed on ministerial earnings. To compute self-employment tax, allowable trade or business expenses are subtracted from gross ministerial earnings, then the appropriate rate is applied.

Include the following items in gross income for self-employment tax:

1. Salaries and fees for services, including offerings and honoraria received for marriages, funerals, baptisms, etc.. Include gifts which are considered income as discussed under the section on income.
2. Any housing allowance or utility allowances.
3. Fair Rental Value (FRV) of a parsonage, if provided, including the cost of utilities and furnishings provided.
4. Any amounts received for business expenses treated as paid under a nonaccountable plan, such as an auto allowance.
5. Income tax or self-employment tax obligation of the minister which is paid by the Church.

Example 13

M receives a salary from the church of $20,000. His parsonage/housing allowance is $12,000. The church withholds Federal income tax (by mutual agreement) and issues him a Form W-2. He has unreimbursed employee business expenses (before excluding nondeductible amounts attributable to his exempt income) of $5,200. His net earnings for self-employment tax are $26,800 ($20,000 + $12,000 - $5,200). Note that all of M's unreimbursed business expenses are deductible for self-employment tax purposes, although the portion attributable to the exempt housing allowance is not deductible for Federal income tax purposes. IRC § 265 regarding the allocation of business expenses related to exempt income relates to income tax computations but not self-employment tax computations.

Example 14

G, as shown in Example 8, computes her self-employment taxable income as follows: $12,000 salary plus $9,000 housing allowance plus $3,000 Schedule C income less ($4,500) total business expenses equals $19,500 self-employment income.

NOTE: IRS Publication 517, Social Security and Other Information for Members of the Clergy and Religious Workers is a very useful guide for taxpayers and as a quick reference.

Employee versus Independent Contractor

A minister can be a common law employee for income tax purposes even though the payments for services as a minister is statutorily considered income from self employment for social security and medical taxes and the minister can even apply to be exempt from social security tax.

The handling of business expenses for income tax purposes is determined by whether the minister is classified as an employee or an independent contractor. If an independent contractor then the business expenses are reported on the Schedule C. If an employee then the expenses are reportable subject to statutory limitations as an employee business expense itemized deduction. To be properly reported on Schedule C, a minister’s expense must come from a trade or business of his own, other than that of being an employee.

The fundamental question of employee vs. independent contractor status has received extensive statutory, regulatory, and judicial attention. The statute defines an employee as one who is such

"under the usual common law rules applicable in determining the employer-employee relationship. . . ." IRC § 3121(d)(2). See also Treas. Reg. § 31.3121(d)-1(c).

This subject is complex and dependent on the facts and circumstances in each case, which is why it is highly litigated. As follows is a brief discussion of the subject. Research should be conducted on litigation that has occurred in your appeals circuit to assist in making the status determination. The litigation has generally occurred where the minister claims independent contractor status and the Internal Revenue Service determines the minister was an employee.

The Internal Revenue Services looks at factors that fall within three categories, namely behavioral control, financial control and the relationships of the parties. Behavioral control deals with facts that substantiate the right to direct or control the detail and means by which a worker performs the required services. Financial control deals with facts of the economic aspects of the relationship of the parties and if the worker has the opportunity for the realization of profit or loss. Some factors are: significant investment, un-reimbursed expenses, making services available, and methods of payments. Relationship of the parties is important because it reflects the parties' intent concerning control.

The Courts consider various factors to determine an employment relationship between the parties. Relevant factors include:

1. The degree of control exercised by the principal 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 or loss;
4. Whether or not the principal has the right to discharge the individual;
5. Whether the work is part of the principal's regular business;
6. The permanency of the relationship; and
7. Relationship the parties believe they are creating.

No one factor dictates the outcome. Rather, we must look at all the facts and circumstances of each case. *Weber v. Commissioner*, 60 F.3rd 1104, 1110 (4th Cir. 1995)

In the *Weber* case, where the issue was whether a minister was an employee or independent contractor, the court stated:

"The "right-to-control" test is the crucial test to determine the nature of the working relationship…The degree of control is one of great importance, though not exclusive…Accordingly, we must examine not only the control exercised by the alleged employer, but also the degree to which an alleged employer may intervene to imposed control…In order for an employer to retain the requisite control over the details of an employee's work, the employer need not stand over the employee and direct every move made by that employee…Also, the degree of control necessary to find employee status varies according to the nature of the services provided…
The threshold level of control necessary to find employee status is generally lower when applied to professional services than when applied to nonprofessional services…In *James v. Commissioner* 25 T.C. 1296 (1956), this Court stated that "despite this absence of direct control over the manner in which

professional men (and women) shall conduct their professional activities, it cannot be doubted that many professional men (and women) are employees". Also in *Azad v. United States*, 388 F.2d 74 (8th Circuit, 1968), the Court of Appeals for the Eight Circuit said that "From the very nature of the services rendered by *** professionals, it would be wholly unrealistic to suggest that an employer should undertake the task of controlling the manner in which the professional conducts his activities" Generally a lower level of control applies to professional."

The absence of the need to control the manner in which the minister conducts his or her duties should not be confused with the absence of the right to control. The right to control contemplated by the common law as an incident of employment requires only such supervision as the nature of the work requires. *McGuire v. United States*, 349 F.2d 644, 646 (9th Circuit 1965).

Finally, section 530 of the Revenue Act of 1978 does not apply to the minister's status since they are statutorily exempt from FICA and are subject to SECA. The employer has no federal employment tax obligations. Section 530 terminates the business's, but not the worker's, employment tax liability.

Exhibit 1 JOB AID

Exclusion of Parsonage Allowance under Internal Revenue Code § 107

Home Owned Or Rented/ Housing Allowance Received

The exclusion is limited to the least of:

1. Amount designated as housing allowance

2. Amount actually used to provide a home which is composed of the following items:

- Rent
- House payments
- Furnishing
- Repairs
- Insurance, Taxes
- Utilities
- Other Expenses

3. Fair rental value of home, including furniture, utilities, garage

Amount excludible from income tax liability is the least of 1,2, or 3 above.

If Parsonage provided, you can deduct only the fair rental value

The entire designated housing allowance is subject to self-employment tax unless you have been approved for exemption or are retired.

Exhibit 2 Job Aid

Computation of Allowable Expenses When Tax-Exempt Income Is Received

Step 1 Enter amount of tax-exempt income (Housing allowance or fair rental value of parsonage provided)

Step 2 Total income from ministry computed by adding the following:

- Salary
- Fees
- Allowances
- Step 1 Amount

Step 2 Total of items above to derive total income from ministry

Step 3: Divide step 1 amount by total step 2 amount to obtain the non taxable income %

Step 4 Compute total business expenses substantiated by adding the following items

- Auto
- Travel
- M & E
- Other

Step 4 total of items above to derive total business expenses substantiated

Step 5 Multiply step 4 total by step 3 percentage to obtain nondeductible expenses allocable to tax exempt income

Step 6 Subtract step 5 amount from step 4 amount to obtain the deductible expenses for Federal Income tax purposes