

# Ministerial Tax Issues



GuideStone®

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## Introduction

This brochure explains special tax rules that apply to ministers and churches. Many of the questions and answers are related, so it's important to read the entire brochure.

We prepared this brochure to educate churches and ministers, but you should not rely on it for legal or tax advice. You'll find additional assistance on the IRS website, *IRS.gov*. For specific tax advice, consult an accountant or attorney who is familiar with ministers' tax issues.

For more information about some of the topics in this brochure, see our annual *Ministers' Tax Guide* on our website at [GuideStone.org/TaxGuide](https://www.GuideStone.org/TaxGuide).

## SECTION 1:

# Who is a “Minister for Tax Purposes”?

Ministers must know if they are Ministers for Tax Purposes before they can comply with federal tax laws. Churches must know if any of their employees are Ministers for Tax Purposes before they can comply with federal income tax reporting and withholding rules. Churches may think of a person as a minister, but the IRS may not consider the same person a “Minister for Tax Purposes” under its criteria.

These five questions will help determine if a person is a minister for federal tax purposes:

1. Is the person ordained, licensed or commissioned?
2. Does the person administer ordinances (baptism and the Lord’s Supper)?
3. Does the person conduct religious worship?
4. Does the person have management responsibilities in the church?
5. Is the person considered to be a religious leader by the church?

Generally, a Minister for Tax Purposes must be ordained, licensed or commissioned and answer “yes” to a majority of the other four questions. Throughout this guide, the term “minister” means a Minister for Tax Purposes unless otherwise indicated.

Ministers for Tax Purposes:

- Are eligible for minister’s housing allowance.
- Are self-employed for Social Security purposes.
- Are exempt from federal income tax withholding.
- Use the quarterly estimated tax procedure to pay their taxes unless they elect voluntary withholding on Form W-4 with their church.

These special rules apply only with respect to

services performed in the exercise of ministry.

*Example: Pastor J is a Minister for Tax Purposes. He is employed by a church, but as a bi-vocational minister, he also works a second job for a secular employer. The church can designate a housing allowance for him since his services for the church are performed in the exercise of ministry. However, the secular employer cannot designate any portion of Pastor J’s compensation as a housing allowance since that work is not service in the exercise of ministry.*

- Q.** Are there any general rules about who will pass these tests?
- A.** As a practical matter, most ordained ministers serving a church will answer “yes” to all the questions. Many licensed and commissioned ministers cannot meet all the criteria, but some can. Taxpayers must make their own decisions about whether they are Ministers for Tax Purposes. If they need help, they should consult a competent tax advisor with experience in ministerial tax issues.
- Q.** Should a church ordain, commission or license someone so the church can designate a housing allowance for that person?
- A.** A church should never ordain, commission or license anyone in an effort to make that person eligible for a minister’s housing allowance. Churches should ordain, license or commission clergy for theological reasons, not tax reasons. Remember that the IRS does not automatically consider someone a Minister for Tax Purposes simply because that person is ordained, commissioned or licensed.

## SECTION 2:

# Is a minister employed or self-employed?

*Many ministers do not know if they are employees or self-employed for federal tax reporting purposes. The answer affects their tax returns and how churches report their wages. IRS guidelines tell agents auditing a minister's tax return that the first issue to be resolved is whether the minister is an employee or self-employed for income tax purposes.*

*Tests used by the IRS and federal courts would classify most ministers as employees. The United States Tax Court issued two rulings in 1994 addressing whether a minister is an employee or self-employed for federal income tax reporting purposes. The court applied this seven-factor test in both cases:*

- 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 or loss.*
- 4. Whether or not 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.*
- 7. The relationship the parties believe they are creating.*

*Some ministers believe that they will owe fewer taxes if they report their income taxes as self-employed rather than as an employee. This is rarely true, but even if it were, ministers should follow established criteria about whether they are employees or self-employed.*

**Key Point:** Most ministers have a "dual tax status".

*Generally:*

- They are employees for federal income tax purposes, but*
- Self-employed for Social Security purposes with respect to earnings from services performed in the exercise of their ministry.*

*Dual tax status means that most ministers should file their tax returns as employees and pay self-employment (SECA) taxes on their ministerial income (unless they have been exempted from Social Security).*

*The pastor of a local church will almost always report his church salary as an employee for federal income tax purposes. However, he will be self-employed for purposes of income earned from guest preaching at other churches and from services such as weddings and funerals performed directly for individual members.*

*Churches should issue a Form W-2 to minister employees and should never withhold Social Security and Medicare (FICA) taxes for ministers. Also, churches should not withhold federal income taxes from ministers' wages (except for ministers who have elected voluntary withholding by submitting a Form W-4 to their church).*

*Example: Pastor B is senior pastor at First Baptist Church. He is an employee for federal income tax reporting purposes with respect to his church salary. However, he is self-employed with respect to honoraria he receives for guest speaking appearances in other churches and for compensation from individual members for performing personal services such as weddings and funerals. The church*

issues Pastor B a Form W-2 reporting his church salary. Pastor B reports his church salary as wages on line 1 of Form 1040. He reports his compensation from self-employment activities on Schedule C.

A few ministers are self-employed for federal income tax reporting, such as some traveling evangelists (who have not incorporated their ministry). They file their income taxes as self-employed and often receive a Form 1099-NEC from different churches where they perform services. Churches may need to issue a Form 1099-NEC to some ministers such as traveling evangelists and other workers who are truly self-employed for income tax purposes.

**Key Point:** Most ministers benefit from reporting as employees because:

1. The risk of an IRS audit is substantially lower for employees than for self-employed taxpayers.
2. “Self-employed” ministers reclassified as employees after an IRS audit face additional taxes and penalties.
3. The value of some fringe benefits, such as employer-paid medical coverage, is tax-free to employees but not to self-employed taxpayers.

- Q.** Do employees complete their tax returns differently than self-employed persons?
- A.** Most taxpayers are familiar with Form 1040, but employees and self-employed taxpayers complete their returns differently. Under the Tax Cuts and Jobs Act of 2017, employees can no longer deduct unreimbursed employee business expenses for tax years 2018 to 2025. Taxpayers who are

self-employed for income tax purposes report income and business expenses on Schedule C.

- Q.** Are there any tax advantages to being treated as an employee instead of self-employed for income tax purposes?
- A.** Taxpayers who are employees for income tax purposes may benefit from several tax advantages. Employees may exclude the cost of employer-paid medical and dental insurance from income. They may also exclude the cost of up to \$50,000 of coverage in employer-paid group life insurance. Employees may also be eligible to participate in employer-sponsored retirement plans.
- Q.** Are self-employed taxpayers more likely to be audited by the IRS?
- A.** Taxpayers who report their federal income tax returns as self-employed persons are more likely to be audited by the IRS. IRS data shows that self-employed people are less likely to report their income correctly than employees. Remember that ministers who have income from only one church are likely to be viewed as employees for income tax purposes by the IRS. Churches should issue a Form W-2, not a Form 1099, to minister employees. As explained earlier, ministers often have a dual tax status and will pay SECA taxes on their ministerial earnings, but most ministers should file their tax returns as employees and should receive a Form W-2 from their church.
- Q.** What can happen to ministers who incorrectly file their income tax returns as self-employed instead of as employees?
- A.** The IRS can reclassify ministers as employees for income tax purposes if the IRS decides they should have filed their returns as employees instead of as self-employed taxpayers. If the IRS reclassifies a minister

as an employee, the minister may lose business expense deductions and could owe back taxes and penalties to the IRS.

- Q.** Can churches classify paid workers as independent contractors to avoid paying FICA or withholding income taxes from them?
- A.** No. Churches cannot classify paid workers as independent contractors in an effort to save money. They must follow the law. Some ministers think they will save money on taxes if they treat themselves as self-employed for income tax purposes rather than as employees. This is rarely true, but even if it is, ministers and churches should follow IRS rules.

## SECTION 3:

# How do Social Security rules apply to ministers?

*Most ministers have a dual tax status. They are self-employed for Social Security purposes with respect to earnings from services performed in the exercise of their ministry even if they are employees for income tax purposes. Some exceptions apply to chaplains.*

*Because ministers are self-employed for Social Security purposes, they must attach Schedule SE to Form 1040 unless the IRS has approved their timely application to exempt themselves from SECA taxes. As discussed below, few ministers qualify for this exemption.*

*Ministers pay the SECA tax. They do not pay the employee's share of FICA taxes, even if they report their income taxes as employees and receive a Form W-2 from their church, as most ministers should.*

*Churches must not pay FICA for anyone who is a Minister for Tax Purposes. Some churches want to help their ministers with the burden of SECA taxes. They may pay ministers a Social Security allowance or offset, but this amount is income for both federal income taxes and SECA taxes.*

*In very limited circumstances, ministers may opt out of Social Security or exempt themselves from SECA taxes with respect to their ministerial earnings. However, very few ministers qualify for this exemption. Many new ministers apply to opt out without knowing they are ineligible. Ministers may apply to opt out only if they are opposed on the basis of religious considerations to accepting benefits from Social Security or any other public insurance system that provides retirement or medical benefits. They cannot apply if their sole objection to participation in*

*the Social Security program is the payment of taxes or any other reason. Once the IRS grants the exemption, a minister may not revoke it, even if he regrets it later. In the past, Congress has given ministers very limited opportunities to revoke an exemption, but no such option is currently available. To apply for the exemption, eligible ministers must file an application for exemption (Form 4361) no later than the due date of the federal tax return for the second year in which they have net earnings from self-employment of \$400 or more, any part of which comes from ministerial services. If they miss that deadline, they cannot opt out. The exemption is only effective when approved by the IRS and does not apply without receipt of IRS approval.*

*The exemption is available only for ministerial earnings. Ministers approved for the exemption are not exempt from Social Security taxes on earnings from secular employment. Ministers approved for the exemption may still qualify for Social Security benefits if they have enough quarters from secular employment. They also may qualify for some benefits based on their spouse's Social Security coverage.*

- Q.** *Do churches have to pay FICA for their non-ministerial employees?*
- A.** *Churches must pay their share and withhold the employee's share of FICA for non-ministerial employees except in rare cases where a church has exempted itself from making these payments. Churches cannot classify non-ministerial employees as self-employed to avoid paying FICA.*
- Q.** *Why are some churches exempt from paying FICA for their non-ministerial employees?*

**A.** Few churches qualify to be exempt from paying FICA for their non-ministerial employees. Churches have one chance to exempt themselves from their obligation to pay FICA on behalf of their non-ministerial employees. They may file IRS Form 8274, Certification by Churches and Qualified Church-Controlled Organizations Electing Exemption from Employer Social Security and Medicare Taxes. Churches filing this form must certify that they are opposed for religious reasons to the payment of Social Security taxes, something few churches can do. The deadline for filing Form 8274 relates to the date on which the church must file its first Form 941 on which it reports its employer share of FICA taxes. When churches file Form 8274, they shift the burden of Social Security taxes to their employees, including non-ministerial employees. That means all their employees must pay SECA taxes as if they were self-employed. Churches that are exempt from paying FICA should be sure that applicants, new hires and current employees understand their obligations to pay SECA taxes.

**Q.** How can taxpayers verify the accuracy of Social Security Administration records?

**A.** The Social Security Administration (SSA) automatically sends annual statements to workers and former workers who are 60 and older. Taxpayers can also request statements at other times by completing Form SSA-7004, Request for Social Security Statement by calling 1-800-772-1213. All taxpayers should review their statements carefully. Any errors can be reported and corrected more easily the sooner they are found. For more information about annual statements and other Social Security issues, see the SSA's website at SSA.gov.

## SECTION 4:

# How do ministers pay their taxes?

Special withholding rules apply to ministers. Since ministers' wages are exempt from federal income tax withholding, churches should not withhold income taxes from a minister's paycheck unless the minister enters into a voluntary withholding arrangement with his church by giving the church a completed Form W-4, Employee's Withholding Allowance Certificate. Ministers can increase the amount they want withheld as federal income taxes on Form W-4 to cover their estimated SECA tax liability for the year.

Ministers must prepay their income taxes and SECA taxes in quarterly installments using the estimated tax procedure unless they have entered into a voluntary withholding arrangement with their church. Underpayment penalties may apply if estimated tax payments are less than the actual tax liability. Ministers may change their estimated tax payments during the year if their circumstances change to make them owe more or less taxes.

Ministers should make estimated tax payments if they expect to owe at least \$1,000 in taxes for the current year after subtracting withholding and credits and if those withholding and credits are expected to be less than the smaller of these two amounts: (1) 90 percent of the tax to be shown on their current-year tax return or (2) 100 percent of the tax shown on their prior-year tax return or 110 percent of the tax shown on their prior-year tax return if their adjusted gross income is greater than \$150,000.

The prior-year tax return must cover all 12 months. Ministers should follow these three steps to report and prepay estimated taxes: Step 1. Obtain a copy of IRS Form 1040-ES early enough to compute and make the first payment by April 15.

Step 2. Compute estimated taxes using the Form 1040-ES worksheet.

Step 3. Using one of the four payment vouchers in Form 1040-ES, pay one-fourth of the total estimated taxes to the IRS in each of the four quarterly installments as follows:

For the Period	Due Date
January 1–March 31	April 15
April 1–May 31	June 15
June 1–August 31	September 15
September 1–December 31	January 15

If the due date for making an estimated tax payment falls on a Saturday, Sunday or legal holiday, the payment will be on time if made on the next day that is not a Saturday, Sunday or legal holiday.

Ministers who overpay their estimated taxes may have those overpayments applied to the next year's estimated tax liability or request a refund when they file their tax return.

## Preliminary Questions

- Q.** Are ministers required to pay federal income taxes?
- A.** Yes. Ministers are not exempt from paying federal income taxes.
- Q.** How much income must I earn to be required to file a tax return?
- A.** Generally, ministers are required to file a federal income tax return if they have earnings of \$400 or more. Different rules apply to some ministers who are exempt from SECA taxes.
- Q.** What records should I keep?
- A.** You should keep all receipts, canceled checks and other evidence to prove amounts you claim as deductions, credits or exclusions, including amounts designated as minister's housing allowance.



**Q.** What is the deadline for filing my federal income tax return?

**A.** April 15 unless it falls on a Saturday, Sunday or legal holiday. The payment will be on time if made on the next day that is not a Saturday, Sunday or legal holiday.

**Q.** What if I am unable to file my tax return by the deadline?

**A.** You can obtain an automatic six-month extension (from April 15 to October 15) of time to file your Form 1040 if you file Form 4868 by April 15 with the IRS service center for your area. Your Form 1040 can be filed at any time during the six-month extension period. An extension only relieves you from the obligation to file your return; it is not an extension of the obligation to pay your taxes. Therefore, you must pay the estimated tax due with your Form 4868.

**Q.** Should I prepare my own tax return?

**A.** The answer depends on your ability and experience in working with financial information and in preparing tax returns. Many ministers can prepare their own tax returns if they understand the unique tax rules that apply to ministers. Few of those rules are complex, but other events could make your tax return more complicated. For example, if you purchased or sold a home, it may be prudent to seek professional tax help. You will find many helpful publications on the IRS website, [IRS.gov](http://IRS.gov). The IRS will also answer questions by phone, but it is not liable if its agents answer your questions incorrectly.

**\* Recommendation:** Use these tips to find a competent tax professional if you need one:

- Ask other ministers in your community for recommendations.

- Try to use a CPA or Enrolled Agent (EA) who specializes in tax law and who understands the rules that apply to ministers. CPAs and EAs have completed a rigorous program and are subject to strict requirements.
- Ask local tax professionals if they work with ministers, and if so, with how many.
- Ask local tax professionals a few questions to test their familiarity with ministers' tax issues.
  - For example, ask whether ministers are employees or self-employed for Social Security purposes. Anyone familiar with ministers' taxes will know that ministers always are self-employed for Social Security purposes with respect to their ministerial income.
  - Or, ask a tax professional if a minister's church salary is subject to income tax withholding. Anyone familiar with ministers' taxes should know the answer is no.

## SECTION 5:

### What is minister's housing allowance?

*The housing allowance exclusion is the most important tax benefit available to ministers. Subject to strict rules and limits, ministers may exclude from income for income tax purposes some or all of their church-designated housing allowance. However, when reporting their income for SECA tax purposes, ministers may not exclude the allowance. Some exceptions for retired ministers are discussed below.*

*A housing allowance must be compensation for ministerial services and should not exceed a minister's reasonable compensation. Ministers must substantiate their actual housing expenses. Otherwise, all or part of the housing allowance designation is included in gross income. A worksheet is included in this section to help ministers estimate their annual housing expenses.*

*A housing allowance may be available to ministers who own their own homes, who rent or who live in a rent-free church-owned parsonage.*

*Ministers who own their homes can exclude the lowest of the following three amounts from income for federal income tax purposes when their church employer properly designates a housing allowance for them:*

1. The housing allowance designated by their church, or
2. Actual housing expenses (including mortgage payments, utilities, property taxes, insurance, furnishings, repairs and improvements) or
3. The fair rental value of the home (furnished, including utilities).

*Ministers who rent their homes can exclude the lower of these two amounts:*

1. The amount designated by their church or

2. Actual housing expenses (including rent, renter's insurance, utilities, furnishings, repairs and improvements).

*Ministers who live rent-free in a church-owned parsonage should not include the fair rental value of the parsonage as income for federal income taxes, but they do include the rent-free church-owned parsonage fair rental value as income in figuring net earnings from self-employment (Social Security tax on Schedule SE), unless the minister has an approved exemption from SECA taxes. Churches can designate a housing allowance for a minister who lives in a parsonage if the minister pays for utilities, repairs, furnishings or other eligible expenses.*

*Ministers who live rent-free in a church-owned parsonage may exclude the lower of these two amounts:*

1. The housing allowance designated by their church or
2. Actual housing expenses not paid by the church (including utilities, furnishings, repairs and improvements).

*When a designated housing allowance exceeds a minister's actual housing expenses and the fair rental value of the home, the minister must report the excess housing allowance as wages for federal income tax purposes on line 1 of Form 1040.*

*If a church does not comply with legal requirements regarding a housing allowance designation, then their minister may be deprived of this important tax benefit. They should take official action to designate a housing allowance and record it in the meeting minutes. The IRS recognizes designations included in employment contracts and budget line items, assuming that the designation was appropriately adopted in advance by the church.*

Designation of a housing or parsonage allowance for the next year should be on the church agenda for one of its final meetings during the current year. Churches should consider designating a housing allowance “for the current year and for all future years unless otherwise provided.” This safety net allows a designation to carry over from year to year, preventing problems if a church forgets to designate an allowance one year. However, safety net allowances should not be viewed as a substitute for designating a housing allowance each year.

Churches must designate a housing allowance in advance because retroactive designations are not valid.

*Example: In preparing his income tax return, Pastor H discovers that his church failed to designate a housing allowance for him in the prior year. He asks his church to pass a resolution retroactively designating an allowance. The IRS will not accept a retroactive housing allowance designation, so Pastor H will not be eligible for housing allowance exclusion for the period that the church failed to designate a housing allowance.*

**Key Point:** It is possible that a pastor’s backdating of a board resolution to qualify for a housing allowance for the entire year violates the U.S. Sarbanes-Oxley Act of 2002, exposing the pastor to a fine or imprisonment. Even if the pastor’s action does not violate the Act, it may result in civil or criminal penalties under the tax code.

Churches may designate a housing allowance during a calendar year if they failed to do so before the year started, but such a designation will apply only prospectively.

*Example: Pastor J’s church discovers on March 1 that it failed to designate an allowance for the current year. The church should immediately designate a portion of Pastor J’s remaining current-year compensation as a housing allowance.*

Churches should ask ministers to estimate their housing expenses so they can designate a reasonable amount. This brochure includes a form for this purpose. Churches do not report the designated housing allowance as wages on the minister’s Form W-2.

Ministers who own their home can deduct mortgage interest and real estate taxes on Schedule A (Form 1040), although they exclude those amounts from income as housing allowance. This is often called “the double deduction”, but it is really both an exclusion and a deduction.

*Example: Pastor Y owns a home and incurs housing expenses of \$13,000 for mortgage principal and interest payments, property taxes, utilities, insurance, furnishings and repairs. The church designated \$12,000 of Pastor Y’s compensation (\$35,000) as a minister’s housing allowance in advance. The church reports only \$23,000 of taxable compensation on Pastor Y’s Form W-2 (\$35,000 less \$12,000). Pastor Y is able to itemize deductions on Schedule A (Form 1040). He may claim deductions for both mortgage interest and property taxes, although his taxable income was already reduced when these expenses were excluded from income as part of his housing allowance.*

Home mortgage loan payments qualify as housing allowance expenses, but costs for refinancing or a home equity loan qualify only if the proceeds are used to buy or maintain a principal residence. When a minister pays off a home mortgage, the amount that can be excluded as housing allowance usually decreases signifi-

cantly. Some ministers take a home equity loan or conventional loan secured by a mortgage on their otherwise debt-free home after paying off a mortgage. The Tax Court has ruled that these loan payments are expenses for purposes of the housing allowance exclusion only if the loan was obtained for housing-related expenses.

**Key Point:** Many ministers are eligible to have housing allowance on some or all of their retirement benefits. Eligible retired ministers may exclude their housing allowance from income for federal income tax purposes. An IRS ruling allows church pension boards, such as GuideStone®, to offer this valuable benefit.

The IRS has ruled that retired ministers are eligible for a housing allowance exclusion if a portion of a retired minister’s pension income from a denominational pension fund is designated as a housing allowance by the pension board or the designation is approved by the former church/employer; the retired minister has severed his relationship with the local church and relies on the church pension fund for his pension; and the pension paid to the retired minister compensates him for past services to the denomination or to local churches of the denomination.

GuideStone may designate housing allowance on retirement benefits to Southern Baptist ministers, subject to applicable requirements related to housing allowance and rules and procedures established by GuideStone. In addition, GuideStone will provide assistance to other ministers and ministry organizations it is authorized to serve with respect to facilitating housing allowance on all or a portion of such ministers’ retirement benefits as designated by their former church/employer.

Retired ministers may not be able to exclude the full amount designated as housing allowance from income for federal income tax purposes.

**Key Point:** Retired ministers may be able to exclude their housing allowance from income in figuring their SECA tax.

Retired ministers may be eligible to receive favorable SECA tax treatment on their housing allowance designated by GuideStone (or by their former church/employer through GuideStone). What constitutes “retirement” for purposes of these rules about SECA and the housing allowance depends upon an individual’s particular facts and circumstances. Ministers with questions about whether they are “retired” for this purpose should consult their tax advisors. The question of retirement is specific to ministers’ individual circumstances. Ultimately, the minister must determine if he is retired for this purpose. Many facts and circumstances may be relevant in determining whether retirement has occurred. For example, if a minister is receiving retirement benefits from a plan and is making contributions to the same plan, the IRS may not consider that minister retired for purposes of the housing allowance and the favorable treatment under SECA. Similarly, the IRS may view ministers as not retired if they have not had a meaningful break in service or change in work duties. Ministers and their tax advisors should work together to address the relevant facts and circumstances of each individual case.

## Minister's Housing Allowance Expense Worksheet for Ministers Who Own Their Home

Ministers are permitted to exclude from their church income (for federal income tax purposes) a housing allowance designated in advance by their employing church, to the extent that the allowance is used to pay housing expenses and does not exceed the fair rental value of the home (furnished, including utilities). To assist the church in designating an appropriate amount, the minister can use this form to estimate annual housing expenses. It is designed for ministers who own their home.

Category with estimated expense amount for the year:

Down payment on a home \$ \_\_\_\_\_

Mortgage payments on a loan to purchase or improve your home (include both principal and interest) \$ \_\_\_\_\_

Real estate taxes \$ \_\_\_\_\_

Property insurance \$ \_\_\_\_\_

Utilities (electricity, gas, water, trash pickup, local telephone charges) \$ \_\_\_\_\_

Furnishings and appliances (purchase and repair) \$ \_\_\_\_\_

Structural repairs and remodeling \$ \_\_\_\_\_

Yard maintenance and improvements \$ \_\_\_\_\_

Maintenance items (pest control, etc.) \$ \_\_\_\_\_

Homeowners association dues \$ \_\_\_\_\_

Miscellaneous \$ \_\_\_\_\_

Total estimated expenses for the year \$ \_\_\_\_\_

Please note the following:

- A housing allowance must be designated in advance. Retroactive designations of housing allowances are not permitted.

(Continued on next page)

- A housing allowance can be amended during the year if a minister's housing expenses are more than expected. However, an amendment is effective only prospectively.
- It is the minister's responsibility to notify the church in the event that these estimates prove to be materially inaccurate during the year.
- A minister cannot always exclude the amount a church designates as a housing allowance for income tax reporting purposes. Ministers who are eligible for a housing allowance may exclude the least of these amounts, subject to IRS rules: (1) the designated housing allowance, (2) actual eligible housing expenses or, for ministers who own their homes, (3) the fair rental value of their home, furnished, including utilities.
- If the housing allowance designated by the church exceeds the amount that can be claimed, the excess housing allowance should be reported with wages on line 1 of Form 1040. Write "excess housing allowance" on the dotted line next to line 1.
- The housing allowance exclusion is an exclusion for federal income taxes only. The minister must add the housing allowance as income in reporting SECA taxes on Schedule SE unless the minister is exempt from SECA taxes.

## SECTION 6:

# What is an accountable reimbursement plan?

Churches save ministers taxes when they reimburse them for business (ministry-related) expenses through accountable reimbursement plans, also known as accountable expense reimbursement arrangements.

Accountable reimbursement plans allow ministers to exclude church-reimbursed ministry expenses from income. Proper reimbursements of ministry-related expenses under accountable reimbursement plans are not reported as taxable income on the minister's Form W-2 or Form 1040, and there are no deductions to claim. In effect, the minister reports to the church rather than to the IRS.

A church should adopt an accountable reimbursement plan in a resolution. Plans that follow these rules should comply with IRS requirements:

1. Reimbursements are made only with adequate substantiation. Written evidence is required for all expenses, and receipts are required for expenses of \$75 or more.
2. The evidence must substantiate the amount, date, place and business nature of each expense. A church must require the same degree of substantiation as would be required for a deduction on the minister's income tax return.
3. Expenses must be substantiated and excess reimbursements returned to the church within a "reasonable period of time." The IRS views 60 days as a reasonable period of time for substantiating expenses and 120 days as a reasonable period for returning excess reimbursements.

**Key Point:** Churches penalize ministers financially when they do not reimburse them for ministry-related expenses or when they make reimbursements under non-accountable plans.

Some churches do not reimburse ministers for ministry-related expenses. Other than churches, few employers expect employees to pay business expenses without reimbursement. Churches that think they cannot afford to reimburse ministry-related expenses should remember that they could limit the type and amount of expenses they will reimburse.

Some churches that do not reimburse ministry-related expenses mistakenly think that ministers can "write off" all these expenses when they file their tax returns. The Tax Cuts and Jobs Act of 2017 eliminated the unreimbursed employee business expense deductions for tax years 2018 to 2025. Some churches reimburse ministers for business expenses but may penalize them by reimbursing them under a non-accountable plan. A church has a non-accountable plan if it gives a minister an allowance or reimburses the minister or other employees for business expenses without requiring adequate substantiation of the amount, date, place and business purpose of the expenses or does not require excess reimbursements to be returned to the church. The full amount of a church's reimbursements or allowances under such a plan must be reported as income on Form W-2 issued by the church and on the minister's tax return.

*Example: Pastor R is the senior pastor at his church and reports his federal*

*income taxes as an employee. The church reimburses him for all of his business and professional expenses but does not require him to account for those expenses. He does not have to provide the church treasurer with receipts documenting the amount, time and place, business purpose and business relationship of each expense. Pastor R simply tells the treasurer the total expenses he incurred at the end of the month. This is not an accountable plan. The church must report these reimbursements as income on his Form W-2 and he must report them as income on his Form 1040.*

(2) If the benefits are provided to an officer or director of the church (a “disqualified person”), or a relative of such a person, they will expose the recipient and possibly other members of the church’s governing board to “intermediate sanctions” in the form of substantial excise taxes since the IRS views these benefits as “automatic” excess benefits unless reported as taxable income by the church or recipient in the year provided.

**Key Point:** Churches occasionally reimburse ministers for expenses that are not ministry-related. Reimbursements for personal, living or family expenses are not deductible, and the entire amount of a church’s reimbursement must be included on the minister’s *Form W-2* and *Form 1040*, even if the church requires the minister to document the expenses.

**Caution:** A church cannot reimburse employees’ expenses under an accountable reimbursement arrangement if their expenses do not qualify as business expenses. Such reimbursements, as well as a church’s reimbursement of employees’ unsubstantiated business expenses, are non-accountable. If these reimbursements are not reported as taxable income to the employee in the year the reimbursements are paid, there are two consequences: (1) The employee is subject to back taxes plus penalties and interest on the unreported income.



OUR VISION

**Every servant of Christ finishes well.**



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