

Income Tax for Clergy

In the previous modules, you learned about the unique situation for clergy regarding social security and medicare taxes. In this module, you will learn about the unique situation for clergy regarding income tax.

Clergy include in income certain items that may be considered as gifts for other taxpayers, but they exclude from income housing allowances or provided housing that other taxpayers may need to include in income.

At the end of this module you should be able to:

- List items besides salary that are included in clergy gross income for income tax purposes.
- Explain the rules that enable clergy to exclude a housing allowance or the fair rental value of a parsonage from gross income for income tax purposes.

For income tax purposes, clergy must include in gross income not only salary, but also offerings and fees received for performing marriages, baptisms, funerals, Masses, etc.

Generally, clergy must also include in income love offerings and retirement collections taken up on their behalf. The courts have repeatedly ruled these offerings arise principally from the employer-employee relationship between the minister and the church.

Exclusion of Housing Allowance or Fair Rental Value of a Provided Parsonage

In Module 1, you learned that, for purposes of calculating SE tax, you need to include the following in gross income:

- Any clergy housing allowance, plus any utility allowance.
- The fair rental value of a provided parsonage, plus the cost of furnished utilities.

However, for purposes of figuring income tax, these items are NOT included in gross income.

Click on each item above to learn more.

Housing Allowance

Housing allowances, plus an amount to pay utility costs, are excluded from gross income if both of the following apply:

- The allowance is used to provide a home for the clergy.
- The allowance is not more than reasonable pay for clergy services.

Provided that the allowance is reasonable pay for clergy services, the amount excluded from gross income cannot exceed the smaller of:

- The fair rental value of the home, including furnishings, plus the cost of utilities.
- The actual cost of the home.

Note: The church or employing organization must officially designate the payment as a housing allowance before the payment is made. The designation may be made in an employment contract, by resolution of the church leadership, or in another official church instrument including meeting minutes or the budget. There is no way to back date the designation of the allowance. If no part of the clergy's salary has been designated as a housing allowance, it must be included in gross income.

Fair Rental Value of Parsonage

The fair rental value of a house or parsonage, plus utilities, is excluded from gross income, provided the value is not more than reasonable pay for clergy services.

Example: Rev. Brad Goode is the full-time minister of Center Church. His compensation includes use of the church parsonage, which has a fair rental value of \$12,000, and an annual \$13,000 payment, which includes \$1,200 as an officially designated utility allowance.

The fair rental value of the parsonage is reasonable compensation for Rev. Goode's services, however his actual utility bills for the year exceed the fair rental value of the parsonage. Rev. Goode's actual utility bills for the year are \$1,100. Rev. Goode's gross income includes the fair rental value of the parsonage and \$1,100 of the utility costs, which is the lower of the allowance or his actual utility costs.

Rev. Goode reports \$11,900 for income tax purposes. [\$13,000 payment – \$1,100 excludable actual utility expense = \$11,900]

Clergy Services for the Exclusion of Housing Allowance and Fair Rental Value of a Provided Parsonage

To exclude a housing allowance or the fair rental value of a provided parsonage, the allowance or fair value cannot exceed reasonable pay for clergy services.

For the exclusion, clergy services include all of the following:

- Qualified services defined in Module 1
- Administrative duties and teaching at theological seminaries
- Ordinary duties of clergy performed as an employee of the United States (except for chaplains in the Armed Forces), a state, a possession, a political subdivision, or the District of Columbia

Exclusion of Housing Allowance When Clergy Own Their Home

Clergy who receive a housing allowance as part of their pay, but who own their home, exclude from gross income the smaller of the following:

- The amount actually paid to provide the home
- The amount officially designated as a housing allowance

- Fair rental value of the home, including furnishings, plus utilities

Retired Clergy

Retired clergy exclude the fair rental value of a home, including utilities, furnished by their church as part of pay for past services, or as part of their pension designated as a housing allowance.

Remember from Module 1 that retired clergy also exclude these amounts for SE tax.

Excess Housing Allowance

If clergy receive excess housing allowance or fair rental value of provided housing, the excess is added back to clergy gross income.

Excess is any amount more than the smallest of the following:

- Reasonable salary for clergy services
- Fair rental value of the home, including furnishings, plus utilities
- The amount actually paid to provide the home

Example: Rabbi Harris receives an annual compensation package that includes a \$15,000 combined housing and utility allowance. The allowance is a reasonable amount for his services. A member of the congregation has a furnished rental property that he usually rents out for \$1,100 a month plus utilities. He offers to rent the house to the rabbi for \$800 a month plus utilities to which the rabbi agrees. At the end of the year, the rabbi spent a total of \$12,000 for his housing. [\$9,600 monthly rent payments + \$2,400 utility payments = \$12,000]. If he had paid the fair rental value, he would have paid \$15,600. [\$13,200 monthly rent payments + \$2,400 utility payments]. Although the allowance is reasonable for his services to the congregation, the allowance exceeds the lower of fair rental value or actual cost and the \$3,000 in excess must be included in gross income for income tax purposes. The \$12,000, however, is excluded from gross income.

As you know, the federal income tax is a “pay-as-you-go system”; taxpayers must pay income tax as they earn or receive income during the year.

Because a clergy member’s pay is generally not subject to federal income tax withholding, they may need to make estimated tax payments. Generally, estimated tax payments should be made if the tax due, including SE tax, at the time the tax return is filed is \$1,000 or more.

From this list of items, select the items that are included in clergy gross income for income tax purposes. The items not selected are excluded from clergy gross income for income tax purposes.

Housing allowance

An allowance for utility expenses

The fair market value of provided housing

A collection taken up when clergy retire

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Correct! For income tax purposes, a housing allowance and the fair market value of provided housing, including the cost of utilities, are excluded from clergy gross income. It’s important to note that these items are included in clergy gross income for purposes of figuring SE tax.

Clergy may exclude a housing allowance from gross income when figuring income tax. To exclude a housing allowance, the allowance must meet certain criteria. Check all the items below that are required for an allowance to be excluded.

The allowance must be a reasonable amount for the services the clergy provides.

Clergy must be actively engaged in ministry. They cannot be retired.

The allowance must be used for housing.

The amount of the allowance must be stipulated by the employing organization.
The allowance cannot exceed the amount of the clergy member's ministerial wages.
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Correct! To exclude a housing allowance, the amount of the allowance must be designated in advance by the employing organization and be reasonable for the clergy's services. And, of course, for the housing allowance to be excluded, it must be used for housing.

In this module, Income Tax for Clergy, we discussed:

- Items besides salary that are included in clergy gross income for income tax purposes.
- The rules for clergy to exclude a housing allowance or the fair rental value of a parsonage from gross income for income tax purposes.

Deductible and Nondeductible Clergy Business Expenses

In previous modules, you learned what may be unique about a clergy tax return:

- Clergy who are employees may have to pay SE tax.
- Clergy may be able to exclude housing allowances or the fair rental value of provided housing from gross income for income tax purposes.

In this module, you are going to learn that, like all other taxpayers, clergy can deduct qualified business expenses, but there may be an additional calculation because of excluded housing benefits.

Clergy who are church employees deduct unreimbursed ministerial expenses directly on Schedule A or on Form 2106. Self-employed clergy deduct ministerial expenses on Schedule C. For all taxpayers, business expenses that are allocated to income excluded from tax are not deductible. For clergy who have both business expenses and excluded housing benefits, you need to allocate business expenses between taxable income and excluded income. Only expenses allocated to taxable income can be deducted.

Module Objectives

By the end of this module, Deductible and Nondeductible Clergy Business Expenses, you will be able to:

- Allocate clergy business expenses between taxable and excluded income.
- Explain the Clergy Worksheet.

Expenses Allocable to Excluded Income

Qualified clergy who receive a housing allowance or a provided parsonage do not include the value of these housing benefits in gross income for income tax purposes.

Because taxpayers cannot deduct business expenses allocated to excluded income, clergy who receive excluded housing benefits and who have qualified ministerial expenses must allocate the expenses between taxable and excluded income.

The allocation of business expenses to excluded income is calculated using this formula:

To calculate the nondeductible business expenses allocated to excluded income, multiply qualified expenses from ministerial duties by a ratio of the value of excluded housing benefits over all income earned from ministry

$$\text{Qualified ministerial business expenses} \times \left(\frac{\text{Excluded housing allowance or fair rental value of provided parsonage}}{\text{All income (including amounts excluded from gross income) earned from the ministry}} \right)$$

Allocation Example: Rev. Smith

Rev. Smith received \$40,000 in ministerial compensation. The compensation included \$28,000 salary for ministerial services, a parsonage with a fair rental value of \$10,000, and \$2,000 for performing weddings as self-employed. Rev. Smith incurred \$5,000 of unreimbursed expenses connected with his ministerial services: \$4,500 related to his ministerial salary and \$500 related to the weddings he performed. Because the value of the parsonage is excluded from gross income, you must allocate Rev. Smith's expenses between taxable and excluded income. Expenses allocated to excluded income are not deductible.

The nondeductible portion of expenses related to Rev. Smith's ministerial salary is \$1,125. [$\$4,500 \times (\$10,000 \div \$40,000) = \$1,125$] The remaining \$3,375 is deductible on his Schedule A.

The nondeductible portion of expenses related to Rev. Smith's self-employment is \$125. [$\$500 \times (\$10,000 \div \$40,000) = \125]. The remaining \$375 is deductible on his Schedule C.

Required Clergy Worksheet

Clergy receiving excluded housing benefits who have nondeductible ministerial business expenses must attach a statement to their tax return containing the following information:

- A list of each item of taxable ministerial income by source (such as salary, wedding fee, baptism fees, etc.) and the amount
- A list of each item of excluded ministerial income by source (housing allowance or fair rental value of parsonage) and amount
- A list of otherwise deductible ministerial expenses and the amount
- How the nondeductible part of the expenses was figured
- A statement that the other deductions claimed on the tax return are not allocable to the excluded income

TPS automatically prepares the required statement when the client's occupation is entered as clergy. However, you are required to

make a manual entry on Schedule C to capture reduction of expenses due to excluded income. This statement must be filed with the tax return. You will see a demonstration of TPS in the next module.

Deductible Expenses of Self-Employed Clergy

Like all self-employed taxpayers, self-employed clergy can deduct amounts paid for medical and dental insurance and qualified long-term care for themselves, their spouse, and their dependents.

They can also deduct one-half of their SE tax. Both of these deductions are taken as an adjustment to income on Form 1040.

The deduction for self-employed health deduction is no longer allowed on Schedule SE. However, you can still take it on Form 1040, line 29. See Form 1040, line 29 instructions.

You need to prepare a Clergy Worksheet for clergy who have no business expenses.

True False

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That's correct. You only need to prepare the Clergy Worksheet for clergy who have qualified business expenses. You will learn how to prepare the worksheet in the next module.

In this module, Deductible and Nondeductible Clergy Business Expenses, we discussed:

- How to allocate clergy business expenses between taxable and excluded income.
- The Clergy Worksheet.

TPS Demonstration

In previous modules, you learned the tax theory behind a clergy tax return. In this module, you are going to see a demonstration of how to input a clergy tax return using TPS. Each demonstration will show you the following:

- Entering a Clergy W-2
- Clergy Schedule C and 2106
- The Clergy Statement

TPS Demonstrations

Click on each of the following demonstration topics to view the demonstration.

Each demonstration should be watched in order. Note that while the demonstration has text narration, it also contains audio. Please ensure your speakers are turned on prior to clicking on the links below. Once the demonstration is complete, click the next arrows to return to this menu and select the next demonstration.

1. Clergy W-2
2. Clergy Schedule C and Form 2106
3. Clergy Statement
4. Clergy Statement (continued)

What is the code you use to designate that a Form W-2 belongs to a clergy member?

- Code C
- Code M
- Code P
- Code R

P
That's correct. You use Code P for Pastor when inputting a clergy Form W-2.

Congratulations! You've completed Module 5.

The final exam contains twenty multiple choice questions covering the course material. You must answer 80% or more of the questions correctly to pass the exam. You may use any of the course sections to help you complete the exam. When you pass the exam, follow the instructions to print out the results.

If you fail the exam, you may take it again as many times as you need to.

The final results page will only display the questions that you have answered incorrectly.

Good luck!