

# Ministering to Clergy

Special tax rules create financial planning challenges and opportunities for these unique clients. **By Laurence Dresner**



IF YOU HAVE A MINISTER, PRIEST OR OTHER member of the clergy as a client, you face some interesting challenges. Special tax laws apply to clergy, and even the tax courts and the Internal Revenue Service have interpreted them differently over the years. In addition, it seems that nearly every congregation has its own take on applying the rules, is adamant that its interpretation is correct and is unwilling to change.

Clergy's tax status offers unique planning opportunities for savvy clients and potentially costly pitfalls for unwary ones.

Financial planners who have clergy for clients must school themselves in this quirky part of the tax code in order to help clerics make the most of their status.

## DUAL TAX STATUS

For tax purposes, most workers are classified as either employees or self-employed. Clergy, however, are both. For federal income tax purposes, the IRS in nearly all cases considers clergy to be employees. On the other hand, clergy are not subject to Social Security and

Medicare taxes, even though they receive a W-2 from their congregation. Instead, clergy pay self-employment tax. This dual tax status is the source of both the opportunities and the pitfalls for clergy members and their planners.

Most clergy are better off reporting their federal income taxes as employees for several reasons:

- The value of certain fringe benefits is excluded, including employer-paid health insurance premiums, group term life insurance and contributions to retirement plans.
- Clergy can be reimbursed by their congregations for business expenses without any income tax consequences, as long as the reimbursements are through an "accountable plan."
- Self-employed individuals have a higher risk of being audited than employees. If they are audited and reclassified as employees, they will be subject to penalties and additional taxes.

Being classified as an employee for federal income tax purposes does have its downside, however. For example, unreimbursed business expenses are subject to a floor of 2% of adjusted gross income (AGI) and must be reported on Schedule A.

Whether clergy are classified as employees or as self-employed, they are exempt from federal tax withholding. However, clergy who are considered employees can request that their income taxes and self-employment taxes be withheld from their salary payments—a strategy I recommend. Otherwise, clergy must make quarterly estimated payments for federal income taxes and self-employment taxes to avoid underpayment penalties.

## THE HOUSING QUESTION

Another source of opportunity and pitfalls involves parsonage. Parsonage is the tax rule that allows clergy to exempt from their federal income taxes a portion of salary that's earmarked for housing costs. Nearly 100 years old, parsonage originated when many congregations provided housing to attract clergy to their communities. This exemption has broadened over the years to where today, clergy can exempt the annual rental value of their home from their taxable income, even if they own the home themselves.

In 2002, the Ninth Circuit Court debated the constitutionality of parsonage. Because of that case, Congress passed the Clergy Housing Allowance Clarification Act of 2002, which President Bush signed into law. The act clarified the constitutionality of parsonage and also made clear that a parsonage allowance is now limited to the fair rental value of the home. (Previously, the parsonage value was determined using any one of three tests.)

The parsonage amount is not a deduction from a clergy member's income. It's just not reported as income. The rules do differ depending on whether the clergy is receiving parsonage (if the house is congregation-owned) or a housing allowance (house is owned by the clergy member). For simplicity's sake, however, I use the two interchangeably in this article.

Many clergy fail to take full advantage of the law when determining the correct amount of parsonage, and this is an area where financial planners can be of great service. Parsonage not only includes maintenance and upkeep of the house, but also its contents, the property and the garage. It does not include domestic help or food. Any parsonage amount that exceeds actual usage is reported as taxable income.

Some clergy have told me they've been warned that there is a limit as to how much parsonage can be designated. But as long as the declared amount can be verified (using receipts, etc.), there is no dollar or percentage ceiling. Some clergy clients insist on using a lower figure than they are entitled to because they are uncomfortable declaring a parsonage amount that may represent almost their entire salary. That's a personal decision, not a determination based on the statutes.

The IRS requires the congregation to follow specific procedures to authenticate the part of a cleric's income designated as parsonage. Failure to comply can leave both the congregation and the clergy open to fines during an audit. The parsonage amount can be modified as circumstances dictate, as long as these procedures are followed. A financial planner can help ensure that the procedures are followed correctly.

## SOME PITFALLS

Since the parsonage amount is excluded

from federal tax, it is not listed on the cleric's W-2 as taxable income (although it can show up—with an explanation—in box 14 of the W-2). This can present a problem when clergy members apply for a home mortgage. Since mortgage lenders often use the W-2 (and 1040) as a basis for determining how much an applicant can borrow, this "missing" amount can significantly reduce the size of the loan.

A financial planner must be prepared to explain (and support with documentation) why the clergy member can in fact afford a larger mortgage and why that parsonage amount doesn't show up as taxable income. When submitting an application for disability insurance, clergy can run into the same income determination situation with the insurance carrier. I recommend submitting a letter explaining parsonage, including citations from the tax law, along with the application.

**Parsonage payments are not listed on the cleric's W-2. This can present a problem when a clergy member applies for a mortgage—the income may appear insufficient to qualify for a loan.**

The Clergy Housing Allowance Clarification Act applies only to housing and parsonage allowances for federal income tax purposes. Real estate taxes and mortgage interest for a clergy member's home not only counts in determining parsonage, but is also an itemized deduction on his or her Schedule A. This "double deduction" is allowed by the IRS (revenue ruling 87-32).

But housing and parsonage allowances are included as income for self-employment taxes. So even though the parsonage amount is excluded from federal tax, it must be included as self-employment income for Social Security purposes. This is where many tax preparers fail to prepare a clergy member's tax return properly.

When it comes to Social Security, clergy are always self-employed. Therefore, they must pay Social Security taxes

of 12.4% on income up to \$90,000 for 2005 and 2.9% for Medicare on all self-employment income, just like regular taxpayers. One-half of the self-employment tax can be deducted to calculate AGI when determining federal income taxes.

Clergy members may file for an exemption from self-employment tax if they conscientiously object to, or if their religious principles oppose, the acceptance of public insurance. This filing for exemption can not be made for economic gain, and the IRS must approve the exemption.

## MAKING BUSINESS DEDUCTIONS WORK

Business deductions are one area where clergy have unique planning opportunities. Clergy employees can be reimbursed for business expenses and exclude those payments from income, if they are made under an accountable plan. An accountable plan is an arrangement that requires business expenses to be for a business purpose, substantiated within a reasonable period of time and reimbursed within a reasonable period of time.

Valid deductible business expenses can include telephone bills, supply purchases and fees for maintaining credentials. Dry cleaning for robes and other religious vestments may also be deductible.

Under a non-accountable plan, the clergy employee must report reimbursements as income. Deductibility limits for travel, meals, entertainment and lodging are the same for clerics as for other taxpayers. Business expenses, then, are deductible as miscellaneous itemized deductions subject to the 2% AGI floor. Using an accountable plan allows the clergy to be reimbursed 100%, whereas claiming a deduction on a tax return does not.

A home office deduction is rarely allowed since congregations typically provide an office, and parsonage allowances are already excluded from income. Contributions made by clergy to their congregations are deductible as itemized charitable deductions on Schedule A, not as a business expense.

The Deason Rule (Internal Revenue Code Section 265(a)(1)), states that expenses allocated to tax-exempt income (i.e., parsonage or housing allowance) can-

not be deducted from regular income tax. The rule applies to clergy who are able to take a business expense deduction for unreimbursed business expenses. Clergy who can claim an exclusion from gross income for the housing allowance/parsonage must reduce their business expense deduction by the percentage of income that is excluded from income tax reporting for the housing allowance/parsonage.

Clergy can deduct those expenses from their self-employment tax, however. They must allocate the expenses between the taxable income (from the ministry and self-employment income) and tax-exempt income (parsonage or housing allowance), and attach a statement to their return explaining how they allocated the income.

For example, assume a minister receives a total compensation package of \$75,000, divided between a salary of \$50,000 and a housing allowance of \$25,000. The minister

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has deductible unreimbursed business expenses of \$8,000. The exempt portion of his or her income (\$25,000 housing allowance) represents 33% of the total. Therefore, the minister is able to deduct only 66% of the business expenses (\$5,280).

Many clergy mistakenly believe that special offerings or bonuses they receive are gifts. In fact, the IRS considers them to be compensation for services rendered and therefore, they must be included in the clergy's gross income. (They are not tax-deductible by the person giving the money.) Fees paid directly to clergy for weddings, bar mitzvahs, love offerings and funerals must be included on Schedule C as self-employment income. This is true even if the clergy is an employee.

Fees paid directly to the congregation are not considered compensation to the cleric unless the congregation then writes a check to that cleric. (In that case, the person paying the fee can declare a tax deduction on his or her return.)

## RETIREMENT AND INVESTING OPTIONS

Many clergy (but not all) have access to a 403(b) pension plan through their denomination's arrangement, known as a Church Plan. When regular taxpayers retire, financial planners often recommend that employees roll their 401(k) pensions into a self-directed IRA. This usually gives employees better investment choices and possibly lower costs. However, this is the worst advice you can give to clergy. Rolling their 403(b) savings out of their pension plans forces them to lose irrevocably the benefit of designating some part of their distributions as tax-free parsonage.

If a clergy member has access to a pension plan, advisers can help with allocation choices as well as dovetailing outside-the-plan investments for an efficient portfolio strategy. For clergy who don't have access to a 403(b) plan, advisers can help set up other types of retirement accounts to compensate. If a clergy member receives a W-2, options include Roth IRAs, a tax-efficient (taxable) portfolio, a personally owned annuity and cash-value life insurance. If the clergy member receives a 1099, SEP-IRAs and Keoghs are possible options.

Many clergy also have special requirements for selecting investments based on their religious convictions. For these clients, financial advisers must be prepared to research the investment choices mutual funds make and to develop an in-depth understanding of socially responsible funds.

This article has touched on just a few of the strategies planners can use to help clergy clients make the most of their unique status. These clients face many tax complexities, and they can benefit greatly from expert tax and financial planning advice. **FP**

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