

# The Basics of Employment Taxes and the Housing Allowance for Clergy



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# The Basics of Employment Taxes and the Housing Allowance for Clergy

## Who is eligible?

1. Duly ordained, commissioned, or licensed minister
2. For services performed in the exercise of ministry
  - a. Performance of sacerdotal functions – baptism, communion, marriages, funerals, prayer for the sick
  - b. Conduct of religious worship – depends upon the tenets and practices of the particular religious body constituting the minister’s church or church denomination
  - c. Control, conduct, and maintenance (i.e., directing, managing, or promoting the activities) of religious organizations, boards, societies, and other integral agencies that are under the authority of a church or church denomination
  - d. Services performed pursuant to a valid assignment or designation by a religious body constituting the minister’s church
3. See provided whitepaper for more detailed information on what are considered services by ministers in exercise of ministry on page 4

## Employment taxes

1. Ministers have a dual tax status
  - a. Generally, an employee for federal income tax purposes – receives a Form W-2
  - b. Self-employed for employment tax purposes (Social Security and Medicare)
  - c. Wages are not considered FICA wages (rather, they are SECA earnings)
  - d. Minister is responsible for paying the full amount of self-employment taxes (if applicable, see below) on Form SE of his/her Form 1040
2. Ministers may opt out of the Social Security/Medicare system
  - a. Must file Form 4361 (generally by April 15 of the third year of ministry)
  - b. Must certify that you are “conscientiously opposed to, or because of my religious principles I am opposed to, the acceptance (for the services I perform as a minister...) of any public insurance that makes payments in the event of death, disability, old age, or retirement; or that makes payments toward the cost of, or provides services for, medical care.” Conscientious opposition must be rooted in religious beliefs.

- c. Once the exemption is approved, it cannot be revoked (under current law)
- d. Plan for retirement!!!!!!!

### Housing allowance

1. Ministers may exclude the amount of their compensation that their employing church designates in writing in advance as a housing allowance, subject to certain limitations
  - a. Changes to the amount designated as housing allowance may be made during the year, but only on a prospective basis
2. Limitations – excludible portion is limited to the lesser of:
  - a. Amount designated in writing in advance by the employing church
  - b. Fair rental value of home (furnished, including utilities)
  - c. The amount actually used for housing-related expenses
    - i. Down payment on home
    - ii. Mortgage payments or rent
    - iii. Utilities
    - iv. Repairs
    - v. Furnishings
    - vi. Insurance
    - vii. Property taxes
    - viii. Additions to home
    - ix. Maintenance
    - x. Homeowners' association dues
3. Exclusion is for income tax purposes only; housing allowance amount is subject to self-employment tax
  - a. Unless the minister has elected out of SE tax for clergy earnings by filing Form 4361 (see above)
  - b. Housing allowance paid to retired clergy is not subject to SE tax
4. See provided worksheet to estimate maximum housing allowance on page 7

## What Are Services by Ministers in the Exercise of Ministry?

*Following is a very brief and simplified summary of the rules related to services “in the exercise of ministry” for a member of the clergy. This information is intended as a simple overview. For in-depth analysis of this topic, see the current edition of the Church & Clergy Tax Guide by Richard Hammar.*

In general, ministerial tax treatment is afforded to any payment for services performed by a duly ordained, licensed, or commissioned minister “in the exercise of his ministry.” Therefore, in order to determine whether a particular employee qualifies for ministerial tax treatment, an organization must determine whether that employee’s duties are “in exercise of ministry.”

*This summary does not address the issue of whether a minister’s ordination, licensing, or commissioning is valid – which can be a significant issue in some circumstances. For example, some churches and denominations do not recognize clergy credentials issued outside the church or denomination. The tenets and practices of a particular church are relevant in addressing this issue.*

Treasury Regulation §1.1402(c)-5(b)(2) states that service performed by a minister in the exercise of his ministry includes the following:

1. The ministration of sacerdotal functions and the conduct of religious worship,
2. The 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 church denomination (including directing, managing, or promoting the activities of such organizations), and
3. Services provided to an organization which is neither a religious organization nor operated as an integral agency of a religious organization pursuant to an assignment or designation by a religious body constituting his church.

### **Category 1**

The first category noted above addresses “the ministration of sacerdotal functions and the conduct of religious worship.” Whether service performed by a minister constitutes the ministration of sacerdotal functions or the conduct of religious worship depends on the tenets and practices of the particular religious body constituting his church or church denomination. However, the IRS has indicated that the term “sacerdotal functions” generally includes performing baptisms, communion, marriages, and funerals. Presumably, the term “conduct of religious worship” includes not only leading worship services or delivering sermons, but all related preparation.

### ***Examples***

The Regulations provide an example of services performed by a minister which constitute the conduct of religious worship or the ministration of sacerdotal functions, as follows:

M, a duly ordained minister, is engaged to perform service as a chaplain at N University. M devotes his entire time to performing his duties as chaplain which include the conduct of religious worship, offering spiritual counsel to the university students, and teaching a class in religion. M is performing service in the exercise of his ministry.

The Regulations provide another example of a situation in which a minister is not considered to be performing ministerial services, as follows:

M, a duly ordained minister, is engaged by N University to teach history and mathematics. He performs no other service for N although from time to time he performs marriages and conducts funerals for relatives and friends. N University is neither a religious organization nor operated as an integral agency of a religious organization. M is not performing the service for N pursuant to an assignment or designation by his ecclesiastical superiors. The service performed by M for N University is not in the exercise of his ministry. However, service performed by M in performing marriages and conducting funerals is in the exercise of his ministry. [Note that the ministerial duties were not performed in connection with his employment with the university.]

There is no bright line test as to how much of a minister's duties for a particular employer must be in the conduct of religious worship and the ministration of sacerdotal functions in order for a minister to qualify for ministerial tax treatment. However, various rulings by the IRS indicate that such duties must be his primary duties. For example, in Revenue Ruling 68-68, 1968-1 CB 51, the IRS ruled that the rental value of an apartment furnished to an ordained minister by a charitable organization, which was neither a religious organization or an integral agency thereof, did not qualify for the housing allowance exclusion. The minister's basic functions were the directorship of the organization's advisory council and the coordination of its cultural programs. In connection with his position, he occasionally performed certain sacerdotal duties including the conduct of worship services. The IRS acknowledged that while the minister occasionally performed sacerdotal duties, his overall duties were not basically the conduct of religious worship or the ministration of sacerdotal functions as contemplated by the Regulations, and therefore no part of his salary could be designated as a ministerial housing allowance.

Similarly, in PLR 9124059 (3/21/1991), the IRS privately ruled that a Presbyterian minister employed by a Biblical counseling organization could not exclude any of his salary as a ministerial housing allowance. The minister spent 50 percent of his working hours providing "spiritual and pastoral counsel to individuals about a variety of issues, including marital difficulties, depression, anxiety, sexual problems, eating disorders and gender identity." The minister's counseling approach was based on "applying Biblical principles of human nature and behavior" to the problems of patients. The minister spent 35 percent of his time preparing for and leading three small Bible studies groups and two discussion groups of other ordained ministers. Ten percent of his time was spent preparing for and teaching Sunday school classes in nearby congregations; 5 percent of his time was spent on preaching, leading worship services, officiating at weddings and administering the sacraments. Less than 5 percent of the minister's time was taken up with administrative duties. The IRS concluded that since only 5 percent of the minister's working hours were spent performing duties such as the conduct of religious worship or the performance of sacerdotal functions, none of the duties performed by the minister qualified as services performed in the exercise of his ministry. Accordingly, the minister was not eligible to exclude any amounts designated as a housing allowance from his gross income.

*Numerous additional cases and rulings exist addressing what constitutes the conduct of religious worship and the ministration of sacerdotal functions – taking into consideration various facts and circumstances.*

### **Category 2**

The second category noted above (which covers "directing, managing, or promoting the activities of" an organization) is applicable only to ministers who are employed by a church, a church-controlled or denomination-controlled organization, or an integral agency of a church-controlled or denomination-controlled organization. This category of services includes management and administrative leadership roles in covered organizations.

A religious organization is considered church-controlled or denomination-controlled if it is organized and dedicated to carrying out the tenets and principles of a faith in accordance with either the requirements or sanctions governing the creation of institutions of the faith (Treasury Regulations §§1.1402(c)-5(b)(2) and 31.3121(b)(8)-1(b)).

In this context, it is not completely clear if an association of churches, especially an interdenominational association of churches, is considered a church-controlled or denomination-controlled organization, or an integral agency thereof. Therefore, for an association of churches, a facts and circumstances determination must be made; there are various cases and rulings which provide additional context regarding the factors that the IRS considers when making this determination.

For example, in Rev. Rul. 56-187, the IRS ruled that Category 2 services performed by a duly ordained minister for an association of churches were in the exercise of his ministry. The facts in the ruling indicated that the association was organized by local congregations in order that they might work together toward meeting the religious and moral needs of the community. The association was an official interdenominational agency serving the member denominations and was under the supervision of a governing body of delegated representatives appointed by the member denominations. The IRS concluded that, although the association of churches was not under the authority of a religious body constituting a particular church or church denomination, it was composed of churches having fundamentally similar objectives and the association's governing body constituted "a central board of interdenominational strategy developing a common mind, planning united policies, and providing for concerted action resulting in the formation of policies embodying the dictates of each member denomination."

Further, Rev. Rul. 72-606 noted that in order to determine whether a church-related institution is an integral agency of a religious organization, the IRS "utilizes a number of criteria including the following: (1) whether the religious organization incorporated the institution; (2) whether the corporate name of the institution indicates a church relationship; (3) whether the religious organization continuously controls, manages, and maintains the institution; (4) whether the trustees or directors of the institution are approved by or must be approved by the religious organization or church; (5) whether trustees or directors may be removed by the religious organization or church; (6) whether annual reports of finances and general operations are required to be made to the religious organization or church; (7) whether the religious organization or church contributes to the support of the institution; and (8) whether, in the event of dissolution of the institution, its assets would be turned over to the religious organization or church." The Ruling notes that the absence of one or more of the outlined factors is not necessarily determinative.

Ultimately, the specific facts and circumstances of each particular situation must be evaluated in order to make a final determination as to whether an association of churches is considered a church-controlled or denomination-controlled organization, or an integral agency thereof, for purposes of determining if managerial and administrative services are "in exercise of ministry" and thus eligible for ministerial tax treatment.

*Other cases and rulings exist that address whether an organization is considered a religious organization under the authority of a religious body constituting a church or church denomination, or an integral agency thereof. Additional guidance is also available with respect to what constitutes control, conduct, and maintenance of religious organizations in this context.*

### **Category 3**

The third category above relates only to services performed pursuant to a valid assignment or designation by a minister's church.

*A body of rulings and case law addresses the validity of clergy assignments for purposes of this provision. A simple letter written by a church that purports to assign a minister to a particular position, that is primarily tax-motivated, and that is issued subsequent to the minister obtaining the relevant position, is not a valid assignment.*

*This sample document is provided for general information purposes. It does not constitute professional advice. It is a generic document that is not specifically designed for your organization. We have provided it as a matter of professional courtesy for you to consider, together with your legal counsel, as you determine policies and/or provisions of your governing documents that are appropriate for your organization. In establishing your organization's policies or provisions of your governing documents, you should consider, together with your legal counsel, your unique operational, financial, and legal circumstances.*



**Batts Morrison  
Wales & Lee**

CERTIFIED PUBLIC ACCOUNTANTS

**WORKSHEET TO ESTIMATE MAXIMUM HOUSING ALLOWANCE  
(For Ministers Who Own or Rent Their Home)**

Minister's Name: \_\_\_\_\_

Church Name: \_\_\_\_\_

Calculation for the year 20\_\_\_\_ or the period \_\_\_\_\_ TO \_\_\_\_\_ # of Months \_\_\_\_\_

| <b>FAIR RENTAL VALUE (Including Furnishings and Utilities)</b>   |      |  |
|--|------|--|
| 1. What is the monthly market rental value of your home?<br>(If you rent your home, apartment, etc., enter monthly rent.)<br>(See instructions on reverse.)  |      |  |
| 2. What is the monthly rental value of your furniture, appliances and other furnishings? Estimate if necessary. (See instructions on reverse.)   |      |  |
| 3. How much is your average monthly utility bill (electric, gas, water, sewer, garbage, etc.)?   |      |  |
| 4. Enter the total of lines 1-3.   | -    |  |
| 5. Multiply line 4 by 12. This is the estimated fair rental value for one year (including furnishings and utilities).<br>(If period of calculation is less than one year, multiply by the appropriate number of months.) | \$ - |  |

|   | Estimate<br><small>(Complete in advance)</small> | Actual*<br><small>(Complete after year-end)</small> |
|---|--|---|
| <b>COSTS INCURRED TO PROVIDE A HOME</b>   |  |   |
| 6. If you own your home, enter expected mortgage payments (both principal and interest) for the year or other applicable period, if less than 1 year. (Include insurance and taxes paid as part of monthly payments or paid separately.) Also include any extra mortgage payments to be made, down payments to be made, real estate commissions to be paid, etc.<br><br><small>Note:<br/>Certain home equity loan payments may not be included in these costs. Consult your tax advisor for help.</small> |  |   |
| 7. If you rent, enter total rent for the year or other applicable shorter period. (Include renter's insurance premiums, if any.)  |  |   |
| 8. What is the estimated cost of maintenance and repairs, including lawn maintenance, pest control, painting, etc. for the year or applicable shorter period?   |  |   |
| 9. Enter the amount you expect to pay for furnishings, appliances, decorator items, cleaning supplies, etc. for the year or applicable shorter period.  |  |   |
| 10. Estimated utilities cost for the year or applicable shorter period (Line 3 multiplied by the appropriate number of months [12 if for a year]).  | -  |   |
| 11. Enter the total of lines 6-10 above. This is total of costs to provide a home.  | \$ -   | \$ -  |
| <b>SALARY</b>   |  |   |
| 12. Enter your annual total compensation, including salary and housing allowance for the year or applicable shorter period.   |  |   |
| 13. Enter the amount on line 5, 11 or 12 whichever is least.<br><b>This is your estimated maximum tax-free housing allowance for the period.</b>  |  |   |

(SEE INFORMATION ON REVERSE)

\*Note: This column is for use after year-end as described on reverse.

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NOTE: PRESENT THIS TO THE BOARD FOR RATIFICATION IN ADVANCE OF THE PERIOD TO WHICH IT APPLIES. SUBMIT REVISED ESTIMATES IF ANY OF THE ESTIMATED AMOUNTS CHANGE SIGNIFICANTLY DURING THE YEAR. IF THE HOUSING ALLOWANCE GRANTED TO YOU EXCEEDS YOUR ACTUAL HOUSING COSTS FOR THE YEAR, THE EXCESS MUST BE RECOGNIZED AS INCOME BY YOU ON YOUR TAX RETURN.

**(Use the ACTUAL column on the front of this worksheet after the year is over to determine your actual costs of providing a home for the year.)**

**Instructions To Line 1:**

1. If you own your home, the best method of determining this amount is to have an appraiser or rental real estate specialist provide you with a written estimate of the monthly rental value. If this is not feasible, you should estimate the fair rental value using some reasonable method.

**Instructions To Line 2:**

2. The amount on this line should be your estimate of the amount that the monthly rental value of your home would increase if the home were furnished. There are no specific rules providing guidance in this area, but a reasonable estimate should be made.

**BOARD APPROVAL:**

THIS AFFIRMS THAT THE BOARD OF DIRECTORS HAS APPROVED THE DESIGNATION OF \$\_\_\_\_\_ OF THE SALARY OF (Minister's Name)\_\_\_\_\_ AS A TAX-FREE HOUSING ALLOWANCE FOR THE PERIOD \_\_\_\_\_, AND AN EQUIVALENT ANNUAL AMOUNT THEREAFTER UNTIL FUTURE NOTICE.

SIGNED: \_\_\_\_\_  
Secretary

DATE: \_\_\_\_\_

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