

Housing Allowance and Other Clergy Tax Issues Revised December 2015

By Dennis R. Walsh, CPA

This is a summary of special income tax issues applicable to clergy employed by units of government and serving in other non-traditional settings. All information provided is intended for educational purposes. As laws are constantly changing, the reader should seek competent guidance as necessary and be aware of applicable legislative, administrative, and judicial action that may have occurred since preparation of this document.

Q1: When is an individual a minister for tax purposes?

Whether the services of a duly ordained, licensed, or commissioned clergyperson are classified as in the “exercise of ministry” for federal tax purposes determines if tax rules unique to clergy are applicable.

- For services other than as an employee of a theological seminary or church-controlled organization, in order to be considered in the exercise of ministry the services must involve either:
- The ministration of sacerdotal functions (.e.g. communion, baptism, funerals, etc.), or
- The conduct of religious worship

The following should also be considered:

- The determination of what constitutes the performance of “sacerdotal functions” and the conduct of religious worship depends on the tenets and practices of the individual’s church. Treas. Reg. § 1.1402(c)-5(b)(2)(i).
- A minister who is performing the conduct of worship and ministration of sacerdotal functions is performing service in the exercise of his/her ministry, whether or not these services are performed for a religious organization. Treas. Reg. § 1.1402(c)-5(b)(2)(iii).
- The service of a chaplain in the Armed Forces is considered to be those of a commissioned officer and not in the exercise of his or her ministry. Treas. Reg. § 1.107-1(a)

Q2: What special tax issues are applicable to compensation paid for services in the exercise of ministry?

- Except for ministers employed by units of government, compensation is not subject to income tax withholding, although ministers often elect to have income tax withheld.

- With the exception of clergy employed by government agencies as discussed later, ministers are considered self-employed for Social Security tax purposes. Unless granted exemption from Social Security coverage, ministers pay Social Security tax under the Self-Employment Contributions Act (SECA).
- A minister is eligible to exclude from gross income the rental value of an employer provided dwelling or the payment of a cash housing allowance, to the extent used to provide a home. Such a housing exclusion has no effect upon the amount of income subject to Social Security taxes.

Q3: Are ministers employees or self-employed?

Most ministers have a dual tax status for services performed in the exercise of ministry. That is, they are employees for income tax purposes under common law, but are treated as self-employed by statute for purposes of Social Security coverage. The proper classification of a minister as an employee or independent contractor for income tax purposes is determined on a facts and circumstances basis in the same manner as secular employees, using the criteria outlined in IRS Publication 15-A, Employer's Supplemental Tax Guide.

Q4: What is the legal authority for a housing allowance?

Internal Revenue Code § 107 authorizes an exclusion from gross income for the rental value of an employer provided home or for the payment of an allowance to a minister to provide a home. A housing allowance is available to qualified employees of federal, state, and local government. Treas. Reg. § 1.107-1(a).

Q5: Is a housing allowance mandatory?

In general, whether to treat qualifying services of a minister as in the exercise of ministry and to designate a housing allowance is the employer's decision.

Certain states mandate this classification for their state-employed chaplains through statutory provisions, or authorize it through administrative agency action. Other states do not designate a housing allowance for state-employed clergy. See Exhibit 1 for a summary of current state practices.

In 1972, the IRS ruled that chaplains employed by the federal government are not eligible to exclude a housing allowance because there is no statutory authority for any federal agency to make the required advance designation. The IRS affirmed this position again in 2002. It appears that legislative action would be required to extend housing allowance availability to chaplains employed by the federal government.

Q6: How is a housing allowance implemented?

The tax regulations require that the housing allowance be designated pursuant to official action taken in advance of such payment by the employing church or other qualified organization. Treas. Reg. § 1.107-1(b).

There is no prescribed form or wording for the designation, but it should include all of the following elements:

- Date, to establish that designation occurred in advance of payment
- Name of minister
- Designation of a dollar amount as housing allowance under Section 107 of the Internal Revenue Code
- Period for which the designation is to be effective
- Name, title, and signature of designating official

It is permissible to make a “perpetual” designation, i.e. stating that the designation applies to all future compensation until changed or revoked, so that it is not necessary to provide another designation for future periods unless there is a change. IRS Publication 517 states that a definite amount must be designated.

Q7: How much may be designated as a housing allowance?

The maximum amount that may be designated as a housing allowance is the reasonable value of services performed by the minister. Thus, if compensation is not excessive in relation to the value of services performed, it is permissible to designate the entire amount of compensation as a housing allowance.

As a practical matter, however, because of the limitations on the amount that may be excluded from income, there is no advantage to designating an amount that is substantially in excess of what the employee will likely be able to exclude in a particular year.

A common practice is to designate an amount that is above the portion of salary typically used for the costs of providing a home, in order to lessen the risk of the employee losing any tax benefit as a result of the employer under-designating a housing allowance.

Q8: What happens to the housing allowance designation?

The employer should provide a duly authorized copy of the housing allowance designation to the minister employee and keep a copy in the personnel file. The designation is not filed with the IRS by the employer, nor should it be filed with the employee’s tax return. Only in the event of an audit might it be necessary to provide a copy to the IRS.

Q9: How is a housing allowance reported on an employee’s pay stub?

There is no prescribed format for reporting a housing allowance on an employee's pay statement. However, it is good practice to show the housing allowance as a separate element of total compensation. This facilitates verification of correct payment and proper withholding of any applicable taxes.

Q10: How is a housing allowance reported on IRS Form W-2, Employee Wage Statement?

The incorrect reporting of a housing allowance as the result of an improperly prepared IRS Form W-2 places a minister employee at a much higher risk of an IRS audit.

The amount of housing allowance paid is not to be included with taxable wages reported in Box 1 of Form W-2. Instead, as explained in the instructions for IRS Form W-2, it may be shown as an informational item in Box 14 with an accompanying description.

Reporting the housing allowance in Box 14 may be useful for documenting such non-taxable income received for other purposes, such as loan or student financial aid applications. However, it is not a substitute for the required advance designation.

Churches and other non-government employers do not report any amounts in boxes 3 through 6 of Form W-2, since wages paid for services in the exercise of ministry are not subject to the withholding or matching of Social Security or Medicare taxes by the employer. IRC § 3121(b)(8).

For ministers employed by government agencies and performing services in the exercise of ministry, the amount of housing allowance paid is included with Social Security wages (Box 3) and Medicare wages (Box 5). Clergy employed by government agencies are subject to FICA taxes in the same manner as secular employees. Treas. Reg. § 1.1402(c)-5(c)(3). This is true even where a minister is otherwise exempt from Social Security coverage on ministerial earnings as a result of having applied for exemption and having received an approved IRS Form 4361.

However, as stated earlier the amount of housing allowance paid is not to be included with taxable wages reported in Box 1 of Form W-2. This is a common and confusing practice of government agencies employing clergy.

Unlike a housing allowance paid to a minister employed by a church or other non-government entity, the amount of housing allowance paid by a government agency is subject to income tax withholding. As a result, such employers typically take the position that it should also be reported as taxable wages in Box 1 of Form W-2.

However, the governing provision is solely for purposes of the collection of income tax at source, and does not address the separate issue of Form W-2 reporting. Treas Reg. § 31.3401(a)(9)-1(c)(3). IRS guidance for government employers regarding this issue appears to be needed.

If a housing allowance is included with wages in Box 1, when preparing Form 1040 the minister's only recourse for reporting the excludable amount is to enter it as a negative amount on line 21, "Other income," a procedure not authorized by the IRS. Additionally, including the housing allowance in Box 1 makes it impossible for a minister to comply with the authorized procedure for reporting any portion of a housing allowance that may not be excludable in a particular year, as set forth in IRS Publication 517 (see Q13).

Q11: How much of a designated housing allowance may an employee exclude from income?

As part of his or her annual income tax preparation, a minister accounts for the amount of designated housing allowance that may actually be excluded from income. The amount that may be excluded in any particular year is limited to the smallest of the following amounts:

- Amount designated by the employer in advance of payment
- Amount spent on qualified housing costs
- The fair rental value of the minister's dwelling including furnishings, plus the cost of utilities

The fair rental value limitation applies regardless of whether the home is owned or rented. If owned, the minister will need to make a reasonable estimate of rental value based on comparable rentals in the local market.

Q12: What types of expenses may a minister apply to a designated housing allowance?

Qualified housing costs include mortgage payments (both principal and interest) on debt to purchase or improve a home, real estate taxes, property insurance, utilities, furnishings, repairs and maintenance, and household supplies. Mortgage interest and real estate taxes may also be deducted as itemized deductions, even when applied to the housing allowance.

Q13: If a designated housing allowance is not fully excludable from income, how is the non-excludable portion handled?

Any portion of a designated housing allowance not properly excludable from income is required to be included in gross income for the year received. The minister must add any such excess to wages reported on Form 1040, line 7. IRS Publication 517 instructs to also report this amount on the dotted line next to line 7 and to enter "Excess allowance" and the amount.

Q14: What should a minister attach to his or her annual income tax return to report a housing allowance?

There is no separate form or attachment that should be included with a minister's tax return to report a housing allowance. Exclusion of a housing allowance from income is accomplished as the result of the employer not including the housing allowance along with wages reported in Box 1 of IRS Form W-2. If less than the entire amount of a designated housing allowance is excludable for a particular year, then the minister adds the non-excludable portion to taxable wages on Form 1040, line 7, as previously explained.

Q15: How does state income tax treatment of a housing allowance differ from federal treatment?

Treatment of the ministerial housing allowance by states that impose an individual income tax varies from state to state. Many states follow the federal treatment without modification of the amount excluded for federal purposes. A Minister may wish to inquire with his or her state revenue department or seek assistance from a local tax practitioner skilled with clergy tax issues.

Q16: How does a housing allowance affect an income tax deduction for professional expenses by a minister?

If a minister has unreimbursed professional expenses to report on IRS Form 2106, Employee Business Expenses, or on Schedule C of Form 1040, Profit or Loss from Business (Sole Proprietorship), if properly classified as self-employed for income tax purposes, and excludes any part of a housing allowance from income, then an adjustment must be made to proportionately reduce the expenses otherwise eligible for deduction. The expenses must be reduced by the ratio that the excluded housing allowance bears to total compensation.

For example, if a minister employee receives a \$60,000 salary and \$20,000 is excluded from income as housing allowance, then one-third of employee expenses are not deductible (i.e. $\$20,000/\$60,000 = 33\%$). There is an example of this computation and related tax return attachment in IRS Publication 517.

In the case of a minister employee itemizing deductions, this limitation will have a detrimental effect only if such unreimbursed job expenses, when added to a minister's other "miscellaneous" itemized deductions, exceeds 2% of adjusted gross income; and only then to the extent that total itemized deductions exceed the applicable standard deduction, i.e. the minister is otherwise able to benefit by itemizing deductions.

The following table illustrates states authorizing designation of a ministerial housing allowance for state-employed clergy. A chaplain employee performing ministerial services should contact their employing agency to assure that a housing allowance has been properly documented in advance of payment and to obtain a copy of the designation. See Q6.

Exhibit 1 –Housing Allowance for State-Employed Clergy

| State | Housing allowance | Amount |
|----------------|-------------------|-------------|
| Alabama | No | |
| Alaska | Yes | 45% |
| Arizona | Yes | 40% |
| Arkansas | Yes | 25% |
| California | Yes | 50% |
| Colorado | No | |
| Connecticut | Yes | 35% |
| Delaware | No | |
| Florida | Yes | 33% |
| Georgia | No | |
| Hawaii | n/a | |
| Idaho | n/a | |
| Illinois | Yes | 20% |
| Indiana | Yes | 33% |
| Iowa | No | |
| Kansas | No | |
| Kentucky | No | |
| Louisiana | No | |
| Maine | No | |
| Maryland | Yes | \$20,270.91 |
| Massachusetts | No | |
| Michigan | Yes | 35% |
| Minnesota | No | |
| Mississippi | No | |
| Missouri | Yes | ** |
| Montana | No | |
| Nebraska | n/a | |
| Nevada | No | |
| New Hampshire | No | |
| New Jersey | Yes | ** |
| New Mexico | n/a | |
| New York | Yes | 20% |
| North Carolina | No | |
| North Dakota | No | |
| Ohio | Yes | 25% |
| Oklahoma | Yes | 40% |
| Oregon | Yes | 35% |
| Pennsylvania | Yes | 20% |
| Rhode Island | n/a | |
| South Carolina | Yes | 25% |
| South Dakota | n/a | |
| Tennessee | No | |

| | | |
|---------------|-----|-------------------------|
| Texas | Yes | 30% |
| Utah | No | |
| Vermont | n/a | |
| Virginia | n/a | |
| Washington | Yes | 40% |
| West Virginia | No | |
| Wisconsin | Yes | 20% or \$1,800, greater |
| Wyoming | n/a | |

*n/a - Chaplains serve as volunteers or are outsourced as independent contractors
 **MO & NJ: Chaplain requests a specific dollar amount to be designated*

For more discussion of ministerial classification for clergy not employed by a church or church-controlled organization, see *Housing Allowance for Nonprofit Clergy: Yes or No?*, found on the “Resources” page at www.walshfdn.net.

Questions and suggestions regarding this information are invited. While we attempt to provide accurate and up to date information, laws and policies are subject to change. Competent personal guidance should be obtained as needed.

About the author

The mission of The Micah Project is to advance the gospel of Jesus Christ as a means to reconciliation, justice, and mercy. “And what does the LORD require of you? To act justly and to love mercy and to walk humbly with your God” (Micah 6:8). As part of this mission, we provide technical guidance to religious workers and exempt organizations.

Dennis Walsh can be reached at (336) 285-6753 or nonprofitcpa365@gmail.com.