PART 3 Step-by-Step Tax Return Preparation

TAX FORMS AND SCHEDULES

This step-by-step analysis covers these forms and schedules:

Form 1040 is the basic document you will use. It summarizes all of your tax information. Details are reported on supplementary schedules and forms.

Schedule A is for itemized deductions for medical and dental expenses, taxes, interest, contributions, casualty and theft losses, and miscellaneous items. Some expenses related to ministerial income may also be deducted on *Schedule A*.

Schedule B is for reporting dividend and interest income.

Schedule C is for reporting your income and expenses from business activities you conduct other than in your capacity as an employee. Examples would be fees received for guest speaking appearances in other churches or fees received directly from members for performing personal services, such as weddings and funerals.

Schedule SE is for Social Security taxes due on your self-employment income and on your salary and housing allowance as an employee of the church, if you are an ordained minister.

Form 2106 is used to report expenses you incur in your capacity as an employee of the church.

These forms and schedules, along with others, are included in the illustrated example in Part 4 of this guide. These forms and schedules are the ones most commonly used by ministers, but you may have a need for others. These forms may be obtained at your local post office or IRS office. Or, you can obtain them by calling the IRS toll-free forms hotline at 1-800-TAX-FORM (1-800-829-3676). They also are available on the IRS website *(IRS .gov)*.

Form 1040

Step 1: Name and address

Print or type the information in the spaces provided. If you are married filing a separate return, enter your spouse's name on line 3 instead of below your name. If you filed a joint return for 2015 and you are filing a joint return for 2016 with the same spouse, be sure to enter your names and Social Security numbers in the same order as on your 2015 return.

If you plan to move after filing your return, use *Form 8822* to notify the IRS of your new address.

If you changed your name because of marriage, divorce, etc., be sure to report the change to the SSA before filing your return. This prevents delays in processing your return and issuing refunds. It also safeguards your future Social Security benefits.

Enter your P.O. Box number only if your post office does not deliver mail to your home.

If you want $3 to go to the presidential election campaign fund, check the box labeled "you." If you are filing a joint return, your spouse can also have $3 go to the fund (check "spouse"). If you check a box, your tax or refund will not change.

Step 2: Filing status

Select the appropriate filing status from the five options listed in this section of the *Form 1040*.

Step 3: Exemptions

You generally are allowed one exemption for yourself. If you are married, you may be allowed an exemption for your spouse. These are called personal exemptions. Some restrictions apply (see IRS *Publication 501*).

You are allowed one exemption for each person you can claim as a dependent. The term "dependent" means a **qualifying child** or **qualifying relative.** To claim a dependency exemption for a **qualifying child**, the following tests must be met:

1. The child must be your son, daughter, stepchild, foster child, brother, sister, half brother, half sister, stepbrother, stepsister, or a descendant of any of them.
2. The child must be (a) under age 19 at the end of the year and younger than you (or your spouse, if filing jointly); (b) under age 24 at the end of the year, a full-time student, and younger than you (or your spouse, if filing jointly); or (c) any age if permanently and totally disabled.
3. The child must have lived with you for more than half of the year.
4. The child must not have provided more than half of his or her own support for the year.
5. The child is not filing a joint return for the year (unless that return is filed only as a claim for refund).

If the child meets the rules to be a qualifying child of more than one person, only one person can actually treat the child as a qualifying child.

To claim a dependency exemption for a **qualifying relative,** the following tests must be met:

1. The person cannot be your qualifying child or the qualifying child of any other taxpayer.

2. The person either (a) must be your child, stepchild, foster child, or a descendant of any of them; your brother, sister, half brother, half sister, stepbrother, or stepsister; your father, mother, grandparent, or other direct ancestor, but not a foster parent; your stepfather or stepmother; a son or daughter of your brother or sister; a brother or sister of your father or mother; your son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law; or (b) must live with you all year as a member of your household (and your relationship must not violate local law).

3. The person's gross income for the year must be less than $4,050.

4. You must provide more than half of the person's total support for the year.

The following conditions apply both to the **qualifying child** or **qualifying relative** exemptions:

- You cannot claim any dependents if you, or your spouse if filing jointly, could be claimed as a dependent by another taxpayer.
- You cannot claim a married person who files a joint return as a dependent unless that joint return is only a claim for refund and there would be no tax liability for either spouse on separate returns.
- You cannot claim a person as a dependent unless that person is a U.S. citizen, U.S. resident alien, U.S. national, or a resident of Canada or Mexico for some part of the year.

For more information on dependents, see IRS *Publication 501.*

Step 4: Income

Several items of income are reported on lines 7 through 21. The most important of these (for ministers) are discussed below.

☞ **Key Point:** Some items, such as the housing allowance, are not reported as income. They are called exclusions and are explained below.

Line 7. Wages, salaries, tips, etc.

☞ **Key Point:** The amount reported on line 7 ordinarily will be the same as reported by the church as wages in box 1 of the minister's *Form W-2*.

As an employee, you should receive a *Form W-2* from your church reporting your wages at the end of each year. Report this amount on line 7.

Determining church wages or salary. Besides a salary, ministers' wages may include several other items, including:

- Bonuses
- Excess housing allowance (the amount by which a housing allowance exceeds the lesser of a minister's actual housing expenses or the fair rental value of the minister's home)
- The cost of sending a minister to the Holy Land (if paid by the church)
- Retirement gifts paid by a church
- Most Christmas and special occasion offerings
- The portion of a minister's Social Security tax paid by a church
- Personal use of a church-provided car
- Purchases of church property for less than fair market value
- Business expense reimbursements under a non-accountable plan
- Reimbursements the church made for the minister's moving expenses (but not if the minister substantiated the reimbursed expenses under an accountable arrangement)
- Church reimbursements of a spouse's travel expenses incurred while accompanying a minister on a business trip (this represents income to the minister unless the spouse's presence serves a legitimate business purpose and the spouse's expenses are reimbursed under an accountable arrangement)
- Discretionary funds established by a church for a minister to spend on current needs — if the minister is allowed to distribute funds for his personal benefit
- Below-market interest loans of at least $10,000 made by a church to a minister (some exceptions apply)
- Cancellation of a minister's debt to a church
- Severance pay
- Payment of a minister's personal expenses by the church
- Love gifts

☞ **Key Point:** The IRS can assess intermediate sanctions in the form of substantial excise taxes against a minister who is an officer or director of his employing church, and in some cases against church board members, if the minister is paid an excess benefit. Excess benefits may occur if a church pays a minister an excessive salary, makes a large retirement or other special occasion gift to a minister, gives church property (such as a parsonage) to the minister, or sells church property to the minister at an unreasonably low price. A rebuttable presumption arises that compensation is reasonable if it is approved by an independent board on the basis of comparable data or independent compensation surveys and the basis for the board's decision is documented.

☞ **Key Point:** The IRS has ruled that disqualified persons receive automatic excess benefits resulting in intermediate sanctions, regardless of amount, if they use church assets (vehicles, homes, credit cards, computers, etc.) for personal purposes or receive non-accountable expense reimbursements (not supported by adequate documentation of business purpose), unless such benefits are reported as taxable income by the church on the disqualified person's *W-2*, or by the disqualified person on his or her *Form 1040*, for the year in which the benefits are provided. A disqualified person is an officer or director of the employer or a relative of such a person. The concept of automatic excess benefits will directly affect the compensation practices of most churches and expose some ministers and church board members to intermediate sanctions.

If some of these items were not reported on your *Form W-2,* they still must be reported as income. Your church should issue a corrected *Form W-2* (*Form W-2c*) for the year in which one or more items of taxable income was not reported on your *Form W-2*. If you have filed an income tax return for the year shown, you may have to file an amended return. Compare amounts on *Form W-2c* with those reported on your income tax return. If the corrected amounts change your U.S. income tax, file *Form 1040X, Amended U.S. Individual Income Tax Return,* with *Copy B* of *Form W-2c* to amend the return you previously filed.

Items not reported on line 7. Some kinds of income are not taxable. These items are called **exclusions.** Most exclusions apply in computing both income taxes and self-employment taxes. The housing allowance is an example of an exclusion that applies only to income taxes and not to self-employment taxes. Some of the more common exclusions for ministers include:

Gifts. Gifts are excludable from taxable income so long as they are not compensation for services. However, employers generally are not permitted to give tax-free gifts to employees.

Life insurance and inheritances. Life insurance proceeds and inheritances are excludable from taxable income. Income earned before distributions of proceeds is generally taxable as income.

Employer-paid group life insurance. Employees may exclude the cost of employer-provided group term life insurance so long as the amount of coverage does not exceed $50,000.

Tuition reductions. School employees may exclude from their taxable income a qualified tuition reduction provided by their employer. A qualified tuition reduction is a reduction in tuition charged to employees or their spouses or dependent children by an employer that is an educational institution.

Lodging. The value of lodging furnished to an employee on an employer's premises and for the employer's convenience may be excludable from taxable income if the employee is required to accept the lodging as a condition of employment. This exclusion is not available in the computation of self-employment taxes.

Educational assistance. Amounts paid by an employer for an employee's tuition, fees, and books may be excludable from the employee's taxable income. The exclusion may not exceed $5,250 per year.

Employer-provided child care. The value of free childcare services provided by a church to its employees is excluded from employees' income so long as the benefit is based on a written plan that does not discriminate in favor of highly compensated employees. Other conditions apply.

Nondiscrimination rules. Many of the exclusions are not available to employees who are either highly compensated employees or key employees if the same benefit is not available on a nondiscriminatory basis to lower-paid employees. For 2016 and 2017, a highly compensated employee is an employee whose compensation for the previous year was in excess of $120,000.

Employee status. Some exclusions are available only to taxpayers who report their income taxes as employees and not as self-employed persons. Many, however, apply to both employees and self-employed persons.

Four other exclusions will be discussed separately — the housing allowance, tax-sheltered annuities, qualified scholarships, and sale of one's home.

Housing allowance

☞ **Key Point:** The housing allowance is being challenged in a federal court in Wisconsin as an unconstitutional preference for religion. The current status of this case is summarized in a special section at the beginning of this tax guide.

The most important tax benefit available to ministers who own or rent their homes is the housing allowance exclusion. Ministers who own or rent their homes do not pay federal income taxes on the amount of their compensation that their employing church designates in advance as a housing allowance, to the extent that (1) the allowance represents compensation for ministerial services; (2) it is used to pay housing expenses; and (3) it does not exceed the fair rental value of the home (furnished, plus utilities). Housing-related expenses include mortgage payments, rent, utilities, repairs, furnishings, insurance, property taxes, additions, and maintenance.

Under no circumstances can a church designate a housing allowance retroactively. Some churches fail to designate housing allowances and thereby deprive ministers of an important tax benefit.

Ministers who live in a church-owned parsonage do not pay federal income taxes on the fair rental value of the parsonage.

$ **Tax-savings tip.** Ministers who live in a church parsonage and incur any out-of-pocket expenses in maintaining the parsonage (such as utilities, property taxes, insurance, furnishings, or lawn care) should be sure that their employing church designates in advance a portion of their annual compensation as a parsonage allowance. The amount so designated is not reported as wages on the minister's *Form W-2* at the end of the year (if the allowance exceeds the actual expenses, the difference must be reported as income by the minister). This is a very important tax benefit for ministers living in a church-provided parsonage. Unfortunately, many of these ministers are not aware of this benefit or are not taking advantage of it.

$ **Tax-savings tip.** Ministers who own their homes lose the largest component of their housing allowance exclusion when they pay off their home mortgage loan. Many ministers in this position have obtained home equity loans or a conventional loan secured by a mortgage on their otherwise debt-free home and have claimed their payments under these kinds of loans as a housing expense in computing their housing allowance exclusion. The Tax Court has ruled that this is permissible only if the loan was obtained for housing-related expenses.

$ **Tax-savings tip.** Ministers should be sure that the designation of a housing or parsonage allowance for the next year is on the agenda of the church (or church board) for one of its final meetings during the current year. The designation should be an official action, and it should be duly recorded in the minutes of the meeting. The IRS also recognizes designations included in employment contracts and budget line items — assuming in each case that the designation was appropriately adopted in advance by the church and supported by underlying documentation as to each minister's anticipated housing expenses.

The rental value of a parsonage, and a housing allowance, are exclusions only for federal income tax reporting purposes. Ministers cannot exclude a housing allowance or the fair rental value of a parsonage when computing self-employment taxes **unless they are retired.** The tax code specifies that the self-employment tax does **not** apply to "the rental value of any parsonage or any parsonage allowance provided after the [minister] retires."

The housing allowance is available to ministers whether they report their income taxes as employees or as self-employed (whether the church issues them a *W-2* or a *1099*).

Housing expenses to include in computing your housing allowance exclusion

Ministers who own or rent their home should take the following expenses into account in computing their housing allowance exclusion:

- Down payment on a home (but remember, a housing allowance is non-taxable only to the extent that it does not exceed the lesser of actual housing expenses or the fair rental value of a minister's home, furnished, plus utilities)
- Mortgage payments on a loan to purchase or improve your home (include both interest and principal)
- Rent
- 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.)
- Homeowner's association dues

☞ **Key Point:** In 2007 the Tax Court characterized Internet expenses as utility expenses. This suggests that a housing allowance may be used to pay for Internet expenses (i.e., Internet access, cable television). Neither the IRS nor the Tax Court has addressed this issue directly, so be sure to check with a tax professional about the application of a housing allowance to these expenses.

Please note the following:

- A housing allowance must be designated in advance. Retroactive designations of housing allowances are not effective.
- The housing allowance designated by the church is not necessarily non-taxable. It is non-taxable (for income taxes) only to the extent that it is used to pay for housing expenses and, for ministers who own or rent their home, does not exceed the fair rental value of their home (furnished, plus utilities).
- A housing allowance can be amended during the year if a minister's housing expenses are more than expected. However, an amendment is only effective prospectively. Ministers should notify their church if their actual housing expenses are significantly more than the housing allowance designated by their church. Remember, however, that it serves no purpose to designate a housing allowance greater than the fair rental value of a minister's home (furnished, plus utilities).
- If the housing allowance designated by the church exceeds housing expenses or the fair rental value of a minister's home, the excess housing allowance should be reported on line 7 of *Form 1040*.
- The housing allowance exclusion is an exclusion for federal income taxes only. Ministers must add the housing allowance as income in reporting self-employment taxes on *Schedule SE* (unless they are exempt from self-employment taxes).
- The fair rental value of a church-owned home provided to a minister as compensation for ministerial services is not subject to federal income tax.

Example: A church designated $25,000 of Pastor D's 2016 compensation as a housing allowance. Pastor D's housing expenses for 2016 were utilities of $4,000, mortgage payments of $18,000, property taxes of $4,000, insurance payments of $1,000, repairs of $1,000, and furnishings of $1,000. The fair rental value of the home (including furnishings) is $15,000. Pastor D's housing allowance is non-taxable in computing income taxes only to the extent that it is used to pay housing expenses and does not exceed the fair rental value of his home (furnished, plus utilities). Stated differently, the non-taxable portion of a housing allowance is the least of the following three amounts: (1) the housing allowance designated by the church; (2) actual housing expenses; or (3) the fair rental value of the home (furnished, plus utilities). In this case, the lowest of these three amounts is the fair rental value of the home, furnished, plus utilities ($19,000), and so this represents the non-taxable portion of Pastor D's housing allowance. Pastor D must report the difference between this amount and the housing allowance designated by his church ($6,000) as additional income on line 7 of *Form 1040.*

Example: Same facts as the previous example, except the church designated $12,000 of Pastor D's salary as a housing allowance. The lowest of the three amounts in this case would be $12,000 (the church-designated housing allowance), and so this represents the non-taxable amount. Note that Pastor D's actual housing expenses were more than the allowance, and so he was penalized because of the low allowance designated by his church.

Example: Pastor Y owns a home and incurred housing expenses of $12,000 in 2016. These expenses include mortgage principal and interest, property taxes, utilities, insurance, and repairs. The church designated (in advance) $12,000 of Pastor Y's 2016 compensation as a housing allowance. Pastor Y is able to itemize expenses on *Schedule A (Form 1040)*. He is able to claim itemized deductions on *Schedule A* for both his mortgage interest and his property taxes, even though his taxable income was already reduced by these items because of their inclusion in the housing allowance. This is often referred to as the double deduction. In fact, it represents an exclusion and a deduction.

Example: In preparing his income tax return for 2016, Pastor H discovers that his church failed to designate a housing allowance for him for 2016. He asks his church to pass a resolution retroactively granting the allowance for 2016. Such a resolution is ineffective, and Pastor H will not be eligible for any housing allowance exclusion in 2016.

Key Point: The Sarbanes-Oxley Act makes it a crime to knowingly falsify any document with the intent to influence "the investigation or proper administration of any matter within the jurisdiction of any department or agency of the United States . . . or in relation to or contemplation of any such matter or case," and this provision contains no exemption for churches or pastors. It is possible that a pastor's backdating of a board resolution to qualify for a housing allowance for the entire year violates this provision in the Sarbanes-Oxley Act, 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.

$ Tax-savings tip. Ministers should be sure that the designation of a housing or parsonage allowance for the next year is on the agenda of the church board for one of its final meetings during the current year. The designation should be an official action, and it should be duly recorded in the minutes of the meeting. The IRS also recognizes designations included in employment contracts and budget line items — assuming, in each case, that the designation was duly adopted in advance by the church.

How much should a church designate as a housing allowance?

Many churches base the housing allowance on their minister's estimate of actual housing expenses for the new year. The church provides the minister with a form on which anticipated housing expenses for the new year are reported. For ministers who own their homes, the form asks for projected expenses in the following categories: down payment, mortgage payments, property taxes, property insurance, utilities, furnishings and appliances, repairs and improvements, maintenance, and miscellaneous. Many churches designate an allowance in excess of the anticipated expenses itemized by the minister. Basing the allowance solely on a minister's anticipated expenses penalizes the minister if actual housing expenses turn out to be higher than expected. In other words, the allowance should take into account unexpected housing costs or inaccurate projections of expenses.

☞ **Key Point:** The housing allowance is available only if two conditions are met: (1) The recipient is a Minister for Tax Purposes (as defined above), and (2) the allowance is compensation for services performed in the exercise of ministry.

Churches sometimes neglect to designate a housing allowance in advance of a new calendar year. For example, a church board may discover in March of 2017 that it failed to designate a housing allowance for its pastor for 2017. It is not too late to act. The church should immediately designate a portion of its minister's remaining compensation for 2017 as a housing allowance. This problem can be avoided by stipulating in each annual housing allowance designation that the allowance is for the current year and **all future years unless otherwise provided.** If such a resolution had been adopted in the December 2015 board meeting (i.e., "for 2016 and future years"), it would not matter that the church neglected to designate a minister's 2017 allowance until March of 2017, since the previous designation would have carried over. Such safety net designations are not a substitute for annual housing allowances (they have never been addressed or endorsed by the IRS or Tax Court). Rather, they provide a basis for claiming a housing allowance if a church neglects to designate one.

☞ **Key Point:** Remember — churches cannot designate a housing allowance retroactively.

☞ **Key Point:** The IRS has ruled that a retired minister is eligible for a housing allowance exclusion if the following conditions are satisfied: (1) A portion of the retired minister's pension income is designated as a housing allowance by his church or the church pension board of a denominational pension fund; (2) the retired minister has severed his relationship with the local church and relies on the fund for a pension; and (3) the pensions paid to retired ministers "compensate them for past services to the local churches of the denomination or to the denomination." Retired ministers who receive benefits from a denominational pension fund will be eligible in most cases to have some or all of their benefits designated in advance as a housing allowance. This is an attractive benefit for retired ministers that is not available with some other kinds of retirement plans. Retired ministers also can exclude from their gross income the rental value of a home (plus utilities) furnished to them by their church as a part of their pay for past services. A minister's surviving spouse cannot exclude a housing allowance or rental value of a parsonage unless the allowance or parsonage is for ministerial services he performs or performed.

The self-employment tax does not apply to the rental value of a parsonage or a housing allowance provided after a minister retires.

☞ **Key Point:** Ministers who own their homes lose the largest component of their housing allowance exclusion when they pay off their home mortgage loan. Many ministers in this position have obtained home equity loans — or a conventional loan secured by a mortgage on their otherwise debt-free home — and have claimed their payments under these kinds of loans as a housing expense in computing their housing allowance exclusion. The Tax Court has ruled that this is permissible only if the loan was obtained for housing-related expenses.

Section 403(b) plans

For 2016, payments made by your church and your salary reduction contributions to a 403(b) plan are not reportable income for income tax or self-employment tax purposes as long as the total amount credited to your retirement account does not exceed contribution limits under sections 415(c) and 402(g) of the tax code.

Contribution limits

For 2016, total annual additions (employer contributions, salary reduction, and tax-paid contributions) could not exceed the lesser of 100 percent of your compensation (excluding a minister's housing allowance) or $53,000. This rule is known as the section 415(c) limit. Excess contributions can result in income tax, additional taxes, and penalties. The effect of excess contributions depends on the type of excess contribution. The distributed excess amount may not be rolled over to another 403(b) plan or to an IRA.

✓ **New in 2017.** The limit on annual additions is $54,000 for 2017.

Minister's housing allowance and contribution limits

For 2016, the section 415(c) limit restricts 403(b) contributions to the lesser of 100 percent of compensation or $53,000. For 2017, this amount is $54,000. Does the term "compensation" include a minister's housing allowance? This is an important question for ministers, since the answer will determine how much can be contributed to a 403(b) plan. If the housing allowance is treated as compensation, then ministers will be able to contribute larger amounts. The tax code specifies that the term "compensation" for purposes of applying the section 415(c) limit to a 403(b)(3) plan "means the participant's includible compensation determined under section 403(b)(3)." Section 403(b)(3) defines compensation to include "the amount of compensation which is received from the employer . . . and which is includible in gross income." Section 107 of the tax code specifies that a minister's housing allowance (or the annual rental value of a parsonage) is **not** included in the minister's gross income for income tax reporting purposes. Therefore, it would appear that the definition of compensation for purposes of computing the section 415(c) limit would **not** include the portion of a minister's housing allowance that is excludable from gross income, or the annual rental value of a parsonage. For many years the IRS website included the following question and answer addressing this issue:

Q. I am an employee minister in a local church. Each year, my church permits $25,000 as a yearly tax-free housing allowance. I would like to use my yearly housing allowance as compensation to determine my annual contribution limits (to a TSA) under section 415(c) of the *Internal Revenue Code.* May I do so?

A. No. For purposes of determining the limits on contributions under section 415(c) of the *Internal Revenue Code,* amounts paid to an employee minister, as a tax-free housing allowance, may not be treated as compensation pursuant to the definitions of compensation under section 1.415-2(d) of the income tax regulations.

Salary reduction contributions (section 402(g))

In addition to the section 415(c) limit there is an annual limit on elective deferrals. The limit applies to the total of all elective deferrals contributed (even if contributed by different employers) for the year on your behalf to a variety of retirement plans, including 403(b) plans. Generally, you cannot defer more than an allowable amount each year for all plans covering you. For 2016, the allowable limit was $18,000. If you defer more than the allowable amount for a tax year, you must include the excess in your taxable income for that year.

✓ **Same in 2017.** The dollar limit on annual elective deferrals remains at $18,000.

☞ **Key Point:** Church employees can make a special election that allows their employer to contribute up to $10,000 for the year, even if this is more than 100 percent of your compensation. The total contributions over your lifetime under this election cannot be more than $40,000.

The limit on elective deferrals increases for individuals who have attained age 50 by the end of the year. The additional amount that may be made is the lesser of (1) the applicable dollar amount or (2) the participant's compensation for the year reduced by any other elective deferrals of the participant for the year. The applicable dollar amount is $6,000 for 2016 and 2017. Catch-up contributions are not subject to any other contribution limits and are not taken into account in applying other contribution limits.

Qualified scholarships

☞ **Key Point:** Qualified scholarships are excludable from taxable income.

Amounts received as a qualified scholarship by a candidate for a degree may be excluded from gross income. A qualified scholarship is any grant amount that, in accordance with the conditions of the grant, is used for tuition and course-related expenses. Qualified tuition and related expenses are those used for (1) tuition and fees required for the enrollment or attendance at an educational institution or (2) fees, books, supplies, and equipment required for courses of instruction at the educational institution. The scholarship need not specify that it is to be used only for qualified tuition and related expenses. All that is required is that the recipient uses the scholarship for such expenses and that the scholarship does not specify that it is to be used for non-qualified expenses (such as room and board).

☞ **Key Point:** Amounts paid by a church for the education of a pastor or other church employee cannot be treated as a non-taxable scholarship if paid as compensation for services.

Any amount received in excess of the qualified tuition and related expenses, such as amounts received for room and board, is not eligible for this exclusion.

Any amount received that represents payment for teaching, research, or other services required as a condition for receiving a qualified scholarship cannot be excluded from gross income. In addition, amounts paid by a church for the education of a pastor or other church employee cannot be treated as a non-taxable scholarship if paid as compensation for services.

✍ **Example:** First Church establishes a scholarship fund for seminary students. Robert is a church member who is pursuing a master's degree at a seminary. The church votes to award him a scholarship of $2,500 for 2017. So long as Robert uses the scholarship award for tuition or other course-related expenses, he need not report it as income on his federal tax return, and the church need not issue him a *1099-MISC*. The better practice would be for the church to stipulate that the scholarship is to be used for tuition or other course-related expenses (for example, fees, books, supplies) or for the church to pay the expenses directly to the educational institution. This will ensure that the scholarship does not inadvertently become taxable income because its specific use was not designated and the recipient used it for non-qualified expenses.

Sale or exchange of your principal residence

An individual taxpayer can exclude up to $250,000 ($500,000 if married filing a joint return) of gain realized on the sale or exchange of a principal residence. To be eligible for the exclusion, the taxpayer must have owned and used the residence as a principal residence for at least two of the five years ending on the sale or exchange. A taxpayer who fails to meet these requirements by reason of a change of place of employment, health, or certain unforeseen circumstances can exclude an amount equal to the fraction of the $250,000 ($500,000 if married filing a joint return) equal to the fraction of the two years that the ownership and use requirements were met.

In most cases, gain from the sale or exchange of your main home will not qualify for the exclusion to the extent that the gains are allocated to periods of non-qualified use. Non-qualified use is any period after 2008 during which the property is not used as the main home.

The gain resulting from the sale of the property is allocated between qualified and non-qualified use periods based on the amount of time the property was held for qualified and non-qualified use. Gain from the sale or exchange of a main home allocable to periods of qualified use will continue to qualify for the exclusion for the sale of your main home. Gain from the sale or exchange of property allocable to non-qualified use will not qualify for the exclusion.

Gain is, in most cases, allocated to periods of non-qualified use based on the ratio which: (1) the aggregate periods of non-qualified use during the period the property was owned by you over (2) the total period the property was owned by you. You do not incorporate any period before 2009 for the aggregate periods of non-qualified use. Certain exceptions apply. For details, see IRS *Publication 523.*

A period of non-qualified use does not include: (1) any portion of the five-year period ending on the date of the sale or exchange after the last date you (or your spouse) use the property as a main home; (2) any period (not to exceed an aggregate period of 10 years) during which you (or your spouse) are serving on qualified official extended duty as a member of the uniformed services; or (3) any other period of temporary absence (not to exceed an aggregate period of two years) due to change of employment, health conditions, or such other unforeseen circumstances as may be specified by the IRS.

Line 8a. Taxable interest income: attach Schedule B *if more than $1,500*

Complete this line only if you had taxable interest income. If you had taxable interest income of more than $1,500, complete *Schedule B.* Report tax-exempt interest income on line 8b.

Line 9a. Ordinary dividend income: attach Schedule B *if more than $1,500*

Complete this line only if you had dividend income. If you had dividend income of more than $1,500, complete *Schedule B.*

Line 12. Business income (or loss): attach Schedule C *or* C-EZ

Complete this line only if you had any net earnings from self-employment activities. These include:

- Compensation reported to you on a *Form 1099-MISC*
- Fees received directly from church members for performing personal services (such as weddings and funerals)
- Honoraria you received for guest speaking appearances in other churches

If you received income from any of these kinds of activities, compute your net earnings on *Schedule C* and transfer this amount to line 12. This guide includes more detailed information in the section on *Schedule C*. You may be able to use the simpler *Schedule C-EZ* if several conditions are met. See the instructions to *Schedule C-EZ* for details.

Line 13. Capital gain (or loss): attach Schedule D

Complete this line only if you had any gains or losses from the sale of capital assets. These include stocks, bonds, and property. Gain or loss is reported on *Schedule D.* You also may have to file *Form 8949* (see the instructions to both forms for details).

Line 16a. Pensions and annuities

You should receive a *Form 1099-R* showing the total amount of your pension and annuity payments before income tax or other deductions were withheld. This amount should be shown in box 1 of *Form 1099-R*. Pension and annuity payments include distributions from 401(k) and 403(b) plans. Do not include the following payments on lines 16a and 16b. Instead, report them on line 7:

- Disability pensions received before you reach the minimum retirement age set by your employer.
- Corrective distributions (including any earnings) of excess salary deferrals or excess contributions to retirement plans. The plan must advise you of the year(s) the distributions are includible in income.

Many denominational pension funds annually designate 100 percent of pension and disability benefits paid to retired ministers as a housing allowance. In such cases, the *Form 1099-R* may show that the taxable amount of the pension income is "not determined" by checking the box on line 2b. If you are a retired or disabled minister, you may exclude all or a portion of your pension or disability income from your gross income reported on line 16a of *Form 1040* if (1) you can document that the monies were actually spent on housing-related expenses during the tax year and (2) the amount excluded does not exceed the fair rental value of the home (furnished, including utilities).

IRS *Publication 517* states: "If you are a retired minister, you can exclude from your gross income the rental value of a home (plus utilities) furnished to you by your church as a part of your pay for past services, or the part of your pension that was designated as a rental allowance. However, a minister's surviving spouse cannot exclude the rental value unless the rental value is for ministerial services he or she performs or performed."

☞ **Key Point:** Surviving spouses of deceased ministers cannot exclude any portion of the benefits received from their deceased spouse's 403(b) account as a housing allowance.

Taxation of distributions from a 403(b) plan

Amounts you contribute through salary reduction, and the earnings attributable to these contributions, generally cannot be withdrawn before you reach age 59½, separate from service, die, or become disabled. In some cases of financial hardship, you may withdraw your own salary reduction contributions (but not the earnings on them) prior to the occurrence of any of the above events. A 403(b) plan may make hardship distributions only if permitted by the plan.

Once amounts are distributed, they are generally taxable as ordinary income unless designated in advance as a minister's housing allowance. In addition, if amounts are distributed prior to your reaching age 59½, you will be assessed an additional tax of 10 percent of the amount which is includable in income, unless one of the following exceptions applies:

- The distributions are part of a series of substantially equal periodic payments made over your life or the lives of your beneficiaries and after you separate from service.
- The distributions are made after you separate from service in or after the year in which you reach age 55.
- The distributions do not exceed the amount of unreimbursed medical expenses that you could deduct for the current year.
- The distributions are made after your death or after you become disabled.
- The distributions are made to an alternate payee pursuant to a qualified domestic relations order.

The additional tax is computed on *Form 5329.*

☞ **Key Point:** You must receive all, or at least a certain minimum, of your interest accruing after 1986 in a 403(b) plan by April 1 of the calendar year following the later of the calendar year in which you become age 70½, or the calendar year in which you retire. This required minimum is called your required minimum distribution (RMD).

Line 20a. Social Security benefits

☞ **Key Point:** Individuals who receive Social Security retirement, disability, or survivor benefits may have to pay taxes on a portion of their benefits.

If you received Social Security benefits in 2016, you need to know whether or not these benefits are taxable. Here are several rules the IRS has formulated to assist Social Security beneficiaries in knowing if their benefits are taxable:

1. How much, if any, of your Social Security benefits are taxable depends on your total income and marital status.
2. Generally, if Social Security benefits were your only

income for 2016, your benefits are not taxable and you probably do not need to file a federal income tax return.

3. If you received income from other sources, your benefits will not be taxed unless your modified AGI is more than the base amount for your filing status.
4. Your taxable benefits and modified AGI are computed on a worksheet in the instructions to *Form 1040A* and *Form 1040.*
5. You can do the following quick computation to determine whether some of your benefits may be taxable:
   - First, add one-half of the total Social Security benefits you received to all your other income, including any tax-exempt interest and other exclusions from income.
   - Then, compare this total to the base amount for your filing status. If the total is more than your base amount, some of your benefits may be taxable.
6. The 2016 base amounts are:
   - $32,000 for married couples filing jointly
   - $25,000 for single, head of household, qualifying widow/widower with a dependent child or married individuals filing separately who did not live with their spouses at any time during the year
   - $0 for married persons filing separately who lived together during the year
7. For additional information on the taxability of Social Security benefits, see IRS *Publication 915, Social Security and Equivalent Railroad Retirement Benefits. Publication 915* is available at *IRS.gov.*

Working after you retire. Many churches employ retired persons who are receiving Social Security benefits. Persons younger than full retirement age may have their Social Security retirement benefits cut if they earn more than a specified amount. Full retirement age (the age at which you are entitled to full retirement benefits) for persons born in 1943–1954 is 66 years. In the year you reach full retirement age, your monthly Social Security retirement benefits are reduced by $1 for every $3 you earn above a specified amount ($3,740 per month for 2017). No reduction in Social Security benefits occurs for income earned in the month full retirement age is attained (and all future months). Persons who begin receiving Social Security retirement benefits prior to the year in which they reach full retirement age will have their benefits reduced by $1 for every $2 of earned income in excess of a specified amount. For 2017 this annual amount is $16,920.

While the SSA has never officially addressed the issue, it is likely that a minister's housing allowance counts as earnings for purposes of the annual earnings test.

Line 21. Other income: list the type and amount

➤ **Recommendation.** If you have other income to report on line 21, consider enclosing an explanation of your other income with your *Form 1040* or write a brief explanation in the space provided next to line 21. This will help to avoid confusion.

Complete this line only if you have other income. This includes the following items:

- A canceled debt or a debt paid for you by another person (unless the person who canceled or paid your debt intended it to be a gift)
- The fair market value of a free tour you receive from a travel agency for organizing a group of tourists (in some cases this may be reported on *Schedule C*)
- Most prizes and awards
- Some taxable distributions from a Health Savings Account (HSA) or Archer MSA (see IRS *Publication 969*)
- Jury duty pay

Step 5: Adjustments to income

You may deduct certain adjustments from gross income in computing your AGI. Report the adjustments on lines 23 through 37 of *Form 1040*. The most relevant adjustments to ministers are summarized below.

Line 26. Moving expenses

If your allowable moving expenses are not reimbursed by your employer, or they are reimbursed under a non-accountable plan, you compute your moving expense deduction on *Form 3903* and report your deduction on line 26. Allowable moving expenses are expenses you incurred because of a change of jobs or your acceptance of a new job, if you satisfy the following three conditions:

1. Your new job location is at least 50 miles farther from your former home than your old job location was. For example, if your old job was three miles from your former home, your new job must be at least 53 miles from that home (measured according to the shortest of the more commonly traveled routes between those points).
2. If you report your income taxes as an employee, you must work full time for at least 39 weeks during the first 12 months after you arrive in the general area of your new job location. You do not have to work for one employer for the 39 weeks. However, you must work full time within the same general commuting area. If you are married and file a joint return and both you and your spouse work full time, either of you may satisfy the full-time work test. However, you may not combine your weeks of work.

3. Your move must be closely related, both in time and place, to the start of work at your new job location. In general, moving expenses incurred within one year from the date you first reported to work are considered closely related **in time** to the start of work at the new location. It is not necessary that you make arrangements to work before moving to a new location, as long as you actually do go to work. If you do not move within one year, you ordinarily may not deduct the expenses unless you can show that circumstances existed that prevented the move within that time. A move is generally not closely related **in place** to the start of work if the distance from your new home to the new job location is greater than the distance from your former home to the new job location.

If your employer reimburses your allowable moving expenses under an accountable plan, the reimbursements are not reported by the employer as taxable income, and you have no deduction to report on line 26. To be an accountable plan, your employer's reimbursement arrangement must require you to meet all three of the following rules: (1) Your expenses must have a business connection — that is, you must have paid or incurred deductible expenses while performing services as an employee of your employer; (2) you must adequately account to your employer for these expenses within a reasonable period of time; and (3) you must return any excess reimbursement or allowance within a reasonable period of time. See IRS *Publication 521* for details.

If for all reimbursements you meet the three rules for an accountable plan (listed earlier), your employer should **not** include any reimbursements of expenses in your income in box 1 of your *Form W-2.* Instead, your employer should include the reimbursements in box 12 (code P) of your *Form W-2.*

An employer's reimbursements of an employee's moving expenses under an arrangement that does not meet the three requirements of an accountable plan must be reported as wages in box 1 of the employee's *Form W-2.*

Deductible moving expenses

Moving your household goods and personal effects. You may deduct the cost of packing, crating, and transporting your household goods and personal effects from your former home to your new one. You may also deduct (1) the cost of storing and insuring household goods and personal effects for all or part of the time the new job location remains your main job location; and (2) reasonable expenses of moving your personal effects to and from storage.

Travel expenses. You may deduct the cost of transportation and lodging (but not meals) for you and members of your household while traveling from your former home to your new home. You may deduct expenses of only one trip to your new home. However, all of the members of your household do not need to travel together.

You may not deduct any of the following expenses as moving expenses: pre-move house-hunting expenses; the expenses of disposing of your former home and obtaining your new home; home improvements to help you sell your former home; loss on the sale of your former home; mortgage penalties; any part of the purchase price of your new home; and real estate taxes. Use *Form 3903* to compute the deduction.

As noted above, if your employer reimburses your allowable moving expenses under an accountable arrangement, the reimbursements are not reportable as taxable income to you and there are no deductions to report.

Line 27. One-half of self-employment tax

☞ **Key Point:** Every minister who pays Social Security taxes on ministerial income qualifies for this deduction. Some are not claiming it.

All ministers are self-employed for Social Security with respect to their ministerial income. They can deduct half of their actual self-employment taxes as an adjustment on line 27 of *Form 1040*, whether or not they are able to itemize deductions on *Schedule A.*

Line 32. Payments to an Individual Retirement Account (IRA)

An Individual Retirement Arrangement, or IRA, is a personal savings plan which allows you to set aside money for retirement, while offering tax advantages. You can set up different kinds of IRAs with a variety of organizations, such as a bank or other financial institution, a mutual fund, or a life insurance company.

The original IRA is referred to as a Traditional IRA. A Traditional IRA is any IRA that is not a Roth IRA or a SIMPLE IRA. You may be able to deduct some or all of your contributions to a Traditional IRA. You may also be eligible for a tax credit equal to a percentage of your contribution. Amounts in your Traditional IRA, including earnings, generally are not taxed until distributed to you. IRAs cannot be owned jointly. However, any amounts remaining in your IRA upon your death can be paid to your beneficiary or beneficiaries.

To contribute to a Traditional IRA, you must be under age 70½ at the end of the tax year. You, or your spouse if you file a joint return, must have taxable compensation, such as wages, salaries, commissions, tips, bonuses, or net income from self-employment. Compensation does not include earnings and profits from property, such as rental income, interest and dividend income, or any amount received as pension or annuity income, or as deferred compensation.

For 2016, if you file a joint return and your taxable compensation is less than that of your spouse, the most that can be contributed for the year to your IRA is the smaller of the following two amounts: (1) $5,500 ($6,500 if you are age 50 or older) or (2) the total compensation includible in the gross income of both you and your spouse for the year, reduced by your spouse's IRA contribution for the year to a Traditional IRA and any contributions for the year to a Roth IRA on behalf of your spouse.

For 2016, the maximum annual dollar contribution limit for IRA contributions remains at $5,500. Also, the additional catch-up contribution limit for an individual who has attained age 50 before the end of the taxable year remains at $1,000.

✓ **Same in 2017.** The maximum annual dollar contribution limit for IRA contributions remains at $5,500 for 2017. Also, the additional catch-up contribution limit for an individual who has attained age 50 before the end of the taxable year remains at $1,000.

All IRA contributions must be made by the due date of your tax return, not including extensions. This means that your 2016 IRA contribution must be made by April 15, 2017, even if you obtain an extension for filing this return.

If you or your spouse were covered by an employer retirement plan at any time during 2016 and you made IRA contributions, your allowable IRA deduction may be less than your contributions. Even if your spouse is covered by an employer-sponsored retirement plan, you may be able to deduct part or all of your contributions to an IRA for 2016 if you were not covered by an employer plan and your AGI was less than $194,000 ($196,000 for 2017).

Your allowable deduction may be reduced or eliminated, depending on your filing status and the amount of your income. The deduction begins to decrease (phase out) when your income rises above a certain amount and is eliminated altogether when it reaches a higher amount. (See IRS *Publication 590*.) The amounts vary depending on your filing status. The *Form W-2* you receive from your church or other employer has a box used to show whether you were covered for the year. The Pension Plan box should have a mark in it if you were covered. Employer retirement plans include 403(b) tax-sheltered annuities.

Figure your deduction using the worksheets in the instructions to *Form 1040* or in *Publication 590.*

Individuals who cannot claim a deduction for an IRA contribution still can make non-deductible IRA contributions, subject to the lesser of $5,500 (for 2016 and 2017) or earned income limits. Earnings on these amounts continue to accumulate on a tax-deferred basis. When distributions are made from the IRA, special rules apply in figuring the tax on the distributions when both deductible and non-deductible contributions were made to the IRA. *Form 8606* is used to designate a contribution as non-deductible and must be filed, or the full amount of future withdrawals may be taxed. Withdrawals before age 59½ are subject to a 10 percent penalty tax that also applies to deductible IRA contributions.

Distributions from a Traditional IRA are fully or partially taxable in the year of distribution. If you made only deductible contributions, distributions are fully taxable. Use *Form 8606* to figure the taxable portion of withdrawals.

Distributions made prior to age 59½ may be subject to a 10 percent additional tax. You also may owe an excise tax if you do not begin to withdraw minimum distributions by April 1 of the year after you reach age 70½.

A Roth IRA differs from a Traditional IRA in several respects. A Roth IRA does not permit a deduction at the time of contribution. Regardless of your age, you may be able to establish and make non-deductible contributions to a Roth IRA. You do not report Roth contributions on your tax return. To be a Roth IRA, the account or annuity must be designated as a Roth IRA when it is set up. Like a Traditional IRA, a Roth IRA can be set up, but there are limitations on the amount that can be contributed and the time of year that contributions can be made. You do not include in your gross income qualified distributions or distributions that are a return of your regular contributions from your Roth IRA. Refer to *Publication 590* for additional information on Roth IRA(s).

For information on conversions from a Traditional IRA to a Roth IRA, refer to *Publication 590*. No further contributions to a Traditional IRA are permissible in the year you reach age 70½ or for any later year, and distributions from a Traditional IRA must generally begin by April 1 of the year following the year in which you reach age 70½. However, you must receive at least a minimum amount for each year starting with the year you reach age 70½ (your 70½ year). If you do not (or did not) receive that minimum amount in your 70½ year, then you must receive distributions for your 70½ year by April 1 of the next year. This means that you will have two required distributions in that year.

Even if you receive a distribution from your IRA before age 59½, you may not have to pay the 10 percent penalty if the distributions are not more than your qualified education expenses or you use the distributions to buy, build, or rebuild a first home. See IRS *Publication 590-B* for an explanation of exceptions to the age 59½ rule.

In the past, qualified charitable distributions of up to $100,000 could be made from an IRA to a church or other charity. A qualified charitable distribution was any distribution from an IRA directly by the IRA trustee to a charitable organization, including a church, that was made on or after the date the IRA owner attains age 70½. This provision expired at the end of 2014 but was made permanent for 2015 and future years by the PATH Act of 2015.

✍ **Example:** A church has a senior pastor who is 52 years old and a youth pastor who is 30 years old. The church does not participate in a retirement program for its staff. In 2017, the senior pastor can contribute $6,500 to an IRA (maximum annual contribution of $5,500 plus a catch-up contribution of $1,000), and the youth pastor can contribute $5,500.

Step 6: Adjusted gross income

Line 37. Compute AGI

Subtract your total adjustments (line 36) from your total income (line 22) to compute your AGI (line 37). Carry this amount to line 38 at the top of page 2 of your *Form 1040.*

Step 7: Tax computation

Line 40. Itemized deductions or standard deduction

☞ **Key Point:** Itemize your deductions on *Schedule A* only if they exceed the standard deduction for your filing status.

On line 40 you enter either your itemized deductions from *Schedule A* or a standard deduction amount. Itemized deductions are discussed under *Schedule A* in this guide. For 2016, the standard deduction amounts are as follows:

Filing Status	Standard Deduction Amount
Single	$6,300
Married filing jointly or qualifying widow(er)	$12,600
Married filing separately	$6,300
Head of household	$9,300

Line 42. Personal exemptions

For 2016, the personal exemption amount is $4,050. Multiply this amount times the number of exemptions claimed on line 6 and enter the total on line 42.

Line 44. Compute tax

Most ministers can use the tax tables to determine their income taxes. Some higher income ministers must use the tax rate schedules (a spouse's income is considered in deciding whether or not to use the tax rate schedules).

Step 8: Credits

Line 49. Credit for child and dependent care expenses: attach Form 2441

Complete this line if you are eligible for a credit for child or dependent care expenses.

Line 51. Retirement Savings Contributions Credit (Saver's Credit)

If you make eligible contributions to certain eligible retirement plans or to an IRA, you may be able to take a tax credit. The amount of the Saver's Credit you can get is generally based on the contributions you make and your credit rate. Refer to *Publication 590* or the instructions for *Form 8880* for more information. If you are eligible for the credit, your credit rate can be as low as 10 percent or as high as 50 percent, depending on your AGI. The lower your income, the higher the credit rate; your credit rate also depends on your filing status. These two factors will determine the maximum credit you may be allowed to take. You are not eligible for the credit if your AGI exceeds a certain amount.

The credit is available with respect to elective deferrals to a 401(k) plan, a 403(b) annuity, a SIMPLE or a simplified employee pension (SEP); contributions to a Traditional or Roth IRA; and voluntary after-tax employee contributions to a 403(b) annuity or qualified retirement plan. The amount of the credit for 2016 is described in the following table:

Adjusted Gross Income			
Joint Returns	Heads of Household	Single Filers	Amount of Credit
$1–37,000	$1–27,750	$1–18,500	50% of eligible contributions up to $2,000 ($1,000 maximum credit)
$37,001–40,000	$27,751–30,000	$18,501–20,000	20% of eligible contributions up to $2,000 ($400 maximum credit)
$40,001–61,500	$30,001–46,125	$20,001–30,750	10% of eligible contributions up to $2,000 ($200 maximum credit)
over $61,500	over $46,125	over $30,750	0%

For married couples filing jointly, each spouse is eligible for the credit.

For more information about this credit, see *Form 8880* and *Publication 590.*

Line 52. Child tax credit

An individual may claim a tax credit for each qualifying child under the age of 17 at the end of 2016. The amount of credit per child is $1,000. A child who is not a citizen, national, or resident of the United States cannot be a qualifying child. A qualifying child (1) is a son, daughter, stepchild, foster child, brother, sister, stepbrother, stepsister, or a descendant of any of them, for example, your grandchild, niece, or nephew; (2) was under age 17 at the end of 2016; (3) did not provide over half of his or her own support for 2016; (4) lived with you for more than half of 2016; (5) is claimed as a dependent on your return; (6) does not file a joint return for the year; and (7) was a U.S. citizen, a U.S. national, or a U.S. resident alien.

You must reduce your child tax credit if either of the following exception applies:

1. The amount of taxable income reported on your tax return is less than the credit. If this amount is zero, you cannot take this credit because there is no tax to reduce. But you may be able to take the additional child tax credit.
2. Your modified AGI is above the following amounts:
   - Married filing jointly – $110,000
   - Single, head of household or qualifying widow(er) – $75,000
   - Married filing separately – $55,000

For most taxpayers, modified AGI is generally the same as AGI. But see IRS *Publication 972* for exceptions.

The child tax credit is in addition to the dependent care credit you can claim if you pay someone to care for your dependent child who is under age 13 (or a disabled dependent) so you can work.

An additional child tax credit exists for certain individuals who get less than the full amount of the child tax credit. The additional child tax credit may give you a refund even if you do not owe any tax. A worksheet in IRS *Publication 972* will assist you in determining your eligibility for the additional child tax credit.

Step 9: Other taxes

Now that you have subtracted credits from your federal income tax, you report other taxes you may owe.

Line 57. Self-employment tax: attach Schedule SE *(also see line 27)*

☞ **Key Point:** All ordained ministers must pay self-employment taxes on compensation received from the exercise of their ministry, unless they have received IRS recognition of exempt status.

Ministers are self-employed for Social Security purposes with respect to their ministerial income. They compute their self-employment taxes on *Schedule SE* and report the total tax on line 57 of *Form 1040*.

Step 10: Payments

Line 64. Federal income tax withheld

Ministers' wages based on the performance of ministerial services are exempt from federal income tax withholding. As a result, only those ministers who have entered into a voluntary withholding arrangement with their church will have income taxes withheld and reported on line 64. The church should report the amount of voluntarily withheld taxes on the minister's *Form W-2.*

☞ **Key Point:** Ministers who enter into voluntary withholding arrangements will have federal income taxes withheld from their wages. Under no circumstances should a church withhold the employee's share of FICA taxes from the wages of such a minister, since ministers are self-employed for Social Security with respect to ministerial compensation. Ministers can request (on *Form W-4*) that their church withhold an additional amount of income taxes to cover their expected self-employment tax liability. These additional withholdings must be treated as income taxes withheld (on *Form W-2* and *Form 941*) rather than the employee's share of FICA taxes. They constitute a credit that can be applied to both income taxes and self-employment taxes. Ministers still must complete *Schedule SE* to report their self-employment tax liability.

Line 65. 2017 estimated tax payments

Compensation paid to ministers for ministerial duties is not subject to tax withholding. As a result, ministers must pre-pay their income tax and Social Security (self-employment) taxes by using the quarterly estimated tax procedure, unless they have entered into a voluntary withholding agreement with their employing church. The estimated tax procedure is summarized in Part 2 of this guide in the section "How do ministers pay their taxes?" The total amount of estimated tax payments made to the IRS is reported as a payment of taxes on line 65.

Line 66. Earned income credit

The earned income credit reduces tax you owe and may give you a refund even if you do not owe any tax. A number of technical requirements must be met in order to qualify for this credit. Unfortunately, many taxpayers who qualify for the earned income credit do not claim it because it is so difficult to compute. In most cases, the amount of your earned income credit depends on: (1) whether you have no qualifying child, one qualifying child, two qualifying children, or three or more qualifying children; and (2) the amount of your earned income and modified AGI.

You may be able to claim the earned income credit for 2016 if (1) you do not have a qualifying child and you earned less than $14,880 ($20,430 if married filing jointly); (2) a qualifying child lived with you and you earned less than $39,296 ($44,846 if married filing jointly); (3) two qualifying children lived with you and you earned less than $44,648 ($50,198 if married filing jointly); or (4) three or more qualifying children lived with you and you earned less than $47,955 ($53,505 if married filing jointly).

The maximum earned income credit for 2016 is (1) $506 with no qualifying child; (2) $3,373 with one qualifying child; (3) $5,572 with two qualifying children; and (4) $6,269 with three or more qualifying children.

You can compute the credit yourself or the IRS will compute it for you. To figure the amount of your earned income credit, you must use the EIC Worksheet and EIC Table in the instructions for *Form 1040*, line 66a. Ministers may want to consider having the IRS compute the credit for them, especially due to confusion about how the housing allowance affects the credit.

> ☞ **Key Point:** The instructions to *Form 1040*, line 66, state that a housing allowance, or fair rental value of a parsonage, is included in the definition of earned income when computing the earned income credit for ministers who have not exempted themselves from self-employment taxes. Unfortunately, the instructions are less clear for ministers who have exempted themselves from self-employment taxes, but the instructions suggest that these ministers do not include a housing allowance or the fair rental value of a parsonage in computing their earned income for purposes of the credit. Ministers who are affected by this issue should consult their own tax advisor for help.

Step 11: Refund or amount you owe

After totaling your payments, you can calculate whether you owe the government or a refund is due you. If you owe a tax, be certain to enclose with your return a check in the amount you owe payable to the United States Treasury. Do not attach the check to your return. Include your daytime phone number and your Social Security number, and write "*Form 1040* for 2016" on the check. You also may have to pay an underpayment penalty (refer to line 79 of *Form 1040*).

If you have overpaid your taxes, you have two options: (1) request a full refund or (2) apply the overpayment to your 2017 estimated tax.

Step 12: Sign here

You must sign and date the return at the bottom of page 2. If you are filing a joint return, your spouse must also sign the return. In the "your occupation" space, enter your occupation — **minister.**

OTHER FORMS AND SCHEDULES

Schedule A

> ☞ **Key Point:** If your itemized deductions exceed your standard deduction, you should report your itemized deductions on *Schedule A (Form 1040).* This section will summarize the itemized deductions.

Step 1: Medical and dental expenses (lines 1–4)

You may deduct certain medical and dental expenses (for you, your spouse, and your dependents) if you itemize your deductions on *Schedule A,* but only to the extent that your expenses exceed 10 percent of your AGI. You must reduce your medical expenses by the amounts of any reimbursements you receive for those expenses before applying the 10 percent test. Reimbursements include amounts you receive from insurance or other sources for your medical expenses (including Medicare). It does not matter if the reimbursement is paid to the patient, the doctor, or the hospital.

> ☞ **Key Point:** If either you or your spouse were born before January 2, 1952, the medical expense deduction is allowed for expenses exceeding 7.5 percent of AGI. If you are claiming the 7.5 percent threshold amount for medical and dental expenses, make sure you check the appropriate box(es) on line 39a of *Form 1040* for your situation.

The following expenses are deductible as medical expenses:

- Fees for medical services
- Fees for hospital services
- Meals and lodging at a hospital during medical treatment (subject to some limits)
- Medical and hospital insurance premiums that you pay
- Special equipment
- Medicare A premiums you pay if you are exempt from Social Security and voluntarily elect to pay Medicare A premiums
- Medicare B premiums you pay
- Medicare D premiums you pay
- Medicare Supplement premiums you pay (or are deducted from your pension)
- Long-term care insurance premiums, subject to certain limitations on the amount that may be deducted
- Special items (false teeth, artificial limbs, eyeglasses, hearing