

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

aids, crutches, etc.)

- Transportation for necessary medical care. For 2016, the standard mileage rate for medical travel was 19 cents per mile (it decreases to 17 cents for 2017).
- Medicines and drugs requiring a prescription, and insulin
- The portion of a life-care fee or founder's fee paid either monthly or in a lump sum under an agreement with a retirement home that is allocable to medical care
- Wages of an attendant who provides medical care
- The cost of home improvements if the main reason is for medical care
- Program to stop smoking
- Exercise expenses (including the cost of equipment to use in the home) if required to treat an illness (including obesity) diagnosed by a physician, and the purpose of the expense is to treat a disease rather than to promote general health and the taxpayer would not have paid the expense but for this purpose

**The following items are not deductible as medical expenses:**

- Funeral services
- Health club dues (except as noted above)
- Household help
- Life insurance
- Maternity clothes
- Non-prescription medicines and drugs
- Nursing care for a healthy baby
- Toothpaste, cosmetics, toiletries
- Trip for general improvement of health
- Most cosmetic surgery

## Step 2: Taxes you paid (lines 5–9)

Generally, real estate, state and local income, and personal property taxes actually paid during 2016 are deductible. Ministers who own their homes and pay real property taxes can include the full amount of such taxes in computing their housing allowance exclusion. They may also fully deduct the amount of the taxes as an itemized deduction on *Schedule A*. Federal income tax and gasoline taxes are not deductible for federal income tax purposes.

Congress enacted legislation in 2004 providing that, at the election of the taxpayer, an itemized deduction may be taken for state and local general sales taxes in lieu of the itemized deduction for state and local income taxes. This provision was added to address the unequal treatment of taxpayers in the nine states that assess no income tax. Taxpayers in these states cannot take advantage of the itemized deduction for state income taxes. Allowing them to deduct sales taxes helps offset this disadvantage.

This provision expired at the end of 2014 but was made permanent for 2015 and future years by the PATH Act of 2015.

## Step 3: Interest you paid (lines 10–15)

Interest is an amount paid for the use of borrowed money. Interest that you pay for personal reasons (that is, interest on a car loan, credit card, or a personal loan) is not deductible as an itemized deduction on *Schedule A*. In most cases, you will be able to deduct all of your mortgage interest on any loans secured by your main home, including first and second mortgages, home equity loans, and refinanced mortgages. Whether your home mortgage interest is deductible under these rules depends on the date you took out the mortgage, the amount of the mortgage, and your use of the proceeds. If all of your mortgages fit into one of the following categories, you can deduct all of your interest and report it on *Schedule A (Form 1040)*:

- Mortgages you took out on your main home on or before October 13, 1987.
- Mortgages you took out on your main home after October 13, 1987, to buy, build, or improve your home, but only if these mortgages (plus any mortgages in the preceding category) total \$1 million or less throughout 2016 (\$500,000 if married filing separately).
- Mortgages you took out after October 13, 1987, on your main home, other than to buy, build, or improve your home, but only if these mortgages total \$100,000 or less throughout 2016 (\$50,000 if married filing separately).

If you had a main home and a second home, the dollar limits explained in the second and third categories described above apply to the total mortgage on both homes.

**Key Point:** Ministers who own their home can deduct mortgage interest payments as an itemized deduction even though such payments were included in computing the housing allowance exclusion (the so-called double deduction). However, ministers are subject to the limitations on mortgage loans discussed in this section.

The term “points” is sometimes used to describe certain charges paid by a borrower. They are also called loan origination fees, maximum loan charges, or premium charges. If the payment of any of these charges is **only** for the use of money, it ordinarily is interest paid in advance and must be deducted in installments over the life of the mortgage (not deducted in full in the year of payment). However, points are deductible in the year paid if the following requirements are satisfied:

1. Your loan is secured by your main home. (Your main home is the one you ordinarily live in most of the time.)
2. Paying points is an established business practice in the area where the loan was made.
3. The points paid were not more than the points generally charged in that area.

4. You use the cash method of accounting. This means you report income in the year you receive it and deduct expenses in the year you pay them. Most individuals use this method.
5. The points were not paid in place of amounts that ordinarily are stated separately on the settlement statement, such as appraisal fees, inspection fees, title fees, attorney fees, and property taxes.
6. The funds you provided at or before closing, plus any points the seller paid, were at least as much as the points charged. The funds you provided are not required to have been applied to the points. They can include a down payment, an escrow deposit, earnest money, and other funds you paid at or before closing for any purpose. You cannot have borrowed these funds from your lender or mortgage broker.
7. You use your loan to buy or build your main home.
8. The points were computed as a percentage of the principal amount of the mortgage.
9. The amount is clearly shown on the settlement statement (such as the *Settlement Statement, Form HUD-1*) as points charged for the mortgage. The points may be shown as paid from either your funds or the seller's.

#### Step 4: Gifts to charity (lines 16–19)

Cash contributions to churches, schools, and most other public charities are deductible up to 50 percent of AGI. Contributions of property are subject to different limitations. See IRS *Publication 526*. Contributions of cash or checks are reported on line 16, while contributions of non-cash property are reported on line 17. If you do not itemize deductions, you cannot deduct any of your charitable contributions.

The value of personal services is never deductible as a charitable contribution, but unreimbursed expenses incurred in performing services on behalf of a church or other charity may be. For example, if you drive to and from volunteer work on behalf of a charity, you may deduct the actual cost of gas and oil or you may claim the standard charitable mileage rate of 14 cents for each substantiated mile (for 2016 and 2017). Unreimbursed travel expenses incurred while away from home (whether within the United States or abroad) in the course of donated services to a tax-exempt religious or charitable organization are deductible as a charitable contribution. There are two ways to do this.

Individuals performing the charitable travel can keep track of their own travel expenses and then claim a charitable contribution for the total on *Schedule A*. Or, these individuals could provide their church or charity with a travel report substantiating all travel expenses. In such a case, the church or charity could issue the individual a charitable contribution receipt for the total amount of the substantiated travel expenses. Travel expenses that can be received include airfare, lodging, meals, and incidental expenses.

No charitable deduction is allowed for travel expenses incurred while away from home in performing services for a religious or charitable organization unless there is no significant element of personal pleasure, recreation, or vacation involved in the travel.

 **Example:** Pastor J goes on a trip to Europe. He is in Europe for 10 days and conducts one-hour services on two of those days. Pastor J will not be able to claim a charitable contribution deduction for the travel expenses that he incurs in making this trip. The same rule would apply if Pastor J's spouse or children go along on the trip.

Charitable contributions must be claimed in the year they are delivered. One exception is a check that is mailed to a charity — it is deductible in the year the check is mailed (and postmarked), even if it is received early in the next year.

Charitable contributions generally are deductible only to the extent they exceed the value of any premium or benefit received by the donor in return for the contribution.

There are limits on the amount of a contribution that can be deducted. Generally, cash contributions to churches, schools, and other public charities are deductible up to a maximum of 50 percent of AGI. In some cases, contributions that exceed these limits can be carried over and claimed in future years. Some charitable contributions are limited to 20 percent or 30 percent of AGI, depending on the recipient and the form of the contribution.

Designated contributions are those that are made to a church with the stipulation that they be used for a specified purpose. If the purpose is an approved project or program of the church, the designation will not affect the deductibility of the contribution. An example is a contribution to a church building fund. However, if a donor stipulates that a contribution be spent on a designated individual, no deduction is allowed unless the church exercises full administrative control over the donated funds to ensure that they are being spent in furtherance of the church's exempt purposes. Designated contributions that ordinarily are not deductible include contributions to church benevolence or scholarship funds that designate a specific recipient. Contributions to benevolence or scholarship funds ordinarily are deductible if the donor does not earmark a specific recipient.

Contributions to a church or missions board that specify a particular missionary may be tax-deductible if the church or missions board exercises full administrative and accounting control over the contributions and ensures that they are spent in furtherance of the church's mission. Direct contributions to missionaries, or any other individual, are not tax-deductible, even if they are used for religious or charitable purposes.

Charitable contributions must be properly substantiated. Individual cash contributions of less than \$250 may be substantiated by a canceled check or a receipt from the charity. Special rules govern the substantiation of individual contributions of cash or property of \$250 or more. These rules are explained in the supplement to this guide, the *Federal Reporting Requirements for Churches*, located on GuideStone's website.

If you contribute property that you value at \$500 or more, you must include a completed *Form 8283* with your *Form 1040*. Complete only Section A if the value claimed is \$500 or more but less than \$5,000. If you claim a deduction of more than \$5,000 for a contribution of non-cash property (other than publicly traded securities), then you must obtain a qualified appraisal of the property and include a qualified appraisal summary (Section B of *Form 8283*) with your *Form 1040*.

Special rules apply to donations of cars, boats, and planes. See the instructions to IRS *Form 1098-C* for details.

**Key Point:** The Tax Court ruled that a donor who contributed property worth more than \$10,000 to a church was not eligible for a charitable contribution deduction, even though there was no dispute as to the value of the property, because he failed to attach a qualified appraisal summary (*Form 8283*) to the tax return on which the contribution was claimed.

## Step 5: Casualty and theft losses (line 20)

Most taxpayers have at some time suffered damage to their property as a result of hurricanes, earthquakes, tornadoes, fires, vandalism, car accidents, floods, or similar events. When property is damaged or destroyed by such events, it is called a casualty. If your property is stolen, you may also have a deductible theft loss. You must itemize your deductions on *Schedule A* to be able to claim a casualty or theft loss to non-business property. To determine your deduction, you must reduce the amount of your casualty and theft losses by any insurance or reimbursement you receive. No deduction is allowed for a casualty or theft loss that is covered by insurance unless a timely insurance claim for reimbursement has been filed.

You can deduct personal casualty or theft losses only to the extent that:

1. The amount of each separate casualty or theft loss is more than \$100, and
2. The total amount of all losses during the year (reduced by the \$100 limit) is more than 10 percent of the amount on *Form 1040*, line 38.

The 10 percent of AGI limitation does not apply to a casualty loss that occurred in an area determined by the President of the United States to warrant federal disaster assistance. For information on disaster losses, see IRS *Publication 547*.

To claim a casualty or theft loss, you must be able to show

that the loss in fact occurred. In addition, the loss generally is defined as the lesser of (1) the decrease in fair market value of the property as a result of the casualty or theft or (2) your adjusted basis in the property before the casualty or theft.

Calculate non-business casualty and theft losses on *Form 4684* and report them on *Schedule A* as an itemized deduction.

**Key Point:** Losses that do not qualify for a casualty loss deduction include money or property misplaced or lost; breakage of china, glassware, furniture, and similar items under normal conditions; and progressive damage to property (buildings, clothes, trees, etc.) caused by termites, moths, other insects, or disease. However, a sudden destruction due to an unexpected or unusual infestation of beetles or other insects may result in a casualty loss.

## Step 6: Job expenses and certain miscellaneous deductions (lines 21–27)

You may deduct certain miscellaneous expenses on *Schedule A*. These deductions are in addition to the itemized deductions for medical expenses, taxes, interest, charitable contributions, and casualty and theft losses. Most miscellaneous itemized expenses are deductible only to the extent that they exceed 2 percent of AGI. Miscellaneous expenses subject to the 2 percent floor include:

- Unreimbursed and non-accountable reimbursed employee business expenses (discussed more fully below)
- Professional society dues
- Safe deposit box rental
- Employee educational expenses
- Tax preparation fees
- Home office used regularly and exclusively for work
- Tools and supplies used in your work
- Expenses of looking for a new job
- Investment counsel fees
- Professional books and periodicals
- Investment expenses
- 50 percent of unreimbursed business meals and entertainment
- IRA custodial fees

Certain miscellaneous expenses are not subject to the 2 percent floor. However, these expenses ordinarily are not available to ministers.

### Employee business expenses

**Key Point:** Most ministers incur business expenses. How these expenses are handled, by both the minister and the church, significantly impacts whether (and to what extent) they are deductible.

The more common examples of ministerial business expenses are summarized below.

### Local transportation expenses

These expenses include the cost of transportation by air, rail, bus, taxi, etc., and the cost of driving and maintaining your car. Transportation expenses include:

- The ordinary and necessary costs of getting from one workplace to another in the course of your ministry when you are traveling within the city or general area of your home
- Visiting church members
- Going to business meetings away from your regular workplace

Transportation expenses do not include expenses you incur in traveling away from home overnight. Those expenses are travel expenses (see below).

Expenses incurred in driving your car for business purposes within your community represent one of the most important business expenses for ministers. A common example would be driving your car from your church to a hospital to visit members. Commuting to and from work is never a business expense. However, if you drive to a hospital (or some other business location) on the way home from church, the expenses incurred in driving from the church to the second business location are business expenses even though you are on the way home. The remaining miles between the second business location and your home are non-deductible commuting expenses. If you have an office in your home (see below) that you use as your principal place of business for your church, you may deduct the cost of traveling between your home office and work places associated with your employment.

These expenses can be deducted using either a standard mileage rate or the actual costs of operating the car for business miles. Most ministers choose the standard mileage rate because of its simplicity. However, it is available only if it is selected for the first year a car is used in your trade or business. The actual expense method is very complex and is explained fully in *IRS Publication 463*.

The standard business mileage rate for 2016 was 54 cents per mile. (The standard business mileage rate is 53.5 cents per mile for 2017.)

 **Key Point:** The standard business mileage rate for 2017 is 53.5 cents per mile.

Ministers should consider the advantages of using a church-owned car for their business travel. This will eliminate most record keeping and reporting requirements. Some conditions apply. See the illustration at the end of this guide for a summary of the various tax options pertaining to business use of a car.

### Travel expenses

Travel expenses are the ordinary and necessary expenses of traveling away from your “tax home” (your regular place of business) on ministry-related business. You are traveling away from home if your duties require you to be away from the general area of your tax home substantially longer than an ordinary day’s work and you need to sleep or rest to meet the demands of your work while away from home.

#### Deductible travel expenses include:

- Air, rail, and bus fares
- Operating and maintaining your car while driving away from home on business
- Taxi fares or other costs of transportation between the airport or station and your hotel or from one work site to another
- Meals and lodging while you are away from home on business
- Cleaning and laundry expenses
- Telephone expenses (business calls while on a business trip)
- Tips

The travel expenses of a spouse who accompanies a minister on a business trip are almost never deductible as a business expense and cannot be reimbursed under an accountable arrangement. In rare cases, an employer’s reimbursement of the travel expenses of an employee’s spouse may qualify as a non-taxable **working condition fringe benefit**, so long as these conditions are met: (1) The employer has not treated such amounts as compensation; (2) the amounts would be deductible as a business expense without regard to the limitation on the deductibility of a spouse’s travel expenses, meaning that the spouse’s presence on the trip is primarily for a legitimate business purpose; and (3) the employee substantiates the expenses under an accountable arrangement. This is a highly aggressive position that should not be adopted without the advice of a tax professional.

One way for the **unreimbursed** travel expenses of a non-employee spouse to be deductible would be if the spouse performed substantial church-related activities during the trip. Under these circumstances, the spouse’s unreimbursed travel expenses may qualify for a charitable contribution deduction.

### Entertainment expenses

You may be able to deduct entertainment expenses you incur for your ministry. You may take the deduction only if you can demonstrate that the amounts spent are either (1) directly related to the active conduct of your ministry or (2) associated with the active conduct of your ministry and the entertainment occurred directly before or after a substantial business discussion. These two tests are summarized below.

**Directly related test.** To show that entertainment was directly related to the active conduct of your business, you ordinarily must be able to demonstrate that (1) the main purpose of the entertainment was the transaction of business; (2) you did engage in business during the entertainment period; and (3) you had more than a general expectation of deriving income or some other specific business benefit at some indefinite future time.

**Associated entertainment.** To show that entertainment was associated with the active conduct of your ministry, you must be able to demonstrate that you had a clear business purpose in incurring the expense and that the meal or entertainment directly preceded or followed a substantial business discussion.

Entertainment includes any activity generally considered to provide entertainment, amusement, or recreation. This covers entertaining guests at restaurants; social or athletic facilities; sporting events; or hunting, fishing, vacation, or similar trips. Expenses are not deductible when business acquaintances take turns picking up each other's entertainment expenses without regard to whether any business purposes are served. Ministers incur entertainment expenses in a variety of situations. Common examples include entertaining denominational leaders, guest speakers, or church groups (youth, choir, the deacons, etc.), or meeting with members at a restaurant for counseling purposes.

**Key Point:** You may deduct only 50 percent of your business-related entertainment expenses, including meals. This 50 percent limitation is incorporated directly into the tax returns (see *Form 2106*). This rule does not apply to expenses you incur that are reimbursed by your employer under an accountable reimbursement arrangement (described elsewhere in this guide).

Entertainment expenses incurred in your home are especially scrutinized by the IRS. You must be able to demonstrate that your expenses were not purely social but rather had a primary business purpose.

Entertainment expenses of spouses may also be deductible if their presence serves a legitimate business purpose or if it would be impractical under the circumstances to entertain the business associate without including their spouse.

The IRS frequently challenges entertainment expenses, and so you should be prepared to fully substantiate such expenses as described below.

**Example:** Pastor S invites the members of the church board to his home for dinner and a meeting. The expenses incurred by Pastor S and his guests for food and beverages ordinarily will constitute entertainment expenses.

**Example:** Pastor S invites a friend and fellow minister to his home for dinner. The friend resides in another state and is visiting Pastor S for the day. Ordinarily, such a visit will be a social visit and the expenses associated with it will not be deductible.

**Example:** Pastor K is the head of staff of his church. He takes a prospect for a ministerial staff position out to dinner, where they discuss the person's background and suitability for the position. The person's spouse comes along because it would be impractical to discuss the position solely with the prospect. Further, Pastor K's spouse accompanies her husband because the other spouse is present. Pastor K pays everyone's meal expense. The cost of the meals of all four people is an entertainment expense. This result is based on the following example in IRS *Publication 463*: "You entertain a customer. The cost is an ordinary and necessary business expense and is allowed under the entertainment rules. The customer's spouse joins you because it is impractical to entertain the customer without the spouse. You can deduct the cost of entertaining the customer's spouse. If your spouse joins the party because the customer's spouse is present, the cost of the entertainment for your spouse is also deductible."

## Educational expenses

Certain educational expenses are deductible by ministers. You may deduct expenses you have for education, such as tuition, books, supplies, correspondence courses, and certain travel and transportation expenses, even though the education may lead to a degree, if the education satisfies one or both of the following conditions:

1. The education is required by your employer, or by law or regulation, to keep your salary, status or job or
2. The education maintains or improves skills required in your present work.

However, you may not deduct expenses incurred for education, even if one or both of the requirements mentioned above are met, if the education is required to meet the minimum educational requirements to qualify you in your trade or business or is part of a program of study that will lead to qualifying you in a new trade or business, even if you did not intend to enter that trade or business.

**Example:** The minister at First Church takes a class at a local university. Expenses associated with the course are deductible educational expenses if the course maintains or improves job skills and is not a part of a

program of study that will qualify the minister for a new trade or business.

Employer-paid educational expenses are excludable from the gross income and wages of an employee if provided under an educational assistance program. Employees are limited to an exclusion of up to \$5,250 of the benefits they receive during a calendar year. This exclusion applies to both income tax and Social Security tax.

An educational assistance program in the context of church employers is a separate written plan of an employer for the exclusive benefit of its employees to give them educational assistance (1) that does not have eligibility requirements that discriminate in favor of officers or highly compensated employees or their dependents; (2) that does not provide eligible employees with a choice between educational assistance and cash; and (3) that provides for reasonable notification of the availability and the terms of the program to eligible employees.

### Subscriptions and books

Ministers often purchase books and subscribe to journals and other periodicals that are directly relevant to the performance of their professional duties. The income tax regulations specify that “a professional man may claim as deductions the cost of . . . subscriptions to professional journals [and] amounts currently paid for books . . . the useful life of which is short.”

The cost of a subscription will be deductible as a business expense if it is related to the conduct of a minister’s trade or business. Professional clergy journals and specialized clergy periodicals clearly satisfy this test. News magazines may also qualify if a minister can demonstrate that the information contained in such periodicals is related to his ministry (e.g., sources of illustrations for sermons). The cost of a general circulation daily newspaper is not deductible.

The unreimbursed cost of books that are related to one’s ministry is a business expense. The same is true for the cost of books reimbursed by the church under a non-accountable arrangement. Deduct the cost of any book that you acquired for use in your ministry and that has a useful life (not the same as its physical life) of less than one year. For example, the cost of a book that you purchase and read, but have no intention of using again, can be deducted in full in the year of purchase.

The unreimbursed cost of commentaries or theological dictionaries and encyclopedias that are acquired for extended reference use also may be deducted fully in the year of purchase. Alternatively, ministers can allocate the purchase price of reference books to their useful life by means of annual depreciation deductions. The depreciation deduction is computed using the Modified Accelerated Cost Recovery System (MACRS) method. See IRS *Publication 946* for details.

### Personal computers

Church employees who purchase a computer that is used for business as well as personal use may be entitled to deduct the cost of the computer in the year of purchase or claim an annual depreciation deduction over the useful life of the computer. However, note that personal computers are listed property and, as a result, are subject to strict substantiation requirements regarding business use. Here are the rules that apply:

You can claim a deduction for the entire purchase price in the year of purchase (you do not need to depreciate the computer). The price must be reduced by the percentage of use that is personal as opposed to business related. This is the option used by most ministers because of its simplicity.

Alternatively, you can claim a depreciation deduction for the cost of a computer that you use in your work as an employee if its use is:

- For the convenience of your employer, and
- Required as a condition of your employment

**For the convenience of your employer** means that you can clearly demonstrate that you cannot perform your job without the home computer. The fact that the computer enables you to perform your work more easily and efficiently is not enough. Further, you must prove that the computers available at your place of employment are insufficient to enable you to properly perform your job. Obviously, this is a difficult test to satisfy.

**Required as a condition of your employment** means that you must not be able to properly perform your duties without the computer. It is not necessary that your employer explicitly requires you to use the computer. On the other hand, it is not enough that your employer merely states that your use of the home computer is a condition of your employment. If you are an employee and these tests are not met, you cannot deduct any of the cost of your home computer.

If you are an employee and you meet both tests described above, you can claim a business deduction if you use your home computer more than 50 percent of the time during the year in your work.

 **Example:** You occasionally take work home at night rather than work late at the office. You own and use a computer that is similar to the one you use at the office to complete your work at home. Since your use of the computer is not for the convenience of your employer and is not required as a condition of your employment, you cannot claim a depreciation deduction for it.

The depreciation method you use depends on whether you meet the more-than-50 percent-use test. You meet this test if you use the computer more than 50 percent in your work. If you meet this test, you may be able to take the **section 179 deduction** for the year you place the item in service. This means that you can deduct in the year of purchase the portion of the purchase price that corresponds to the percentage of business use. If you do not meet the more-than-50 percent-use test, you are limited to the straight line method of depreciation, and you cannot claim the section 179 deduction for the cost of the computer in the year of purchase. The more-than-50 percent-use test does not apply to a computer used only in a part of your home that meets the requirements of a home office. You may be able to take a section 179 deduction for the year you place the computer in service.

Your use of a computer in connection with investments does not count as use in your work. However, you can combine your investment use with your work use in figuring your depreciation deduction.

For more information on depreciation and the section 179 deduction for computers and other items used in a home office, see *Publication 946*.

You must keep records to prove your percentage of business and investment use.

### Cell phones

The value of an employer-provided cell phone, provided primarily for non-compensatory business reasons, is excludable from an employee's income as a working condition fringe benefit. **Personal use** of an employer-provided cell phone, provided primarily for non-compensatory business reasons, is excludable from an employee's income as a de minimis fringe benefit. (Employers: You provide a cell phone primarily for non-compensatory business purposes if there are substantial business reasons for providing the cell phone. Examples of substantial business reasons include the employer's need to contact the employee at all times for work-related emergencies. However, you cannot exclude from an employee's wages the value of a cell phone provided as a means of providing additional compensation to an employee.)

### Office in the home

The IRS audit guidelines for ministers instruct IRS agents to take the position that a minister who excludes all of his housing expenses as a housing allowance exclusion has, in effect, already deducted all of the expenses associated with an office in the home and should not be able to claim any additional deduction of these expenses as an itemized (home office) deduction on *Schedule A*.

### How to report employee business expenses

The deductibility of your business expenses depends on whether you are an employee or self-employed, whether or not the expenses are reimbursed by the church, and whether any reimbursed expenses are paid under an accountable or a non-accountable reimbursement plan. This section addresses the tax treatment of business expenses for ministers who report their income taxes as employees. The tax treatment of business expenses for ministers with self-employment income is discussed later (under the section on *Schedule C*).

The business expenses of ministers who are employees for federal income tax reporting purposes (this includes most ministers as explained earlier) can be handled in any of the following three ways:

#### *Method 1: Accountable reimbursed expenses*

The best way for ministers to handle business expenses is to have their employing church adopt an accountable business expense reimbursement arrangement. To be an accountable plan, your employer's reimbursement or allowance arrangement must include all of the following four 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 (generally, within 60 days after they are paid or incurred).
3. You must return any excess reimbursement or allowance within a reasonable period of time (generally, within 120 days after the expense was paid or incurred). An excess reimbursement or allowance is any amount you are paid that is more than the business-related expenses that you adequately accounted for to your employer.
4. Business expense reimbursements must be paid for by the employer and cannot be funded out of an employee's salary (for example, through salary reductions).

Reimbursements of business expenses under such an arrangement are not reported as taxable income on a minister's *Form W-2* or *Form 1040*, and there are no deductions to claim. In effect, the minister is reporting to the church rather than to the IRS.

An accountable business expense reimbursement arrangement should be established by the church in an appropriate resolution. In adopting a resolution, pay special attention to the following rules:

Condition the reimbursement of any expense on adequate substantiation. This will include written evidence for all expenses and receipts for expenses of \$75 or more. For most business

expenses, the evidence must substantiate the amount, date, place, and business nature of each expense.

**Key Point:** A church must require the same degree of substantiation as would be required for a deduction on the minister's income tax return.

**Example:** Pastor R is senior minister at First Church. He reports his federal income taxes as an employee, and the church reimburses him for all of his business and professional expenses (by means of a credit card or cash reimbursements). However, Pastor R is not required to account for such expenses by providing the church treasurer with receipts documenting the amount, time, place, and business purpose (and, for entertainment expenses, the business relationship) of each expense. Pastor R simply informs the treasurer at the end of each month of the total expenses incurred during that month. Assume further that Pastor R cannot itemize deductions on *Schedule A* (he does not have sufficient deductions). If Pastor R received reimbursements of \$4,000 in 2016: (1) the church would report all reimbursements (\$4,000) as income on Pastor R's *W-2*, and Pastor R would report them as income (salary) on his *Form 1040*; and (2) Pastor R cannot deduct the reimbursed expenses as a miscellaneous itemized deduction on *Schedule A* since he does not have sufficient expenses to itemize. In other words, all of Pastor R's business expense reimbursements are includable in his income for tax purposes, but he cannot offset any of this income by deducting his business expenses. Even if Pastor R could itemize deductions, his non-accountable reimbursed expenses would be treated just like unreimbursed expenses — they are deductible only as miscellaneous itemized deductions and only to the extent that they (along with most other miscellaneous expenses) exceed 2 percent of his AGI. Clearly, the tax impact of these rules can be costly for ministers who do not account to their employing church for their business expenses. Further, if the church and Pastor R neglect to report the reimbursements as taxable income, the reimbursements become an automatic excess benefit that may trigger costly penalties against Pastor R (assuming he is an officer or director or the relative of one) and possibly members of the church board.

**Example:** Same facts as the previous example, except that the church adopts a reimbursement plan that meets the requirements of an accountable plan, and Pastor R is reimbursed for \$4,000 of substantiated expenses. Under these facts, the church would not

report the \$4,000 of reimbursements as income on Pastor R's *Form W-2*, and Pastor R would not have to report the reimbursements or claim the expenses on his *Form 1040*. Further, the excess benefit penalties would be avoided.

Churches occasionally reimburse ministers for non-business expenses. Such reimbursements, though they require an accounting, ordinarily must be included in the minister's wages for income tax reporting purposes, and they are not deductible by the minister. Such personal, living, or family expenses are not deductible, and the entire amount of a church's reimbursement must be included on the minister's *Form W-2* and *Form 1040*.

Business expenses must be substantiated by adequate evidence to support an income tax deduction or an expense reimbursement under an accountable reimbursement plan of an employer. Stricter substantiation rules apply to transportation, travel, and entertainment expenses.

#### **Method 2: Non-accountable reimbursed expenses**

**Key Point:** Ministers who are employees for income tax reporting purposes deduct any business expenses reimbursed by their church under a non-accountable reimbursement plan on *Schedule A* if they are able to itemize and only to the extent that such expenses exceed 2 percent of AGI. The full amount of the church's reimbursements must be included in the minister's income whether or not the expenses are deductible. A church has a non-accountable plan if it reimburses ministers (or other employees) for business expenses without requiring adequate substantiation of the amount, date, place, and business purpose of the expenses or does not require excess reimbursements to be returned to the church.

A **non-accountable** plan is a reimbursement arrangement that does not meet one or more of the four rules listed earlier under Method 1. In addition, even if your employer has an accountable plan, the following payments will be treated as being paid under a **non-accountable** plan:

- Excess reimbursements you fail to return to your employer, and
- Reimbursement of non-deductible expenses related to your employer's business

An arrangement that repays you for business expenses by reducing the amount reported as your wages, salary, or other pay will be treated as a **non-accountable** plan. This is because you are entitled to receive the full amount of your pay whether or not you have any business expenses.

It is common for churches to reimburse a minister's business expenses without requiring any substantiation of actual

expenses or a return of reimbursements in excess of substantiated expenses (for example, excess reimbursements). The most common example is the monthly car allowance. Many churches pay their minister a monthly allowance to cover business use of an automobile, without requiring any substantiation of actual expenses or a return of the amount by which the allowances exceed actual expenses. Such a reimbursement arrangement is called **non-accountable** since the minister is not required to account for (substantiate) the actual amount, date, place, and business purpose of each reimbursed expense. Another common example would be a church that reimburses expenses that are claimed by a minister without adequate substantiation.

For ministers who are employees, the full amount of the church's reimbursements or allowances must be reported as income on the minister's *Form W-2* (and *Form 1040*). The minister can deduct actual expenses only as a miscellaneous itemized deduction on *Schedule A* to the extent these expenses exceed 2 percent of AGI. The church's reimbursements are fully reported as income to the minister who, in many cases, is unable to claim any deduction because of insufficient itemized expenses to use *Schedule A*.

▲ **Caution. Non-accountable** reimbursements of the expenses of a disqualified person that are not reported as taxable income by the recipient or employer are classified as automatic excess benefits by the IRS, triggering the imposition of substantial excise taxes (called intermediate sanctions) of up to 225 percent of the amount of the excess benefit. Disqualified persons include officers or directors, including any minister who is an officer or director, and their relatives. This penalty then pertains to most senior or lead pastors, as well as any of their relatives, such as a youth pastor who is the senior pastor's child. In some cases, board members who approve such an arrangement may face penalties of up to \$20,000 (collectively).

☞ **Key Point:** The limitations on the deductibility of unreimbursed and non-accountable reimbursed employee business expenses can be avoided if the church adopts an accountable reimbursement plan. Reimbursements paid by the church under an accountable arrangement are not reported as income to the minister, and the minister need not claim any deductions.

The IRS has advised ministers to comply with the so-called Deason allocation rule when computing deductions for unreimbursed business expenses as well as business expenses reimbursed by a church under a **non-accountable** arrangement. This rule requires ministers to reduce their business expense deduction by the percentage of their total compensation that

consists of a tax-exempt housing allowance. This rule does not apply to the computation of self-employment taxes, since the housing allowance is not deductible in computing these taxes. The Deason rule can be avoided if a church adopts an accountable business expense reimbursement arrangement.

☞ **Key Point:** The IRS audit guidelines for ministers instruct agents to apply the so-called Deason allocation rule when auditing ministers.

### **Method 3: Unreimbursed expenses**

☞ **Key Point:** Unreimbursed expenses are expenses that are not reimbursed by the church. They may be deducted only as a miscellaneous itemized deduction on *Schedule A* to the extent they exceed 2 percent of a minister's AGI.

Many ministers incur unreimbursed business expenses. These are expenses that are not reimbursed by the church. Ministers who are employees for income tax reporting purposes claim their unreimbursed business expenses on *Schedule A* — if they are able to itemize and only to the extent that such expenses exceed 2 percent of AGI.

☞ **Key Point:** Ministers who are employees for income tax reporting purposes cannot claim any deduction for unreimbursed employee business expenses for which an employer reimbursement was available.

## **Schedule B**

*Schedule B* is used to report taxable interest income and dividend income of more than \$1,500.

### **Step 1: Interest income (lines 1–4)**

List (on line 1) the name of each institution or individual that paid you taxable interest if you received more than \$1,500 of taxable interest in 2016. Be sure the interest you report on line 1 corresponds to any *Forms 1099-INT* you received from such institutions. Do not include tax-exempt interest.

### **Step 2: Dividend income (lines 5–6)**

List (on line 5) the name of each institution that paid you dividends if you received more than \$1,500 in dividends in 2016. Be sure the dividends you report on line 5 correspond to any *1099-DIV* forms you received from such institutions.

### **Step 3: Foreign accounts and foreign trusts**

Be sure to complete this part of the schedule if you had more than \$1,500 of either taxable interest or dividends.

## Schedule C

- 🗨️ **Key Point:** Most ministers who serve local churches or church agencies are employees for federal income tax purposes with respect to their church salary. They report their church salary on line 7 of *Form 1040* and receive a *Form W-2* from the church. They do not report their salary as self-employment earnings on *Schedule C*.
- 🗨️ **Key Point:** Use *Schedule C* to report income and expenses from ministerial activities you conduct other than in your capacity as a church employee. Examples would be fees for guest speaking in other churches and fees received directly from church members for performing personal services, such as weddings and funerals.
- **Recommendation.** Some ministers are eligible to use the simpler *Schedule C-EZ*.

### Step 1: Introduction

Complete the first several questions on *Schedule C*. Ministers should list code 541990 on line B, since this is the code the IRS uses in a clergy tax illustration in *Publication 517*. Some ministers who report their church compensation as self-employed point to this code as proof that ministers serving local churches can report as self-employed. This is not so. This code applies to the incidental self-employment activities of ministers who report their church salaries as employees. It also applies to those few ministers who are self-employed, such as traveling evangelists.

### Step 2: Income (lines 1–7)

Report on line 1 your gross income from your self-employment activity.

### Step 3: Expenses (lines 8–27)

▲ **Warning.** Many ministers continue to report their income taxes as self-employed. One perceived advantage of doing so is the ability to deduct business expenses on *Schedule C* by ministers who do not have enough itemized deductions to use *Schedule A*. This advantage is often illusory. Most ministers, if audited by the IRS, would be reclassified as employees and their *Schedule C* deductions disallowed. This could result in substantial additional taxes, penalties, and interest, especially if the minister is not able to itemize expenses on *Schedule A*. The best way for ministers to handle their business expenses is through an accountable expense reimbursement arrangement.

Report any business expenses associated with your self-employment earnings on lines 8 through 27. For example, if you incur transportation, travel, or entertainment expenses in

the course of performing self-employment activities, you deduct these expenses on lines 8 through 27 of *Schedule C*.

Since self-employed ministers list only their net self-employment earnings (that is, after deducting all business and professional expenses) as a component of gross income on line 12 of *Form 1040*, they in effect are able to deduct 100 percent of their business and professional expenses even if they do not have enough itemized deductions to use *Schedule A*.

Self-employed persons can deduct only 50 percent of business meals and entertainment. Further, self-employed persons who use *Schedule C* to report their business deductions are not subject to the 2 percent floor that applies to the deduction of employee business and professional expenses that are either unreimbursed or reimbursed under a **non-accountable** reimbursement plan. In addition, ministers who report their church income as self-employed are taxed on the value of certain fringe benefits (including employer-paid medical insurance).

- 🗨️ **Key Point:** One of the reasons the audit rate is higher for self-employed taxpayers is that only 30 percent of all taxpayers have sufficient itemized expenses to use *Schedule A*. If the IRS can reclassify taxpayers from self-employed to employee status, it will generate more tax dollars, since only 30 percent of taxpayers can itemize deductions on *Schedule A*. Business expenses that could have been claimed by a self-employed taxpayer on *Schedule C* are lost if that taxpayer is reclassified as an employee and has insufficient expenses to itemize on *Schedule A*.

- 📖 **Example:** Pastor M reports his income taxes as a self-employed person. He has \$4,000 of business expenses in 2016 that were not reimbursed by his church. He deducted all of them on *Schedule C*. He did not have enough expenses to itemize deductions on *Schedule A*. Pastor M is later audited by the IRS, and he is reclassified as an employee. He will not be able to deduct any of the \$4,000 of business expenses since they are deductible, by an employee, only as an itemized deduction on *Schedule A*. Further, Pastor M will have to pay interest and possibly penalties in addition to the additional taxes.

## Schedule C-EZ

The IRS has released a simpler form of *Schedule C* that can be used by some people with self-employment earnings. The new *Schedule C-EZ* can be used instead of *Schedule C* if you meet all of these requirements:

- You had business expenses associated with your trade or business of \$5,000 or less in 2016.
- You use the cash rather than the accrual method of accounting.

- You did not have an inventory at any time during the year.
- You did not have a net loss from your trade or business.
- You had only one business as a sole proprietor.
- You had no employees.
- You do not use *Form 4562* to compute a depreciation deduction with regard to your trade or business.
- You do not claim a deduction for the business use of your home.

Many ministers who report their church compensation as employees will be able to use this form to report small amounts of self-employment earnings they receive during the course of a year as honoraria for occasional guest speaking in other churches or as fees received directly from church members for services rendered on their behalf (for example, weddings and funerals).

## Schedule SE

**Key Point:** Use *Schedule SE* to report Social Security taxes on any income you earned as a minister if you have not applied for and received IRS approval of an exemption application (*Form 4361*). Remember, ministers always are self-employed for Social Security with respect to their ministerial services. They pay self-employment taxes and not FICA taxes with respect to compensation from such services.

**Key Point:** Ministers who have received IRS approval of an application for exemption from self-employment taxes (*Form 4361*) do not pay self-employment taxes on compensation received for their ministerial services.

### Step 1: Section A (line 2)

Most ministers use the short *Schedule SE* rather than the long *Schedule SE*. This means that they complete Section A on page 1 of the schedule rather than Section B on page 2.

Ministers report their net self-employment earnings on line 2 of Section A. This amount is computed as follows:

Add the following to the church salary:

- Other items of church income (including taxable fringe benefits)
- Fees you receive for weddings, baptisms, funerals, masses, etc.
- Self-employment earnings from outside businesses
- Annual fair rental value of a parsonage, including utilities paid by the church (unless you are retired)
- A housing allowance (unless you are retired)
- Business expense reimbursements (under a **non-accountable** plan)
- The value of meals served on the church's premises for

the convenience of the employer

- Any amount a church pays toward your income tax or self-employment tax

And then deduct the following:

- Most income tax exclusions other than meals or lodging furnished for the employer's convenience, and the foreign earned income exclusion
- Annual fair rental value of a parsonage provided to you after you retire
- Housing allowance provided to you after you retire
- Contributions by your church to a tax-sheltered annuity plan set up for you, including any salary reduction contributions (elective deferrals) that are not included in your gross income
- Pension payments or retirement allowances you receive for your past ministerial services

**Unreimbursed, and non-accountable reimbursed, expenses.** The clear implication of the tax code and IRS Revenue Ruling 80-110 is that unreimbursed business expenses, and reimbursed business expenses under a **non-accountable** plan, are deductible by pastors in computing their self-employment tax liability even if they are not able to deduct these expenses in computing their income tax liability because they do not have enough itemized expenses to use *Schedule A*. This understanding is clearly reflected in IRS *Publication 517*.

However, this understanding is contradicted by the following statement in the instructions to *Schedule SE*: "If you were a duly ordained minister who was an employee of a church and you must pay self-employment (SE) tax, the unreimbursed business expenses that you incurred as a church employee are allowed only as an itemized deduction for income tax purposes." This statement implies that unreimbursed employee business expenses are never deductible in computing net earnings from SE, regardless of whether they can be claimed as itemized deductions on *Schedule A*. This statement is clearly wrong, since section 1402 says that self-employed persons can reduce self-employment earnings in computing their self-employment tax liability by "the deductions attributable to the trade or business." This clearly includes unreimbursed business expenses.

Because of the confusion caused by the instructions to *Schedule SE*, ministers should consult with a tax professional before claiming unreimbursed expenses and **non-accountable** reimbursed expenses as deductions in computing self-employment tax liability on *Schedule SE*.

### Step 2: Section A (line 4)

Ministers (and other taxpayers who are self-employed for Social Security) can reduce their taxable earnings by 7.65 percent, which is half the FICA tax paid by employers and

employees. To do this, multiply net earnings from self-employment times 0.9235 on line 4. Self-employment taxes are paid on the reduced amount.

### Step 3: Section A (line 5)

The self-employment tax for 2016 is computed on this line. The self-employment tax rate for 2016 is 15.3 percent, which consists of the following two components:

1. A Medicare hospital insurance tax of 2.9 percent and
2. An old-age, survivor and disability (Social Security) tax of 12.4 percent

For 2016, the 2.9 percent Medicare tax applied to all net earnings from self-employment regardless of amount. The 12.4 percent Social Security tax applied to only the first \$118,500 of net self-employment earnings.

### Form 2106

 **Key Point:** Use *Form 2106* to compute your employee business expenses claimed on *Schedule A*.

### Step 1: Enter your expenses

On lines 1 through 6, you report your employee business expenses. For most ministers, the most significant employee business expense is the business use of a car. This expense is computed on Part II (side 2) of *Form 2106* and then reported on line 1 of Part I. Ministers may use the actual expense method of computing their car expenses or the standard mileage rate. Most ministers elect the standard mileage rate. Under this method, substantiated business miles are multiplied times the current standard mileage rate (54 cents per mile for business miles driven during 2016). You compute your vehicle expenses using the standard mileage rate in Section B of Part II (line 22).

 **Key Point:** The reimbursement standard mileage rate for business in 2016 was 54 cents per mile.

Those ministers using the actual expense method compute their car expenses in Section C of Part II. Some restrictions apply to use of the standard mileage rate. First, you must maintain adequate records to substantiate your business miles, and second, you must use the standard mileage rate for the first year you began using your car for business purposes.

On line 3, you report your travel expenses incurred while away from home overnight on business. This would include travel to other cities to perform weddings or funerals or trips to denominational meetings. Do not include meals and entertainment on line 3 (these items are reported separately on line 5). On line 4, report business expenses other than local transportation, overnight travel, and meals and entertainment. This would include education, publications, and the other kinds of business

expenses discussed previously in this guide.

### Step 2: Enter amounts your employer gave you for expenses listed in Step 1

If your employer (church) reimbursed some or all of your business expenses and does not report them as income in box 1 of your *Form W-2*, report the amount of these reimbursements on line 7. This would include any amount reported under code L in box 12 of your *Form W-2* (substantiated car expense reimbursements up to the standard business mileage rate).

### Step 3: Figure expenses to deduct on Schedule A (Form 1040)

On lines 8 through 10, you compute the amount of your business expense deduction to be claimed on *Schedule A*. The deduction will be limited to the amount that exceeds 2 percent of your AGI.

### Form 2106-EZ

Employees can use a simplified *Form 2106-EZ* to compute their business expense deduction for 2016 if their employer did not reimburse business expenses and they use the standard mileage rate for computing automobile expenses.