

Ministers' Tax Guide for 2017 Returns



2018

**TAX RETURN
PREPARATION
GUIDE**

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GuideStone®

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This publication is intended to provide a timely, accurate, and authoritative discussion of tax reporting compliance and the impact of recent changes in the tax laws. It is not intended as a substitute for legal, accounting, or other professional advice. If legal, tax, or other expert assistance is required, the services of a competent professional should be sought. Although we believe this book provides accurate information, there may be changes resulting from IRS or judicial interpretations of the tax code, new tax regulations, or technical corrections that occurred after the printing of this edition that are not reflected in the text.



Welcome to the *2018 Tax Return Preparation Guide (Ministers' Tax Guide for 2017 Returns)*, written exclusively for ministers by noted CPA and attorney Richard Hammar.

We are privileged to provide this reliable resource as we enter 2018 — GuideStone's centennial year of service.

We know that ministerial tax preparation can be complicated. While this book addresses the most commonly asked questions and most commonly used forms, you can find more extensive information on the IRS website, *irs.gov*. For specific tax advice, you'll want to consult an accountant or an attorney who is familiar with the intricacies of ministerial taxes.

As we begin our second century of service advocating on behalf of pastors and other ministers, this tax guide serves as a tangible reminder of our mission to honor the Lord by being a lifelong partner with our participants in enhancing their financial security. This resource is provided at no cost to our participants and other Southern Baptist and evangelical pastors and church workers. Additional copies of this free booklet may be downloaded at *GuideStone.org/TaxGuide*.

May God bless you in the ministry you have received from the Lord!

Sincerely,

A handwritten signature in black ink, appearing to read "O.S. Hawkins". The signature is stylized and fluid, with a long horizontal line extending to the right.

O.S. Hawkins
President
GuideStone Financial Resources of the Southern Baptist Convention®

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Special Supplement

CURRENT STATUS OF THE PARSONAGE AND HOUSING ALLOWANCE EXCLUSIONS

By Richard R. Hammar, J.D., LL.M., CPA

On November 22, 2013, U.S. District Judge Barbara Crabb of the U.S. District Court for the Western District of Wisconsin struck down the ministerial housing allowance as an unconstitutional preference for religion (*Freedom From Religion Foundation, Inc., v. Lew*, 983 F. Supp.2d 1051 (W.D. Wis. 2013)). The ruling was in response to a lawsuit brought by the Freedom From Religion Foundation (FFRF) and two of its officers challenging the constitutionality of the housing allowance and the parsonage exclusion. The federal government, which defended the housing allowance since it is a federal statute, asked the court to dismiss the lawsuit on the ground that the plaintiffs lacked standing to pursue their claim in federal court.

“Standing” is a constitutional requirement of any plaintiff in a federal case and generally means that a plaintiff must have suffered some direct injury as a result of a challenged law. The Wisconsin court concluded that the plaintiffs had standing on the grounds that they would have been denied a housing allowance exclusion had they claimed one on their tax return. The government appealed this ruling to a federal appeals court — the 7th U.S. Circuit Court of Appeals in Chicago.

On November 13, 2014, the appeals court issued its ruling, reversing the Wisconsin court’s decision (*Freedom From Religion Foundation, Inc., v. Lew*, 773 F.3d 815 (7th Cir. 2014)). It concluded that the plaintiffs lacked standing to pursue their challenge to the housing allowance. The plaintiffs had asserted that they had standing due to their “injury” of being denied a tax-free housing allowance should they claim one on their tax returns. But the appeals court refused to base standing on theoretical injury. It concluded: “Only a person that has been denied such a benefit can be deemed to have suffered cognizable injury. The plaintiffs here have never been denied the parsonage exemption because they have never requested it; therefore, they have suffered no injury.”

It suggested that this deficiency could be overcome if the FFRF’s officers filed tax returns claiming a housing allowance that was later rejected by the IRS in an audit: “The plaintiffs could have sought the exemption by excluding their housing allowances from their reported income on their tax returns and then petitioning the Tax Court if the IRS were to disallow the exclusion. Alternatively, they could have . . . paid income tax on their housing allowance, claimed refunds from the IRS, and then sued if the IRS rejected or failed to act upon their claims.”

The FFRF responded to the appeals court’s ruling by designating a housing allowance for two of its officers. The officers

reported their allowances as taxable income on their tax returns and thereafter filed amended tax returns seeking a refund of the income taxes paid on the amounts of their designated housing allowances. The FFRF claims that in 2015 the IRS denied the refunds sought by its officers (one of whom had died and was represented by her executor).

Having endeavored to correct the standing problem, the FFRF renewed its legal challenge to the housing allowance in the U.S. District Court in Wisconsin, where the litigation began.

First, on October 6, 2017, U.S. District Judge Barbara Crabb of the U.S. District Court for the Western District of Wisconsin again ruled that the ministerial housing allowance is an unconstitutional preference for religion (*Gaylor v. Mnuchin*, (W.D. Wis. 2017)). Judge Crabb observed:

[The housing allowance] violates the establishment clause because it does not have a secular purpose or effect and because a reasonable observer would view the statute as an endorsement of religion.

Although defendants try to characterize [the housing allowance] as an effort by Congress to treat ministers fairly and avoid religious entanglement, the plain language of the statute, its legislative history and its operation in practice all demonstrate a preference for ministers over secular employees. Ministers receive a unique benefit . . . that is not, as defendants suggest, part of a larger effort by Congress to provide assistance to employees with special housing needs. A desire to alleviate financial hardship on taxpayers is a legitimate purpose, but it is not a secular purpose when Congress eliminates the burden for a group made up of solely religious employees but maintains it for nearly everyone else. Under my view of the current law, that type of discriminatory treatment violates the establishment clause.

Judge Crabb acknowledged that “Congress could have enacted a number of alternative exemptions without running afoul of the First Amendment. For example, Congress could have accomplished a similar goal by allowing any of the following groups to exclude housing expenses from their gross income: (1) all taxpayers; (2) taxpayers with incomes less than a specified amount; (3) taxpayers who live in rental housing provided by the employer; (4) taxpayers whose employers impose housing-related requirements on them, such as living near the workplace, being on call or using the home for work-related purposes; or (5) taxpayers who work for nonprofit organizations, including churches.”

☞ **Key Point:** But perhaps of most interest was Judge Crabb’s suggestion that the tax code be amended to apply to taxpayers “who work for tax-exempt

organizations under § 501(c)(3) and are on call at all times.” Such an amendment would cover most clergy, but few enough employees of secular charities to be feasible as a matter of tax policy.

Second, Judge Crabb stayed the enforcement of her ruling until the end of October so that the parties could submit briefs on appropriate remedies for the plaintiffs. It is likely, though not certain, that when the issue of remedies is resolved, the judge will do what she did in her earlier decision in 2014 and stay enforcement of the ruling pending an appeal. But this is not certain, and so ministers and churches should be alert to developments.

Third, a ruling by the 7th U.S. Circuit Court of Appeals would apply to ministers in that circuit, which includes the states of Illinois, Indiana, and Wisconsin. It would become a national precedent binding on ministers in all states if affirmed by the United States Supreme Court — an unlikely outcome because the Supreme Court accepts less than 1 percent of all appeals. Note, however, that the IRS would have the discretion to follow or not follow such a ruling in other circuits and might be inclined to follow it nationwide to promote consistency in tax administration.

Fourth, churches should continue to designate housing allowances for their ministers for 2018 and future years until the housing allowance is conclusively declared unconstitutional. This could occur in various ways, including the following: (1) Judge Crabb’s ruling is not appealed by the government, and the IRS applies it nationally; (2) Judge Crabb’s ruling is appealed to the 7th U.S. Circuit Court of Appeals, the court affirms Judge Crabb’s ruling, and the IRS elects to apply it nationally; or (3) the Supreme Court accepts an appeal of the appellate court’s ruling and determines that the housing allowance is an unconstitutional preference for religion in violation of the First Amendment’s ban on any establishment of religion. Ministers should understand that claiming a housing allowance exclusion while this litigation is pending poses a risk that the exclusion may be disallowed and an amended tax return will need to be filed. Ministers should be prepared for this outcome, though it is unlikely that the housing allowance will be declared unconstitutional retroactively. Again, be alert to future developments.

Fifth, the U.S. Department of Justice, which defends the constitutionality of federal legislation (such as the housing allowance), filed a brief with the court asking it to dismiss the FFRF’s challenge to the constitutionality of the parsonage exclusion. The Department of Justice noted that section 107 of the tax code grants tax exclusions both for the rental value of parsonages provided to clergy as compensation for the performance

of ministerial services and for housing allowances provided to clergy who own or rent their home. But since none of the FFRF’s officers was living in housing owned by the FFRF, they lacked standing to challenge the constitutionality of section 107’s exclusion of the rental value of church-owned parsonages.

The court, noting that the FFRF had not opposed this argument, issued a summary judgment dismissing the FFRF’s challenge to the constitutionality of the parsonage exclusion.

Sixth, and in conclusion, ministers and churches should be aware that the housing allowance is under attack. Judge Crabb’s ruling may be affirmed on appeal and applied nationwide by the IRS. Should that occur, there are three actions that will need to be implemented quickly:

- (1) Many ministers will experience an immediate increase in income taxes. As a result, they should be prepared to increase their quarterly estimated tax payments to reflect the increase in income taxes in order to avoid an underpayment penalty. Note that there will be no effect on self-employment taxes (SECA) (Social Security taxes for the self-employed), for which the housing allowance is not tax-exempt.
- (2) Many churches will want to increase ministers’ compensation to offset the adverse financial impact. Thousands of ministers have purchased a home and obtained a mortgage loan on the assumption that the housing allowance would continue to be available as it has for more than a half-century. The sudden elimination of this tax benefit will immediately thrust many clergy into a dire financial position with a mortgage loan based on a tax benefit that no longer is available. Many church leaders will want to reduce the impact of such a predicament by increasing compensation. Such an increase could be phased out over a period of years to minimize the impact on the church. I will be monitoring all future developments and will keep you posted as they occur.
- (3) Ministers who are considering the purchase of a new home should not base the amount and affordability of a home mortgage loan on the availability of a housing allowance exclusion unless and until the courts conclusively rule in favor of the constitutionality of the allowance.

 **Key Point:** Ministers should address with a tax professional the continuing availability of the housing allowance.

All references in this publication to line numbers on IRS forms are for the draft versions of the 2017 forms, since the final forms had not been released by the IRS as of the date of publication.

HOW TO USE THIS GUIDE

This book contains the basic information you need to complete your 2017 federal income tax return. It gives special attention to several forms and schedules and the sections of each form most relevant to ministers. The companion resource — *Federal Reporting Requirements for Churches* — helps churches comply with their federal tax reporting requirements.

This guide is divided into the following sections:

- **Part 1: Introduction** — This section reviews tax highlights for 2017 and presents several preliminary questions you should consider before preparing your tax return.
- **Part 2: Special Rules for Ministers** — In this section, you learn whether or not you are a Minister for Tax Purposes, whether you are an employee or self-employed for both income tax and Social Security purposes, and how you pay your taxes.
- **Part 3: Step-by-Step Tax Return Preparation** — This section explains how to complete the most common tax forms and schedules for ministers.
- **Part 4: Comprehensive Examples and Forms** — This section shows a sample tax return prepared for an active minister and spouse and for a retired minister and spouse.
- **Federal Reporting Requirements for Churches** — This resource provides assistance to churches (especially treasurers and bookkeepers) in filing federal tax forms.

TAX HIGHLIGHTS FOR 2017

1. Temporarily extend the American Opportunity Tax Credit

One of the most important and divisive provisions in the Affordable Care Act (ACA, or Act) is a requirement that applicable individuals are required to maintain minimum essential health care coverage or pay a penalty. This requirement is known as the individual mandate, or individual shared responsibility. For 2017, failure to maintain minimum essential health care coverage resulted in a penalty of the greater of 2.5 percent of household income or \$695 per adult and \$347.50 per child under 18, up to a maximum of \$2,085 per family. After 2017, dollar amounts increase by an annual Cost-of-Living Adjustment (COLA).

Key Point: The IRS announced late in 2017 that for the upcoming 2018 filing season it will not accept electronically filed tax returns if the taxpayer does not address the health coverage requirements of the Act. The IRS will not accept the electronic tax return until the taxpayer indicates whether they had coverage, had an exemption, or will make a shared responsibility payment. Returns filed on paper that do not address the health coverage requirements may be suspended pending the receipt of additional information, and any refunds may be delayed.

The ACA imposes the most significant reporting obligations since the introduction of *Form W-2* in 1943. In fact, the new reporting obligations are similar to *Form W-2* in that there are forms that must be issued to individual employees and a transmittal form that is sent to the IRS along with copies of all the forms issued to employees. And, as with *Form W-2*, the IRS can assess penalties for failure to comply with the current reporting obligations. The requirements are as follows:

- (1) Providers of minimum essential coverage are required to file *Forms 1094-B* and *1095-B* for 2017. *Forms 1094-B* and *1095-B* are used to report certain information to the IRS and to employees about individuals who are covered by minimum essential coverage and therefore aren't liable for the individual shared responsibility payment.
- (2) Applicable large employers, generally employers with 50 or more full-time employees (including full-time equivalent employees) in the previous year, must file one or more *Forms 1094-C* (including a *Form 1094-C* designated as the Authoritative Transmittal, whether or not filing multiple *Forms 1094-C*) and must file a *Form 1095-C* for each employee who was a full-time employee of the employer for any month of the calendar year. Generally, the employer is required to furnish a copy of the *Form 1095-C* (or a substitute form) to the employee.

These reporting requirements are addressed further in the *Federal Reporting Requirements for Churches* section.

2. 21st Century Cures Act

Sections 105(h) and 106 of the tax code specify that an employee may exclude from taxable income amounts provided through an arrangement under which (1) an employer pays or reimburses premiums for health insurance purchased in the individual insurance market for the employee and family members

(referred to as an employer payment plan, or EPP) or (2) an employer reimburses the employee for medical expenses generally of the employee and family members (referred to as a Health Reimbursement Arrangement, or HRA).

In the final days of 2016, Congress enacted the 400-page 21st Century Cures Act, with massive bipartisan support. The Act addressed several health-related issues and, perhaps of most interest to church leaders, included a provision relieving many small employers of one of the most feared provisions in the ACA: the \$100 per day per employee penalty that the IRS could impose upon any employer that continued to pay or reimburse employees' medical insurance under a private plan.

The relief from the \$100 per day per employee penalty will not benefit all churches. A church may be subject to the penalty if, for example, it offers an EPP or HRA and (1) it is an applicable large employer with an average of 50 full-time and full-time equivalent employees during the previous calendar year; (2) it offers a group health plan to any of its employees; (3) it contributes more than \$5,130 (\$10,260 for a family) to an EPP or HRA, adjusted for inflation; or (4) the arrangement fails to satisfy one or more of the other requirements for a qualified small employer health reimbursement arrangement (QSEHRA).

The Act is effective retroactively.

 **Key Point:** Late in 2017, Republican members of the House of Representatives introduced the 429-page *Tax Cuts and Jobs Act*. Once enacted, many of the provisions in this bill would significantly impact the way Americans pay taxes. Note that the Senate Republicans, and Democrats in both houses of Congress, may oppose some or all of these provisions. Church leaders should be alert to future developments. To learn more, download the free resource, *2017 Tax Cuts and Jobs Act* from our website at GuideStone.org/TaxGuide.

3. Other tax changes of interest to churches and church staff

There were several tax developments in 2017 that will affect tax reporting by both ministers and churches for 2017 and future years. Here is a rundown of some of the key provisions:

- You may be able to claim the earned income credit for 2017 if (1) you do not have a qualifying child and you earned less than \$15,010 (\$20,600 if married filing jointly); (2) a qualifying child lived with you and you earned less than \$39,617 (\$45,207 if married filing jointly); (3) two qualifying children lived with you and you earned less than \$45,007 (\$50,597 if married filing jointly); or (4) three or more qualifying children lived with you and you earned less than

\$48,340 (\$53,930 if married filing jointly). The maximum earned income credit for 2017 is (1) \$510 with no qualifying child; (2) \$3,400 with one qualifying child; (3) \$5,616 with two qualifying children; and (4) \$6,318 with three or more qualifying children.

- For contributions in 2017 to a Traditional IRA, the deduction phase-out range for an individual covered by a retirement plan at work begins at income of \$99,000 for joint filers and \$62,000 for a single person or head of household. These 2017 amounts increase to \$101,000 and \$63,000 for 2018.
- The dollar limit on annual elective deferrals an individual may make to a 403(b) retirement plan is \$18,000 for 2017. It increases to \$18,500 for 2018.
- The catch-up contribution limit on elective deferrals to a 403(b) retirement plan for individuals who had attained age 50 by the end of the year was \$6,000 for 2017. It remains at \$6,000 for 2018.
- The IRS has announced that it will not issue private letter rulings addressing the question of “whether an individual is a minister of the gospel for federal tax purposes.” This means taxpayers will not be able to obtain clarification from the IRS in a letter ruling on their status as a minister for any one or more of the following matters: (1) eligibility for a parsonage exclusion or housing allowance; (2) eligibility for exemption from SECA; (3) self-employed status for Social Security; or (4) exemption of wages from income tax withholding. The IRS also has announced that it will not address “whether amounts distributed to a retired minister from a pension or annuity plan should be excludable from the minister’s gross income as a parsonage allowance.”
- The standard business mileage rate was 53.5 cents per mile for business miles driven during 2017. The standard business mileage rate for 2018 is 54.5 cents per mile.
- The IRS maintains that a minister’s housing allowance is earned income in determining eligibility for the earned income credit for ministers who have not opted out of Social Security by filing a timely *Form 4361*. For ministers who have opted out of Social Security, the law is less clear, and the IRS has not provided guidance.
- Recent tax law changes will result in lower taxes and lower estimated tax payments for many taxpayers. Be sure your estimated tax calculations or withholdings take into account the most recent tax law changes.
- 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 (\$3,780 per month for 2018). 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 2018 this annual amount is \$17,040.

- For 2017 the following inflation adjustments took effect:
 - The amount of income you need to earn to boost you to a higher tax rate was adjusted for inflation.
 - The value of each personal and dependency exemption, available to most taxpayers, increased to \$4,050.
 - The standard deduction is \$12,700 for married couples filing a joint return and \$6,350 for singles and married individuals filing separately. Nearly two out of three taxpayers take the standard deduction, rather than itemizing deductions, such as mortgage interest, charitable contributions, and state and local taxes.

Will Congress give ministers another opportunity to revoke an exemption from Social Security? It does not look likely, at least for now. No legislation is pending that would provide ministers with this option.

Both the president and House Republicans offered proposals for tax reform in 2017 that may serve as a blueprint for future tax legislation. These proposals included, but were not limited to, the following:

- Consolidate the current seven tax brackets into three brackets and lower the top individual income tax rate to 33 percent. Going forward, these income tax brackets will be indexed for inflation.
- Eliminate the alternative minimum tax.
- Reduce taxes on investment income.
- Consolidate the basic standard deduction, the additional standard deduction, and the personal exemptions for families and individuals. The new larger standard deduction would be \$24,000 for married individuals filing jointly, \$18,000 for single individuals with a child in the household, and \$12,000 for other individuals. These amounts would be adjusted annually for inflation.
- Eliminate itemized deductions except home mortgage interest and charitable contributions.

- Consolidate the child tax credit and personal exemptions for dependents into an increased child tax credit of \$1,500. The first \$1,000 would be refundable as under current law. A non-refundable credit of \$500 also would be allowed for non-child dependents.

PRELIMINARY QUESTIONS

Below are several questions you should consider before preparing your 2017 federal tax return.

Q. Must ministers pay federal income taxes?

- A. Yes. Ministers are not exempt from paying federal income taxes.

Q. How much income must I earn to be required to file a tax return?

- A. Generally, ministers are required to file a federal income tax return if they have earnings of \$400 or more. Different rules apply to some ministers who are exempt from SECA.

Q. Can I use the simpler *Forms 1040-A* or *1040-EZ* rather than the standard *Form 1040*?

- A. Most ministers must use the standard *Form 1040*.

Q. What records should I keep?

- A. You should keep all receipts, canceled checks, and other evidence to prove amounts you claim as deductions, exclusions, or credits.

Q. What is the deadline for filing my federal income tax return?

- A. The deadline for filing your 2017 federal tax return is April 17, 2018.

Q. What if I am unable to file my tax return by the deadline?

- A. You can obtain an automatic 6-month extension (from April 17 to October 15, 2018) to file your 2017 *Form 1040* if you file *Form 4868* by April 17, 2018, with the IRS Service Center for your area. Your *Form 1040* can be filed at any time during the 6-month extension period. An extension only relieves you from the obligation to file your return; **it is not an extension of the obligation to pay your taxes.** You must make an estimate of your tax for 2017 and pay the estimated tax with your *Form 4868*.

Q. Should I prepare my own tax return?

- A. The answer depends on your ability and experience in working with financial information and in preparing tax returns. Keep in mind: Ministers' taxes present a number of unique rules, but these rules are not complex. Many ministers will be able to prepare their own tax returns if they understand the unique rules that apply. These rules are summarized in this document. On the other hand, if you experienced unusual events in 2017, such as the sale or purchase of a home or the sale of other capital assets, it may be prudent to obtain

professional tax assistance. The IRS provides a service called Taxpayer Assistance, but it is not liable in any way if its agents provide you with incorrect answers to your questions. Free taxpayer publications are available from the IRS, and many of these are helpful to ministers.

► **Recommendation:** If you need professional assistance, here are some tips that may help you find a competent tax professional:

- Ask other ministers in your community for their recommendations.
- If possible, use a CPA who specializes in tax law and who is familiar with the rules that apply to ministers. A CPA has completed a rigorous educational program and is subject to strict ethical requirements.
- Ask local tax professionals if they work with ministers and, if so, with how many.
- Ask local tax professionals a few questions to test their familiarity with ministers' tax issues. For example, ask whether ministers are employees or self-employed for Social Security. Anyone familiar with ministers' taxes will know that ministers are self-employed for Social Security with respect to their ministerial duties. Or, ask a tax professional if a minister's church salary is subject to income tax withholding. The answer is no, and anyone familiar with ministers' taxes should be able to answer this question.

WHO IS A MINISTER FOR FEDERAL TAX PURPOSES?

Key Point: The IRS has its own criteria for determining who is a Minister for Tax Purposes. The criteria the IRS uses to determine who is a minister are not necessarily the same as those used by churches and denominations. Whether or not one qualifies as a Minister for Tax Purposes is a very important question, since special tax and reporting rules apply to ministers under federal tax law.

These rules include:

- Eligibility for housing allowances
- Self-employed status for Social Security
- Exemption of wages from income tax withholding (ministers use the quarterly estimated tax procedure to pay their taxes, unless they elect voluntary withholding)
- Eligibility under very limited circumstances to exempt themselves from SECA

These special rules apply only with respect to services performed in the exercise of ministry.

Example: Pastor J is an ordained minister at his church. In addition, he works a second job for a secular employer. Assume that Pastor J qualifies as a minister for federal tax purposes. Since his church duties constitute services performed in the exercise of ministry, the church can designate a portion of his compensation as a housing allowance. However, the secular employer cannot designate any portion of Pastor J's compensation as a housing allowance, since this work would not be service in the exercise of ministry.

According to the IRS, ministers are individuals who are duly ordained, commissioned, or licensed by a religious body constituting a church or church denomination. They are given the authority to conduct religious worship, perform sacerdotal functions, and administer ordinances or sacraments according to the tenets and practices of that church or denomination. If a church or denomination ordains some ministers and licenses or commissions others, anyone licensed or commissioned must be able to perform substantially all the religious functions of an ordained minister to be treated as a Minister for Tax Purposes. See *IRS Publication 517*.

ARE MINISTERS EMPLOYEES OR SELF-EMPLOYED FOR FEDERAL TAX PURPOSES?

Key Point: Most ministers are considered employees for federal income tax purposes under the tests currently used by the IRS and the courts and should receive a *Form W-2* from their church reporting their taxable income. However, ministers are self-employed for Social Security (with respect to services they perform in the exercise of their ministry).

Ministers have a **dual** tax status. For federal income taxes, they ordinarily are employees, but for Social Security they are self-employed with regard to services performed in the exercise of ministry. These two rules are summarized below:

Income taxes. For federal income tax reporting, most ministers are employees under the tests currently used by the IRS. This means that they should receive a *Form W-2* from their church at the end of each year (rather than a *Form 1099*). It also means that they report their employee business expenses on *Schedule A* rather than on *Schedule C*. A few ministers are self-employed, such as some traveling evangelists and interim pastors. Also, many ministers who are employees of a local church are self-employed for other purposes. For example, the minister of a local church almost always will be an employee, but will be self-employed with regard to guest speaking appearances in other churches and services performed directly for individual members (such as weddings and funerals).

Example: Pastor B is a minister at First Baptist Church. He is an employee for federal income tax reporting purposes with respect to his church salary. However, he is self-employed with respect to honoraria he receives for speaking in other churches and for compensation church members offer for performing personal services such as weddings and funerals. The church issues Pastor B a *Form W-2* reporting his church salary. Pastor B reports this amount as wages on line 7 of *Form 1040*. He reports compensation and expenses from self-employment activities on *Schedule C*.

Key Point: Most ministers will be better off financially being treated as employees, since the value of various fringe benefits will be tax-free, the risk of an IRS audit is substantially lower, and reporting as an employee avoids the additional taxes and penalties that often apply to self-employed ministers who are audited by the IRS and reclassified as employees.

§ **Tax Tip:** Ministers and other church staff members should carefully review their *Form W-2* to be sure that it does not report more income than was actually received. If an error was made, the church should issue a corrected tax form (*Form W-2c*).

The Tax Court test. The United States Tax Court has created a seven-factor test for determining whether a minister is an employee or self-employed for federal income tax reporting purposes. The test requires consideration of the following seven factors: (1) the degree of control exercised by the employer over the details of the work; (2) which party invests in the facilities used in the work; (3) the opportunity of the individual for profit or loss; (4) whether or not the employer has the right to discharge the individual; (5) whether the work is part of the employer's regular business; (6) the permanency of the relationship; and (7) the relationship the parties believe they are creating. Most ministers will be employees under this test.

Social Security. The tax code treats ministers as self-employed for Social Security with respect to services performed in the exercise of their ministry — even if they report their income taxes as employees. This means that ministers must pay SECA unless they have filed a timely exemption application (*Form 4361*) that has been approved by the IRS. As noted below, few ministers qualify for this exemption.

☞ **Key Point:** While most ministers are employees for federal income tax reporting purposes, they are self-employed for Social Security with respect to services they perform in the exercise of their ministry. This means that ministers are not subject to the employee's share of Social Security and Medicare taxes (FICA), even though they report their income taxes as employees and receive a *Form W-2* from their church. Rather, they pay SECA.

EXEMPTION FROM SECA

If ministers meet several requirements, they may exempt themselves from SECA with respect to their ministerial earnings. Among other things, the exemption application (*Form 4361*) must be submitted to the IRS within a limited time period. The deadline is the due date of the federal tax return for the second year in which a minister has net earnings from self-employment of \$400 or more, any part of which comes from ministerial services. Further, the exemption is available only to ministers who are opposed on the basis of religious considerations to the acceptance of benefits under the Social Security program (or any other public insurance system that provides retirement or medical benefits). A minister who files the exemption application may still purchase life insurance or participate in retirement programs administered by non-governmental institutions (such as a life insurance company).

A minister's opposition must be to accepting benefits under Social Security (or any other public insurance program). Economic, or any other non-religious considerations, are not a valid basis for the exemption, nor is opposition to paying SECA.

The exemption is effective only when it is approved by the IRS. Few ministers qualify for exemption. Many younger ministers opt out of Social Security without realizing that they do not qualify for the exemption. A decision to opt out of Social Security is irrevocable. Congress did provide ministers with a brief window of time to revoke an exemption by filing *Form 2031* with the IRS. This opportunity expired in 2002 and has not been renewed.

An exemption from SECA applies only to ministerial services. Ministers who have exempted themselves from SECA must pay Social Security taxes on any non-ministerial compensation they receive. And, they remain eligible for Social Security benefits based on their non-ministerial employment, assuming that they have worked enough quarters. Generally, 40 quarters are required. Also, the Social Security Administration (SSA) has informed the author of this text that ministers who exempt themselves from SECA may qualify for Social Security benefits (including retirement and Medicare) on the basis of their spouse's coverage, if the spouse had enough credits. However, the amount of these benefits will be reduced by the so-called windfall elimination provision. Contact an SSA office for details.

☞ **Key Point:** The amount of earnings required for a quarter of coverage in 2018 is \$1,320. A quarter of coverage is the basic unit for determining whether a worker is insured under the Social Security program.

☞ **Key Point:** Ministers who work after they retire must pay Social Security tax on their wages (unless they exempted themselves from Social Security as a minister and they are employed in a ministerial capacity).

☞ **Key Point:** In 1970, the IRS ruled that ministers who exempt themselves from SECA solely on the basis of economic considerations are not legally exempt (Revenue Ruling 70-197). The IRS concluded: "The taxpayer filed the *Form 4361* solely for economic considerations and not because he was conscientiously opposed to, or because of religious principles opposed to, the acceptance of any public insurance of the type described on the form. Accordingly . . . the taxpayer did not qualify for the exemption since the *Form 4361* filed solely for economic reasons is a nullity." Ministers wanting to revoke an exemption from SECA should discuss this ruling with a tax professional.

HOW DO MINISTERS PAY THEIR TAXES?

Key Point: Ministers must prepay their income taxes and SECA using the estimated tax procedure, unless they have entered into a voluntary withholding arrangement with their church with respect to federal income tax only.

As noted above, ministers' wages are exempt from federal income tax withholding. This means that a church does not have to withhold income taxes from a minister's paycheck. And, since ministers are self-employed for Social Security with respect to their ministerial services, a church does not withhold the employee's share of FICA from a minister's wages. Ministers must prepay their income taxes and SECA using the estimated tax procedure, unless they have entered into a voluntary withholding arrangement with their church. Estimated taxes must be paid in quarterly installments. If your estimated taxes for the current year are less than your actual taxes, you may have to pay an underpayment penalty. You can amend your estimated tax payments during the year if your circumstances change. For example, if your income or deductions increase unexpectedly, you should refigure your estimated tax liability for the year and amend your remaining quarterly payments accordingly.

You will need to make estimated tax payments for 2018 if you expect to owe at least \$1,000 in tax for 2018 after subtracting your withholding and credits and if you expect your withholding and credits to be less than the smaller of (1) 90 percent of the tax to be shown on your 2018 tax return or (2) 100 percent of the tax shown on your 2017 tax return (110 percent if adjusted gross income (AGI) exceeds \$150,000 or, if married filing separately, more than \$75,000). Your 2017 tax return must cover all 12 months.

The four-step procedure for reporting and prepaying estimated taxes for 2018 is summarized below.

Step 1. Obtain a copy of IRS *Form 1040-ES* for 2018 before April 17, 2018. You can obtain forms by calling the IRS toll-free forms hotline at 1-800-TAX-FORM (1-800-829-3676) or from the IRS website (*irs.gov*). If you paid estimated taxes last year, you should receive a copy of your 2018 *Form 1040-ES* in the mail with payment vouchers preprinted with your name, address, and Social Security number.

Step 2. Compute your estimated tax for 2017 using the *Form 1040-ES* worksheet. Ministers' quarterly estimated tax payments should take into account both income taxes and self-employment taxes.

Step 3. Pay one-fourth of your total estimated taxes for 2018 in each of four quarterly installments as follows:

For the Period	Due Date
January 1–March 31	April 17, 2018
April 1–May 31	June 15, 2018
June 1–August 31	September 17, 2018
September 1–December 31	January 15, 2019

You must send each payment to the IRS, accompanied by one of the four payment vouchers contained in *Form 1040-ES*.

Step 4. After the close of 2017, compute your actual tax liability on *Form 1040*. Only then will you know your actual income, deductions, exclusions, and credits. If you overpaid your estimated taxes (that is, actual taxes computed on *Form 1040* are less than all of your estimated tax payments plus any withholding), you can elect to have the overpayment credited against your first 2018 quarterly estimated tax payment or spread it out in any way you choose among any or all of your next four quarterly installments. Alternatively, you can request a refund of the overpayment. If you underpaid your estimated taxes (that is, your actual tax liability exceeds the total of your estimated tax payments plus any withholding), you may have to pay a penalty.

Key Point: Ministers who report their income taxes as employees can **voluntarily** request that their employing church withhold income taxes from their wages. Simply furnish the church with a completed *Form W-4* (withholding allowance certificate). Since ministers are not employees for Social Security with respect to ministerial compensation, the church does not withhold the employee's share of FICA. However, ministers can request on *Form W-4* (line 6) that an additional amount of income tax be withheld to cover their estimated SECA liability for the year. The excess income tax withheld is a credit that is applied against the minister's SECA liability. Many churches understandably withhold FICA in addition to income taxes for a minister who requests voluntary withholding. Such withholding must be reported as income tax withheld.