

Part 3. Step-by-Step Tax Return Preparation

Tax forms and schedules

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

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

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

Schedule B is for reporting dividend and interest income.

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

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

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

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

Form 1040

Step 1: Label and general information

You should affix the name and address label that you received in the mail from the IRS at the top of your Form 1040. Address changes or other corrections should be made directly on the label. Make sure you report your Social Security number and that of your spouse if you are filing jointly (Social Security numbers are no longer printed on the labels you receive from the IRS). If you are on a January 1 through December 31 (calendar) tax year, you do not need to write in the beginning and ending dates of your tax year.

If you want \$3 to go to the presidential election campaign fund, check the box labeled “yes.” Regardless of your answer,

the amount of taxes you owe or the amount of refund you receive will not change.

Step 2: Filing status

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

Step 3: Exemptions

To claim a dependency exemption for a qualifying child, the child must be a United States citizen or resident, and meet the following five tests:

1. The child must be your child (including an adopted child, stepchild or eligible foster child), brother, sister, stepbrother, stepsister or a descendant of any of them.
2. The child must have lived with you for more than half of 2009. An exception applies, in certain cases, for children of divorced or separated parents.
3. At the end of 2009, the child must be under age 19, or under age 24 and a student, or any age and permanently and totally disabled.
4. The child must not have provided over half of his or her own support in 2009.
5. If the child meets the rules to be a qualifying child of more than one person, you must be the person entitled to claim the child as a qualifying child.

To claim a dependency exemption for a qualifying relative, the relative must meet all of the following conditions:

- The person must be either your relative or any other person (other than your spouse) who lived in your home all year as a member of your household. If the person is not your relative, your relationship must not violate local law.
- The person cannot be your qualifying child (see above) or the qualifying child of another person in 2009.
- The person must have gross income of less than \$3,650. If the person is permanently and totally disabled, certain income from a sheltered workshop may be excluded for this purpose.
- You must have provided over half of the person’s support in 2009. Exceptions apply, in certain cases, for children of divorced or separated parents and for a person supported by two or more taxpayers.

Step 4: Income

Several items of income are reported on lines 7 through 22. The most important of these (for ministers) are discussed below.

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

Line 7. Wages, salaries, tips, etc.

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

As an employee, you should receive a Form W-2 from your church reporting your wages at the end of each year. Report this amount on line 7. Then, determine if this amount reflects all of your church income. If it does not, report the remaining income on line 21 as other income.

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

1. Bonuses.
2. Excess housing allowance (the amount by which a housing allowance exceeds the lesser of a minister's actual housing expenses or the fair rental value of the minister's home).
3. The cost of sending a minister to the Holy Land (if paid by the church).
4. Most Christmas and special occasion offerings.
5. Retirement gifts paid by a church.
6. The portion of a minister's Social Security tax paid by a church to the minister.
7. Personal use of a church-provided car.
8. Purchases of church property for less than fair market value.
9. Business expense reimbursements under a non-accountable plan.
10. Reimbursements the church made for the minister's moving expenses (but not if the minister substantiated the reimbursed expenses under an accountable arrangement).
11. Imputed cost of group term life insurance coverage (including death benefits under the Benefits Plan) exceeding \$50,000 and cost of coverage of spouse and dependents over \$2,000 which is paid by the church.
12. Church reimbursements of a spouse's travel expenses incurred while accompanying a minister on a business trip; this represents income to the minister unless the spouse's presence serves a legitimate business purpose and the spouse's expenses are reimbursed under an accountable arrangement.
13. "Discretionary funds" established by a church for a minister to spend on current needs — if the minister is allowed to distribute funds for his personal benefit.
14. "Below-market interest loans" of at least \$10,000 made by a church to a minister.
15. Cancellation of a minister's debt to a church.
16. Severance pay.
17. Payment of a minister's personal expenses by the church.

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

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

If some of these items were not reported on your Form W-2, they still must be reported as income. Either have your church issue a "corrected" Form W-2 (Form W-2c) or report the items as other income on line 21. If this is the case, be sure this is addressed and corrected for future years.

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

1. Gifts, so long as they are not compensation for services. However, employers generally are not permitted to give tax-free gifts to employees.
2. Life insurance proceeds and inheritances.
3. Medical insurance premiums paid by an employer for employees (and their spouses and dependents). This exclusion is not available to self-employed individuals.
4. Amounts received under an employer-financed "accident

and health plan” as payments for permanent injury or loss of bodily function or as reimbursements of medical expenses. The payments can be made on behalf of a spouse or dependent of the employee. This exclusion assumes that the employer has established an “accident or health plan.” Unfortunately, the requirements for such a plan are not specified in the tax code. Employers may reimburse employee medical expenses under either a self-insured plan (for example, reimbursements are paid out of the employer’s own funds rather than through an insurance policy) or an insured plan. However, if reimbursements are made under a self-insured plan, nondiscrimination rules apply. Generally, these rules require that the plan not discriminate in favor of highly compensated individuals (those earning \$110,000 or more for 2010) with regard to either amount of benefits or eligibility to participate.

5. The cost of employer-provided group term life insurance so long as the amount of coverage does not exceed \$50,000.

Key Point. The death benefits under the benefits plan generally exceed the \$50,000 limit. Your W-2 should include imputed income reporting the taxable cost of these benefits.

1. Qualified tuition reductions provided by an employer. A qualified tuition reduction is a reduction in tuition charged to employees or their spouses or dependent children by an employer that is an educational institution.
2. The value of free child-care services provided by a church to its employees, if the benefit is based on a written plan that does not discriminate in favor of highly compensated employees. Other conditions apply.

Housing allowance

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

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

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

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

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

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

The housing allowance is an exclusion only for federal income tax reporting purposes. Ministers cannot exclude a housing allowance when computing self-employment (SECA) taxes unless they are retired. The tax code specifies that the self-employment tax (SECA) does not apply to “the rental value of any parsonage or any parsonage allowance provided after the [minister] retires.”

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

Housing expenses to include in computing your housing allowance exclusion

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

1. Down payment on a home (but remember, a housing allowance is non-taxable only to the extent that it does not exceed the lesser of actual housing expenses or the fair rental value of a minister's home).
2. Mortgage payments on a loan to purchase or improve your home (include both interest and principal).
3. Rent.
4. Real estate taxes.
5. Property insurance.
6. Utilities (electricity, gas, water, trash pickup, local telephone charges).
7. Furnishings and appliances (purchase and repair).
8. Structural repairs and remodeling.
9. Yard maintenance and improvements.
10. Maintenance items (pest control, etc.).
11. Homeowners association dues.

Please note the following:

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

✎ **Example.** A church designated \$20,000 of Pastor D's 2009 compensation as a housing allowance. Pastor D's housing expenses for 2009 were utilities of \$2,000, mortgage payments of \$8,000, property taxes of \$4,000, insurance payments of \$1,000, repairs of \$1,000 and furnishings of \$1,000. The fair rental value of the home (including furnishings) is \$12,000. Pastor D's housing allowance is nontaxable in computing income taxes only to the extent that it is used to pay housing expenses and does not exceed the fair rental value of his home (furnished, plus utilities). Stated differently, the nontaxable portion of a housing allowance is the least of the following three amounts: (1) the housing allowance designated by the church; (2) actual housing expenses; (3) the fair rental value of the home (furnished, plus utilities). In this case, the lowest of these three amounts is the fair rental value of the home, furnished plus utilities (\$14,000), and so this represents the nontaxable portion of Pastor D's housing allowance. Pastor D must report the difference between this amount and the housing allowance designated by his church (\$6,000) as additional income on line 7 of Form 1040.

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

✎ **Example.** Pastor Y owns a home and incurs housing expenses of \$12,000 in 2009. These expenses include mortgage principal and interest, property taxes, utilities, insurance and repairs. The church designated (in advance) \$12,000 of Pastor Y's 2009 compensation as a housing allowance. Pastor Y is able to itemize expenses on Schedule A (Form 1040). He is able to claim itemized deductions on Schedule A for both his mortgage interest and his property taxes, even though his taxable income was already reduced by these items because of their inclusion in the housing allowance. This is often referred to as the "double deduction." In reality, it represents an exclusion and a deduction.

✎ **Example.** In preparing his income tax return for 2009, Pastor H discovers that his church failed to designate a housing allowance for him for 2009. He asks his church to pass a resolution retroactively granting the allowance for 2009. Such a resolution is ineffective, and Pastor H will not be eligible for any housing allowance exclusion in 2009.

☞ **Key Point.** The Sarbanes-Oxley Act makes it a crime to knowingly falsify any document with the intent to influence “the investigation or proper administration of any matter within the jurisdiction of any department or agency of the United States . . . or in relation to or contemplation of any such matter or case,” and this provision contains no exemption for churches or pastors. It is possible that a pastor’s backdating of a board resolution to qualify for a housing allowance for the entire year violates this provision in the Sarbanes-Oxley Act, exposing the pastor to a fine or imprisonment. Even if the pastor’s action does not violate the Act, it may result in civil or criminal penalties under the tax code.

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

How much should a church designate as a housing allowance?

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

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

Churches sometimes neglect to designate a housing allowance in advance of a new calendar year. For example, a church may discover on March 1, 2010, that it has failed to designate a housing allowance for its pastor for 2010. It is not too late to

act. The church should immediately designate a portion of its minister’s remaining compensation in 2010 as a housing allowance. This unfortunate problem can be avoided by stipulating in each annual housing allowance designation that the allowance shall be for the current year and for all future years unless otherwise provided. If such a resolution had been adopted in the December 2009 meeting, it would not matter that the church neglected to designate a minister’s 2010 allowance until March of 2010, since the previous designation would have carried over. Such “safety net” designations are not a substitute for annual housing allowances. Rather, they provide a basis for claiming a housing allowance if a church neglects to designate one.

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

☞ **Key Point.** Retired ministers are eligible for a housing allowance exclusion if the following conditions are satisfied: (1) a portion or all of a retired minister’s pension income is designated as a housing allowance by GuideStone or by the local church that contributed to the fund; (2) the retired minister has severed his relationship with the local church and relies on the fund for a pension; (3) the pensions paid to retired ministers “compensate them for past services to the local churches of the denomination or to the denomination.” Retired ordained ministers who receive benefits will be eligible in most cases to have some or all of their benefits designated in advance as a housing allowance. This is a very attractive benefit for retired ministers.

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

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

Section 403(b) plans

Many ministers and church employees participate in a 403(b) retirement plan. Contributions (other than Roth elective deferrals and after-tax contributions) to a 403(b) plan are not

reportable as income for federal income tax purposes until they are distributed as long as they do not exceed legal contribution limits. Ministers can often save for retirement and save taxes by contributing to this type of plan. Contributions to a 403(b) plan may be made directly by church contributions, employee salary reduction contributions, Roth elective deferrals, and/or employee tax-paid contributions if made available in the plan.

Contribution limits

Legal limits apply to 403(b) contributions. There are tax consequences when contributions exceed those limits. Excess contributions must be reported as taxable income. This section summarizes those complex contribution limit rules.

Taxpayers cannot rely on general rules to know their specific contribution limits.

Two major limits apply to 403(b) plan contributions. You may see different names for these limits, but GuideStone calls them the “Basic Limit” and the “General Limit on salary reduction contributions.” Generally, you can reduce your salary by the lesser of:

1. The Basic Limit (also known as the 415 limit on annual additions); or
2. The General Limit on salary reduction contributions (also known as the 402(g) limit, the limit on salary reduction contributions and Roth elective deferrals, or the limit on elective deferrals).

The Basic Limit controls the combined amount you and your employer may contribute to your 403(b) plan. For 2009, the Basic Limit was the lesser of:

1. 100% of your “includible compensation” or
2. \$49,000 (remains \$49,000 in 2010).

“Includible compensation” generally means the amount of income received from all church-related employers during a tax year, but it does not include the minister’s housing allowance. This means your minister’s housing allowance may affect contributions to your retirement account. See the section below titled “Minister’s housing allowance and contribution limits” for more information.

The General Limit on salary reduction contributions is also known as the 402(g) limit. For employees with less than 15 full-time years of paid denominational service (or its equivalent), the General Limit was \$16,500 in 2009 (remains \$16,500 for 2010).

If you have 15 or more full-time years of paid denominational service (or its equivalent), your General Limit on salary reduction contributions may be increased by the lesser of:

1. \$3,000; or
2. \$15,000 minus amounts contributed above the General Limit on salary reduction contributions in prior years; or

3. \$5,000 times years of church-related service minus prior years’ salary reduction and Roth elective deferral contributions to plans of church-related employers.

This increase is sometimes referred to as the “special catch-up.”

The law allows people getting closer to retirement age an additional “catch up” opportunity to make extra salary reduction contributions to their 403(b) plans. This catch-up is often referred to as the “age 50 catch-up.” If you were age 50 or over in 2009, you may have been eligible to make additional salary reduction plus Roth elective deferral contributions of up to \$5,500. For 2010, the age 50 catch-up remains \$5,500. There is a special coordination requirement between “special catch-up” contributions and “age 50 catch-up” contributions. Contributions above the General Limit on salary reduction contributions must first count toward the “special catch-up.” Unless you have GuideStone perform a free maximum contribution limit calculation, any contributions over the General Limit on salary reduction contributions must be considered as “special catch-up” contributions by GuideStone.

Another limit, the \$10,000 Limit, may allow larger contributions than the other two limits. Employees of denominational employers may elect to have their employers contribute up to \$10,000 a year, but total contributions under this election over an employee’s lifetime cannot exceed \$40,000.

See IRS Publication 571 for more information about 403(b) contribution limits.

Calculating limits is complex but GuideStone will perform the calculations at no cost to participants. Take advantage of this service by calling a GuideStone customer relations specialist at **1-888-98-GUIDE** (1-888-984-8433).

Minister’s housing allowance and contribution limits

As stated above, for 2009 and 2010 the Section 415(c) limit restricts 403(b) contributions to the lesser of 100% of compensation or \$49,000. Does the term “compensation” include a minister’s housing allowance? This is an important question for ministers, since the answer will determine how much can be contributed to a 403(b) plan. If the housing allowance is treated as compensation, then ministers will be able to contribute larger amounts. The tax code specifies that the term “compensation” for purposes of applying the section 415(c) limit to a 403(b)(3) plan “means the participant’s includible compensation determined under section 403(b)(3).” Section 403(b)(3) defines compensation to include “the amount of compensation which is received from the employer . . . and which is includible in gross income.” Section 107 of the tax code specifies that a minister’s housing allowance (or the annual rental value of a parsonage) is not included in the minister’s gross income for income tax reporting purposes. Therefore, it would appear that

the definition of compensation for purposes of computing the Section 415(c) limit would not include the portion of a minister's housing allowance that is excludable from gross income, or the annual rental value of a parsonage. The IRS website contains the following question and answer addressing this issue:

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

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

Retirement savings contributions credit

The tax code allows a tax credit for eligible taxpayers for qualified retirement savings contributions. The maximum annual contribution eligible for the credit is \$2,000. The credit rate depends on the adjusted gross income (AGI) of the taxpayer. Joint returns with AGI of \$55,500 or less, head of household returns of \$41,625 or less, and single returns of \$27,750 or less are eligible for the credit. The credit is available with respect to elective deferrals to a 401(k) plan, a 403(b), a SIMPLE or a simplified employee pension (SEP), contributions to a traditional or Roth IRA, and voluntary after-tax employee contributions to a 403(b) retirement plan. This provision was to expire at the end of 2007, but was made permanent by Congress. The amount of the credit for 2009 is described in the following table.

Adjusted Gross Income			
Joint Returns	Heads of Households	Single Filers	Credit Rate (\$2,000 maximum)
\$0–33,000	\$0–24,750	\$0–16,500	50%
\$33,000–36,000	\$24,750–27,000	\$16,500–18,000	20%
\$36,000–55,500	\$27,000–41,625	\$18,000–27,750	10%
over \$55,500	over \$41,625	over \$27,750	0%

Qualified scholarships

Key Point. Qualified scholarships are excludable from taxable income.

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

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

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

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

Example. First Church establishes a scholarship fund for seminary students. Robert is a church member who is pursuing a master's degree at a seminary. The church votes to award him a scholarship of \$1,500 for 2010. So long as Robert uses the scholarship award for tuition or other course-related expenses, he need not report it as income on his federal tax return, and the church need not issue him a 1099-MISC. The better practice would be for the church to stipulate that the scholarship is to be used for tuition or other course-related expenses (for example, fees, books, supplies), or for the church to pay the expenses directly to the educational institution. This will ensure that the scholarship does not inadvertently become taxable income because its specific use was not designated and the recipient used it for non-qualified expenses.

Sale or exchange of your principal residence

Under prior law, an individual taxpayer could exclude up to \$250,000 (\$500,000 if married filing a joint return) of gain realized on the sale or exchange of a principal residence. To be

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

In 2008 Congress enacted legislation specifying that gain from the sale or exchange of a principal residence allocated to periods of non-qualified use is not excluded from gross income. The amount of gain allocated to periods of non-qualified use is the amount of gain multiplied by a fraction the numerator of which is the aggregate periods of non-qualified use during the period the property was owned by the taxpayer and the denominator of which is the period the taxpayer owned the property.

A period of non-qualified use means any period (not including any period before January 1, 2009) during which the property is not used by the taxpayer or the taxpayer's spouse or former spouse as a principal residence. For purposes of determining periods of non-qualified use, the following are not taken into account: (a) any period after the last date the property is used as the principal residence of the taxpayer or spouse (regardless of use during that period) and (b) any period (not to exceed two years) that the taxpayer is temporarily absent by reason of a change in place of employment, health or certain unforeseen circumstances.

This provision is effective for sales and exchanges after December 31, 2008.

Line 8a. Interest income: Attach Schedule B if over \$1,500

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

Line 9. Dividend income: Attach schedule B if over \$1,500

Complete this line only if you had dividend income. If you had dividend income of more than \$1,500, complete parts II and III of Schedule B.

Line 12. Business income (or loss): Attach schedule C or C-EZ

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

1. Compensation reported to you on a Form 1099-MISC.

2. Fees received directly from church members for performing personal services (such as marriages and funerals).
3. Honoraria you received for guest speaking appearances in other churches

If you received income from any of these kinds of activities, compute your net earnings on Schedule C and transfer this amount to line 12. Schedule C is discussed more fully on pages 48–49 of this book. You may be able to use the simpler Schedule C-EZ if several conditions are met. See the instructions to Schedule C-EZ for details.

Line 13. Capital gain (or loss): Attach schedule D

Complete this line only if you have any gains or losses from the sale of capital assets. These include stocks, bonds and property. Gain or loss is reported on Schedule D.

Line 16a. Total pensions and annuities

The retirement benefits you receive from a retirement plan and other deferred compensation are taxable under federal and some state income tax laws. At your direction, GuideStone may deduct federal tax withholdings from your pension benefits. The 1099-R form you receive from GuideStone reports to the IRS the gross amount of the pension benefits and any amount withheld for income taxes.

If you are a retired or disabled minister, you may exclude all or a portion of your pension or disability income from your gross income reported on line 16a of Form 1040 if (1) you can document that the monies were actually spent on housing-related expenses during the tax year, and (2) the amount excluded does not exceed the fair rental value of the home (furnished, including utilities).

Key Point. Do not report the amount of pension income excluded as housing allowance as earned income in computing self-employment taxes (SECA).

Key Point. Ministers receiving retirement benefits from GuideStone will be eligible in most cases to have some or all of their benefits designated in advance as a housing allowance, as long as their contributions were attributable to ministerial compensation. This is a very attractive benefit for ministers who have retired from the ministry.

GuideStone reports retirement benefits to the IRS on a Form 1099-R. If you received a retirement benefit in 2009 and all or part of the benefit was designated as minister's housing allowance, the designated amount is not automatically excludable from gross income. If you own your home, the excludable amount is the least of the designated housing allowance, actual

housing expenses or the fair rental value of the home (furnished, including utilities). If your designated housing allowance exceeds either of these two other amounts, the “excess housing allowance” is reportable on line 16b of Form 1040, in addition to the amount reported in Box 2a on your Form 1099-R. In some cases, GuideStone combines distributions from more than one plan and reports the total on a single Form 1099-R. This usually occurs when the distributions share the same distribution code (see Box 7 on Form 1099-R). GuideStone combines any designations of minister’s housing allowance relating to multiple distributions. Amounts designated as minister’s housing allowance appear at the lower left-hand corner of Form 1099-R.

The IRS crosschecks the Form 1099-R numbers against your income tax return. Therefore, it is important to report GuideStone retirement benefits on your income tax return even if the entire amount is designated as a housing allowance. Report these amounts on line 16a and line 16b of Form 1040. Read the Form 1040 instructions for line 16a and line 16b carefully. We encourage you to seek guidance from your tax advisor concerning the accurate reporting of your retirement benefits. In some cases, you may receive more than one Form 1099-R from GuideStone. If so, you will need to consider all your Form 1099-Rs when completing line 16a and line 16b. Here are some general guidelines for reporting your GuideStone retirement benefits.

If Box 2a of your Form 1099-R shows a dollar amount or \$0.00

1. Enter the amount from Box 1 of your Form 1099-R (your gross distribution) on line 16a and the amount from Box 2a (taxable amount) on line 16b.
2. If all or a portion of your benefit is designated as minister’s housing allowance, the amount reportable as taxable income on your Form 1040 may be more than the amount shown as the taxable amount in Box 2a of the Form 1099-R. The difference may be due to “excess” housing allowance. Excess housing allowance is reportable as taxable income on line 16b of your Form 1040 in addition to the amount reported in Box 2a on your Form 1099-R.

If Box 2b of your Form 1099-R shows taxable amount not determined

1. If the entire amount shown in Box 1 of your Form 1099-R is taxable, enter this amount on line 16b of the Form 1040. Do not make an entry on line 16a. Generally, if your benefit does not include a return of tax-paid contributions and/or no portion of the benefit is designated as minister’s housing allowance, the entire amount is taxable and reportable on line 16b.

2. If some or none of your retirement benefit is taxable, complete both line 16a and line 16b of Form 1040. Enter the amount from Box 1 of your Form 1099-R on line 16a. Enter the taxable portion, if any, on line 16b. If all of your retirement benefit is excludable from gross income because it is a return of tax-paid contributions and/or designated as minister’s housing allowance (and all of it is excludable as a housing allowance), enter zero on line 16b.
3. To determine the taxable portion reportable on line 16b, begin with the amount in Box 1 of your Form 1099-R. Subtract from this amount the portion attributable to the return of tax-paid contributions and the amount that can be excluded as a minister’s housing allowance.

Taxation of distributions from a 403(b) plan

Amounts you contribute through salary reduction, and the earnings attributable to these contributions, generally cannot be withdrawn before you reach age 59½, separate from service, die, or become disabled. In some cases of hardship, you may withdraw your own salary reduction contributions or Roth elective deferrals (but not the earnings on these) prior to the occurrence of any of the above events.

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

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

The additional tax is computed on Form 5329.

Special notice to those receiving benefits

GuideStone issues IRS Form 1099-R to recipients of retirement plan distributions. Generally, Form 1099-R reports distributions from pensions, annuities, retirement plans and IRAs. This includes distributions from 403(b) plans such as the 403(b)

(9) Retirement Plan, the Voluntary Retirement Plan and the Self-Employed Ministers and Chaplains Plan.

If all or a portion of your distribution is designated as minister's housing allowance in accordance with applicable law and GuideStone's rules and procedures, your Form 1099-R will reflect the gross amount distributed to you. Only you can determine if the entire amount designated as minister's housing allowance is excludable from gross income. The amount designated as minister's housing allowance is reported at the lower left portion of your copy of Form 1099-R.

The gross amount reported on Form 1099-R in Box 1 must be reflected on the minister's income tax return on line 16a on Form 1040, even if 100% of the distribution is designated as minister's housing allowance.

If you receive an inquiry from the IRS concerning your gross distribution and the amount includible in gross income due to the minister's housing allowance designation, you may respond to the IRS by referencing the Form 1099-R and the amount it shows as minister's housing allowance, as well as the amounts you reported on line 16a and 16b of your Form 1040.

Line 20a. Social Security benefits

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

If you received Social Security benefits other than supplemental security income benefits (SSI) in 2009, part of the amount you received may be taxable. If you received Social Security benefits during 2009, you will receive Form SSA-1099 before January 31, 2010 showing the amount of benefits you received. Consider the following guidelines when determining whether your 2009 Social Security benefits are taxable:

1. In general, if the only income (including any retirement benefits) you received during 2009 was your Social Security benefits, your benefits probably will not be taxable and you probably will not have to file a return.
2. If you received other income in addition to Social Security benefits in 2009, your benefits generally will not be taxable unless your income is over a certain amount.
3. Your Social Security benefits generally are not taxable if your "provisional income" (adjusted gross income plus tax-exempt interest and some other forms of tax-exempt income plus half of your Social Security benefits) received during the year is less than \$25,000 if you are single or \$32,000 if you are married and file a joint return.
4. If your provisional income (defined above) received during the year is more than \$25,000 but less than \$34,000 if you are single, or more than \$32,000 but less than \$44,000 if you are married and file a joint return, then some of your Social Security benefits will be taxable.

You are taxed on the lesser of (1) half of your Social Security benefits, or (2) half of the amount by which your total income exceeds \$25,000 (if you are single) or \$32,000 (if you are married and file jointly).

5. If your provisional income (defined above) received during the year is more than \$34,000 if you are single or more than \$44,000 if you are married and file a joint return, then you may have to pay tax on up to 85% of your benefits.

Working after you retire.

Many churches employ retired persons who are receiving Social Security benefits. But 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 (\$3,140 per month for 2010). 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 2010 this annual amount is \$14,160.

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

Line 21. Other income: List the type and amount

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

1. A canceled debt or a debt paid for you by another person (unless the person who canceled or paid your debt intended it to be a gift).
2. The fair market value of a free tour you receive from a travel agency for organizing a group of tourists (in some cases this may be reported on Schedule C).
3. Most prizes and awards.

Step 5: Adjustments to income

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

Line 26. Moving expenses

If your “allowable moving expenses” are not reimbursed by your employer, or they are reimbursed under a non-accountable plan, you compute your moving expense deduction on Form 3903 and report your deduction on line 26. If your employer reimburses your allowable moving expenses under an accountable plan, the reimbursements are not reported by the employer as taxable income, and you have no deduction to report on line 26. To be an accountable plan, your employer’s reimbursement arrangement must require you to meet all three of the following rules: (1) your expenses would have been deductible had you paid them yourself; (2) you must adequately account to your employer for these expenses within a reasonable period of time; and (3) you must return any excess reimbursement or allowance within a reasonable period of time.

Allowable moving expenses are expenses you incurred because of a change of jobs or your acceptance of a new job, if you satisfy the following conditions:

1. Your new job location is at least 50 miles farther from your former home than your old job location was. For example, if your old job was three miles from your former home, your new job must be at least 53 miles from that home (measured according to the shortest of the more commonly traveled routes between those points).
2. If you report your income taxes as an employee, you must work full-time for at least 39 weeks during the first 12 months after you arrive in the general area of your new job location. You do not have to work for one employer for the 39 weeks. However, you must work full-time within the same general commuting area. If you are married and file a joint return and both you and your spouse work full-time, either of you may satisfy the full-time work test. However, you may not combine your weeks of work.
3. Your move must be closely related, both in time and place, to the start of work at your new job location. In general, moving expenses incurred within one year from the date you first reported to work are considered closely related in time to the start of work at the new location. It is not necessary that you make arrangements to work before moving to a new location, as long as you actually do go to work. If you do not move within one year, you ordinarily may not deduct the expenses unless you can show that circumstances existed that prevented the move within that time. A move is generally not closely related in place to the start of work if the distance from your new home to the new job location is greater than the distance from your former home to the new job location.

Deductible moving expenses include the following:


Moving your household goods and personal effects. You may deduct the cost of packing, crating and transporting your household goods and personal effects from your former home to your new one. You may also deduct the cost of storing and insuring household goods and personal effects within any consecutive 30-day period after the day your things are moved from your former home and before they are delivered to your new home.

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

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

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

Line 27. One-half of self-employment tax

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

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

Line 32. Payments to an individual retirement account (IRA)

An individual retirement account (IRA) is a savings plan that lets you set aside money for your retirement. Contributions to an IRA may be tax deductible, and earnings are not taxed until they are distributed to you. Anyone who has compensation is eligible to set up or contribute to an IRA. Compensation includes an employee’s salary or a self-employed person’s earnings, or any other amounts you receive for performing personal services. Compensation does not include rental income, interest income,

dividend income, or any amount received as a pension, annuity or deferred compensation. Further, compensation does not include a minister's housing allowance or the fair rental value of a church-provided parsonage.

For 2009 the contribution ceiling for an IRA is the lesser of \$5,000 or 100% of your annual compensation. All IRA contributions must be made by the due date of your tax return, not including extensions. This means that your 2009 IRA contribution must be made by April 15, 2010, even if you obtain an extension for filing this return.

For 2009, if you file a joint return and your taxable compensation is less than that of your spouse, the most that can be contributed for the year to your IRA is the smaller of the following two amounts: (1) \$5,000 (\$6,000 if you are age 50 or older), or (2) the total compensation includible in the gross income of both you and your spouse for the year, reduced by your spouse's IRA contribution for the year to a traditional IRA and any contributions for the year to a Roth IRA on behalf of your spouse.

If you or your spouse were covered by an employer retirement plan at any time during 2009 and you made IRA contributions, your allowable IRA deduction may be less than your contributions. Your allowable deduction may be reduced or eliminated, depending on your filing status and the amount of your income. The deduction begins to decrease (phase out) when your income rises above a certain amount and is eliminated altogether when it reaches a higher amount. (See IRS Publication 590.) The amounts vary depending on your filing status. The W-2 form you receive from your church or other employer has a box used to show whether you were covered for the year. The "Pension Plan" box should have a mark in it if you were covered. Employer retirement plans include 403(b) tax-sheltered annuities.

Even if your spouse is covered by an employer-sponsored retirement plan, you may be able to deduct your contributions to an IRA for 2009 if you were not covered by an employer plan and your adjusted gross income was less than \$176,000 (\$177,000 for 2010).

Individuals who cannot claim a deduction for an IRA contribution still can make nondeductible IRA contributions, subject to the lesser of \$5,000 or earned income limits. Earnings on these amounts continue to accumulate on a tax-deferred basis. When distributions are made from the IRA, special rules apply in figuring the tax on the distributions when both deductible and nondeductible contributions were made to the IRA. Form 8606 is used to designate a contribution as nondeductible and must be filed or the full amount of future withdrawals may be taxed. Withdrawals before age 59½ are subject to a 10% penalty tax that also applies to deductible IRA contributions.

No further contributions to an IRA are permissible once you reach age 70½, and distributions from an IRA must begin no later than the end of the year in which you reach that age.

The IRS has interpreted this rule to mean that distributions must begin by April 1, of the year following the year you reach age 70½. If this rule applies to you, you should consult your tax adviser.

Summarized below are a few important rules that pertain to IRAs.

1. Taxpayers can make early withdrawals from an IRA to pay for qualified higher education expenses of the taxpayer or the taxpayer's spouse, child or grandchild — without triggering the 10% penalty that applies to early distributions from an IRA.
2. The deductible IRA "phase-out" ranges are increased if either you or your spouse is an active participant in an employer-sponsored retirement plan.
3. Subject to income limitations, taxpayers can make annual nondeductible contributions of up to \$5,000 to a Roth IRA, and distributions from such an IRA are not taxed if they are made after a five-year holding period and are made as a result of the account holder's attaining age 59½ or older, death, disability or purchase of a first home. Earnings on Roth IRAs accumulate tax-free.
4. Taxpayers can withdraw up to \$10,000 from their IRA prior to age 59½ for first-time homebuyer expenses without triggering the 10% penalty that in prior years applied to "premature distributions."
5. Qualified charitable distributions of up to \$100,000 may be made from an IRA to a church or other charity. A qualified charitable distribution is any distribution from an IRA directly by the IRA trustee to a charitable organization, including a church, that is made on or after the date the IRA owner attains age 70½. This provision is effective for distributions made in 2008 and 2009.

✓ **New in 2009.** Most ministers incur ministry-related expenses. Both the church and the minister can affect if and how these expenses are deductible. Common examples of ministerial business expenses are summarized below.

✍ **Example.** A church has a senior pastor who is 52 years old, and a youth pastor who is 30 years old. The church does not participate in a retirement program for its staff. In 2009 the senior pastor can contribute \$6,000 (maximum annual contribution of \$5,000 plus a "catch-up" contribution of \$1,000), and the youth pastor can contribute \$5,000.

Step 6: Adjusted gross income

Line 37. Compute adjusted gross income

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

Step 7: Tax computation

Line 40. Itemized deductions or standard deduction

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

On line 40 you enter either your itemized deductions from Schedule A or a standard deduction amount. Itemized deductions are discussed under Schedule A, beginning on page 35 of this guide. For 2009, the standard deduction amounts are as follows:

Filing Status	Standard Deduction Amount
Single	\$5,700
Married filing jointly or Qualifying widow(er)	\$11,400
Married filing separately	\$5,700
Head of household	\$8,350

In some cases your standard deduction may be higher than these amounts. Use Schedule L (Form 1040) to figure your standard deduction if:

- You paid state or local real estate taxes in 2009,
- You paid state or local sales or excise taxes (or certain other taxes or fees in a state without a sales tax) on the purchase of a new motor vehicle after February 16, 2009, or
- You have a net disaster loss on Form 4684, line 18.

If you compute your standard deduction using Schedule L, be sure to check the box on line 40b (Form 1040), and include your completed Schedule L with your tax return.

Line 42. Personal exemptions

For 2009, the personal exemption amount is \$3,650. Multiply this amount times the number of exemptions claimed on line 6 and enter the total on line 42. Personal exemptions are phased out for certain high-income ministers. The instructions to Form 1040 contain a worksheet that should be used to compute this reduced exemption amount.

Line 44. Compute tax

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

Step 8: Credits

Line 48. Credit for child and dependent care expenses: Attach Form 2441

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

Line 51. Child tax credit

An individual may claim a tax credit for each qualifying child under the age of 17. The amount of credit per child is \$1,000 through 2010 and \$500 thereafter. A child who is not a citizen, national or resident of the United States cannot be a qualifying child.

The credit is phased out for individuals with income over certain threshold amounts. Specifically, the otherwise allowable child tax credit is reduced by \$50 for each \$1,000 (or fraction thereof) of modified adjusted gross income over \$75,000 for single individuals or heads of households, \$110,000 for married individuals filing joint returns, and \$55,000 for married individuals filing separate returns. For purposes of this limitation, modified adjusted gross income includes certain otherwise excludable income.

To the extent the child credit exceeds the taxpayer's tax liability, the taxpayer is eligible for a refundable credit (the additional child tax credit) equal to 15% of earned income in excess of a threshold dollar amount (the earned income formula). The threshold dollar amount is \$8,500 (2009) and is indexed for inflation. It is reported on Form 8812 and line 65 (Form 1040).

Families with three or more children may determine the additional child tax credit using the alternative formula if this results in a larger credit than determined under the earned income formula. Under the alternative formula, the additional child tax credit equals the amount by which the taxpayer's Social Security taxes exceed the taxpayer's earned income credit (EIC).

Earned income is defined as the sum of wages, salaries and other taxable employee compensation plus net self-employment earnings. Unlike the EIC, which also includes the preceding items in its definition of earned income, the additional child tax credit is based only on earned income to the extent it is included in computing taxable income.

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

Step 9: Other taxes

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

Line 56. Self-employment tax: Attach Schedule SE (also see line 27)

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

Key Point. All ministers for tax purposes must pay self-employment taxes (SECA) on compensation received from the exercise of their ministry, unless they have received IRS recognition of exempt status.

Ministers are self-employed for Social Security purposes with respect to their ministerial income. They compute their self-employment taxes on Schedule SE and report the total tax on line 56 of Form 1040.

Step 10: Payments

Line 61. Federal income tax withheld

Ordained ministers' wages are exempt from federal income tax withholding. As a result, only those ministers who have entered into a voluntary withholding arrangement with their church will have income taxes withheld and reported on line 61. The church should report the amount of voluntarily withheld taxes on the minister's Form W-2.

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

Line 62. 2009 estimated tax payments

Compensation paid to ministers for ministerial duties is not subject to tax withholding. As a result, ministers must prepay their income tax and self-employment taxes (SECA) by using the quarterly estimated tax procedure, unless they have entered into a voluntary withholding agreement with their employing church. The estimated tax procedure is summarized above on page 10. The total amount of estimated tax payments made to the IRS is reported as a payment of taxes on line 62.

Line 64. Earned income credit

✓ **New in 2009.** The maximum earned income credit for 2009 is (1) \$457 with no qualifying child; (2) \$3,043 with one qualifying child; (3) \$5,028 with two qualifying children; and (4) \$5,657 with three or more qualifying children.

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

one qualifying child, two qualifying children, or three or more qualifying children; and (2) the amount of your earned income and modified adjusted gross income.

You may be able to claim the earned income credit for 2009 if (1) you do not have a qualifying child, and you earned less than \$13,440 (\$18,440 if married); (2) a qualifying child lived with you and you earned less than \$35,463 (\$40,463 if married filing jointly); (3) two qualifying children lived with you and you earned less than \$40,295 (\$45,295 if married filing jointly); or (4) three or more qualifying children lived with you and you earned less than \$43,279 (\$48,279 if married filing jointly).

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 64a. 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 (lines 64a and 64b) clearly state that a housing allowance, or fair rental value of a parsonage, are included in the definition of earned income when computing the earned income credit for ministers who have not exempted themselves from self-employment taxes (SECA). 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. The author has confirmed with the IRS national office that this is not the intent of the law, but the IRS has failed to clarify this issue. Ministers who are affected by this issue should consult their own tax adviser 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 attach to the return a check payable to the Internal Revenue Service. Include your daytime phone number, your Social Security number, and write Form 1040 for 2009 on the check. You also may have to pay an underpayment penalty (refer to line 76 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 2010 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 yourself, your spouse and your dependents) if you itemize your deductions on Schedule A, but only to the extent that your expenses exceed 7.5% of your adjusted gross income. You must reduce your medical expenses by the amounts of any reimbursements you receive for those expenses before applying the 7.5% 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.

The following expenses ARE deductible as medical expenses:

1. Fees for medical services.
2. Fees for hospital services.
3. Meals and lodging provided by a hospital during medical treatment (subject to some limits).
4. Medical and hospital insurance premiums that you pay.
5. Special equipment.
6. Medicare A premiums you pay if you are exempt from Social Security and voluntarily elect to pay Medicare A premiums.
7. Medicare B premiums you pay.
8. Medicare Supplement premiums you pay (or are deducted from your pension).
9. Long-term care insurance premiums, subject to certain limitations on the amount that may be deducted.
10. Special items (false teeth, artificial limbs, eyeglasses, hearing aids, crutches, etc.).
11. Transportation for necessary medical care. For 2009, the standard mileage rate for medical travel was 24 cents per mile. It decreases to 16.5 cents per mile in 2010.
12. Medicines and drugs requiring a prescription.
13. 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.
14. Wages of an attendant who provides medical care.
15. The cost of home improvements if the main reason is for medical care.
16. 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:

1. Funeral services.
2. Health club dues (except as noted above).
3. Household help.
4. Life insurance.
5. Maternity clothes.
6. Nonprescription medicines and drugs.
7. Nursing care for a healthy baby.
8. Program to stop smoking.
9. Toothpaste, cosmetics, toiletries.
10. Trip for general improvement of health.

Step 2: Taxes you paid (lines 5–9)

Generally, real estate, state and local income and personal property taxes actually paid during 2009 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.

You can elect to deduct state and local general sales taxes instead of state and local income taxes as an itemized deduction on Schedule A (Form 1040), line 5b. Generally, you can use either your actual expenses or the state and local sales tax tables to figure your sales tax deduction. The deduction is available through 2009.

You may be able to deduct state and local sales and excise taxes (or certain other taxes or fees in a state without a sales tax) paid after February 16, 2009, for the purchase of any new motor vehicles. To figure the amount you can deduct, you will need to complete the Worksheet for line 7 on the back of Schedule A (Form 1040). In states without a sales tax, you may be able to deduct certain other taxes or fees instead. Take the deduction on Schedule A if you are itemizing deductions and are not electing to deduct state and local general sales taxes. If you are not itemizing deductions, these taxes may increase your standard deduction and are claimed on Schedule L.

If the amount on Form 1040, line 38, is equal to or greater than \$135,000 (\$260,000 if married filing jointly), you cannot deduct these taxes.


Key Point. If you elected to deduct state and local general sales taxes on line 5b, you cannot deduct new motor vehicle taxes on line 7.

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):

1. Mortgages you took out on your main home on or before October 13, 1987.
2. 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 2009 (\$500,000 if married filing separately).
3. 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 2009 (\$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 homes 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; (2) paying points is an established business practice in your area; (3) the points you paid were not more than the points generally charged in your area; (4) you use the cash method of accounting; (5) the points were not paid in the place of amounts that ordinarily are stated separately on the settlement statement, such as appraisal fees,

attorney fees and property taxes; (6) you use your loan to buy or build your main home; (7) the points were computed as a percentage of the principal amount of the mortgage; (8) the amount is clearly shown on the settlement statement; (9) the funds you provided at or before closing, plus any points the seller paid, were at least as much as the points charged.


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

Cash contributions to churches, schools and most other public charities are deductible up to 50% of adjusted gross income. 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 2009 and 2010). 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 receipted 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% of adjusted gross income. In some cases, contributions that exceed these limits can be carried over and claimed in future years. Some charitable contributions are limited to 20% or 30% of adjusted gross income, 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. Current 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 entitled *Federal Reporting Requirements for Churches*.

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 \$500, and
2. The total amount of all losses during the year (reduced by the \$500 limit) is more than 10% of the amount on Form 1040, line 38.

The 10% 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 Pub. 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.

Step 6: Job expenses and most other 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% of adjusted gross income. Miscellaneous expenses subject to the 2% floor include:

1. Unreimbursed and nonaccountable reimbursed employee business expenses (discussed more fully below).
2. Professional society dues.
3. Safety deposit box rental.
4. Employee educational expenses.
5. Tax counsel and assistance.
6. Office.
7. Home expenses—work.
8. Related supplies.
9. Expenses of looking for a new job.
10. Investment counsel fees.
11. Professional books and periodicals.
12. Investment expenses.
13. 50% of unreimbursed business meals and entertainment.
14. IRA custodial fees.

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

Employee business expenses

☞ **Key Point.** Ministers who own their homes 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.

☞ **Key Point.** 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 has in effect already “deducted” all of the expenses associated with a home office, and should not be able to claim any additional home office deduction on Schedule A.

Local transportation expenses

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.

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 917.

The standard business mileage rate for 2009 was 55 cents per mile.

☞ **Key Point.** The standard business mileage rate for 2010 is 50 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 expenses that you incur while traveling away from home overnight for your work or business. A common example would be automobile, lodging and meal expenses you incur in traveling to a convention meeting. You can deduct these expenses if you can substantiate them, as explained below.

Deductible travel expenses include:

1. Air, rail and bus fares.
2. Operating and maintaining your car.
3. Taxi fares or other costs of transportation between the airport or station and your hotel, or from one work site to another.
4. Meals and lodging while you are away from home on business.
5. Cleaning and laundry expenses.
6. Telephone and telegraph expenses.
7. Tips.

IRS regulations clarify that while a non-employee spouse's travel expenses incurred while accompanying a minister on a business trip are not deductible as a business expense, the reimbursement of those expenses by the church will not represent taxable income so long as the spouse's presence on the trip serves a legitimate business purpose and the spouse's expenses are reimbursed under an accountable arrangement.

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 could be claimed as 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) you had more than a general expectation of deriving income or some other specific business benefit at some indefinite future time; (2) you did engage in business during the entertainment period; and (3) the main purpose of the entertainment was the transaction of business.

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 on hunting, fishing, vacation, or similar trips. Expenses are not deductible when business acquaintances take turns picking up each other's entertainment checks 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, church groups (youth, choir, the deacons, etc.), or meeting with members at a restaurant for counseling purposes.

Key Point. You may deduct only 50% of your business-related entertainment expenses, including meals. This 50% 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 plan" (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 his or her spouse. If a spouse's entertainment expenses are deductible because it is impractical to entertain his or her spouse without the spouse being included, your spouse's entertainment expenses incurred on the same occasion will also be deductible. For example, your spouse joins you because your business associate's spouse will be present.

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 church's deacons 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 senior minister 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 a deductible entertainment expense.

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.

Example. A senior pastor takes a counseling course 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.

Subscriptions and books

Ministers often subscribe to a number of periodicals and purchase books that are directly relevant to the performance of their professional duties. The cost of a subscription is a legitimate business expense if it is related to the minister's duties at the church. Minister's journals and specialized 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 (for example, 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 your ministry is a professional business expense and accordingly is deductible.

Personal computers

Many ministers have purchased personal computers that they use at home. Since computers lend themselves to personal as well as business use, they are singled out for special treatment. If you report your income taxes as an employee (or you report as self-employed but are reclassified as an employee by the IRS in an audit) and you purchase a home computer that you use in connection with your work, you must meet the following tests to claim any depreciation of section 179 deduction:

1. Your use of the computer in your home must *be for the convenience of your employer*; and
2. Your use of the computer in your home *is required as a condition of your employment*.

What do these terms mean? 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% of the time during the year in your work. You can claim a deduction for the entire purchase price in the year of purchase (you do not need to depreciate the computer). Of course, the price must be reduced by the percentage of use that is personal as opposed to business related.

Cell phones

The tax code imposes strict substantiation requirements on the business use of certain kinds of personal property including cell phones. These requirements include substantiation of the business use of the phone, and compliance with the complex "convenience of the employer" and "condition of employment" tests form a depreciation or section 179 deduction. These requirements are cumbersome, and many feel that the modest cost of cell phone charges does not warrant compliance with these rules. The Tax Court has repeatedly rejected attempts by employers and employees to use reasonable estimates in calculating the business use of cell phones.

Many churches simply increase the taxable wages of employees (who in the past were provided with a cell phone) by a specified amount, and leave to the employees the task of compliance with the substantiation requirements in the event they choose to claim a business expense deduction on their tax return for the business use of a cell phone. This approach avoids the waste of substantial amounts of time by church staff in ensuring the substantiation requirements are met.

New in 2009. There are two developments concerning cell phones. First, legislation was introduced in 2009 to relax the strict substantiation rules that apply to cell phones. This legislation received significant support, including from the IRS Commissioner. It was pending at the time of publication of this text. Second, in 2009 the IRS revealed four optional methods for handling employer-provided cell phones that it is considering. Any of these options would simplify compliance with the tax law.


Office in the home

Most ministers have an office in their home. For the costs of such an office to be deductible as a business expense, several conditions must be satisfied. These include:

1. The costs must not have been excluded as minister's housing allowance.
2. The home office must be your principal place of business.
3. The home office must be exclusively used in your trade or business. This means that the home office must not be used by other family members (for example, to watch television or do homework). The use of a part of your home for both personal and business purposes does not meet the exclusive use test.
4. The home office must be used on a regular basis in your trade or business. This means that you must use the home office on a continuous basis for professional purposes (for example, preparing sermons, conducting counseling, doing research, contacting members, writing correspondence, preparing for church meetings). Occasional or incidental use of the office for such purposes is not enough, even if the office is used for no other purposes.

5. If you are an employee, the home office must be for the convenience of the employer. This means that the home office must do more than make the employee's job easier or efficient — it must be essential to the performance of your job.

Very few ministers will satisfy all of these conditions, which means that a home office deduction generally is not available.


 **Key Point.** 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 accordingly should not be able to claim any additional deduction of such 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 below (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: 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% of a minister's adjusted gross income.

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% of adjusted gross income.

 **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.

Method 2: Nonaccountable 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% of adjusted gross income. 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 nonaccountable 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 not requiring excess reimbursements to be returned to the church.

It is very 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 a non-accountable reimbursement arrangement, 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 1040). The minister can deduct actual expenses only as a miscellaneous itemized deduction on Schedule A to the extent these expenses exceed 2% of adjusted gross income. These rules are especially harsh, since 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 expense reimbursements that are not reported as taxable income on a minister's W-2 or Form 1040 are classified as an “automatic excess benefit” by the IRS, meaning that the minister and church board members are exposed to substantial excise taxes (called “intermediate sanctions”). Only officers and directors (and their relatives) are subject to this rule.

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 (SECA) 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: Accountable reimbursed expenses

🔑 **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 best way for ministers to handle business expenses is to have their employing church adopt an accountable business expense reimbursement arrangement. Under such an arrangement, (1) a church agrees to reimburse ministers (and other church workers, if desired) for those business expenses that are properly substantiated as to date, amount, place and business purpose, and (2) ministers are required to return any excess reimbursements (in excess of substantiated expenses) to the church. Reimbursements of business expenses under such an arrangement are not reported as taxable income on the 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. The evidence must substantiate the amount, date, place and business nature of each expense. The key point is this: A church must require the same degree of substantiation as would be required for a deduction on the minister's income tax return.
- Expenses must be substantiated and excess reimbursements returned to the church, within a reasonable time. Expenses will be deemed substantiated within a reasonable period of

time if they are substantiated within 60 days. Excess reimbursements will be deemed to be returned to the employer within a reasonable period of time if they are returned within 120 days.

- Business expense reimbursements cannot be funded under an accountable plan out of a minister's own salary (for example, through salary reductions).

🔑 **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 and place, business purpose and 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 2009: (1) the church would report the entire 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 any portion of 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 then only to the extent that they (along with most other miscellaneous expenses) exceed 2% of his adjusted gross income. 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" triggering intermediate sanctions against (1) Pastor R (assuming he is an officer or director, or the relative of one) of up to 225% of the excess benefit (\$9,000), and (2) the board, up to a maximum penalty of \$20,000.

🔑 **Example.** Same facts as the previous example, except that the church adopts an accountable reimbursement 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.

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.

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 2009. Be sure the interest you report on line 1 corresponds to any 1099-INT forms 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 2009. Be sure the dividends you report on line 1 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 received for guest speaking appearances 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 the code 813000 on line B, since this is the code that refers to ministers and chaplains. 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 so-called advantage to this arrangement is the ability of the minister to fully deduct business expenses on Schedule C whether or not the minister can itemize deductions on Schedule A. This advantage is 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, particularly if the minister is not able to use Schedule A. The best way for all 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% of their business and professional expenses even if they do not have enough itemized deductions to use Schedule A.

Self-employed people, like church employees, can deduct only 50% of business meals and entertainment. Further, self-employed people who use Schedule C to report their business

deductions are not subject to the 2% floor that applies to the deduction of employee business and professional expenses that are either unreimbursed or reimbursed under a non-accountable reimbursement plan. Some ministers point to these as advantages of reporting church income as self-employed rather than as employees. Nothing could be further from the truth. The IRS considers most ministers serving local churches and church agencies to be employees rather than self-employed for federal income tax reporting purposes. The so-called advantage of being able to deduct all of one's business expenses on Schedule C is of little value in the event of an IRS audit and reclassification as an employee. In addition, a minister who reports his church income as self-employed is taxed on the value of certain fringe benefits (including employer-paid medical insurance).

Key Point. One of the reasons the audit rate is much higher for self-employed taxpayers is that only 30% 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 far more tax dollars since only 30% of taxpayers can itemize deductions on Schedule A. 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 2009 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:

1. You had business expenses associated with your trade or business of \$5,000 or less in 2009.
2. You use the cash rather than the accrual method of accounting.
3. You did not have an inventory at any time during the year.
4. You did not have a net loss from your trade or business.
5. You had only one business as a sole proprietor.

6. You had no employees.
7. You do not use Form 4562 to compute a depreciation deduction with regard to your trade or business.
8. 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 appearances or as fees received directly from church members for services rendered on their behalf (for example, marriages 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 purposes with respect to their ministerial services. They pay self-employment taxes (SECA), and never FICA taxes, with respect to such services.

Key Point. Ministers who have received IRS approval of an application for exemption from self-employment taxes (SECA) (Form 4361) do not pay any Social Security taxes on compensation received for their ministerial services. They do not use Schedule SE.

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:

1. Add the following to the church salary:
 - other items of church income (including taxable fringe benefits)
 - self-employment earnings from outside businesses
 - annual rental value of parsonage, or non-taxable portion of housing allowance
 - business expense reimbursements made under a non-accountable plan.
2. Next, subtract the following from the above total:
 - unreimbursed business expenses (disregard the Deason reduction rule);
 - business expenses reimbursed under a non-accountable plan (disregard the Deason reduction rule);
 - most income tax exclusions other than the housing allowance, the fair rental value of a parsonage and the foreign earned income exclusion.

Step 2: Section A (line 4)

Ministers (and other taxpayers who are considered self-employed for Social Security purposes) can reduce their taxable earnings by 7.65%, which is half the Social Security and Medicare 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 (SECA) for 2009 is computed on this line. The self-employment tax (SECA) rate for 2009 is 15.3%, which consists of the following two components:

- a Medicare hospital insurance tax of 2.9% and
- an old-age, survivor and disability (Social Security) tax of 12.4%.


For 2009, the 2.9% Medicare tax applies to all net earnings from self-employment regardless of amount. The 12.4% Social Security tax applies to only the first \$102,000 of net self-employment earnings (in 2009).

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 (55 cents per mile for business miles driven during 2009). You compute your vehicle expenses using the standard mileage rate in Section B of Part II (line 22).

 **Key Point.** The business standard mileage rate for 2010 is 50 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 13 of your Form W-2 (substantiated car expense reimbursements up to the standard business mileage rate), and reimbursements of business expenses under an accountable arrangement.

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% of your adjusted gross income.

Form 2106-EZ

Employees can use a simplified Form 2106-EZ to compute their business expense deduction for 2009 if their employer did not reimburse business expenses and they use the standard mileage rate for computing automobile expenses.