

Federal Reporting Requirements for Churches

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

Introduction

The most important federal reporting obligation for most churches is the withholding and reporting of employee income taxes and Social Security taxes. These payroll reporting requirements apply, in whole or in part, to almost every church. Yet many churches do not comply with them for one or more of the following three reasons.

- The church treasurer is elected by the congregation and does not remain in office long enough to understand the application of tax reporting rules to churches.
 - Church leaders assume that churches are exempt from tax reporting requirements. This is a false assumption. The courts have rejected the argument that the application of the payroll tax reporting rules to churches violates the constitutional guaranty of religious freedom.
 - A number of special tax reporting rules apply to churches, and these often are not clearly understood by church staff members. These special rules include the following:
1. **Ministers are always self-employed for Social Security purposes with respect to their church compensation.** While most ministers are employees for federal income tax reporting purposes, they are self-employed for Social Security with respect to their church compensation. This means that they pay the “self-employment tax” (SECA) rather than the employee’s share of Social Security and Medicare taxes — even if they report their federal income taxes as a church employee. It is incorrect for churches to treat ministers as employees for Social Security purposes and to withhold the employee’s share of Social Security and Medicare taxes from their wages.
 2. **A minister’s wages are exempt from income tax withholding.** A minister’s compensation is exempt from income tax withholding whether a minister reports his income taxes as an employee or as self-employed. Ministers use the estimated tax procedure to pay their federal taxes, unless they have entered into a voluntary withholding agreement with their employing church.
 3. **Some churches are exempt from the employer’s share of Social Security and Medicare taxes because they filed a timely exemption application.** For most churches, this exemption had to be filed before October 31, 1984. This exemption does not excuse the church from income tax withholding, filing Form 941 or issuing W-2 forms to church employees. The non-minister employees of a church that filed such an exemption application are treated as self-employed for Social Security purposes, and must pay the self-employment tax (SECA) if they are paid \$108.28 or more during the year.
- ✓ **New in 2011.** The Tax Relief and Jobs Creation Act of 2010 provides a payroll tax holiday for 2011. Under current law employees pay a 6.2% Social Security tax on all wages

earned up to \$106,800 and self-employed individuals pay a 12.4% Social Security self-employment tax on all their self-employment income up to the same amount. The Tax Relief Act provides a payroll tax and self-employment tax “holiday” during 2011 of two percentage points. This means employees will pay only 4.2% on wages and self-employment individuals will pay only 10.4% on self-employment income up to the threshold. This provision will result in an increase in take-home pay for millions of workers. The IRS has issued new withholding tables in Publication 15 that reflect this change, and churches should begin using the new tables as soon as possible. For any Social Security tax that is over-withheld during January, employers should make an offsetting adjustment in workers’ pay as soon as possible but not later than March 31, 2011. Employers and payroll companies will handle the withholding changes, so workers typically won’t need to take any additional action, such as filling out a new W-4 withholding form.

Note: The term “Church” is used broadly throughout this publication and refers to actions that may be taken by the session and/or by the congregation depending on the nature of the action.

- ▲ **Warning.** Federal law specifies that any corporate officer, director or employee who is responsible for withholding taxes and paying them over to the government may be liable for a penalty in the amount of 100% of such taxes if they are either not withheld or not paid over to the government. This penalty is of special relevance to church leaders, given the high rate of non-compliance by churches with the payroll reporting procedures.

Maximizing tax benefits for your minister

Housing allowance

The most important tax benefit available to ministers who own or rent their home is the housing allowance exclusion. Unfortunately, many churches fail to designate a portion of their minister’s compensation as a housing allowance and thereby deprive the minister of an important tax benefit.

A housing allowance is simply a portion of a minister’s compensation that is so designated in advance by the minister’s employing church. For example, in December of 2010 a church agrees to pay its pastor “total compensation” of \$45,000 for 2011, and designates \$15,000 of this amount as a housing allowance (the remaining \$30,000 is salary). This “costs” the church nothing. It is simply a matter of designating part of a minister’s salary as “housing allowance.”

The tax code specifies that the housing allowance of a minister who owns or rents a home is nontaxable in computing federal income taxes to the extent that it is (1) declared in advance, (2) used for housing expenses and (3) does not exceed the fair rental value of the minister’s home (furnished, plus utilities).

☞ **Key Point.** Under no circumstances can a church designate a housing allowance retroactively.

☞ **Key Point.** Although repayments of principal and interest on a home loan secured by a mortgage on a minister's home qualify as a housing expense to which a housing allowance can be applied, costs associated with refinancing a principal residence or a home equity loan qualify only if the proceeds are used for acquiring or maintaining a principal residence.

Ministers who live in church-owned housing that is provided "rent-free" as compensation for ministerial services do not include the annual fair rental value of the parsonage as income in computing their federal income taxes. The annual fair rental value is not "deducted" from the minister's income. Rather, it is not reported as additional income anywhere on Form 1040 (as it generally would be by non-clergy workers). Ministers who live in a church-provided parsonage do not pay federal income taxes on the amount of their compensation that their employing church designates in advance as a parsonage allowance to the extent that the allowance represents compensation for ministerial services, and is used to pay parsonage-related expenses such as utilities, repairs and furnishings.

Note that the housing allowance and fair rental value of a parsonage are non-taxable only when computing federal income taxes. Ministers must include their housing allowance and rental value of a parsonage as taxable earnings when computing their Social Security taxes (except for retired ministers).

☞ **Key Point.** Church treasurers should be sure that the designation of a housing allowance for the following tax year is on the agenda of the church for one of its final business meetings of 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 church duly adopted the designation and that there is underlying specific documentation of each minister's housing allowance computations.

Accountable reimbursements

The best way for ministers to handle their ministry-related business expenses is to have their employing church adopt an accountable expense reimbursement arrangement. An accountable arrangement is one that meets the following four requirements: (1) only business expenses are reimbursed; (2) no reimbursement without an adequate accounting of expenses within a reasonable period of time (not more than 60 days after an expense is incurred); (3) any excess reimbursement or allowance must be returned to the employer within a reasonable period of time (not more than 120 days after an excess reimbursement is

paid); (4) an employer's reimbursements must come out of the employer's funds and not by reducing the employee's salary. Under an accountable plan, an employee reports to the church rather than to the IRS. The reimbursements are not reported as income to the employee, and the employee does not claim any deductions. This is the best way for churches to handle reimbursements of business expenses.

Reimbursements of business expenses under such an accountable arrangement are not reported as taxable income on an employee's Form W-2 or Form 1040, and there are no deductions to claim. In effect, the employee is reporting to the church rather than to the IRS. This often translates into significant tax savings for the employee.

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

1. **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.
2. **Expenses must be substantiated, and excess reimbursements returned to the church, within a reasonable time.** Expenses will be deemed substantiated within a reasonable time if they are substantiated within 60 days. Excess reimbursements will be deemed to be returned to the employer within a reasonable time if they are returned within 120 days.

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.

Flexible spending accounts

A church or employing organization may set up a flexible spending account for ministers and lay employees. A flexible spending account utilizes a salary reduction agreement for the purpose of reimbursing ministers and lay employees for certain healthcare and dependent care expenses.

Section 125 of the tax code allows salary reductions for a flexible spending account provided:

1. The salary reduction is established in advance. (This is interpreted to mean prior to both the compensation and the expense.)
2. Reimbursement is made only when a bona fide expense has been incurred by the member.

3. The member agrees to forfeit any unused balance in the account at the end of the plan year.

Key Point. The IRS has amended the “use it or lose it” rule for flex plans. The amendment allows employers to amend their flex plan to provide for a grace period of two-and-a-half months. Expenses for qualified benefits incurred during the grace period may be paid or reimbursed from benefits or contributions remaining unused at the end of the immediately preceding plan year.

Healthcare spending accounts

These accounts allow an employee to set aside pre-tax dollars to pay for eligible medical, dental, vision and hearing care expenses. Eligible expenses include:

- Special equipment such as crutches, wheelchairs, guide dogs and artificial limbs.
- Deductibles or copayments required by either the member of his or her spouse’s medical or dental plan.
- Expenses that exceed the member’s medical or dental coverage, such as physical exams and orthodontics.
- Hearing aids.
- Vision exams, eyeglasses, contact lenses.
- Copayment for prescription drugs.
- Psychoanalyst and psychologist fees not covered under the medical plan.
- 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.

Some churches offer medical reimbursement arrangements for medical expenses that are not reimbursed by the medical plan. These arrangements are not subject to income tax or Social Security tax if they are provided as a group plan established to reimburse employees for medical expenses not covered by the plan (for example, deductibles, coinsurance). For more information, see IRS Publication 535.

Section 403(b) plans

Contributions to a Retirement Savings Plan or other retirement income account are not reportable income for tax purposes as long as they do not exceed contribution limits under Code sections 415 and 402(g). See IRS Publication 571.

COMPLYING WITH FEDERAL PAYROLL TAX REPORTING OBLIGATIONS

Step 1. Obtain an employer identification number (EIN) from the federal government if this has not been done.

This number must be recited on some of the returns listed below and is used to reconcile a church’s deposits of withheld

taxes with the W-2 forms it issues to employees. The EIN is a nine-digit number that looks like this: 00-0246810. If your church does not have an EIN, you may apply for one online. Go to the IRS website at www.irs.gov and click on the Online EIN Application link. You may also apply for an EIN by calling 1-800-829-4933, or you can fax or mail Form SS-4 to the IRS. You should have only one EIN.

Key Point. The employer identification number is not a “tax exemption number” and has no relation to your non-profit corporation status. It merely identifies you as an employer subject to tax withholding and reporting and ensures that your church receives proper credit for payments of withheld taxes. You can obtain an EIN by submitting a Form SS-4 to the IRS.

Step 2. Determine whether each church worker is an employee or self-employed.

In some cases, it is difficult to determine whether a particular worker is an employee or is self-employed. If in doubt, churches always should treat a worker as an employee, since substantial penalties can be assessed against a church for treating a worker as self-employed whom the IRS later reclassifies as an employee. In general, a self-employed worker is one who is not subject to the control of an employer with respect to how a job is to be done. Further, a self-employed person typically is engaged in a specific trade or business and offers his or her services to the general public. The IRS has developed 20 criteria to assist in classifying a worker as an employee or self-employed. Factors that tend to indicate employee status include the following:

- The worker is required to follow an employer’s instructions regarding when, where and how to work.
- The worker receives “on-the-job” training from an experienced employee.
- The worker is expected to perform the services personally and not use a substitute.
- The employer rather than the worker hires and pays any assistants.
- The worker has a continuing working relationship with the employer.
- The employer establishes set hours of work.
- The worker is expected to work full time (more than 20 hours a week).
- The work is done on the employer’s premises.
- The worker must submit regular oral or written reports to the employer.
- The worker’s business expenses are reimbursed by the employer.
- The employer furnishes the worker’s tools, supplies and equipment.
- The worker does not work for other employers.
- The worker does not advertise his or her services to the general public.

Not all of these factors must be present for a worker to be an employee. But if most of them apply, the worker is an employee. Once again: If in doubt, treat the worker as an employee.

☞ **Key Point.** For 2011 churches must withhold 28% of the compensation paid to a self-employed person who fails to provide his or her Social Security number to the church. This is referred to as “backup withholding” and is designed to promote the reporting of taxable income.

☞ **Key Point.** Some fringe benefits are non-taxable only when received by employees. A common example is employer-paid medical insurance.

Step 3. Obtain the Social Security number for each worker.

After determining whether a worker is an employee or self-employed, you must obtain the worker’s Social Security number. A worker who does not have a Social Security number can obtain one by filing Form SS-5. If a self-employed worker performs services for your church (and earns at least \$600 for the year), but fails to provide you with his or her Social Security number, then the church is required by law to withhold a specified percentage of compensation as backup withholding. The backup withholding rate is 28% for 2011.

A self-employed person can stop backup withholding simply by providing the church with a correct Social Security number.

The church will need the correct number to complete the worker’s Form 1099-MISC (discussed later).

Churches can be penalized if the Social Security number they report on a Form 1099-MISC is incorrect, unless they have exercised “due diligence.” A church will be deemed to have exercised due diligence if it has self-employed persons provide their Social Security numbers using Form W-9. It is a good idea for churches to present self-employed workers (e.g., guest speakers, contract laborers) with a Form W-9, and to backup withhold unless the worker returns the form. The church should retain each Form W-9 to demonstrate its due diligence.

All taxes withheld through backup withholding must be reported to the IRS on Form 945. The Form 945 for 2010 must be filed with the IRS by January 31, 2011. However, if you made deposits on time in full payment of the taxes for the year, you may file the return by February 10, 2011.

Step 4. Have each employee complete a Form W-4.

These forms are used by employees to claim withholding allowances. A church will need to know how many withholding allowances each non-minister employee claims to withhold the correct amount of federal income tax. Ordained ministers need not file a Form W-4 unless they enter into a voluntary withholding agreement with the church. A withholding allowance lowers the amount of tax that will be withheld from an employee’s wages. Allowances generally are available for the employee,

the employee’s spouse, each of the employee’s dependents, and in some cases for itemized deductions.

Ask all new employees to give you a signed Form W-4 when they start work. If an employee does not complete such a form, then the church must treat the employee as a single person without any withholding allowances or exemptions. Employers must put into effect any Form W-4 that replaces an existing certificate no later than the start of the first payroll period ending on or after the 30th day after the day on which you received the replacement Form W-4. Of course, you can put a Form W-4 into effect sooner, if you wish. Employers are not responsible for verifying the withholding allowances that employees claim.

Tip. The “withholding calculator” found on the IRS website (www.irs.gov) can help employees determine the proper amount of federal income tax withholding. Another useful resource, Publication 919 (*How Do I Adjust My Tax Withholding?*), is available on the IRS website.

Step 5. Compute each employee’s taxable wages.

The amount of taxes that a church should withhold from an employee’s wages depends on the amount of the employee’s wages and the information contained on his or her Form W-4. A church must determine the wages of each employee that are subject to withholding. Wages subject to federal withholding include pay given to an employee for service performed. The pay may be in cash or in other forms. Measure pay that is not in money (such as property) by its fair market value. Wages often include a number of items in addition to salary. (There is a comprehensive list of examples in Step 10.)

Step 6. Determine the amount of income tax to withhold from each employee’s wages.

The amount of federal income tax the employer should withhold from an employee’s wages may be computed in a number of ways. The most common methods are the wage bracket method and the percentage method.

Wage bracket method. Under the wage bracket method, the employer simply locates an employee’s taxable wages for the applicable payroll period (that is, weekly, biweekly, monthly) on the wage bracket withholding tables in IRS Publication 15 (“Circular E”), and determines the tax to be withheld by using the column headed by the number of withholding allowances claimed by the employee. You can obtain a copy of IRS Publication 15 at any IRS office or by calling the IRS forms number (1-800-829-3676) or by downloading a copy from the IRS website (www.irs.gov).

Percentage method. Under the percentage method, the employer multiplies the value of one withholding allowance (derived from a table contained in Publication 15) by the number of allowances an employee claims on Form W-4, subtracts the total from the employee’s wages and determines the amount to be withheld from another table.

- **Recommendation.** Be sure to obtain a new IRS Publication 15 (Circular E) in January of 2011. It will contain updated tables for computing the amount of income taxes to withhold from employees' 2011 wages and other helpful information.

Both of these methods are explained in detail in Publication 15. Each year, a church must obtain a copy of Publication 15 to ensure that the correct amount of taxes is being withheld.

Step 7. Withhold Social Security and Medicare taxes from nonordained employees' wages.

Employees and employers each pay Social Security and Medicare taxes (FICA) equal to 7.65% of an employee's wages. The 7.65% tax rate is comprised of two components: (1) a Medicare hospital insurance tax of 1.45%, and (2) an "old age, survivor and disability" (Social Security) tax of 6.2%. There is no maximum amount of wages subject to the Medicare tax. For 2011, the maximum wages subject to Social Security taxes (the 6.2% amount) remains at \$106,800 (no change from the 2010 amount).

The Tax Relief and Jobs Creation Act of 2010 provides a payroll tax "holiday" for 2011. In order to stimulate the economy by increasing the take-home pay of millions of Americans, Congress reduced the employees' share of Social Security taxes from 6.2% to 4.2%. Employers still pay the full 6.2%.

The IRS has issued new withholding tables in Publication 15 that reflect this tax holiday for 2011, and churches should begin using the new tables as soon as possible. For any Social Security tax that is over-withheld during January, employers should make an offsetting adjustment in workers' pay as soon as possible but not later than March 31, 2011. Employers and payroll companies will handle the withholding changes, so workers typically won't need to take any additional action, such as filling out a new W-4 withholding form.

The Social Security tax rates for 2010 and 2011 are as follows:

Year	Tax on Employee	Tax on Employer	Combined Tax
2010	7.65%	7.65%	15.3%
2011	5.65%	7.65%	13.3%

- ☞ **Key Point.** Federal law allowed churches that had non-minister employees as of July 1984 to exempt themselves from the employer's share of Social Security and Medicare taxes by filing a Form 8274 with the IRS by October 30, 1984. Many churches did so. The exemption was available only to those churches that were opposed for religious reasons to the payment of Social Security taxes. The effect of such an exemption is to treat all non-minister church employees as self-employed for Social Security purposes. Such employees must pay the self-employment tax (SECA) if they are

paid \$108.28 or more for the year. Churches hiring their first non-minister employee after 1984 have until the day before the due date for their first quarterly 941 form to file the exemption application. Churches can revoke their exemption by filing a Form 941 accompanied by full payment of Social Security and Medicare taxes for that quarter.

Step 8. The church must deposit the taxes it withholds.

Churches accumulate three kinds of federal payroll taxes:

- income taxes withheld from employees' wages,
- the employees' share of Social Security and Medicare taxes (withheld from employees' wages), and
- the employer's share of Social Security and Medicare taxes.

Most employers must deposit payroll taxes on a monthly or semiweekly basis. An employer's deposit status is determined by the total taxes reported in a four-quarter "lookback" period. For 2011, the lookback period will be July 1, 2009 through June 30, 2010.

Monthly depositor rule. Churches that reported payroll taxes of \$50,000 or less in the lookback period will deposit their withheld taxes for 2011 on a monthly basis. Payroll taxes withheld during each calendar month, along with the employer's share of FICA taxes, must be deposited by the 15th day of the following month.

Semiweekly depositor rule. Churches that reported payroll taxes of more than \$50,000 in the lookback period must deposit their withheld taxes on a semiweekly basis. This means that for paydays falling on Wednesday, Thursday or Friday, the payroll taxes must be deposited on or by the following Wednesday. For all other paydays, the payroll taxes must be deposited on the Friday following the payday.

Payment with return rule. If you accumulate less than a \$2,500 tax liability during the quarter, you may make a payment with Form 941 instead of depositing monthly. This rule will affect most churches' deposit schedule. See IRS Publication 15, Circular E, for more information.

- ☞ **Key Point.** Beginning in 2011 all deposits must be made using the Electronic Federal Tax Payment System (EFTPS). There are penalties for depositing late, or for mailing payments directly to the IRS that are required to be deposited, unless you have reasonable cause for doing so. To enroll in EFTPS, call 800-555-4477, or to enroll online, visit www.eftps.gov. For general information about EFTPS, call 800-829-4933.

Step 9. All employers subject to income tax withholding, Social Security and Medicare taxes, or both, must file Form 941 quarterly.

Form 941 reports the number of employees and amount of Social Security and Medicare taxes and withheld income taxes

that are payable. Form 941 is due on the last day of the month following the end of each calendar quarter:

Due Date of Quarter	Ending	Form 941
1 st (January–March)	March 31	April 30
2 nd (April–June)	June 30	July 31
3 rd (July–September)	September 30	October 31
4 th (October–December)	December 31	January 31

Form 941 may now be filed electronically. For more information, visit the IRS website at www.irs.gov/efile or call 1-800-829-1040.

Key Point. Should a church with only one employee, its minister, file a Form 941? It is the position of the IRS national office that churches with only one employee (the minister) need not file a Form 941. This opinion is based in part on an income tax regulation specifying that every employer shall file a Form 941 for each calendar quarter in which it is “required to deduct and withhold” income taxes. Since a church with only one employee (its minister) is not required to withhold income taxes (ministers’ wages are exempt from income tax withholding), there is no need for a church under such circumstances to file Form 941. This assumes that the minister has not elected voluntary withholding. Of course, issuing the minister a Form W-2 without filing a quarterly Form 941 will present an apparent discrepancy that may trigger an IRS inquiry. On the other hand, submitting a Form 941 that reports a minister’s wages but no withholdings for Social Security or Medicare taxes will also raise questions. In either case, the apparent discrepancy can be easily explained.

Key Point. Form 944 replaces Form 941 for eligible small employers. The purpose of new Form 944 is to reduce burden on the smallest employers by allowing them to file their employment tax returns annually, and in most cases pay the employment tax due with their return. Generally, you are eligible to file this form only if your payroll taxes for the year are less than \$2,500. Do not file Form 944 unless the IRS has sent you a notice telling you to file it.

Step 10. Prepare a Form W-2 for every employee, including ordained ministers on the church’s staff.

✓ **New in 2011.** Healthcare reform legislation passed by Congress in 2010 contained a provision requiring the 2011 Form W-2 to be modified to include a box for employers to report the value of the healthcare insurance they provide for their employees. The IRS

announced late in 2010 that it will defer this requirement in order to provide employers with the time they need to make changes to their payroll systems or procedures in preparation for compliance with the new reporting requirement. In a public announcement, the IRS stated: “Although reporting the cost of coverage will be optional with respect to 2011, the IRS continues to stress that the amounts reportable are not taxable. Included in the Affordable Care Act passed by Congress in March, the new reporting requirement is intended to be informational only, and to provide employees with greater transparency into overall health care costs.” *IRS News Release IR-2010-103*

Key Point. If your employees give their consent, you may be able to furnish Copies B, C and two of Forms W-2 to your employees electronically. See IRS Publication 15-A for additional information. If you file your 2010 Forms W-2 with the Social Security Administration electronically, the due date is extended to March 31, 2011. For information on how to file electronically, call the SSA at 1-800-772-6270. You may file a limited number of Forms W-2 and W-3 online using the SSA website at www.ssa.gov/employer. The site also allows you to print out copies of the forms for filing with state or local governments, distribution to your employees, and for your records.

A church reports each employee’s wages and withheld income taxes as well as Social Security and Medicare taxes on this form. Wages of a minister who reports his income taxes as an employee do not include the housing allowance exclusion. A church should provide triplicate copies of Form W-2 directly to employees before February 1 of the following year, and submit an additional copy for each employee to the Social Security Administration before March 1 (along with a Form W-3 transmittal form).

Key Point. Be sure to add cents to all amounts. Make all dollar entries without a dollar sign and comma, but with a decimal point and cents. For example, \$1,000 should read “1000.00.” Government scanning equipment assumes that the last two figures of any amount are cents. If you report \$40,000 of income as “40000,” the scanning equipment would interpret this as 400.00 (\$400)!

You may need some assistance with some of the boxes on the Form W-2. Consider the following:

Box a. Report the employee’s Social Security number. Insert “applied for” if an employee does not have a Social Security number but has applied for one.

Box b. Insert your church’s federal employer identification number (EIN). This is a nine-digit number that is assigned by the

IRS. If you do not have one, you can obtain one by submitting a completed Form SS-4 to the IRS. Some churches have more than one EIN (for example, some churches that operate a private school have a number for both the church and the school). Be sure that the EIN listed on an employee's Form W-2 is the one associated with the employee's actual employer.

Box c. Enter your church's name, address and ZIP Code.

Box d. You may use this box to identify individual W-2 forms. You are not required to use this box.

Box e. Enter the employee's name.

Box f. Enter the employee's address and ZIP Code.

Box 1. Report all wages paid to workers who are treated as employees for federal income tax reporting purposes. This includes:

- Salary.
- Taxable fringe benefits (including cost of employer-provided group term life insurance coverage that exceeds \$50,000).
- The value of the personal use of an employer-provided car.
- Bonuses.
- Most Christmas gifts paid by the church.
- Business expense reimbursements paid under a non-accountable plan (one that does not require substantiation of business expenses, or does not require excess reimbursements to be returned to the church, or reimburses expenses out of salary reductions). Also note that such reimbursements are subject to income tax and Social Security withholding if paid to non-minister employees.
- If you reimburse employee travel expenses under an accountable plan using a per diem rate, include in Box 1 the amount by which your per diem rate reimbursements for the year exceed the IRS-approved per diem rates. Also note that such excess reimbursements are subject to income tax and Social Security withholding if paid to non-minister employees or ministers who have elected voluntary tax withholding. Use code L in Box 12 to report the amount equal to the IRS-approved rates.
- If you reimburse employee travel expenses under an accountable plan using a standard mileage rate in excess of the IRS-approved rate (50 cents per mile for 2010), include in Box 1 the amount by which your mileage rate reimbursements for the year exceed the IRS-approved rates. Also note that such excess reimbursements are subject to income tax and Social Security withholding if paid to non-minister employees or ministers who have elected voluntary tax withholding. Use code L in Box 12 to report the amount equal to the IRS-approved rates.
- Employer reimbursements of an employee's nonqualified (non-deductible) moving expenses.
- Any portion of a minister's self-employment taxes (SECA) paid by the church.
- Amounts includible in income under a nonqualified deferred compensation plan because of section 409A.

- Designated Roth contributions made under a section 403(b) salary reduction agreement.
- Church reimbursements of a spouse's travel expenses incurred while accompanying a minister on a business trip represent 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.
- Churches that make a "below-market interest loan" to a minister of at least \$10,000 create taxable income to the minister.
- Churches that forgive a minister's debt to the church create taxable income to the minister.
- Severance pay.
- Payment of a minister's personal expenses by the church.

For ministers who report their income taxes as employees, do not report the annual fair rental value of a parsonage and do not report any portion of a minister's compensation that was designated (in advance) as a housing allowance by the church. Also, some contributions made to certain retirement plans out of an employee's wages are not reported. But amounts distributed to an employee by the employer under a nonqualified deferred compensation plan are included in Box 1. See Boxes 11 and 13.

Box 2. List all federal income taxes that you withheld from the employee's wages. The amounts reported in this box (for all employees) should correspond to the amount of withheld income taxes reported on your four 941 forms.

- ✓ **New in 2011.** The Tax Relief and Jobs Creation Act of 2010 provides a payroll tax holiday for 2011. Under current law employees pay a 6.2% Social Security tax on all wages earned up to \$106,800, and self-employed individuals pay a 12.4% Social Security self-employment tax of on all their self-employment income up to the same amount. The Tax Relief Act provides a payroll tax and self-employment tax "holiday" during 2011 of two percentage points. This means employees will pay only 4.2% on wages, and self-employed individuals will pay only 10.4% on self-employment income up to the threshold. This provision will result in an increase in take-home pay for millions of workers. The IRS has issued new withholding tables in Publication 15 that reflect this change, and churches should begin using the new tables as soon as possible. For any Social Security tax that is over withheld during January, employers should make an offsetting adjustment in workers' pay as soon as possible but not later than March 31, 2011. Employers and payroll companies will handle the withholding changes, so workers typically won't need to take any additional action, such as filling out a new W-4 withholding form.

Box 3. Report an employee's wages subject to the "Social Security" component (the 6.2% rate) of FICA taxes. Box 3 should not list more than the maximum wage base for the "Social Security" component of FICA taxes (\$106,800 for both 2010 and 2011). This box usually will be the same as Box 1, but not always. For example, certain retirement contributions are included in Box 3 that are not included in Box 1. To illustrate, contributions to a 403(b) plan by salary reduction agreement may be excludable from income and not reportable in Box 1, but they are subject to FICA taxes and accordingly they represent Social Security and Medicare wages for non-minister employees. Remember that ministers (including those who report their income taxes as employees) are self-employed for Social Security with respect to their ministerial services, and so they pay self-employment taxes rather than the employee's share of Social Security and Medicare taxes.

Churches that filed a timely Form 8274 exempting themselves from the employer's share of FICA taxes do not report the wages of non-minister employees in this box since such employees are considered self-employed for Social Security purposes.

Box 4. Report the "Social Security" component (6.2% in 2010; 4.2% in 2011) of FICA taxes that you withheld from the employee's wages. This tax is imposed on all wages up to a maximum of \$106,800 in both 2010 and 2011. Do not report the church's portion (the "employer's share") of Social Security and Medicare taxes. Ministers who report their income taxes as employees are still treated as self-employed for Social Security purposes with respect to their ministerial services. For ordained ministers, this box should be left blank.

Box 5. Report a non-minister employee's current and deferred (if any) wages subject to the Medicare component (1.45%) of FICA taxes. This will be an employee's entire wages regardless of amount. There is no ceiling. For most workers (earning less than \$106,800 in 2010 or 2011) the maximum amount of wages subject to the "Social Security" tax (Boxes 3 and 5) should show the same amount. If you paid more than \$106,800 to a non-minister employee in 2010, Box 3 should show \$106,800 and Box 5 should show the full amount of wages paid.

Box 6. Report the Medicare component (1.45%) of FICA taxes that you withheld from the non-minister employee's wages. This tax is imposed on all wages, current and deferred (if any), regardless of amount.

Box 10. Show the total dependent care benefits under a dependent care assistance program (section 129) paid or incurred by you for your employee. Include the fair market value of employer-provided daycare facilities and amounts paid or incurred in a section 125 cafeteria plan. Report all amounts paid or incurred including those in excess of the \$5,000 exclusion. Include any amounts over \$5,000 in Boxes 1, 3 and 5. For more information, see IRS Publications 15-A and 15-B.

Box 11. Report the total amount you distributed to an employee under a nonqualified deferred compensation (NQDC) plan. Also report these distributions in Box 1. Unlike

qualified plans, NQDC plans do not meet the qualification requirements for tax-favored status for this purpose. NQDC plans include those arrangements traditionally viewed as deferring the receipt of current compensation, and include termination pay and rabbi trusts.

If you did not make distributions this year, show deferrals (plus earnings) under a NQDC plan that became taxable for Social Security and Medicare taxes during the year (but were for prior year services) because the deferred amounts were no longer subject to a substantial risk of forfeiture. Also report these amounts in Boxes 3 (up to the Social Security wage base) and 5. Do not report in Box 11 deferrals included in Boxes 3 or 5 and deferrals for current year services (such as those with no risk of forfeiture).

The purpose of Box 11 is for the Social Security Administration to determine if any part of the amount reported in Box 1 or Boxes 3 or 5 was earned in a prior year. The SSA uses this information to verify that it has properly applied the Social Security earnings test and paid the correct amount of benefits.

If your church made distributions and is reporting any deferrals in Boxes 3 and 5, do not complete Box 11.

For additional information, see IRS Publication 15.

Box 12. Insert the appropriate code and dollar amount in this box. Insert the code letter followed by a space and then insert the dollar amount on the same line within the box. Do not enter more than three codes in this box. If more are needed, use another Form W-2. Use capital letters for the codes, and remember not to use dollar signs or commas. For example, to report a \$3,000 contribution to a section 403(b) tax-sheltered annuity, you would report "E 3000.00" in this box. The codes are as follows:

- A — This will not apply to church employees.
- B — This will not apply to church employees.
- C — You (the church) provided your employee with more than \$50,000 of group term life insurance. Report the cost of coverage in excess of \$50,000. It should also be included in Box 1 (and in Boxes 3 and 5 for non-minister employees). See page 12 for additional information.
- D — Generally not applicable to churches.
- E — The church made contributions to a 403(b) plan pursuant to a "salary reduction agreement" on behalf of the employee. Report the amount of the contributions. While this amount ordinarily is not reported in Box 1, it is included in Boxes 3 and 5 for non-minister employees since it is subject to Social Security and Medicare taxes with respect to such workers.
- F, G, H, I — Generally not applicable to churches.
- J — You (the church) are reporting sick pay. Show the amount of any sick pay that is not includable in the employee's income because he or she contributed to the sick pay plan.
- K — Generally not applicable to churches.
- L — You (the church) reimbursed the employee for employee business expenses using the standard mileage rate or the per diem rates, and the amount you reimbursed

exceeds the amounts allowed under these methods. Enter code "L" in Box 12, followed by the amount of the reimbursements that equal the allowable standard mileage or per diem rates. Any excess should be included in Box 1. For non-minister employees, report the excess in Boxes 3 and 5 as well. Do not include any per diem or mileage allowance reimbursements for employee business expenses in Box 12 if the total reimbursements are less than or equal to the amount deemed substantiated under the IRS-approved standard mileage rate or per diem rates.

M, N — Generally not applicable to churches.

P — You (the church) paid qualified moving expenses reimbursements directly to an employee. Report the amount of these reimbursements but only if they were made under a non-accountable arrangement. Do not report reimbursements of qualified moving expenses that you paid directly to a third party on behalf of the employee (for example, to a moving company), or the employee under an accountable arrangement.

R — Report employer contributions to a medical savings account on behalf of the employee. Any portion that is not excluded from the employee's income also should be included in Box 1.

S — Report employee salary reduction contributions to a Simple retirement account. However, if the Simple account is part of a 401(k) plan, use code D.

T — Report amounts paid (or expenses incurred) by an employer for qualified adoption expenses furnished to an employee under an adoption assistance program.

W — Report employer contributions to a health savings account (HSA).

Y — It is no longer necessary to report deferrals under a section 409A nonqualified deferred compensation plan in Box 12 using code Y.

Z — Report income under section 409A on a nonqualified deferred compensation plan that was included in Box 1.

BB — Report designated Roth contributions under a section 403(b) salary reduction agreement. Do not use this code to report elective deferrals under code E.

CC — Wages exempt under the HIRE Act (for employer use only).

Box 13. Check the appropriate box.

- **Statutory employee.** Churches rarely if ever have statutory employees. These include certain drivers, insurance agents and salespersons.
- **Retirement plan.** Mark this checkbox if the employee was an active participant (for any part of the year) in any of the following: (1) a qualified pension, profit-sharing, or stock bonus plan described in section 401(a) (including a 401(k) plan); (2) an annuity contract or custodial account described in section 403(b); (3) a simplified employee pension (SEP) plan; or (4) a SIMPLE retirement account.
- **Third-party sick pay.** Churches generally will not check this box.

Box 14. This box is optional. Use it to provide information to the church employee. Some churches report a church-designated housing allowance in this box (for ministers who report their income taxes as employees). The IRS uses Box 14 for this purpose in a comprehensive minister tax example in the current edition of its Publication 517, but this is not a requirement.

§ Tax Tip. The IRS has provided the following suggestions to reduce the discrepancies between amounts reported on Forms W-2, W-3 and Form 941: First, be sure the amounts on Form W-3 are the total amounts from Forms W-2. Second, reconcile Form W-3 with your four quarterly Forms 941 by comparing amounts reported for: (1) Income tax withholding (Box 2); (2) Social Security and Medicare wages (Boxes 3, 5 and 7). (3) Social Security and Medicare taxes (Boxes 4 and 6). Amounts reported on Forms W-2, W-3 and 941 may not match for valid reasons. If they do not match, you should determine that the reasons are valid.

Step 11. Prepare a Form 1099-MISC for every self-employed person receiving non-employee compensation of \$600 or more.

To illustrate, if a minister reports his federal income taxes as a self-employed person, then the church must issue the minister a Form 1099-MISC before February 1 of the following year and submit an additional copy to the IRS before March 1 (along with a Form 1096 transmittal form).

This same requirement applies to any non-employee to whom the church pays "non-employee" compensation of \$600 or more during the year. To illustrate, if a guest speaker visited a church in 2010 and received compensation from the church in an amount of \$600 or more (net of any travel expense reimbursement properly accounted for by the recipient) then the church must issue the person a Form 1099-MISC before February 1, 2011.

The same rule applies to other "non-employees," including some part-time custodians and certain self-employed people who perform miscellaneous services for the church (plumbers, carpenters, lawn maintenance, etc.). Exceptions apply. For example, a church need not issue a 1099-MISC to a corporation, or to a person who will be receiving a Form W-2 for services rendered to the church. Also, travel expense reimbursements paid to a self-employed person under an accountable reimbursement plan do not count toward the \$600 figure.

To send the individual a properly completed Form 1099-MISC, the church will need to obtain his or her name, address, and Social Security number. Churches should obtain this information at the time of the person's visit, since it often can be difficult to obtain the necessary information at a later date. IRS Form W-9 can be used to obtain this information. If a self-employed person who is paid \$600 or more during the course of a year by a church refuses to provide his or her Social Security

number, then the church is required to withhold a percentage of the person's total compensation as "backup withholding." See "Step 2" above. The backup withholding rate for 2010 and 2011 is 28%.

Need help completing a W-2, W-3, 1099 or 1096 Form?


The IRS operates a centralized call site to answer questions about reporting information on these forms. If you have any questions about completing these forms, call the IRS at 1-866-455-7438, Monday through Friday, 8:30 a.m. to 4:30 p.m. EST.

OTHER IMPORTANT REQUIREMENTS FOR CHURCHES

Reporting group term life insurance

You must include in the income of employees an imputed cost of employer-provided group term life insurance coverage (including death benefits under the Benefits Plan) that exceeds \$50,000. You must also include the imputed cost of all employer-provided group term life insurance on the life of a spouse or dependent if the coverage provided exceeds \$2,000. The imputed cost can be determined according to the following table.

Cost per \$1,000 of protection for 1-month period	
Age Brackets	Cost
Under 25	5 cents
25-29	6 cents
30-34	8 cents
35-39	9 cents
40-44	10 cents
45-49	15 cents
50-54	23 cents
55-59	43 cents
60-64	66 cents
65-69	\$1.27
70 and above	\$2.06

 **Example.** Church A pays the premiums on a \$70,000 group term insurance policy on the life of Pastor B with B's wife as beneficiary. Pastor B is 29 years old. Church A also pays the premium on a \$5,000 group term policy which covers Pastor B's wife who is 30 years old. The church would have to report \$21.90 as the imputed cost of the insurance provided to Pastor B and his wife. This amount is computed as follows: (1) For Pastor B, the table shows the "cost" per month for each \$1,000 of group term life insurance in excess

of \$50,000. To compute the cost for Pastor B, take 6 cents x 12 months = 72 cents x 20 (corresponding to \$20,000 of group term insurance in excess of \$50,000) = \$14.40. (2) In addition, the cost of the entire \$5,000 of insurance provided to Pastor B's wife would have to be computed. Take 8 cents x 12 months = 96 cents x 5 = \$4.80. Combine this amount with the cost of Pastor B's excess insurance to obtain the taxable amount of \$19.20. Church A should include this amount with wages in Box 1 of Form W-2. This amount should also be reported in Box 12 and labeled "C." Any includable amount is subject to income tax as well as Social Security and Medicare withholding for non-ordained church employees.

Form I-9

All employers are responsible for verifying the identity and eligibility of employees to work in the United States if those employees were hired after November 6, 1986. As employers, churches must complete an Employment Eligibility Verification form for each new employee. This form is better known as Form I-9.

Form I-9 is not an IRS form and is not filed with any government agency. However, it is important for churches to be familiar with this form because they can be assessed fines for failing to comply with the requirements summarized below.

Churches should:


- Ensure that each new employee completes Section 1 of the Form I-9 at the time of the hire. Review the employee's documents and fully complete Section 2 of the Form I-9 within three business days of the hire. Collect a Form I-9 for all employees, including ministers, hired after November 6, 1986 even if the church has no doubt that someone is a U.S. citizen. An employee signs part of the form and the employer signs part of the form. The form's instructions list documents employees may show to verify their identity and eligibility to work in the United States.
- Review the United States Citizenship and Immigration Services (USCIS) website for instructions that will assist you in completing the Form I-9. You can also download Form I-9 from the USCIS website.
- Collect forms from new employees only, not from all applicants. When extending job offers, churches should clarify that employment is conditioned on completion of a Form I-9. Employers should remind new employees to bring their documents the first day of work. Forms should be completed no later than the end of the employee's third day at work.
- Accept documents that appear to be genuine and relate to the employee. If churches act reasonably when deciding that a document is genuine, they will not be held responsible for a mistake. Churches may keep photocopies of

original identification and verification documents with each employee form. This is not required by law but may be helpful in case there is ever a question about whether a document was genuine.

- Keep each Form I-9 for at least three years. If a church employs a person for more than three years, the church must retain the form until one year after the person leaves employment. Forms should be kept confidential.
- Upon request, show completed forms to authorized officials of the Bureau of Immigration and Customs Enforcement, Department of Labor or the Justice Department's Office of Special Counsel for Unfair Immigration-Related Employment Practices. Officials will give three days' notice before inspection.

Annual certification of racial nondiscrimination

Churches that operate, supervise or control a private school must file a certificate of racial nondiscrimination (Form 5578) each year with the IRS. The certificate is due by the 15th day of the fifth month following the end of the organization's fiscal year. This is May 15 of the following year for organizations that operate on a calendar year basis. This means that the Form 5578 for 2010 is due May 15, 2011. A "private school" is defined as an educational organization that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly conducted. The term includes primary, secondary, preparatory, or high schools, and colleges and universities, whether operated as a separate legal entity or an activity of a church.

 **Key Point.** The term "school" also includes preschools. This is what makes the reporting requirement relevant for many churches. As many as 25% of all churches operate a preschool program. Private religious schools that are not affiliated with or controlled by a church also must file the form. Form 5578 is easy to complete. A church official simply identifies the church and the school, and certifies that the school has "satisfied the applicable requirements of section 4.01 through 4.05 of Revenue Procedure 75-50." This reference is to the following requirements: The school has a statement in its charter, bylaws or other governing instrument, or in a resolution of its governing body, that it has a racially nondiscriminatory policy toward students.

- The school has a statement of its racially nondiscriminatory policy toward students in all its brochures and catalogs dealing with student admissions, programs and scholarships.

- The school makes its racially nondiscriminatory policy known to all segments of the general community served by the school through the publication of a notice of its racially nondiscriminatory policy at least annually in a newspaper of general circulation or through utilization of the broadcast media. However, such notice is not required if one or more exceptions apply. These include:

1. During the preceding three years, the enrollment consists of students at least 75% of whom are members of the sponsoring church or religious denomination and the school publicizes its nondiscriminatory policy in religious periodicals distributed in the community;
2. The school draws its students from local communities and follows a racially nondiscriminatory policy toward students and demonstrates that it follows a racially nondiscriminatory policy by showing that it currently enrolls students of racial minority groups in meaningful numbers. The school can demonstrate that all scholarships or other comparable benefits are offered on a racially nondiscriminatory basis. Filing the certificate of racial nondiscrimination is one of the most commonly ignored federal reporting requirements. Churches that operate a private school (including a preschool), as well as independent schools, may obtain copies of Form 5578 by calling the IRS forms number (1-800-829-3676) or by visiting the IRS website at www.irs.gov.

Charitable contribution substantiation rules

Several important rules apply to the substantiation of charitable contributions, including the following:

Cash contributions. The Pension Protection Act of 2006 amended the tax code to require all cash contributions, regardless of amount, to be substantiated by either a bank record (such as a canceled check) or a written communication from the charity showing the name of the charity, the date of the contribution and the amount of the contribution. The recordkeeping requirements may not be satisfied by maintaining other written records. In the past, donors could substantiate cash contributions of less than \$250 with "other reliable written records showing the name of the charity, the date of the contribution, and the amount of the contribution" if no canceled check or receipt was available. This is no longer allowed. As noted below, additional substantiation requirements apply to contributions (of cash or property) of \$250 or more, and these must be satisfied as well.

Substantiation of contributions of \$250 or more. Donors will not be allowed a tax deduction for any individual cash (or property) contribution of \$250 or more unless they

receive a written acknowledgment from the church that satisfies the following requirements:

1. The receipt must be in writing.
2. The receipt must identify the donor by name (a Social Security number is not required).
3. For contributions of property (not including cash) valued by the donor at \$250 or more, the receipt must describe the property. No value should be stated.
4. The receipt must state whether or not the church provided any goods or services to the donor in exchange for the contribution, and if so, the receipt must include a good faith estimate of the value of those goods or services.
5. If the church provides no goods or services to a donor in exchange for a contribution, or if the only goods or services the church provides are “intangible religious benefits,” then the receipt must contain a statement to that effect.
6. The written acknowledgment must be received by the donor on or before the earlier of the following two dates: (1) the date the donor files a tax return claiming a deduction for the contribution, or (2) the due date (including extensions) for filing the return.

Quid pro quo contributions of more than \$75. If a donor makes a “quid pro quo” contribution of more than \$75 (that is, a payment that is partly a contribution and partly a payment for goods or services received in exchange), the church must provide a written statement to the donor that satisfies two conditions:

The statement must inform the donor that the amount of the contribution that is tax-deductible is limited to the excess of the amount of any money (or the value of any property other than money) contributed by the donor over the value of any goods or services provided by the church or other charity in return. The statement must provide the donor with a good faith estimate of the value of the goods or services furnished to the donor.

A written statement need not be issued if only “token” goods or services are provided to the donor. For 2010, token goods or services were those having a value not exceeding the lesser of \$96 or 2% of the amount of the contribution. This amount is adjusted annually for inflation. In addition, the rules do not apply to contributions in return for which the donor receives solely an intangible religious benefit that generally is not sold in a commercial context outside the donative context.

Gifts of property. Several additional rules apply to the substantiation of contributions of non-cash property valued by the donor at \$500 or more. Donors who claim a deduction over \$500 but not over \$5,000 for a non-cash charitable contribution must retain certain records and complete the front side (Section A, Part I, and Part II if applicable) of IRS Form 8283 and enclose the completed form with the Form 1040 on which the charitable contribution is claimed.

Special rules apply to donations of cars, boats and planes valued by the donor at more than \$500. The church must provide the donor with a written acknowledgment, and send a Form 1098-C to the IRS containing required information about the donation. The Form 1098-C can be used as the written acknowledgment that must be issued to a donor. See the instructions to Form 1098-C for more information.

For contributions of non-cash property valued at more than \$5,000, a donor must obtain a qualified appraisal of the donated property from a qualified appraiser and complete a qualified appraisal summary (Section B of Form 8283) and have the summary signed by the appraiser and a church representative. The completed Form 8283 is then enclosed with the Form 1040 on which the charitable contribution deduction is claimed.

Helpful numbers and resources

- To request IRS forms **1-800-TAX-FORM** or **1-800-829-3676**
- IRS homepage *www.irs.gov*
- *ChurchLawToday.com* (a Christianity Today International website featuring Richard Hammar)
- *YourChurchResources.com*