

Ministers Tax Guide for 2008 Returns

A step-by-step commentary for ministers

Includes special section

Important federal 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 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. Every effort has been made to make the materials in this text current as of the date of publication. However, there may be changes resulting from IRS or judicial interpretations of the Tax Code, new tax regulations or forms, or technical corrections that occurred after the printing of this edition that are not reflected in the text.

Throughout this document tax examples are given that include fictional first names of clergy, lay employees and congregational names. The names for the persons, places and groups in these examples were chosen at random and do not refer to any particular clergy, lay employees, parishes or institutions.

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Welcome to the *Ministers Tax Guide for 2008 Returns*. We trust you will find this year's edition a useful tool as you prepare your federal income tax forms.

This year's tax guide includes the features you've come to expect, with important information about changes in the tax laws, and the *Important federal requirements for churches* for church treasurers.

This year's guide is written once again by Richard Hammar, and has been edited by our legal and compliance staff to address the tax issues that impact the greatest number of Southern Baptist pastors. Of course, as the tax laws continue to change and become more complex, it's harder to summarize so much information. You'll find additional assistance on the IRS Web site, www.irs.gov. For specific tax advice, you'll want to consult an accountant or attorney who is familiar with the unique issues surrounding ministers' taxes.

Additional copies of this booklet may be ordered through our Customer Service specialists by calling **1-888-98-GUIDE** (1-888-984-8433), weekdays from 7 a.m. to 6 p.m. CST. You can also download this booklet in its entirety, or by section, on our Web site, www.GuideStone.org.

This last year, we challenged our employees to consider 2008 the Year of Service. Our employees were challenged to serve you, our valued participants, and serve one another. This annual *Ministers Tax Guide* is one of the tangible ways we strive to serve you as you minister to others. May God richly bless you in your ministry in 2009 and beyond.

Sincerely,

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

O.S. Hawkins

President – Chief Executive Officer

GuideStone Financial Resources of the Southern Baptist Convention

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Part 1. Introduction

How to use this guide

This tax guide contains basic information you need to complete your 2008 federal income tax return. Special attention is given to sections of forms and schedules most relevant to ministers.

 **Key Point.** Congress, the courts or the IRS may change tax rules at any time, in some cases retroactively. This guide includes the law in effect at the time of preparation. Be sure to refer to the final instructions for Form 1040 when completing your tax return.

This guide is divided into the following sections:

- **Part 1. Introduction.** This section includes instructions on how to use the guide, plus a review of important tax developments that occurred during 2008.
- **Part 2. Basic tax questions for ministers and churches.** This section answers basic tax questions ministers and churches need to understand to comply with tax, payroll and reporting requirements.
- **Part 3. 403(b) plans and IRAs.** This section discusses basic rules applicable to 403(b) plans and IRAs.
- **Part 4. Step-by-step tax return preparation using 2008 tax forms and schedules.** This section explains how to fill out the tax forms and schedules used by ministers.
- **Part 5. Comprehensive example for active minister.** This section includes a sample tax return for an active minister.
- **Part 6. Comprehensive example for retired minister.** This section includes a sample tax return for a minister who is retired.
- **Important federal requirements for churches.** This is a special section for church administrators or treasurers.
- **Appendices.** The Appendices include other helpful information for ministers.

Tax highlights for 2008

There were several tax developments in 2008 that will affect tax reporting by both ministers and churches for 2008 and future years. Here is a rundown of some of the key provisions:

1. The state and local sales tax deduction was extended through 2009.
2. The popular above-the-line deduction for higher education expenses was extended through 2009. This provision allows taxpayers to deduct up to \$4,000 (depending on their income) of higher education expenses in lieu of claiming the Hope or Lifetime Learning tax credits.

3. The above-the-line deduction for teacher classroom expenses was extended through 2009. This provision allows teachers to deduct up to \$250 of out-of-pocket costs incurred to purchase books, supplies and other classroom equipment.
4. Tax-free “qualified charitable distributions” of up to \$100,000 may be made from an IRA to a church or other charity by IRA owners who are age 70½ or older. This provision was extended through 2009.
5. You may be able to claim the earned income credit for 2008 if (1) a child lived with you and you earned less than \$33,995 (\$36,995 if married filing jointly); (2) two or more children lived with you and you earned less than \$38,646 (\$41,646 if married filing jointly); or (3) a child did not live with you and you earned less than \$12,880 (\$15,880 if married filing jointly).
6. If you are covered by a retirement plan at work, your deduction for contributions to a traditional IRA is reduced (phased out) if your modified adjusted gross income (AGI) is more than \$85,000 but less than \$105,000 for a married couple filing a joint return or a qualifying widow(er), or more than \$53,000 but less than \$63,000 for a single individual.
7. The dollar limit on annual elective deferrals an individual may make to a 403(b) retirement plan remained at \$15,500 in 2008. It increases to \$16,500 for 2009.
8. The catch-up contribution limit on elective deferrals to a 403(b) retirement plan for individuals who had attained age 50 by the end of the year was \$5,000 in 2008. It increases to \$5,500 for 2009.
9. The IRS has announced that it will not issue private letter rulings addressing the question of “whether an individual is a minister of the gospel for federal tax purposes.” This means taxpayers will not be able to obtain clarification from the IRS in a letter ruling on their status as a minister for any one or more of the following matters: (1) eligibility for a parsonage exclusion or housing allowance; (2) eligibility for exemption from self-employment taxes; (3) self-employed status for Social Security; or (4) exemption of wages from income tax withholding. The IRS also has announced that it will not address “whether amounts distributed to a retired minister from a pension or annuity plan should be excludable from the minister’s gross income as a parsonage allowance.”
10. The standard business mileage rate was 50.5 cents per mile for business miles driven during the first six months of 2008, and 58.5 cents per mile for business miles driven during the last six months of 2008. The standard business mileage rate for 2009 is 55 cents per mile.

11. The IRS maintains that a minister's housing allowance is "earned income" in determining eligibility for the earned income credit for ministers who have not opted out of Social Security by filing a timely Form 4361. For ministers who have opted out of Social Security the law is less clear, and the IRS has not provided guidance.
12. Recent tax cuts enacted by Congress will result in lower taxes, and lower estimated tax payments, for many taxpayers. Be sure your estimated tax calculations or withholdings take into account the most recent tax law changes. The same goes for tax cuts enacted in 2009.
13. There are three developments concerning cell phones. First, recent Tax Court rulings indicate that there will be no relaxation in the strict substantiation requirements that apply to the business use of cell phones. Second, legislation was introduced in 2008 to relax the strict substantiation rules that apply to cell phones. While this legislation was not enacted, it shows that the need for cell phone reform is receiving some attention. Third, the IRS priority guidance plan for 2009 lists the substantiation of cell phone expenses as an issue that will receive further guidance.
14. Many churches employ retired persons who are receiving Social Security benefits. Persons younger than full retirement age may have their Social Security retirement benefits cut if they earn more than a specified amount. Full retirement age (the age at which you are entitled to full retirement benefits) for persons born in 1943–1954 is 66 years. In the year you reach full retirement age, your monthly Social Security retirement benefits are reduced by \$1 for every \$3 you earn above a specified amount (\$3,140 per month for 2009). 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 2009 this annual amount is \$14,160.
15. For 2008 the following inflation adjustments took effect:
 - The amounts of income you need to earn to boost you to a higher tax rate were adjusted for inflation.
 - The personal exemption amount (the amount you can deduct for yourself, your spouse, and each dependent) was adjusted for inflation. For 2008, the amount increased to \$3,500 per person.
 - The standard deduction (the amount you can deduct if you do not itemize your deductions) increased to \$10,900 in 2008 for married couples filing jointly. This is twice the amount of the standard deduction for single taxpayers (\$5,450) for 2008. Single taxpayers who are 65 years of age or older, or blind, get a \$1,350 increase in their standard deduction for 2008. Married taxpayers who are 65 years of age or older, or blind, get a \$1,050 increase in their standard deduction for 2008.
16. Will Congress give ministers another opportunity to revoke an exemption from Social Security? It does not look likely, at least for now. No legislation is pending that would provide ministers with this option.
17. Congress enacted the alternative minimum tax (AMT) in 1969 in order to raise additional tax revenue for the Vietnam War. The goal was to stop 155 taxpayers with incomes above \$200,000 from completely avoiding taxes. Unfortunately, the tax was never adjusted for inflation, so it applies to an ever-increasing number of taxpayers. Congress provided a temporary fix (for 2008 only) by increasing the 2008 exemption amounts to \$69,950 for married couples filing jointly and \$46,200 for single taxpayers. Without this relief, congressional estimates indicated that as many as 20 million taxpayers would have been hit by the AMT in 2008. This temporary patch will result in a loss of \$62 billion in tax revenues that otherwise would have been collected.
18. The maximum rate of tax on the adjusted net capital gain of an individual is 15%. Any adjusted net capital gain which otherwise would be taxed at a 10 or 15% ordinary income rate is taxed at a 5% rate (zero for taxable years beginning after 2008). Congress has extended these lower capital gains tax rates through 2010.
19. In the past, only taxpayers who were able to itemize deductions on Schedule A (Form 1040) were able to deduct their state and local property taxes. Congress enacted legislation in 2008 that provides a limited tax deduction for state and local property taxes to non-itemizers by increasing their standard deduction for a taxable year beginning in 2008 by the lesser of (1) the amount allowable to the taxpayer as a deduction for state and local taxes, or (2) \$500 (\$1,000 in the case of a married individual filing jointly). This provision only applies to 2008.
20. The IRS issued final regulations in 2007 that address the legal requirements that apply to 403(b) retirement plans. The regulations took effect on Jan. 1, 2009. Among other things, the regulations require the adoption of a written plan by Jan. 1, 2009, and they limit the transferability of employees' 403(b) accounts to third party vendors without employer authorization (and the adoption of an information sharing agreement). Because of the administrative inconvenience associated with multiple third party investment providers, most churches and public charities are only approving one provider. For many churches, this will be a denominational retirement plan. (In December 2008, the IRS issued Notice 2009-3 that extended the deadline for adoption of a written plan until Jan. 1, 2010. However, compliance with a "reasonable interpretation" of the final regulations is required effective Jan. 1, 2009.)

Part 2. Basic tax questions for ministers and churches

Special tax rules apply to ministers and churches. This section answers your basic questions in one convenient place. Ministers need this information to prepare their tax returns and churches need it to comply with federal payroll withholding and reporting requirements. Other parts of this guide address related details about tax return preparation and payroll reporting requirements.

These rules affect ministers financially and affect how churches should structure ministers' compensation. You and your church will find more information about how to structure a compensation package in our booklet, *Planning Financial Support*. You will find it on our Web site at www.GuideStone.org, or call **1-888-98-GUIDE** (1-888-984-8433) for a free copy.

Who is a minister for tax purposes?

Ministers must know if they are ministers for tax purposes before they can comply with federal tax laws. Churches must know if any of their employees are ministers for tax purposes before they can comply with federal income tax reporting and withholding rules. Churches may think of a person as a minister, but the IRS may not consider the same person a “minister for tax purposes” under its criteria.

These five questions will help determine if a person is a minister for federal tax purposes:

1. Is the person ordained, licensed or commissioned?
2. Does the person administer ordinances (baptism and the Lord's Supper)?
3. Does the person conduct religious worship?
4. Does the person have management responsibilities in the church?
5. Is the person considered to be a religious leader by the church?


Generally, a minister for tax purposes must be ordained, licensed or commissioned **and** answer yes to a majority of the other four questions.

Throughout this guide the term “minister” means a minister for tax purposes unless otherwise indicated.

Ministers for tax purposes:

- Are eligible for a minister's housing allowance.
- Are self-employed for Social Security purposes.
- Are exempt from federal income tax withholding.
- Use the quarterly estimated tax procedure to pay their taxes unless they elect voluntary withholding on Form W-4 with their church.

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

 **Example.** Pastor J is a minister for tax purposes. He is employed by a church, but as a bi-vocational minister, he also works a second job for a secular employer. The church can designate a housing allowance for him since his services for the church are performed in the exercise of ministry. However, the secular employer cannot designate any portion of Pastor J's compensation as a housing allowance since that work is not service in the exercise of ministry.

For more information about who is a minister for tax purposes, see the *Ministerial Tax Issues* brochure on our Web site, www.GuideStone.org, or call GuideStone at **1-888-98-GUIDE** (1-888-984-8433) and ask for a free copy.

Is a minister employed or self-employed?

Many ministers do not know if they are employees or self-employed for federal tax reporting purposes. The answer affects their tax returns and how churches report their wages. IRS guidelines tell agents auditing a minister's tax return that the first issue to be resolved is whether the minister is an employee or self-employed for income tax purposes.

Tests used by the IRS and federal courts would classify most ministers as employees. The United States Tax Court issued two rulings in 1994 addressing whether a minister is an employee or self-employed for federal income tax reporting purposes. The court applied this seven-factor test in both cases:

1. The degree of control exercised by the employer over the details of the work.
2. Which party invests in the facilities used in the work.
3. The opportunity of the individual for profit or loss.
4. Whether or not the employer has the right to discharge the individual.
5. Whether the work is part of the employer's regular business.
6. The permanency of the relationship.
7. The relationship the parties believe they are creating.

Some ministers believe that they will owe fewer taxes if they report their income taxes as self-employed rather than as an employee. This is rarely true, but even if it were, ministers should follow established criteria about whether they are employees or self-employed.

Key Point. Most ministers have a “dual tax status.” Generally:

- They are employees for federal income tax purposes, but
- self-employed for Social Security purposes with respect to earnings from services performed in the exercise of their ministry.

Dual tax status means that most ministers should file their tax returns as employees and pay self-employment (SECA) taxes on their ministerial income (unless they have been exempted from Social Security).

The pastor of a local church will almost always report his church salary as an employee for federal income tax purposes. However, he will be self-employed for purposes of income earned from guest preaching at other churches and from services such as weddings and funerals performed directly for individual members.

Churches should issue a Form W-2 to minister employees and should never withhold Social Security (FICA) taxes for ministers. Also, churches should not withhold federal income taxes from ministers’ wages (except for ministers who have elected voluntary withholding by submitting a Form W-4 to their church).

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

A few ministers are self-employed for federal income tax reporting, such as some traveling evangelists (who have not incorporated their ministry). They file their income taxes as self-employed and often receive a Form 1099-MISC from different churches where they perform services. Churches may need to issue a Form 1099-MISC to some ministers such as traveling evangelists and other workers who are truly self-employed for income tax purposes.

Key Point. Most ministers benefit from reporting as employees because:

1. The risk of an IRS audit is substantially lower for employees than for self-employed taxpayers.
2. “Self-employed” ministers reclassified as employees after an IRS audit face additional taxes and penalties.

3. The value of some fringe benefits, such as employer-paid medical coverage, is tax free to employees but not to self-employed taxpayers.

For more information about whether a minister is employed or self-employed, see the *Ministerial Tax Issues* brochure on GuideStone’s Web site, www.GuideStone.org, or call GuideStone at **1-888-98-GUIDE** (1-888-984-8433) and ask for a free copy.

How do Social Security rules apply to ministers?

Most ministers have a dual tax status. They are self-employed for Social Security purposes with respect to earnings from services performed in the exercise of their ministry even if they are employees for income tax purposes. Some exceptions apply to chaplains.

Because ministers are self-employed for Social Security purposes, they must complete Schedule SE to Form 1040 unless the IRS has approved their timely application to exempt themselves from self-employment (SECA) taxes. As discussed below, few ministers qualify for this exemption.

Ministers pay the self-employment (SECA) tax. They do not pay the employee’s share of Social Security and Medicare (FICA) taxes, even if they report their income taxes as employees and receive a Form W-2 from their church, as most ministers should.

Churches must not pay FICA for anyone who is a minister for tax purposes. Some churches want to help their ministers with the burden of self-employment (SECA) taxes. They may pay ministers a Social Security “allowance” or “offset,” but this amount is income for both federal income taxes and self-employment (SECA) taxes.

In very limited circumstances, ministers may “opt out” of Social Security or exempt themselves from self-employment (SECA) taxes with respect to their ministerial earnings. However, very few ministers qualify for this exemption. Many new ministers apply to opt out without knowing they are ineligible. Ministers may apply to opt out only if they are opposed on the basis of religious considerations to accepting benefits from Social Security or any other public insurance system that provides retirement or medical benefits. They cannot apply if their sole objection to participation in the Social Security program is payment of taxes, or any other reason. Once the IRS grants the exemption, a minister may not revoke it, even if he regrets it later. In the past, Congress has given ministers very limited opportunities to revoke an exemption, but no such option is currently available.

To apply for the exemption, eligible ministers must file an application for exemption (Form 4361) no later than the due date of the federal tax return for the second year in which they have net earnings from self-employment of \$400 or more, any part of which comes from ministerial services. If they miss that deadline, they cannot opt out. The exemption is only effective

when approved by the IRS and does not apply without receipt of IRS approval.

The exemption is available only for ministerial earnings. Ministers approved for the exemption are not exempt from Social Security taxes on earnings from secular employment. Ministers approved for the exemption may still qualify for Social Security benefits if they have enough quarters from secular employment. They also may qualify for some benefits based on their spouse's Social Security coverage.

For more information about ministers and Social Security, see the *Ministerial Tax Issues* brochure on GuideStone's Web site, www.GuideStone.org, or call GuideStone at **1-888-98-GUIDE** (1-888-984-8433) and ask for a free copy.

How do ministers pay their taxes?

Special withholding rules apply to ministers. Since ministers' wages are exempt from federal income tax withholding, churches should not withhold income taxes from a minister's paycheck unless the minister enters into a voluntary withholding arrangement with his church by giving the church a completed Form W-4 (withholding allowance certificate). Ministers can increase the amount they want withheld as federal income taxes on Form W-4 to cover their estimated self-employment (SECA) tax liability for the year.

Ministers must prepay their income taxes and self-employment (SECA) taxes in quarterly installments using the estimated tax procedure unless they have entered into a voluntary withholding arrangement with their church. Underpayment penalties may apply if estimated tax payments are less than the actual tax liability. Ministers may change their estimated tax payments during the year if their circumstances change to make them owe more or less taxes.

Ministers should make estimated tax payments for 2009 if they expect to owe at least \$1,000 in taxes for 2009 after subtracting withholding and credits and if those withholding and credits are expected to be less than the smaller of these two amounts: (1) 90% of the tax to be shown on their 2009 tax return, or (2) 100% of the tax shown on their 2008 tax return or 110% of the tax shown on their 2008 tax return if their adjusted gross income is greater than \$150,000. The 2008 tax return must cover all 12 months.

Ministers should follow these three steps to report and prepay estimated taxes for 2009:

Step 1. Obtain a copy of IRS Form 1040-ES early enough to compute and make the first payment by April 15, 2009.

Step 2. Compute estimated taxes for 2009 using the Form 1040-ES worksheet.

Step 3. Using one of the four payment vouchers in Form 1040-ES, pay one-fourth of the total estimated taxes for 2009 to the IRS in each of the four quarterly installments as follows:

For the Period	Due Date
January 1–March 31	April 15, 2009
April 1–May 31	June 15, 2009
June 1–August 31	September 15, 2009
September 1–December 31	January 15, 2010

If the due date for making an estimated tax payment falls on a Saturday, Sunday or legal holiday, the payment will be on time if made on the next day that is not a Saturday, Sunday or legal holiday.

Ministers who overpay their estimated taxes may have those overpayments applied to the next year's estimated tax liability or request a refund when they file their tax return.

Preliminary questions

Q. Must ministers pay federal income taxes?

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

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

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

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

A. Most ministers must use the standard Form 1040.

Q. What records should I keep?

A. You should keep all receipts, canceled checks, and other evidence to prove amounts you claim as deductions, credits or exclusions including amounts designated as minister's housing allowance.

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

A. April 15, 2009.

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

A. You can obtain an automatic six-month extension (from April 15 to October 15, 2009) of time to file your 2008 Form 1040 if you file Form 4868 by April 15, 2009 with the IRS service center for your area. Your Form 1040 can be filed at any time during the six-month extension period. An extension only relieves you from the obligation to file your return; it is not an extension of the obligation to pay your taxes. Therefore, you must make an estimate of your tax for 2008 and pay the estimated tax with your Form 4868.

Q. Should I prepare my own tax return?

A. The answer depends on your ability and experience in working with financial information and in preparing tax returns. Many ministers can prepare their own tax returns if they understand the unique tax rules that apply to ministers. Few of those rules are complex, but other events in 2008 could make your tax return more complicated. For example, if you purchased or sold a home, you may be prudent to seek professional tax help. You will find many helpful publications on the IRS Web site, *www.irs.gov*. The IRS will also answer questions by phone, but it is not liable if its agents answer your questions incorrectly.

► **Recommendation.** Use these tips to find a competent tax professional if you need one:

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

What is a minister's housing allowance?

The housing allowance exclusion is the most important tax benefit available to ministers. Subject to strict rules and limits, ministers may exclude from income for income tax purposes some or all of their church-designated housing allowance. However, when reporting their income for self-employment (SECA) tax purposes, ministers may not exclude the allowance. Some exceptions for retired ministers are discussed below.

A housing allowance must be compensation for ministerial services and should not exceed a minister's reasonable compensation. Ministers must substantiate their actual housing expenses. Otherwise, all or part of the housing allowance designation is included in gross income. A worksheet is included in this section

to help ministers estimate their annual housing expenses.

A housing allowance may be available to ministers who own their own homes, who rent or who live in a rent-free church-owned parsonage. However, it is available only for a principal residence, not for a second home or vacation home.

Ministers who own their homes can exclude the lowest of the following three amounts from income for federal income tax purposes when their church employer properly designates a housing allowance for them:

1. The housing allowance designated by their church; or
2. Actual housing expenses (including mortgage payments, utilities, property taxes, insurance, furnishings, repairs and improvements); or
3. The fair rental value of the home (furnished, including utilities). Ministers who rent their homes can exclude the lower of these two amounts:
 - The amount designated by their church; or
 - Actual housing expenses (including rent, renter's insurance, utilities, furnishings, repairs and improvements).

Ministers who live rent-free in a church-owned parsonage should not include the fair rental value of the parsonage as income for federal income taxes. Churches can designate a housing allowance for a minister who lives in a parsonage if the minister pays for utilities, repairs, furnishings or other eligible expenses.

Ministers who live rent-free in a church-owned parsonage may exclude the lower of these two amounts:

- The housing allowance designated by their church; or
- Actual housing expenses not paid by the church (including utilities, furnishings, repairs and improvements).

When a designated housing allowance exceeds a minister's actual housing expenses and the fair rental value of the home, the minister must report the "excess" housing allowance as wages for federal income tax purposes on line 7 of Form 1040.

Churches must comply with legal requirements in designating a housing allowance or the minister could be deprived of this important tax benefit. They should take official action to designate a housing allowance and record it in the meeting minutes. The IRS recognizes designations included in employment contracts and budget line items, assuming that the designation was appropriately adopted in advance by the church.

Designation of a housing or parsonage allowance for the next year should be on the church agenda for one of its final meetings during the current year. Churches should consider designating a housing allowance "for the current year and for all future years unless otherwise provided." This "safety net" allows a designation to carry over from year to year, preventing problems if a church forgets to designate an allowance one year. However, safety net allowances should not be viewed as a substitute for designating a housing allowance each year.

Churches must designate a housing allowance in advance because retroactive designations are not valid.

Example. In preparing his income tax return for 2008, Pastor H discovers that his church failed to designate a housing allowance for him for 2008. He asks his church to pass a resolution in 2009 retroactively designating an allowance for 2008. The IRS will not accept a retroactive housing allowance designation so Pastor H will not be eligible for housing allowance exclusion for 2008.

Key Point. It is possible that a pastor's "backdating" of a board resolution to qualify for a housing allowance for the entire year violates 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.

Churches may designate a housing allowance during a calendar year if they failed to do so before the year started, but such a designation only will apply prospectively.

Example. Pastor J's church discovers on March 1, 2009, that it failed to designate an allowance for 2009. The church should immediately designate a portion of Pastor J's remaining 2009 compensation as a housing or parsonage allowance.

Churches should ask ministers to estimate their housing expenses so they can designate a reasonable amount. This guide includes a form for this purpose. Churches do not report the designated housing allowance as wages on the minister's Form W-2.

Ministers who own their home can deduct mortgage interest and real estate taxes on Schedule A (Form 1040) although they exclude those amounts from income as housing allowance. This is often called "the double deduction," but really it is an exclusion and a deduction.

Example. Pastor Y owns a home and incurs housing expenses of \$13,000 in 2008 for mortgage principal and interest payments, property taxes, utilities, insurance, furnishings and repairs. The church designated \$12,000 of Pastor Y's 2008 compensation (\$35,000) as a minister's housing allowance in advance. The church reports only \$23,000 of taxable compensation on Pastor Y's Form W-2 for 2008 (\$35,000 less \$12,000). Pastor Y is able to itemize deductions on Schedule A (Form 1040). He may claim deductions for both mortgage interest

and property taxes, although his taxable income was already reduced when these expenses were excluded from income as part of his housing allowance.

Home mortgage loan payments qualify as housing allowance expenses, but costs for refinancing or a home equity loan qualify only if the proceeds are used to buy or maintain a principal residence. When a minister pays off a home mortgage, the amount that can be excluded as housing allowance usually decreases significantly. Some ministers take a home equity loan or conventional loan secured by a mortgage on their otherwise debt-free home after paying off a mortgage. The Tax Court has ruled that these loan payments are expenses for purposes of the housing allowance exclusion only if the loan was obtained for housing-related expenses.

Key Point. Many ministers were eligible to have housing allowance on some or all of their retirement benefits in 2008, and many ministers will be eligible for this designation in the future. Eligible retired ministers may exclude their housing allowance from income for federal income tax purposes. An IRS ruling allows church pension boards to offer this valuable benefit.

The IRS has ruled that retired ministers are eligible for a housing allowance exclusion if: a portion of a retired minister's pension income from a denominational pension fund is designated as a housing allowance by the pension board or the designation is approved by the former church/employer; the retired minister has severed his relationship with the local church and relies on the church pension fund for his pension; and the pension paid to the retired minister compensates him for past services to the denomination or to local churches of the denomination.

GuideStone Financial Resources of the Southern Baptist Convention may designate housing allowance on retirement benefits to Southern Baptist ministers, subject to applicable requirements related to housing allowance and rules and procedures established by GuideStone Financial Resources. In addition, GuideStone Financial Resources will provide assistance to other ministers and ministry organizations it is authorized to serve with respect to facilitating housing allowance on all or a portion of such ministers' retirement benefits as designated by their former church/employer.

Retired ministers may not be able to exclude the full amount designated as housing allowance from income for federal income tax purposes. See the instructions to lines 16a and 16b.

Key Point. Retired ministers may be able to exclude their housing allowance from income in figuring their self-employment (SECA) tax.

Retired ministers may be eligible to receive favorable self-employment (SECA) tax treatment on their housing allowance designated by GuideStone (or by their former church/employer through GuideStone) for 2008.

What constitutes “retirement” for purposes of these rules about SECA and the housing allowance depends upon an individual’s particular facts and circumstances. Ministers with questions about whether they are “retired” for this purpose should consult their tax advisor. The question of retirement is specific to ministers’ individual circumstances. Ultimately, the minister must determine if he is retired for this purpose.

Many facts and circumstances may be relevant in determining whether retirement has occurred. For example, if a minister is receiving retirement benefits from a plan and is making contributions to the same plan, the IRS may not consider that minister retired for purposes of the housing allowance and the favorable treatment under SECA. Similarly, the IRS may view ministers as not retired if they have not had a meaningful break in service or change in work duties. Ministers and their tax advisors should work together to address the relevant facts and circumstances of each individual case.

For more information about the housing allowance, see the *Ministerial Tax Issues* brochure on GuideStone’s Web site, www.GuideStone.org, or call GuideStone at **1-888-98-GUIDE** (1-888-984-8433) and ask for a free copy.

Minister’s housing allowance expense worksheet for ministers who own their home

Ministers are permitted to exclude from their church income (for federal income tax purposes) a housing allowance designated in advance by their employing church, to the extent that the allowance is used to pay housing expenses and does not exceed the fair rental value of the home (furnished, including utilities). To assist the church in designating an appropriate amount, the minister can use this form to estimate annual housing expenses. It is designed for ministers who own their home.

Category with estimated expense amount for the year

Down payment on a home	\$ _____
Mortgage payments on a loan to purchase or improve your home (include both principal and interest)	\$ _____
Real estate taxes	\$ _____
Property insurance	\$ _____
Utilities (electricity, gas, water, trash pickup, local telephone charges)	\$ _____
Furnishings and appliances (purchase and repair)	\$ _____
Structural repairs and remodeling	\$ _____
Yard maintenance and improvements	\$ _____
Maintenance items (pest control, etc.)	\$ _____
Homeowners association dues	\$ _____
Miscellaneous	\$ _____
Total estimated expenses for the year	\$ _____

Please note the following:

- A housing allowance must be designated in advance. Retroactive designations of housing allowances are not permitted.
- 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.
- It is the minister’s responsibility to notify the church in the event that these estimates prove to be materially inaccurate during the year.
- A minister cannot always exclude the amount a church designates as a housing allowance for income tax reporting purposes. Ministers who are eligible for a housing allowance may exclude the least of these amounts, subject to IRS rules: (1) the designated housing allowance; (2) actual eligible housing expenses, and, for ministers who own their homes; (3) the fair rental value of their home furnished, including utilities.
- If the housing allowance designated by the church exceeds the amount that can be claimed, the excess housing allowance should be reported with wages on line 7 of Form 1040. Write “excess housing allowance” on the dotted line next to line 7.
- The housing allowance exclusion is an exclusion for federal income taxes only. The minister must add the housing allowance as income in reporting self-employment (SECA) taxes on Schedule SE unless the minister is exempt from self-employment (SECA) taxes.

What is an accountable reimbursement plan?

Churches save ministers taxes when they reimburse them for business (ministry-related) expenses through accountable reimbursement plans, also known as accountable expense reimbursement arrangements.

Accountable reimbursement plans allow ministers to exclude church-reimbursed ministry expenses from income. Proper reimbursements of ministry-related expenses under accountable reimbursement plans 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 reports to the church rather than to the IRS.

A church should adopt an accountable reimbursement plan in a resolution. Plans that follow these rules should comply with IRS requirements:

1. Reimbursements are made only with adequate substantiation. Written evidence is required for all expenses, and receipts are required for expenses of \$75 or more.
2. The evidence must substantiate the amount, date, place and business nature of each expense. A church must require the same degree of substantiation as would be required for a deduction on the minister's income tax return.
3. Expenses must be substantiated and excess reimbursements returned to the church within a "reasonable period of time." The IRS views 60 days as a reasonable period of time for substantiating expenses and 120 days as a reasonable period for returning excess reimbursements.

Key Point. Churches penalize ministers financially when they do not reimburse them for ministry-related expenses or when they make reimbursements under non-accountable plans.

Some churches do not reimburse ministers for ministry-related expenses. Other than churches, few employers expect employees to pay business expenses without reimbursement. Churches that think they cannot afford to reimburse ministry-related expenses should remember that they could limit the type and amount of expenses they will reimburse.

Some churches that do not reimburse ministry-related expenses mistakenly think that ministers can "write off" all these expenses when they file their tax returns. But since most ministers are employees for income tax purposes, they cannot deduct any business expenses unless they have enough deductions to itemize on Schedule A of Form 1040. Even when taxpayers can itemize deductions on Schedule A, they can deduct business expenses only to the extent that those expenses exceed 2% of adjusted gross income.

Some churches reimburse ministers for business expenses but may penalize them by reimbursing them under a non-accountable plan. A church has a non-accountable plan if it gives a minister an allowance or reimburses the minister or other employees for business expenses without requiring adequate substantiation of the amount, date, place, and business purpose of the expenses, or does not require excess reimbursements to be returned to the church. The full amount of a church's reimbursements or allowances under such a plan must be reported as income on Form W-2 issued by the church and on the minister's tax return.

Example. Pastor R is the senior minister at his church and reports his federal income taxes as an employee. The church reimburses him for all of his business and professional expenses, but does not require him to account for those expenses. He does not have to provide the church treasurer with receipts documenting the amount, time and place, business purpose and business relationship of each expense. Pastor R simply tells the treasurer the total expenses he incurred at the end of the month. This is not an accountable plan. The church must report these reimbursements as income on his Form W-2 and he must report them as income on his Form 1040.

Key Point. Churches occasionally reimburse ministers for expenses that are not ministry-related. Reimbursements for 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, even if the church requires the minister to document the expenses.

Caution. A church cannot reimburse employees' expenses under an accountable reimbursement arrangement that do not qualify as business expenses. Such reimbursements, as well as a church's reimbursement of employees' unsubstantiated business expenses, are nonaccountable. If these reimbursements are not reported as taxable income to the employee in the year the reimbursements are paid, there are two consequences: (1) The employee is subject to back taxes plus penalties and interest on the unreported income. (2) If the benefits are provided to an officer or director of the church (a "disqualified person"), or a relative of such a person, they will expose the recipient and possibly other members of the church's governing board to "intermediate sanctions" in the form of substantial excise taxes since the IRS views these benefits as "automatic" excess benefits unless reported as taxable income by the church or recipient in the year provided.

Part 3. 403(b) plans and IRAs

This section of the tax guide summarizes general tax rules about 403(b) plans and Individual Retirement Arrangements (IRAs). See this guide's step-by-step instructions in Part 4 for related information.

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. The 403(b)(9) Retirement Plan for Southern Baptist Churches allows all these types of contributions. Participants in the 403(b)(9) Retirement Plan for Southern Baptist Churches may also be eligible for contributions provided by their Baptist state convention. Self-employed ministers may be able to participate in the Self-Employed Ministers and Chaplains Plan offered by GuideStone. The Self-Employed Ministers and Chaplains Plan allows employer, employee salary reduction and Roth elective deferral contributions. For more information see GuideStone's Web site, www.GuideStone.org, or call GuideStone at **1-888-98-GUIDE** (1-888-984-8433).

Ministers and other employees may reduce their federal income taxes and save for retirement by making salary reduction contributions to a 403(b) plan. They must sign a written, legally binding salary reduction agreement with their employer before compensation is made available. If an employee is audited, the IRS will require evidence of a salary reduction agreement to substantiate salary reduction contributions and/or Roth elective deferrals. Participants in a 403(b) plan may make more than one salary reduction agreement change during the year. For a Salary Reduction Agreement, see GuideStone's Web site, www.GuideStone.org, or call GuideStone at **1-888-98-GUIDE** (1-888-984-8433).

Key Point. Salary reduction contributions are excluded from gross income for federal income tax purposes as long as they do not exceed legal limits discussed below. Ministers for tax purposes do not pay self-employment (SECA) tax on tax-sheltered amounts contributed to their 403(b) retirement accounts through salary reduction. However, non-minister employees must pay FICA on those contributions so the employer must withhold FICA on those amounts.

Key Point. Ministers who are self-employed for income tax purposes can participate in 403(b) plans, but employees of a church that offers a 403(b) plan through GuideStone must receive a Form W-2 from their church in order to participate in their church's 403(b) plan. If you are a self-employed minister for income tax purposes or have self-employment income from activities such as writing, guest speaking and conducting weddings and funerals, you may be able to participate in another 403(b) plan through GuideStone.

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:

- The Basic Limit (also known as the 415 limit on annual additions); or
- 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 2008, the Basic Limit was the lesser of:

- 100% of your "includable compensation;" or
- \$46,000 (\$49,000 in 2009).

"Includable 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.

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 \$15,500 in 2008 (\$16,500 for 2009).

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:

- \$3,000; or
- \$15,000 minus amounts contributed above the General Limit on salary reduction contributions in prior years; or
- \$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 2008, you may have been eligible to make additional salary reduction plus Roth elective deferral contributions of up to \$5,000. For 2009, the age 50 catch-up is \$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).

Distributions

Generally, amounts contributed to 403(b) plans through salary reduction or by Roth elective deferrals and earnings on those contributions cannot be withdrawn before age 59½, separation from employment, death or disability. Some limited exceptions apply in hardship situations, but only salary reduction contributions or Roth elective deferrals and not their earnings may be withdrawn in those cases. Note that a proportionate amount of a hardship distribution from Roth elective deferrals will be considered “earnings.”

These withdrawal restrictions do not apply to amounts attributable to salary reduction contributions made before Jan. 1, 1989. Pre-1989 salary reduction contributions, and their earnings, may be distributed prior to these events, but may be subject to an additional tax as discussed below.

Distributed amounts are generally taxable as ordinary income, except to the extent that they are properly designated and excludable from income as a minister's housing allowance. Generally, there is an additional tax of 10% on the amount that is includable in income from distributions prior to age 59½, unless one of the following exceptions applies:

- The distributions are made after death or disability.
- The distributions are part of a series of substantially equal periodic payments made over the taxpayer's life or the lives of beneficiaries and after separation from service.
- The distributions are made after separation from service on or after age 55.
- The distributions are for payment of medical expenses which exceed 7.5% of adjusted gross income.
- The distributions are required due to an IRS levy.
- 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 includable 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. For more information see instructions for lines 16a and 16b discussed later.

Traditional IRAs


Ministers and their spouses may be eligible to contribute to a Traditional IRA. This section summarizes general rules about Traditional IRAs. Contributions to a Traditional IRA may be either deductible or non-deductible. In either case, earnings are not taxed until they are distributed.

Generally, eligible taxpayers may contribute a maximum of \$5,000 annually to a Traditional IRA for 2008 (\$5,000 for 2009). They may also contribute up to \$5,000 for their spouse who has no earned income in 2008 (\$5,000 for 2009). In addition, taxpayers who are age 50 or over or who turn age 50 during the year may make additional catch-up IRA contributions of \$1,000 for 2008 (\$1,000 for 2009).

 **Example.** A church has a senior pastor who is 52 years old and a youth pastor who is 30 years old. In 2008, the senior pastor could contribute \$6,000 (the maximum annual contribution of \$5,000 plus a “catch-up” contribution of \$1,000), and the youth pastor could contribute \$5,000. In 2009, the contribution amounts would be \$6,000 for the senior pastor and \$5,000 for the youth pastor.

You may be able to deduct some or all of your contributions to a Traditional IRA for you or your spouse. You must file a joint return to deduct contributions for your spouse’s IRA. If either you or your spouse were covered by an employer retirement plan at any time during a tax year, your allowable IRA deduction may be reduced or eliminated for that year, depending on your filing status and the amount of your adjusted gross income. See this guide’s step-by-step instructions for line 32, Appendix B and Appendix C for additional information.

Remember that if you cannot deduct some or all of your Traditional IRA contributions, you can still make non-deductible contributions. Special rules apply for calculating taxes on distributions from a Traditional IRA when both deductible and non-deductible contributions were made.

 **Key Point.** File Form 8606 with your Form 1040 to designate a Traditional IRA contribution as non-deductible. Otherwise, the full amount of future withdrawals may be taxed.

Generally, withdrawals before age 59½ from Traditional IRAs are subject to an additional tax of 10% unless the withdrawal is due to one of the following reasons:

- The distributions are made after death or disability.
- The distributions are part of a scheduled series of substantially equal periodic payments over the taxpayer’s life, or over

the joint life expectancy of the taxpayer and a beneficiary. But if a taxpayer requests a distribution in the form of a series of substantially equal payments and modifies the payments before five years have elapsed and before attaining age 59½ the additional tax will apply retroactively to the year payments began through the year of the modification.

- The distributions are for payment of medical expenses which exceed 7.5% of adjusted gross income.
- The distributions are due to an IRS levy.
- The distributions are for payment of medical insurance premiums after job loss in some cases.
- The distributions are for payment of qualified higher education expenses.
- The distributions are for payment toward the expenses of a first-time home purchase up to a lifetime limit of \$10,000.

The 10% tax is in addition to any federal income tax that is owed at distribution. For more information on the additional 10% tax and exceptions, see IRS Publication 590.

Distributions from a Traditional IRA must begin no later than April 1 following the calendar year in which you attain age 70½.

Roth IRAs

Unlike contributions to a Traditional IRA, contributions to a Roth IRA may not be deducted. However, “qualified distributions” from a Roth IRA are tax-free. See Publication 590 for additional information about qualified distributions.

A qualifying individual and his or her spouse can contribute to a Roth IRA. Eligible taxpayers with U.S. taxable earned income can contribute to Roth IRAs subject to income limits.

If you are single:

- You may contribute up to \$5,000 for 2008 (\$5,000 for 2009) if you have a modified adjusted gross income (AGI) of less than \$101,000 (\$105,000 in 2009).
- You may make a partial contribution if you have a modified AGI of at least \$101,000 but less than \$116,000 in 2008 or at least \$105,000 but less than \$120,000 in 2009.
- You cannot make a contribution to a Roth IRA if your modified AGI is \$116,000 or more (\$120,000 in 2009).

If you are married filing jointly:

- You may contribute up to \$5,000 for 2008 (\$5,000 for 2009) if your modified AGI is less than \$159,000 (\$166,000 in 2009).
- You may make a partial contribution if your modified AGI is at least \$159,000 but less than \$169,000 in 2008, or at least \$166,000 but less than \$176,000 in 2009.
- You cannot contribute to a Roth IRA if your modified AGI is \$169,000 or more (\$176,000 in 2009).

You may be eligible to make a contribution on behalf of your spouse if you file a joint federal income tax return. The total combined contribution an eligible couple can make in 2008

is the lesser of \$10,000 or the couple's combined U.S. earned income for the year (\$10,000 for 2009). Also, taxpayers age 50 or over may be eligible to make additional catch-up contributions to Roth IRAs of \$1,000 for 2008 (\$1,000 for 2009).

You do not include in your gross income qualified distributions or distributions that are a return of your regular contributions from your Roth IRA(s).

Generally, a qualified distribution is any payment or distribution from your Roth IRA that meets the following requirements:

1. It is made after the five-year period beginning with the first taxable year for which a contribution was made to a Roth IRA set up for your benefit, and
2. The payment or distribution is:
 - a) Made on or after the date you reach age 59½,
 - b) Made because you are disabled,
 - c) Made to a beneficiary or to your estate after your death, or
 - d) Made for payment toward the expenses of a first-time home purchase up to a lifetime limit of \$10,000.

If you receive a distribution that is not a qualified distribution, part of it may be taxable. To figure the taxable part of a distribution that is not a qualified distribution, complete the worksheet in IRS Publication 590.

Generally, you must pay the 10% additional tax on early distributions on the taxable part of any distributions that are not qualified distributions unless one of the exceptions listed below applies:

- The distributions are made after age 59½.
- The distributions are made after death or disability.
- The distributions are part of a series of substantially equal periodic payments.
- The distributions are for payment of medical expenses which exceed 7.5% of adjusted gross income.
- The distributions are due to an IRS levy.
- The distributions are for payment of medical insurance premiums after job loss in some cases.
- The distributions are not more than qualified higher education expenses.
- The distributions are used to pay certain qualified first-time homebuyer amounts.

You are not required to take distributions from your Roth IRA at any age. The minimum distribution rules that apply to Traditional IRAs do not apply to Roth IRAs while the owner is alive. However, after the death of a Roth IRA owner, some of the minimum distribution rules that apply to Traditional IRAs also apply to Roth IRAs.

See this guide's step-by-step instructions for lines 15a and 15b, IRS Publication 590 and Form 8606 for additional information.

Part 4. Step-by-step tax return preparation

Introduction

This step-by-step analysis covers the following forms and schedules:

- Form 1040 is the basic document summarizing all of your tax information. Details are reported on additional forms and schedules.
- Schedule A reports itemized deductions for medical and dental expenses, taxes, interest, contributions, casualty and theft losses, and miscellaneous items. Some business expenses related to ministerial income may also be deducted on Schedule A.
- Schedule B reports dividend and interest income.
- Schedule C reports income and expenses from your business activities other than your church employment. Examples include payments for guest preaching in other churches or payments received directly from members for performing personal services, such as weddings and funerals.
- Schedule SE reports self-employment (SECA) taxes due on your church salary, minister's housing allowance and other self-employment income.
- Form 2106 or Form 2106-EZ reports expenses you incur as a church employee.

These forms and schedules are the ones most commonly used by ministers, but you may need others. See Appendix A.

Form 1040

Step 1: Presidential election campaign fund

If you want \$3 to go to the presidential election campaign fund, check the "yes" box. Your answer will not affect the amount of taxes you owe or the amount of any refund.

Step 2: Filing status

Select your filing status from the options listed.

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. *Relationship test.* The child must be your child (including an adopted child, stepchild or eligible foster child).
2. *Residency test.* The child must live with you for more than half of the year. Temporary absences for special circumstances, such as for school, vacation, medical care, military service or detention in a juvenile facility count as time lived at home. A child who was born or died during the year is

considered to have lived with you for the entire year if your home was the child's home for the entire time he or she was alive during the year.


3. *Age test.* A child must be under 19 years of age at the end of the year, or under age 24 at the end of 2008 if a student or any age if permanently and totally disabled.
4. *Support test.* The child cannot have provided over half of his or her own support during the year.
5. *Special test for child of more than one person.* In some cases, a child will meet the above four tests and be a qualifying child of more than one person. Only one of these persons can claim the child as a qualifying child. If both persons cannot agree on who will treat the child as a qualifying child, the IRS applies a "tie-breaker" rule to determine which person can claim the child.

To claim a dependency exemption for a qualifying relative, the person must be a relative and 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. A relative includes a brother, sister, stepbrother, stepsister or a descendent of one of these relatives.
- The person cannot be the qualifying child of another person in 2008.
- The person must have gross income of less than \$3,500.
- You must have provided over half of the person's support in 2008 (some exceptions apply).

Step 4: Income

Report income on lines 7 through 21. The most important issues for ministers are discussed below.

 **Key Point.** Some items, such as the minister's housing allowance, are not reported as income. These "exclusions" are explained below.

Line 7. Wages, salaries, tips, etc.

 **Key Point.** The amount reported on line 7 ordinarily should be the same as the amount the church reports as wages in Box 1 of the minister's Form W-2. However, ministers must include excess housing allowance on line 7.

📌 **Key Point.** Ministers and other church employees should receive a Form W-2 reporting their church wages by Jan. 31. If the Form W-2 contains an error, the church should issue a “corrected” Form W-2 or Form W-2c if Form W-2 has already been sent to the Social Security Administration. Copy B of the “corrected” Form W-2 or Form W-2c is given to the employee and Copy A is filed with the Social Security Administration.

Income. Ministers’ wages include much more than a church salary. These items are included in the minister’s gross income and are generally reportable in Box 1 “wages” of the minister’s Form W-2:

- Bonuses.
- The cost of sending a minister to the Holy Land if paid by the church.
- Most Christmas and special occasion offerings, including love offerings.
- Retirement gifts paid by a church.
- Payments to a minister from the church to offset the self-employment (SECA) tax.
- Personal use of a church-provided car.
- Purchases of church property for less than fair market value.
- Business expense reimbursements under a non-accountable plan.
- Church reimbursements for a minister’s moving expenses (but not if the minister substantiated the reimbursed expenses under an accountable arrangement).
- Imputed cost of group term life insurance coverage paid by a church and exceeding \$50,000 for a minister and \$2,000 for a spouse and dependents.
- Church reimbursements for a spouse’s travel expenses incurred while accompanying a minister on a business trip unless the spouse’s presence serves a legitimate business purpose and the spouse’s expenses are reimbursed under an accountable arrangement.
- “Discretionary funds” the church allows the pastor to spend at will if he has the authority to disburse funds directly to himself.
- “Below-market” interest loans greater than \$10,000 made by a church to a minister.
- Cancellation of a minister’s debt to a church.
- Severance pay.
- Payment of a minister’s personal expenses by the church.

Exclusions from income. Some kinds of income are not taxable and are not reported on line 7. These items are called exclusions. Most exclusions apply in computing both income taxes and self-employment (SECA) taxes. However,

the minister’s housing allowance is excluded only from federal income taxes, not from self-employment (SECA) taxes, unless a minister is retired.

📌 **Key Point.** Excess housing allowance for an employed minister should be reported on line 7. Excess housing allowance for a retired minister should be reported on line 16b.

The most important tax benefit available to ministers is the housing allowance exclusion. See Part 2 of this guide for more information.

Subject to all other housing allowance rules, a minister who owns his own home may exclude the lowest of the following three amounts:

1. The amount designated by their church; or
2. Actual housing expenses (including mortgage payments, utilities, property taxes, insurance, furnishings, repairs and improvements); or
3. The fair rental value of the home (furnished, including utilities). The exclusion cannot exceed what is reasonable pay for a minister’s services.

📌 **Example.** A church designated \$8,000 of Pastor D’s 2008 compensation as a minister’s housing allowance. Pastor D’s housing expenses for 2008 were utilities of \$3,000, mortgage payments of \$6,000, property taxes of \$2,000, insurance payments of \$1,000, repairs of \$1,000, and furnishings of \$1,000. The fair rental value of the home (including furnishings and utilities) is \$11,000. Pastor D may exclude his housing allowance only to the extent that it is used for housing expenses and does not exceed the fair rental value of the home. It is easier to say that the housing allowance exclusion is the least of the following three amounts — the housing allowance designated by the church (\$8,000), actual housing expenses (\$14,000) or the fair rental value of the home, furnished, including utilities (\$11,000). In this case, the lowest of these three amounts is the housing allowance designated by the church (\$8,000). As a result, Pastor D can only exclude \$8,000 on his 2008 tax return.

📌 **Example.** Consider the same facts as the previous example about Pastor D except that the church designated \$15,000 of his salary as a housing allowance. The lowest of the three amounts in this case would be \$11,000 — the fair rental value of the home (furnished, including utilities). Pastor D has received an excess housing allowance since his actual housing allowance

exclusion (\$11,000) is lower than his housing allowance designation. Assuming the church reduced the amount shown as wages on his Form W-2 by the amount it designated as housing, Pastor D must report the \$4,000 difference as excess housing allowance on Line 7 of Form 1040.

☞ **Key Point.** Contributions to a 403(b) plan are excluded from income for federal income tax purposes as long as they do not exceed legal contribution limits. Those limits and related rules are summarized in Part 3 of this guide. Excess contributions can have adverse tax consequences.

☞ **Key Point.** 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).

Here are some other common exclusions for ministers:

- Gifts if they are truly gifts and not compensation for services performed. However, employers generally are not permitted to give tax-free gifts to employees. Love offerings from a church to a minister are usually taxable.
- Life insurance proceeds and inheritances.
- Medical insurance premiums if paid by a church for its ministers and their spouses and dependents. This exclusion is not available to individuals who are self-employed for federal income tax purposes. This exclusion is not available to ministers who can choose between cash and this benefit as often happens when the church uses a compensation “package approach.” If a church has adopted a flexible benefit plan, often called a “cafeteria plan” or 125 plan, the minister may sign an agreement in advance to pay for his own medical coverage on a pre-tax basis. That amount is excluded from income.
- The cost of employer-paid group term life insurance if the amount of coverage does not exceed \$50,000. Employer-paid group term life insurance for the employee’s spouse or dependents is excludable from the employee’s gross income if the amount of coverage does not exceed \$2,000. Special rules apply if the employee pays some or all of the cost of dependent coverage with after-tax dollars.
- A qualified tuition reduction from an employer that is an educational institution. This is a reduction in tuition charged to employees, spouses or dependent children.
- The value of free child care services provided by a church to its employees as long as the benefit is based on a written plan that does not discriminate in favor of highly compensated employees. Other conditions apply.

- Contributions to a flexible benefit plan that complies with section 125 of the Internal Revenue Code.
- Sale or exchange of a principal residence. Generally, a married couple filing a joint return can exclude up to \$500,000 of gain from the sale or exchange of a principal residence every two years. Single taxpayers can exclude up to \$250,000. To qualify for the full exclusion, a taxpayer must have owned and occupied the residence as a principal residence for at least two of the five years prior to the date of sale or exchange. Taxpayers do not have to replace a current residence with a residence of equal or greater cost in order to avoid capital gains tax.
- Qualified scholarships received by a candidate for a degree. A qualified scholarship is any grant amount that, according to 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 enrollment or attendance at an educational institution; or (2) fees, books, supplies and equipment required for courses of instruction at the educational institution. Any amount received as payment for teaching, research or other services required as a condition for receiving a qualified scholarship may not 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 nontaxable 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) cannot be excluded.

Lines 8a and 8b. Interest income: attach Schedule B if over \$1,500 or if any special rules apply to you

Enter total taxable interest income on line 8a. Complete parts I and III of Schedule B if you have taxable interest income of more than \$1,500.

Tax-exempt interest income is reported on line 8b. Do not include interest earned on your IRA or Coverdell education savings account. See IRS Publication 550, Investment Income and Expenses, for additional information.

Lines 9a and 9b. Dividend income: attach Schedule B if over \$1,500 or if any special rules apply to you

Enter total ordinary dividends on line 9a. Total ordinary dividends should be shown in Box 1a of Form(s) 1099-DIV sent to you. Fill in and attach Schedule B if the total is over \$1,500 or if you received, as a nominee, ordinary dividends that actually belong to someone else.

Enter total qualified dividends on line 9b. Qualified dividends are eligible for a lower tax rate than other ordinary income. Generally, these dividends are shown in Box 1b of Form 1099-DIV. See IRS Publication 550 for the definition of qualified dividends if you received dividends not reported on Form 1099-DIV. Some dividends may be reported as qualified dividends in Box 1b of Form 1099-DIV but are not qualified dividends. These include dividends received as a nominee. See IRS Form 1040 instructions for additional examples.

Be sure to figure your tax on either Schedule D Tax Worksheet or the Qualified Dividends and Capital Gain Tax Worksheet, whichever applies.

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:

- Compensation reported to you on a Form 1099-MISC.
- Payments received directly from church members for performing personal services such as marriages and funerals.
- Honoraria you received for guest speaking appearances in other churches.

If you received income from any of these kinds of activities, compute your net earnings on Schedule C and transfer this amount to line 12. Schedule C is discussed more fully later in this guide. 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 if required


Generally, if you had a capital gain or loss, including any capital gain distributions, you must complete and attach Schedule D.

If you do not have to file Schedule D, be sure you use the Qualified Dividends and Capital Gain Tax Worksheet to figure your tax.

Lines 15a and 15b. IRA distributions

Complete these lines if you receive a Form 1099-R showing the amount of any distribution from a Traditional or Roth IRA. See IRS Form 1040 Instructions for more information.

Lines 16a and 16b. Pensions and annuities

 **Key Point for retired ministers.** 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 2008 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 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

- 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.
- 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

- 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.
- If some or none of your retirement benefit is taxable, complete both line 16a and line 16b. 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.
- 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.

Lines 20a and 20b. 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 2008, part of the amount you received may be taxable. If you received Social Security benefits during 2008, you will receive Form SSA-1099 before Jan. 31, 2009 showing the amount of benefits you received. Consider the following guidelines when determining whether your 2008 Social Security benefits are taxable:

1. In general, if the only income (including any retirement benefits) you received during 2008 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 2008, 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.
6. If you made contributions to a Traditional IRA for 2008 and you were covered by a retirement plan at work or through self-employment, see Publication 590 to determine if your Social Security benefits are taxable and to calculate your IRA deduction.

Line 21. Other income: list the type and amount

Excess housing allowance should be reported on line 7, not line 21. Include the following items on line 21:

1. A canceled debt, or a debt paid for you by your church or another person.
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.
4. Taxable distributions from a Coverdell education savings account (ESA). See Publication 970.
5. "Qualified tuition program" earnings. See Publication 970 for exclusions.

- **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 on the dotted line next to line 21. This will help avoid confusion and may help you avoid receiving an IRS form letter.

Step 5: Adjustments to income

You may deduct certain adjustments from gross income in computing your adjusted gross income. The adjustments are reported on lines 23 through 36 of Form 1040.

Line 23. Educator expenses

If you were an eligible educator in 2008, you can deduct up to \$250 of qualified expenses you paid in 2008 as an adjustment to gross income on line 23. This deduction is available even if you cannot itemize expenses on Schedule A. If you and your spouse are filing jointly and both of you were eligible educators, the maximum deduction is \$500. An eligible educator is a kindergarten through grade 12 teacher, instructor, counselor, principal or aide who worked in a school for at least 900 hours

during a school year. Qualified expenses include ordinary and necessary expenses for such items as books, supplies, equipment (including computer equipment and software) and other material used in the classroom.

Qualified expenses do not include expenses for home schooling. The amount of your qualified expenses must be reduced by certain items, including employer reimbursements not reported as wages on your W-2 and tax-free distributions from a Coverdell education savings account.

Line 26. Moving expenses

If your employer does not reimburse your “allowable moving expenses,” or if they are reimbursed under a non-accountable plan, 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, then the reimbursements are not reported by the employer as taxable income and you cannot claim a deduction. See Part 2 of this guide for more information about accountable reimbursement plans.

Allowable moving expenses are expenses you incurred because you accept a new job or change jobs 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. 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 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.

Line 27. One-half of self-employment tax

- ☞ **Key Point.** Every minister who pays self-employment (SECA) taxes on ministerial income (almost all ministers) qualifies for this deduction. Some are not claiming it.

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

Line 28. Self-employed SEP, SIMPLE and qualified plans

Generally, ministers do not report their contributions to 403(b) plans on their tax returns. Most ministers are employees for federal income tax purposes. Remember that ministers have a dual tax status. They are usually employees for federal income tax purposes, but they are always treated as self-employed for Social Security purposes for their earnings from the ministry.


However, some ministers, such as some evangelists, are self-employed for federal income tax purposes. Also, some ministers who are employed by a church may have self-employment income relating to the ministry. For example, they may have income from writing religious books and articles or from


preaching at other churches. If you're one of these ministers, you're considered both an employee and an employer for retirement plan contribution purposes. In 2008, you may have been eligible to contribute to the Self-Employed Ministers and Chaplains Plan for your own benefit. If you contributed to this plan, you must report your total contributions as a deduction on line 28 of Form 1040. For more information, see IRS Publications 517 and 571.

Line 32. IRA deduction

If you made contributions to a traditional IRA for 2008, you may be able to take an IRA deduction. But you, or your spouse if filing a joint return, must have had earned income to do so. Also, you must file a joint return to deduct contributions for your spouse's IRA. If either you or your spouse were covered by an employer retirement plan at any time during 2008, your allowable IRA deduction may be reduced or eliminated, depending on your filing status and the amount of your adjusted gross income. Your Form W-2 should have the "Retirement plan" box marked if you were covered by a retirement plan. Employer retirement plans include 403(b) plans such as those available through GuideStone.

For your convenience, Appendix B of this guide includes IRS instructions for line 32 that you need to read carefully before completing the IRA Deduction Worksheet in Appendix C. The completed worksheet in the Comprehensive Example for an active minister may be helpful.

 **Key Point.** All traditional IRA contributions must be made by the due date of your tax return, not including extensions. This means that your 2008 Traditional IRA contribution must be made by April 15, 2009, even if you obtain an extension for filing your return.

 **Key Point.** If you made nondeductible contributions to a Traditional IRA for 2008, you must report them on Form 8606 or the full amount of future withdrawals may be taxed.

See Part 3 of this guide and IRS Publication 590 for more information about contributions to Traditional IRAs and Roth IRAs.

Line 34. Tuition and fees deduction

You may be able to claim a deduction for qualified education expenses paid on behalf of an eligible student who attends an eligible postsecondary educational institution. An eligible student refers to yourself, your spouse or a dependent you claim on your tax return, if enrolled in one or more courses at a college, university, vocational school or other postsecondary

educational institution eligible to participate in federal student aid programs. The deduction is based on the amount of qualified education expenses you paid for the student in 2008 for academic periods beginning in 2008 and the first three months of 2009.

Qualified education expenses are amounts paid in 2008 for tuition and fees required for the eligible student's enrollment at an eligible educational institution. Note, however, that qualified expenses do not include room and board, student health fees, transportation and books.

This deduction is not available to taxpayers with modified adjusted gross income of more than \$80,000 (\$160,000 if married filing a joint return). The maximum deduction is \$4,000.

You may be able to take the Hope Credit or Lifetime Learning Credit for your education expenses instead of the tuition and fees deduction. Figure your tax both ways and choose the one that gives you the lower tax.

Line 36. Add lines 23 through 35

If you are a chaplain and your employer does not exclude your contributions to a 403(b) plan from your earned income, you may be able to deduct your contributions on your income tax return. However, if your employer has agreed to exclude the contributions from your earned income, you cannot claim the contributions as a deduction. If you're a chaplain and can take a deduction, enter your contributions on line 36 of Form 1040. Write "403(b)" on the dotted line next to line 36. For more information, see IRS Publications 517 and 571.


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. Carry this amount to line 38 at the top of page 2 of your Form 1040.

Step 7: Tax computation

Lines 39a and 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.

If you or your spouse were 65 or older or blind at the end of 2008, check the appropriate box(es) on line 39a. Be sure to enter the total number of boxes checked.

On line 40 you will enter either your itemized deductions from Schedule A or a standard deduction amount. Itemized deductions are discussed under Schedule A in this guide. For 2008, the standard deduction amounts are as follows:

Filing Status	Standard Deduction Amount
Single	\$5,450
Married filing jointly	\$10,900
Qualifying widow(er)	\$10,900
Married filing separately	\$5,450
Head of household	\$8,000

If you checked any box on line 39a, use the IRS Standard Deduction Chart For People Who Were Born Before Jan. 2, 1942, or were Blind in the Form 1040 instructions.

Line 42. Personal exemptions

For 2008, the personal exemption amount is \$3,500. Multiply this amount times the number of exemptions claimed on line 6d and enter the total on line 42. Personal exemptions are phased out for certain high-income taxpayers. The instructions to Form 1040 contain a worksheet that should be used to compute this reduced exemption amount.

Line 44. Compute tax

Most ministers must use the tax tables to determine their income taxes. If your taxable income is \$100,000 or more, use the Tax Computation Worksheet in the 1040 Instructions. Do not use the tax tables or Tax Rate Schedules to figure your tax if you are required to figure your tax using Form 8615, Schedule D or the Qualified Dividends and Capital Gain Tax Worksheet. See the instructions to Form 1040 for additional information.

Step 8: Credits

A credit directly reduces your tax liability.

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

If you paid someone to care for your child under age 13 or your dependent or spouse who could not care for himself or herself, you may be eligible for this credit. This credit is computed on Form 2441, as illustrated later in this guide. If you paid these expenses on a pre-tax basis under a flexible spending account (FSA), the credit may not be available.

Line 50. Education credits: attach Form 8863

If you or your dependent paid qualified expenses in 2008 for yourself, your spouse or your dependent to enroll in or attend an eligible educational institution, you may be able to claim an education credit. See Form 8863 for details.

Line 51. Retirement savings contributions credit: attach Form 8880

The tax code allows a temporary non-refundable tax credit for contributions made by eligible taxpayers to a qualified retirement plan. This credit, sometimes called the “saver’s credit,” is available with respect to salary reduction contributions to a 403(b) plan and to contributions to a Traditional or Roth IRA. The maximum annual contribution eligible for the credit is \$2,000.

Non-refundable tax credit by adjusted gross income

Joint Returns	Heads of Households	Single Filers or Married Filing Separately	Percentage of Contribution Credit	Maximum Tax Credit
\$0–32,000	\$0–24,000	\$0–16,000	50%	\$1,000
\$32,001–34,500	\$24,001–25,875	\$16,001–17,250	20%	\$400
\$34,501–53,000	\$25,876–39,750	\$17,251–26,500	10%	\$200
over \$53,000	over \$39,750	over \$26,500	0%	\$0

The credit rate depends on the filing status and adjusted gross income (AGI) of the taxpayer as shown in the table above. In some cases, the amount of the tax credit should be reduced by taxable distributions from some retirement plans.

The credit is available to individuals who are 18 or over, other than individuals who are full-time students or claimed as a dependent on another taxpayer’s return. The amount of the credit based on adjusted gross income is described in the previous table.

Line 52. Child tax credit

If you have one or more children under 17 years of age (at the end of 2008), and you earn less than \$110,000 if married or \$75,000 if single, you will be able to claim a \$1,000 credit on your 2008 tax return for each child. To qualify for the credit, you must have a child who (1) is under 17 years of age; (2) is your child, descendent, stepson or stepdaughter, or foster child; and (3) is claimed by you as a dependent on your tax return. The child care credit is phased out for high-income taxpayers. 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 13 (or a disabled dependent) so that you can work. Worksheets accompanying the instructions for Form 1040, line 52, will help you compute the amount of your credit.

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

An additional child tax credit is available for individuals who get less than the full amount of the child tax credit because their tax is too low. The additional child tax credit (which is figured on Form 8812) may result in a refund even if the person does not owe any tax.

Key Point. The child care credit is refundable to the extent of 15% of a taxpayer's earned income in excess of \$8,500 (for 2008). See Form 8812, and line 66 of Form 1040.

Line 54. Other credits

This line is used to report miscellaneous credits. These include the alternative motor vehicle credit. If you placed an alternative motor vehicle (such as a qualified hybrid vehicle) in service during 2008, you may be entitled to a credit. See Form 8910 for additional information.

Step 9: Other taxes

Now that you have subtracted credits from your federal income tax, you are required to figure other taxes you may owe.

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

Key Point. Ministers must pay self-employment (SECA) taxes on compensation received from the exercise of their ministry unless the IRS has approved their application for exemption from Social Security. See Part 2 of this guide for more information about ministers and Social Security. Ministers are self-employed for Social Security purposes with respect to their ministerial income. They compute their self-employment (SECA) taxes on Schedule SE and report the total tax on line 57 of Form 1040. Remember, ministers can deduct half of their actual self-employment taxes as an adjustment on line 27 of Form 1040.

Tip. If your application for exemption from self-employment taxes as a minister was approved by the IRS, and your only self-employment income was from ministerial services, write "Exempt — Form 4361" on line 57. If you had other self-employment income, see Schedule SE (Form 1040).

Step 10: Payments

Line 62. Federal income tax withheld

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 on Form W-4 will have income taxes withheld and reported in Box 2 of their Form W-2. These ministers must still complete Schedule SE.

Line 63. 2008 Estimated tax payments

Compensation paid to ministers for ministerial duties is not subject to income tax or Social Security (FICA) withholding. As a result, ministers must prepay their income tax and self-employment (SECA) taxes by using the estimated tax procedure, unless they have entered into a voluntary withholding agreement with their employing church. The estimated tax procedure is summarized in Part 2 of this guide. The total amount of estimated tax payments made to the IRS is reported as a payment of taxes on line 63. Include any overpayment from your 2007 return that you applied to your 2008 estimated tax.

Line 64a. Earned income credit (EIC)


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, or two or more qualifying children; and (2) the amount of your earned income and modified adjusted gross income. For 2008, the credit can be as much as \$438 if you do not have a qualifying child, \$2,917 if you have one qualifying child, or \$4,824 if you have more than one qualifying child. A qualifying child is a child who: (1) is your son, daughter, adopted child, grandchild, stepchild, or foster child; (2) was (at the end of 2008) under age 19, under age 24 and a student or any age and permanently and totally disabled; and (3) lived with you in the United States for more than half of 2008 (all of 2008 if a foster child).

You are not eligible for the credit if your earned income is more than:

- \$12,880 (\$15,880 if married filing jointly) if you do not have a qualifying child.
- \$33,995 (\$36,995 if married filing jointly) if you have one qualifying child.
- \$38,646 (\$41,646 if married filing jointly) if you have more than one qualifying child.

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, lines 64a and 64b. 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. 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 advisor for help.

Line 66. Additional child tax credit: attach Form 8812

This credit is for certain people who have at least one qualifying child as defined in the Form 1040 instructions for line 52 (child tax credit). This additional credit may give you a refund even if you do not owe any tax. If you meet the condition in the TIP at the end of the Child Tax Credit Worksheet, then use Form 8812 to see if you can take the additional child tax credit.

Step 11: Refund or amount you owe

After totaling your payments, you can calculate whether you owe tax or if you are due a refund. If you owe tax, make your check payable to the United States Treasury. Do not attach the payment to your return. The IRS recommends you fill out Form 1040-V to process your payment more efficiently. Include your daytime phone number, your Social Security number, and write Form 1040 for 2008 on the check. You also may have to pay an underpayment penalty. See line 76 of Form 1040. If you have overpaid your taxes, you have two options: (1) request a refund; or (2) apply the overpayment to your 2009 estimated tax. See lines 73a and 74.

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. Ministers should enter “minister.”

Step 13: Assemble your return


Assemble any schedules and forms behind Form 1040 in order of the “Attachment Sequence No.” shown in the upper right corner of the schedule or form. If you have supporting statements, arrange them in the same order as the schedules or forms they support and attach them last. Do not attach correspondence or other items unless required to do so. Attach a copy of Form W-2 to the front of Form 1040. Also attach Form(s) 1099-R to the front of Form 1040 if tax was withheld.

Step 14: Label and general information

Attach the name and address label that you received in the mail from the IRS at the top of your Form 1040. Make address changes or other corrections directly on the label. Make sure you report your Social Security number and that of your spouse if you are filing jointly. It is not necessary to write in the beginning and ending dates of your tax year if you are on a Jan. 1 through Dec. 31 (calendar) tax year as most taxpayers are.

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 of Form 1040. This section summarizes 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. Do not count any reimbursements you received for those expenses. Reimbursements include amounts from insurance or other sources, including Medicare. It does not matter if the reimbursement is paid to the patient, the doctor or the hospital.

Generally, you may deduct the following expenses, but see IRS Publication 502 for details and limitations.

- Fees for medical services, hospital services and special medical equipment.
- Some medical and dental insurance premiums that you pay.
- Qualified long-term care services.
- False teeth, artificial limbs, eyeglasses, contact lenses, hearing aids, crutches, etc.
- Transportation for necessary medical care. The standard mileage rate for computing deductible medical expenses was 19 cents per mile for the first half of 2008 and 27 cents per mile for the remainder of 2008. The 2009 rate is 24 cents per mile for medical purposes.
- Prescription medication or insulin.
- Nursing care, but not custodial care.
- The cost of home improvements if the main reason is for medical care.
- Voluntary Medicare A premiums you elect to pay, but only if you are exempt from Social Security (SECA).
- Part B Medicare premiums.
- Weight-loss programs to treat a specific disease (including obesity) diagnosed by a doctor.
- Surgery to improve defective vision, such as laser eye surgery or radial keratotomy.
- Programs to stop smoking and for prescription medications to alleviate nicotine withdrawal.
- Exercise expenses (including the cost of equipment to use in the home) if required to treat an illness (including obesity) diagnosed by a physician, and the purpose of the expense is to treat a disease rather than to promote general

health and the taxpayer would not have paid the expense but for this purpose.

The following items are not deductible as medical expenses:

- Funeral, burial or cremation costs.
- Health club dues.
- Household help.
- Life insurance.
- Cost of diet food.
- Unnecessary cosmetic surgery.
- Medicare A premiums you pay (unless you are exempt from Social Security and voluntarily elect to pay Medicare A premiums).
- Non-prescription medicines and drugs (including nicotine gum and certain nicotine patches).
- Nursing care for a healthy baby.
- Trips for general improvement of health.
- Insurance premiums paid with pre-tax dollars under a flexible benefit plan.

Step 2: Taxes you paid (lines 5–9)

Generally, real estate, state and local income, and personal property taxes actually paid during the tax year are deductible. Ministers who own their homes and pay real estate 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, Social Security, Medicare, gasoline taxes, car inspection fees and license fees are not deductible for federal income tax purposes. You may only deduct personal property tax you paid that is based on value alone and is charged on a yearly basis.

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. Generally, you can use either your actual expenses or the Optional State Sales Tax Tables (in IRS Publication 600) to figure your state and local general sales tax deduction. See the Instructions for Schedule A for details.

\$ Tip. While the sales tax deduction will mainly benefit taxpayers with a state or local sales tax but no income tax (Alaska, Florida, Nevada, New Hampshire, South Dakota, Tennessee, Texas, Washington and Wyoming), it may give a larger deduction to any taxpayer who paid more in sales taxes than income taxes. For example, a person who purchased a new car in 2008 may have sales taxes in excess of state income taxes.

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 (i.e., interest on a car loan, credit card or 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. However, if the total amount of all mortgages is more than the fair market value of the home, additional limits apply. See IRS Publication 936.

- Mortgages you took out on your main home on or before Oct. 13, 1987.
- Mortgages you took out on your main home after Oct. 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 2008 (\$500,000 if single or married filing separately).
- Mortgages you took out on your main home after Oct. 13, 1987, other than to buy, build or improve your home, but only if these mortgages total \$100,000 or less throughout 2008 (\$50,000 if single or 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.
- Ministers who own their homes can deduct mortgage interest payments as an itemized deduction even though these payments were included in computing the minister's housing allowance exclusion. However, the deduction is limited by some rules discussed below.

The term "points" is sometimes used to describe certain charges paid by a borrower. They are also called loan origination fees, maximum loan charges, loan discount or discount points. 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, you may choose to deduct the points 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. The funds you provided at or before closing, plus any points the seller paid, were at least as much as the points charged.
7. You use your loan to buy or build your main home.
8. The points were computed as a percentage of the principal amount of the mortgage.
9. The amount is clearly shown on the settlement statement as points charged for the mortgage.


Generally, you must deduct the points paid to refinance a mortgage over the life of the loan. If you used part of the proceeds to improve your main home, you may be able to deduct the part of the points related to the improvement in the year paid. See IRS Publication 936 for details.

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

Contributions of cash or property to churches, schools and most other public charities are deductible up to a certain limit. If you do not itemize deductions, you cannot deduct any charitable contributions. Generally, contributions are deductible only to the extent they exceed the value of any premium or benefit received by the donor in return for the contribution.

Cash contributions are reported on line 16. Cash contributions include those made by cash, check, credit card or payroll deduction. Contributions of noncash property are reported on line 17.

Charitable contributions must be deducted 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.

 **Key Point.** Contributions must be properly substantiated before they can be deducted. IRS Publications 526 and 1771 explain the rules about substantiating contributions of cash, property or unreimbursed expenses incurred while performing services on behalf of a church or charity. Charitable substantiation rules are also discussed in the special section of this guide, *Important federal requirements for churches*.

All cash contributions, regardless of amount, must 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.

Contributions of \$250 or more must be substantiated by a written acknowledgment provided by the charity. The written

acknowledgment must include certain information to meet IRS requirements. The taxpayer must receive the written acknowledgment before the earlier of the date he or she files a tax return claiming the contribution deduction, or the due date (including extensions) for the tax return for that year.

The value of donated noncash property determines how taxpayers report and substantiate their contributions. For details about determining the value of donated property, see IRS Publication 561.

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 noncash 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.

Failure to comply with substantiation rules may result in denial of a deduction. 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. There was no dispute about the value of the property, but he failed to attach a qualified appraisal summary (Form 8283) to his tax return on which he claimed the deduction. Additional rules apply to charitable donations of vehicles. See the IRS instructions for Form 1098-C for additional information.

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 2008 and 2009.

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 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 deductible, even if they are used for religious or charitable purposes.

Publication 526 discusses limits on charitable contributions. 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.

Step 5: Casualty and theft losses (line 20)

Many taxpayers suffer property damage 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 other 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. In addition, each individual loss must be reduced by \$100, and your total losses are then reduced by 10% of your adjusted gross income.

In order 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. IRS Publication 529 discusses the types of expenses that may and may not be deducted. 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 the following:

- Unreimbursed and non-accountable reimbursed employee business expenses (discussed more fully later).
- Professional society dues.

- Safety deposit box rental.
- Employee educational expenses.
- Tax counsel and assistance.
- Expenses of looking for a new job.
- Investment counsel fees.
- Professional books and periodicals.
- Investment expenses.
- 50% of unreimbursed business meals and entertainment.
- IRA custodial fees.


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. The following charts summarize options for business use of a car.

You must fill in and attach Form 2106 if either:

1. You claim any travel, transportation, meal or entertainment expenses for your job.
2. Your employer paid you for any of your job expenses reportable on line 21. (Does not pertain to reimbursements under an accountable reimbursement plan.)

Some miscellaneous expenses reported on line 28 are not subject to the 2% floor, but they ordinarily are not available to ministers.

Employee business expenses

 **Key Point.** 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.

Local transportation expenses

Expenses of driving your car for business purposes within your community are one of the most important business expenses for ministers. Commuting to and from work is never a business expense. However, if you drive to a hospital to visit a church member (or to 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.

Transportation expenses can be deducted using either a standard mileage rate or the actual costs of operating the car for business miles.

The standard mileage rate for business miles was 50.5 cents per mile for business miles driven during the first half of 2008 and 58.5 during the last half of 2008. The standard business mileage rate for 2009 is 55 cents per mile for business miles driven.

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 in IRS Publication 463.

Business use of a car owned by a minister

A comparison of the major tax options if the church does not maintain an accountable reimbursement plan

Method	Characteristics	Tax Consequences
Actual Expenses	<p>Minister computes actual expenses of operating car for business use.</p> <p>Actual expenses include gas, oil, tires, repairs, tune-ups, batteries, washes, insurance, depreciation, interest on car loans, taxes, licenses, garage rent, parking fees, tolls.</p> <p>Annual depreciation deduction is limited by "luxury car" rules.</p>	<p>Ministers can deduct expenses allocable to the business use of their car, and not reimbursed under an accountable plan, as an itemized deduction on Schedule A (for employees) or as a Schedule C deduction (for self-employed).</p> <p>Deduction allowable only if records substantiate the amount, date, place and business purpose of each expense.</p> <p>Deduction allowable only if records substantiate the business use of the car.</p> <p>In many cases, a larger deduction will be available than with the standard mileage rate — but, the trade-off is that the record-keeping requirements are much more complex.</p>
Standard Mileage Rate	<p>Multiply current IRS standard mileage rate times the number of miles driven for business use.</p> <p>Must be used in first year a car is used for business purposes.</p>	<p>Ministers can deduct expenses allocable to the business use of the car, and not reimbursed under an accountable plan, as an itemized deduction on Schedule A (for employees) or a Schedule C deduction (for self-employed).</p> <p>Ministers must maintain records documenting the business nature of their business miles. Can still deduct parking fees and tolls.</p> <p>Most ministers use this method because of its simplicity.</p>

Business use of a car owned by a church

A comparison of the major tax options if the church does not maintain an accountable reimbursement plan

Method	Characteristics	Tax Consequences
Church-owned vehicle; no personal use permitted.	<p>Church owns vehicle.</p> <p>Vehicle kept on church premises.</p> <p>Written church policy prohibits personal use (including commuting).</p> <p>Minister using car does not live on church premises.</p> <p>Church reasonably believes the vehicle is not used for any personal use.</p>	No income to report (since no personal use allowed).
Church-owned vehicle; no personal use allowed except for commuting (for security or other noncompensatory reasons).	<p>Church owns vehicle.</p> <p>For noncompensatory reasons (such as vehicle security) the church requires the minister to commute.</p> <p>Written church policy prohibits personal use (except commuting).</p>	No income to report (since no personal use allowed).
Church-owned vehicle; no restrictions as to personal use.	None.	<p>Personal use must be valued and reported as income on the minister's Form W-2.</p> <p>Use the general valuation method unless the church has elected one of the three special valuation rules.</p>

Travel expenses

Travel expenses are the expenses that you incur while traveling away from home overnight for your work or business. Examples include 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:

- Air, rail and bus fares.
- Operating and maintaining your car.
- Taxi fares or other costs of transportation between the airport or station and your hotel, or from one work site to another.
- Meals and lodging while you are away from home on business.
- Cleaning and laundry expenses.
- Telephone and facsimile expenses.
- 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. Consider the following examples:

 **Example.** A Baptist church sends messengers to annual convention meetings where they are entitled to vote. Pastor G is an ordained minister who attends an annual convention meeting in another city. Pastor G's church selected his wife as a messenger to accompany him as an official representative of the church. Pastor G's spouse attends all business meetings and exercises her voting privileges. The church does not reimburse the travel expenses of Pastor G's spouse. Pastor G's spouse can deduct her travel expenses as a charitable contribution. This conclusion is supported by the following language in the current edition of IRS Publication 526,

Charitable Contributions: “If you are a chosen representative attending a convention of a qualified organization, you can deduct unreimbursed expenses for travel and transportation, including a reasonable amount for meals and lodging, while away from home overnight in connection with the convention.”

✍ **Example.** Same facts as the previous example except that the church does not select Pastor G’s wife to attend the meeting as a messenger. The church board authorizes the reimbursement of the spouse’s travel expenses based on its belief that the presence of a pastor’s spouse at the meeting is both expected and necessary. The church’s reimbursement of the spouse’s expenses is taxable income and should be added to Pastor G’s Form W-2. IRS Publication 526 states: “You cannot deduct your expenses in attending a church convention if you go only as a member of your church rather than as a chosen representative.”

Entertainment expenses

You may be able to deduct entertainment expenses you incur for your ministry, but 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. In order 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.

✍ **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.

The IRS especially scrutinizes entertainment expenses incurred in your home. 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, then 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 for food for his guests ordinarily will constitute entertainment expenses.

✍ **Example.** Pastor S invites a friend and fellow minister to his home for dinner. The friend lives in another state and is visiting Pastor S for the day. Ordinarily, this 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. Pastor K’s spouse accompanies her husband because the other spouse is present. Pastor K pays for everyone’s meal. The cost of all four meals is a deductible entertainment expense.

Educational expenses

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

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

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

 **Example.** 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. Ministers' 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 as sources for sermon illustrations. The cost of a general circulation daily newspaper is not deductible.

The unreimbursed cost of books related to your ministry is a professional business expense and is deductible.

Personal computers

Many ministers use personal computers at home, but they may not be able to deduct the purchase cost. 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 deduction:

- Your use of the computer in your home must be "for the convenience of your employer."

- Your use of the computer in your home is "required as a condition of your employment."

"For the convenience of your employer" means that you must 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. Also, 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, but 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 then 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) if it costs less than \$250,000 for 2008. The amount of the deduction 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. 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.

Office in the home

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

- The costs must not have already been excluded as minister's housing allowance.
- The home office must be your principal place of business.
- The home office must be used exclusively 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.
- 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 and preparing for church meetings. Occasional or incidental use of the office for these purposes is not enough, even if the office is used for no other purposes.
- 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 your job easier or efficient — it must be essential to the performance of your job.

Very few ministers will satisfy all of these conditions. Therefore 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 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.

How to report employee business expenses

This section addresses how ministers who are employees for income tax purposes report business expenses when completing their tax returns. Ministers who are self-employed for income tax purposes will find information about their business expenses addressed in the instructions for Schedule C.

How churches handle their ministers' business expenses affects if and how ministers can deduct those expenses on Schedule A. See Part 2 of this guide for more information about accountable reimbursement plans.

Unreimbursed expenses

First, churches may decide not to reimburse their ministers for ministry-related expenses. Ministers who report their income taxes as an employee can deduct unreimbursed business expenses on Schedule A only if they have enough deductions to itemize and only to the extent their expenses exceed

2% of their adjusted gross income. IRS audit guidelines for ministers instruct agents to apply the “Deason Allocation Rule.” This rule requires ministers to reduce their business expenses by the percentage of their total compensation that consists of a tax-exempt housing allowance.

Reimbursed expenses under a non-accountable plan

A church has a non-accountable plan if it reimburses ministers or other employees for business expenses without requiring adequate substantiation of the amount, date, place and business purpose of the expenses, or does not require excess reimbursements to be returned to the church. For example, many churches pay ministers 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.

The full amount of a church's reimbursements or allowances under a non-accountable plan must be reported as income on Form W-2. The minister can deduct actual expenses only as a miscellaneous itemized deduction on Schedule A and only to the extent these expenses exceed 2% of adjusted gross income. For ministers who cannot itemize expenses on Schedule A (most cannot), a non-accountable plan is the worst way to handle business expenses. All of the allowances and reimbursements paid by the church must be reported as additional taxable income to the minister, but the minister cannot claim any offsetting deductions because he does not use Schedule A. Ministers also must apply the Deason Allocation Rule. This rule requires ministers to reduce their business expenses by the percentage of their total compensation that consists of a tax-exempt housing allowance.

Reimbursed expenses under an accountable plan

Key Point. Limitations on the deductibility of unreimbursed and non-accountable reimbursed employee business expenses can be avoided if the church adopts an accountable reimbursement plan.

The best way for ministers to handle their business expenses is to have their employing church adopt an accountable reimbursement plan. A church should adopt an accountable reimbursement plan in a resolution. Plans that follow these rules should comply with IRS requirements:

1. Reimbursements are made only with adequate substantiation. Written evidence is required for all expenses, and receipts are required for expenses of \$75 or more.
2. The evidence must substantiate the amount, date, place and business nature of each expense. A church must require the same degree of substantiation as would be required for a deduction on the minister's income tax return.

3. Expenses must be substantiated and excess reimbursements must be returned to the church within a “reasonable period of time.” The IRS views 60 days as a reasonable period of time for substantiating expenses and 120 days as a reasonable period for returning excess reimbursements.

Reimbursements of business expenses under accountable arrangements are not reported as taxable income on the minister’s Form W-2 and there are no deductions to claim. In effect, the minister reports to the church rather than to the IRS.

Example. Pastor R is senior minister at his church. He reports his federal income taxes as an employee, and the church reimburses him for all of his business and professional expenses. However, Pastor R is not required to account for these 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 tells the treasurer the total expenses he incurred at the end of each month. Assume that Pastor R cannot itemize deductions on Schedule A because he does not have sufficient deductions. If Pastor R received reimbursements of \$4,000 in 2008: (1) the church would report the entire reimbursements (\$4,000) as income on Pastor R’s Form 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. 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, for a total penalty of \$9,000, and (2) church board members who approved the arrangement, up to a maximum penalty of \$20,000 collectively.

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.

Key Point. Business expense reimbursements cannot be funded under an accountable plan out of a minister’s own salary, in other words through “salary reductions.”

Churches occasionally reimburse ministers for non-business expenses. 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 even if the church requires the minister to document the expenses.

Key Point. IRS audit guidelines for ministers instruct agents to apply the so-called Deason Allocation Rule. This rule requires ministers to reduce their business expenses claimed on Schedule A or C by the percentage of their total compensation that consists of a tax-exempt housing allowance. This reduction in business expenses does not apply to the computation of self-employment (SECA) taxes since the housing allowance is not deductible in computing these taxes.

Schedule B

Use Schedule B if you have over \$1,500 of taxable interest or \$1,500 of ordinary dividends or if any of the special rules listed in the Schedule B instructions apply to you.

Part 1: Interest income (lines 1–4)

List on line 1 the name of each institution or individual that paid you taxable interest. Be sure the interest you report on line 1 corresponds to every Form 1099-INT, Form 1099-OID and substitute statement you received. Do not list tax-exempt interest unless you receive a Form 1099-INT.

Part 2: Dividend income (lines 5–6)

List on line 5 the name of each institution that paid you ordinary dividends. The dividends you report on line 5 should correspond to the amount shown in Box 1a of any Form 1099-DIV or substitute statement you received. If any capital gain distributions were reported on your Form 1099-DIV, see the instructions to Form 1040, line 13.

Part 3: Foreign accounts and foreign trusts (lines 7–8)

You must complete this part of Schedule B if you had more than \$1,500 of either taxable interest or dividends.

Schedule C

Most ministers who serve local churches or church agencies are employees for federal income tax purposes with respect to their church salary. They should receive a Form W-2 from their church or church agency and report the appropriate amount on line 7 of Form 1040. They should not report their salary as self-employment earnings on Schedule C. However, they should use Schedule C to report income and business expenses from ministerial activities they conduct other than in their capacity as a church employee. Examples include fees received for guest speaking appearances at other churches and fees received directly from church members for performing personal services, such as weddings and funerals.

A few ministers are self-employed for federal income tax purposes, such as traveling evangelists who have not incorporated their ministry. They use Schedule C to report their self-employment income and business expenses.

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 are employed by churches but erroneously report their church compensation as if they were self-employed for income tax purposes) point to this code as proof that ministers serving local churches do not have to report as employees for federal income tax purposes. This is not so.

Step 2: Income (lines 1–7)

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

Step 3: Expenses (lines 8–27)

Report any business expenses associated with your self-employment earnings on lines 8 through 27. Only 50% of business meals and entertainment is deductible.

▲ **Warning.** Many ministers continue to report their income taxes as self-employed when they in fact are employees for income tax purposes. They think that using Schedule C to report business expenses saves them money, but this often is not the case. Most ministers are employees for income tax reporting purposes under the tests currently used by the IRS. If the IRS audits a minister who claims to be self-employed and reclassifies that person as an employee for income tax purposes, Schedule C deductions would be disallowed. This could result in substantial additional taxes, penalties and interest, especially if the minister is not able to use

Schedule A. In addition, a minister who reports church income as self-employed is taxed on the value of some benefits, including employer-paid medical insurance.

✎ **Example.** Pastor M reports his income taxes as a self-employed person. He has \$4,000 of business expenses in 2008 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 (only about 30% of all taxpayers are able to do so). The IRS later audits pastor M, and he is reclassified as an employee. He will not be able to deduct any of the \$4,000 of business expenses since an employee can deduct them only as an itemized deduction on Schedule A. Pastor M will have to pay additional taxes, interest and possibly penalties.

Schedule C-EZ

Schedule C-EZ is a simpler form than Schedule C. Many ministers who report their church compensation as employees can use Schedule C-EZ 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 (e.g., weddings and funerals). You can use it instead of Schedule C if you meet all of the following requirements:

- You had business expenses associated with your trade or business of \$5,000 or less in 2008.
- You use the cash rather than the accrual method of accounting.
- You did not have an inventory at any time during the year.
- You did not have a net loss from your trade or business.
- You had only one business as a sole proprietor.
- You had no employees.
- You are not required to file Form 4562 (the depreciation schedule).
- You do not claim a deduction for the business use of your home.
- You do not have prior year unallowed passive activity losses from this business.

Schedule SE

✎ **Key Point.** Use Schedule SE to report self-employment (SECA) 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 (except for some chaplains). They pay self-employment (SECA) taxes, 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 (Form 4361) do not pay any self-employment (SECA) taxes on compensation received for their ministerial services. They do not use Schedule SE unless they have other income subject to self-employment (SECA) tax. The IRS instructs them to write “Exempt — Form 4361” on line 57 of Form 1040.

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 two 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.
 - Fair rental value of parsonage, or nontaxable portion of minister’s housing allowance (unless you are a retired minister).
 - Business expense reimbursements made under a non-accountable plan.
2. Next, subtract the following from the above total.
 - Unreimbursed business expenses (disregard the Deason Rule).
 - Eligible business expenses previously reimbursed under a non-accountable plan (disregard the Deason Rule).
 - Most income tax exclusions other than the minister’s 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 subject to self-employment taxes for Social Security purposes) can reduce their taxable earnings by 7.65%. This reduction represents the 7.65% an employer pays in Social Security and Medicare taxes for employees subject to FICA. To complete this line, multiply net earnings times 0.9235. The remaining amount is subject to self-employment (SECA) taxes.

Step 3: Section A, line 5

The self-employment (SECA) tax for 2008 is computed on this line. The self-employment tax rate for 2008 is 15.3% and consists of two components: (1) A Medicare hospital insurance tax of 2.9%, and (2) an old-age, survivor and disability (Social Security) tax of 12.4%. The 2.9% Medicare tax applies to all net

earnings from self-employment regardless of the amount. The 12.4% Social Security tax applies to only the first \$102,000 of net self-employment earnings in 2008 (\$106,800 for 2009).

Step 4: Section A, line 6

Multiply line 5 by 50% and enter amount on Form 1040, line 27.

Form 2106

Key Point. Use Form 2106 to compute your employee business expenses claimed on Schedule A. You cannot deduct expenses for travel (including meals, unless you used the standard meal allowance), entertainment or gifts unless you keep records to prove the time, place, business purpose, business relationship (for entertainment and gifts) and amounts of these expenses. Generally, you must also have receipts for all lodging expenses (regardless of the amount) and any other expenses of \$75 or more.

Step 1: Enter your expenses

On lines 1 through 6, you report your employee business expenses. For many ministers, the most significant employee business expense is the business use of a car. This expense is computed on Part II (page 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. The standard mileage rate for business miles was 50.5 cents per mile for business miles driven during the first half of 2008 and 58.5 cents per mile driven during the last half of 2008. The standard business mileage rate for 2009 is 55 cents per mile for business miles driven.

Compute your vehicle expenses using the standard mileage rate in Section B of Part II (line 22). 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 the first year you begin using your car for business purposes. Ministers using the actual expense method compute their car expenses in Sections C and D of Part II.

On line 3, report your travel expenses incurred while away from home overnight on business. This includes 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, meals and entertainment. This includes 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 church reimbursed some or all of your business expenses, report the amount of these reimbursements on line 7 if they were not reported as income by your employer in Box 1 of your Form W-2. This would include any amount reported under code L in Box 12 of your Form W-2 (substantiated car expense reimbursements up to the IRS-allowed standard mileage rate).

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

On lines 8 through 10, you compute the amount of your business expense deduction to be claimed on Schedule A. The deduction will be limited to the amount that exceeds 2% of your adjusted gross income. Apply the Deason Allocation Rule discussed earlier.

Form 2106-EZ

Employees can use a simplified Form 2106-EZ to compute their business expense deductions for 2008 if their employer did not reimburse business expenses and if the employee uses the standard mileage rate for computing automobile expenses.