PART 3 *Step-by-Step Tax Return Preparation*

TAX FORMS AND SCHEDULES

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

Form 1040 is the basic document you will use. It summarizes all of your tax information. Details are reported on supplementary schedules and forms. Note that the IRS has unveiled a new and redesigned *Form 1040* that reflects the many tax law changes made by the TCJA. The new *Form 1040* — about half the size of the current version — replaces the current *Form 1040* as well as the *Form 1040A* and the *Form 1040EZ*. The new *Form 1040* is different from its predecessors in several ways, including the following:

1. It is half the size of the previous *Form 1040* and consists of two half-pages.
2. Health care coverage (mandatory through 2018) is reported by checking a box on page 1 (it was reported on line 61 on the 2017 form).
3. All personal exemptions were repealed after 2017, and so there is no way to claim them on the 2018 *Form 1040*.
4. Some lines have been consolidated. For example, several items of income, capital gains, rental income, etc., are consolidated now from *Schedule 1* and reported on line 6.
5. Wages are now reported on line 1 (instead of line 7 as in past years).
6. AGI is reported on line 7 and without detail on the form (instead of line 37 as in past years).
7. The standard deduction is reported on line 8 and is significantly larger than in 2017 ($12,000 for unmarried persons and $24,000 for married persons filing jointly).
8. Several credits are now reported on *Schedule 3* and consolidated on line 12b (they were reported on separate lines in 2017).
9. Many lines in the previous *Form 1040* have been deleted and transferred to various schedules. In fact, the 79 lines on the 2017 *Form 1040* have been reduced to 23, a reduction of more than 50 lines. For example:
    - Business income is reported on *Schedule C* as in prior years but is then posted to *Schedule 1 (Form 1040)* rather than line 12 as in prior years.
    - Adjustments to income, reported on lines 23–36 of the 2017 *Form 1040*, are now reported on lines 23–36 of *Schedule 1 (Form 1040)*.
    - *Schedule 2 (Form 1040)* lists taxes that were reported on lines 45–47 in the 2017 *Form 1040*.
    - *Schedule 3 (Form 1040)* lists "non-refundable credits", including credits for child and dependent care expenses and education credits, that were reported on lines 48–55 in the 2017 *Form 1040*.
    - *Schedule 4 (Form 1040)* lists "other taxes", including SECA, that were reported on lines 57–63 in the 2017 *Form 1040*.
    - *Schedule 5 (Form 1040)* lists "other payments", including SECA, that were reported on lines 65–73 in the 2017 *Form 1040*.

☞ **Key Point:** Some references in this guide are to lines in the new *Form 1040*, but others refer to lines in the new schedules. Be sure you distinguish between these terms to avoid confusion.

▲ **Caution:** The IRS has announced that there may be additional changes to the 2018 *Form 1040* before it is finalized.

Schedule A is for itemized deductions for medical and dental expenses, taxes, interest, certain disaster-related casualty losses, and charitable contributions.

✓ **New in 2018:** Beginning with tax year 2018, no miscellaneous itemized deductions that formerly were subject to a 2 percent of AGI limitation are allowed. This and other changes to *Schedule A* are addressed later in this guide.

Schedule B is for reporting dividend and interest income.

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

Schedule SE is for reporting SECA due on your self-employment income. Ministers use this schedule since they are deemed self-employed for Social Security with respect to ministerial services (unless they have obtained an approved *Form 4361* from the IRS).

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

Form 1040

Step 1: Filing Status

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

In 2015, the United States Supreme Court ruled that the right of same-sex couples to marry is part of the Fourteenth Amendment's guarantees of due process and equal protection of the laws, and therefore any state law that in any way limits this right is unconstitutional and void (*Obergefell v. Hodges, 135 S. Ct. 2584 (2015)*). The effect of the Supreme Court's decision was to invalidate laws and constitutional provisions in 13 states defining marriage solely as a union between one man and one woman and to treat same-sex marriages the same as opposite-sex marriages for purposes of federal tax law.

Step 2: Name and Address

Print or type the information in the spaces provided. If you are married filing a separate return, enter your spouse's name and Social Security number on the appropriate line(s) below your name. If you filed a joint return for 2017 and you are filing a joint return for 2018 with the same spouse, be sure to enter your names and Social Security numbers in the same order as on your 2017 return.

If you plan to move after filing your return, use *Form 8822* to notify the IRS of your new address.

If you (or your spouse) changed your name because of marriage, divorce, etc., be sure to report the change to the SSA before filing your return. This prevents delays in processing your return and issuing refunds. It also safeguards your future Social Security benefits. If a name change with the SSA has not been completed, the name on file with the SSA must be used in filing your tax return.

Enter your P.O. Box number only if your post office does not deliver mail to your home.

If you want $3 to go to the presidential election campaign fund, check the box labeled "you". If you are filing a joint return, your spouse can also have $3 go to the fund (check "spouse"). If you check a box, your tax or refund will not change.

Step 3: Dependents

In the past, taxpayers were allowed a personal exemption for themselves and certain dependents. All personal exemptions were repealed after 2017, and so they cannot be claimed on the 2018 *Form 1040*. However, it is still necessary to determine who qualifies as dependents and include them on the return. Dependents determine various credits, such as the child tax credit, as well as other tax-related items such as educational credits, medical expenses, child care credit, and EIC, just to name a few.

Step 4: Income

Several items of income are reported on lines 1 through 6 (including amounts carried over from *Schedule 1* lines 10–22). The most important of these (for ministers) are discussed below.

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

Line 1. Wages, salaries, tips, etc.

As an employee, you should receive a *Form W-2* from your church reporting your wages at the end of each year. Report this amount on line 1.

Determining church wages or salary. Besides a salary, ministers' wages reported on *Form W-2* may include several other items. Some items are:

- Bonuses
- The cost of sending a minister to the Holy Land (if paid by a church)
- Most Christmas and special occasion offerings
- Retirement gifts paid by a church
- The portion of a minister's SECA paid by a church
- Personal use of a church-owned vehicle
- Purchases of church property for less than fair market value
- Business expense reimbursements under a non-accountable plan
- Imputed cost of group term life insurance coverage (including death benefits under the benefits plan) exceeding $50,000 and cost of coverage of spouse and dependents if over $2,000 and paid by a church
- Church reimbursements of 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 established by a church for a minister to spend on current needs — if the minister is allowed to distribute funds for his personal benefit
- Imputed interest from below-market interest loans of at least $10,000 made by a church to a minister (some exceptions apply)
- Cancellation of a minister's debt to a church
- Severance pay
- Payment of a minister's personal expenses by a church
- Love gifts

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

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

If some of these items were not reported on your *Form W-2*, they still must be reported as income. Your church should issue a corrected *Form W-2* (*Form W-2c*) for the year in which one or more items of taxable income was not reported on your *Form W-2*. If you receive a *Form W-2c* and have filed an income tax return for the year shown, you may have to file an amended return. Compare amounts on *Form W-2c* with those reported on your income tax return. If the corrected amounts change your U.S. income tax, file *Form 1040X Amended U.S. Individual Income Tax Return* with *Copy B* of *Form W-2c* to amend the return you previously filed.

In addition to what is reported on *Form W-2* (or *Form W-2c*), line 1 of *Form 1040* will also report the amount of excess housing allowance calculated (the amount by which the housing allowance exceeds the lesser of the minister's housing expenses or the fair rental value of the minister's home (furnished, plus utilities)).

Items not reported on line 1. Some kinds of income are not taxable. These items are called **exclusions.** Most exclusions apply in computing both income taxes and SECA. The housing allowance is an example of an exclusion that applies only to income taxes and not to SECA. Some of the more common exclusions for ministers include:

Gifts. Gifts, as defined by the *Internal Revenue Code* and the courts, are excludable from taxable income so long as they are not compensation for services. However, employers are not permitted to give tax-free gifts to employees. Likewise, the IRS and the courts have ruled that gifts ministers receive directly from members of their congregations may not always be excluded from taxable income. Before excluding gifts from taxable income, the minister should consult with a CPA or a tax attorney.

Life insurance and inheritances. Life insurance proceeds and inheritances are excludable from taxable income. Income earned before distributions of proceeds is generally taxable as income.

Employer-provided group term life insurance. Employees may exclude the cost of employer-provided group term life insurance so long as the amount of coverage does not exceed $50,000.

Tuition reductions. School employees may exclude from their taxable income a qualified tuition reduction provided by their employer. A qualified tuition reduction is a reduction in tuition charged to employees or their spouses or dependent children by an employer that is an educational institution.

Lodging. The value of lodging furnished to a minister, i.e., a parsonage, is excluded from income. This exclusion is not available in the computation of SECA. The value of lodging furnished to a non-minister employee on an employer's premises and for the employer's convenience may be excludable from taxable income if the employee is required to accept the lodging as a condition of employment.

Educational assistance. Amounts paid by an employer for an employee's tuition, fees, and books may be excludable from the employee's taxable income if the church has adopted a written educational assistance plan. The exclusion may not exceed $5,250 per year.

Employer-provided childcare. The value of free childcare services provided by a church to its employees is excluded from employees' income so long as the benefit is based on a written plan that does not discriminate in favor of highly compensated employees. Other conditions apply.

Nondiscrimination rules. Many of the exclusions are not available to employees who are either highly compensated employees or key employees if the same benefit is not available on a nondiscriminatory basis to lower-paid employees.

For 2019, a highly compensated employee is an employee whose compensation for the previous year was in excess of $125,000.

☞ **Key Point:** Some exclusions are available only to taxpayers who report their income taxes as employees and not as self-employed persons. Many, however, apply to both employees and self-employed persons.

Four other exclusions are explained below — the housing allowance, tax-sheltered annuities, qualified scholarships, and sale of a home.

Housing Allowance

☞ **Key Point:** The housing allowance is being challenged in a federal lawsuit as an unconstitutional preference for religion. The current status of this case is summarized in a special section at the beginning of this tax guide.

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

A church cannot designate a housing allowance retroactively.

Some churches fail to designate housing allowances prospectively and thereby deprive ministers of an important tax benefit.

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

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

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

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

The rental value of a parsonage and a housing allowance are exclusions only for federal income tax reporting purposes. Ministers cannot exclude a housing allowance or the fair rental value of a parsonage when computing SECA **unless they are retired.** The tax code specifies that SECA does not apply to "the rental value of any parsonage or any parsonage allowance provided after the [minister] retires."

Ministers should check their state income tax rules to determine the housing allowance rules for state income taxes.

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

Housing Expenses to Include in Computing Your Housing Allowance Exclusion

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

- Down payment on a home (but note that a housing allowance is non-taxable only to the extent that it does not exceed the lesser of the amount designated by the church, the actual housing expenses, or the fair rental value of the minister's home (furnished, plus utilities))
- Mortgage payments on a loan to purchase or improve the minister's home (include both interest and principal)

- Rent
- Real estate taxes
- Property insurance
- Utilities (electricity, gas, water, trash pickup, landline telephone charges)
- Furnishings and appliances (purchase and repair)
- Structural repairs and remodeling
- Yard maintenance and improvements
- Maintenance items (pest control, etc.)
- Homeowners association dues

☞ **Key Point:** In 2007, the Tax Court characterized internet expenses as utility expenses. This suggests that a housing allowance may be used to pay for internet expenses (e.g., internet access, cable television). Neither the IRS nor the Tax Court has addressed this issue directly, so be sure to check with a tax professional about the application of a housing allowance to these expenses.

Please note the following:

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

✍ **Example:** A church designated $25,000 of Pastor D's 2018 compensation as a housing allowance. Pastor D's housing expenses for 2018 were utilities of $4,000, mortgage payments of $18,000, property taxes of $4,000, insurance payments of $1,000, repairs of $1,000, and furnishings of $1,000. The fair rental value of the home (furnished) is $19,000. Pastor D's housing allowance is non-taxable in computing income taxes only to the extent that it is used to pay housing expenses and does not exceed the fair rental value of his home (furnished, plus utilities). Stated differently, the non-taxable portion of a housing allowance is the least of the following three amounts: (1) the housing allowance designated by the church; (2) actual housing expenses; or (3) the fair rental value of the home (furnished, plus utilities). In this case, the lowest of these three amounts is the fair rental value of the home (furnished, plus utilities) ($23,000), and so this represents the non-taxable portion of Pastor D's housing allowance. Pastor D must report the difference between this amount and the housing allowance designated by his church ($2,000) as additional income on line 1 of *Form 1040*.

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

✍ **Example:** Pastor Y owns a home and incurred housing expenses of $12,000 in 2018. These expenses include mortgage principal and interest, property taxes, utilities, insurance, and repairs. The church designated (in advance) $12,000 of Pastor Y's 2018 compensation as a housing allowance. Pastor Y is able to itemize expenses on *Schedule A (Form 1040)*. He is able to claim itemized deductions on *Schedule A* for both his mortgage interest and his property taxes (up to $10,000), even though his taxable income was already reduced by these items because of their inclusion in the housing allowance. This is often referred to as the double deduction. In fact, it represents an exclusion and a deduction.

✍ **Example:** In preparing his income tax return for 2018, Pastor H discovers that his church failed to designate a housing allowance for him for 2018. He asks his church to pass a resolution retroactively granting the allowance for 2018. Such a resolution is ineffective, and Pastor H will not be eligible for any housing allowance exclusion in 2018.

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

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

How much should a church designate as a housing allowance?

The IRS has stated that there are no limitations on how much of a minister's compensation can be designated by his employing church as a housing allowance. However, as noted above, this means little, since the non-taxable portion of a church-designated housing allowance for ministers who own or rent their homes cannot exceed the lesser of (1) actual housing expenses or (2) the fair rental value of the home (furnished, plus utilities).

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

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

Churches sometimes neglect to designate a housing allowance in advance of a new calendar year. For example, a church board may discover in March 2019 that it failed to designate a housing allowance for its pastor for 2019. It is not too late to act. The church should immediately designate a portion of its minister's remaining compensation for 2019 as a housing allowance. This problem can be avoided by stipulating in each annual housing allowance designation that the allowance is for the current year **and all future years unless otherwise provided.** If such a resolution had been adopted in the December 2017 board meeting (i.e., "for 2018 and future years") it would not matter that the church neglected to designate a minister's 2019 allowance until March 2019, since the previous designation would have carried over. Such safety net designations are not a substitute for annual housing allowance designations (they have never been addressed or endorsed by the IRS or Tax Court). Rather, they provide a basis for claiming a housing allowance if a church neglects to designate one.

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

☞ **Key Point:** The IRS has ruled that a retired minister is eligible for a housing allowance exclusion if the following conditions are satisfied: (1) A portion of the retired minister's pension income is designated as a housing allowance by his church or the church pension board of a denominational pension fund; (2) the retired minister has severed his relationship with the local church and relies on the fund for a pension; and (3) the pensions paid to retired ministers "compensate them for past services to the local churches of the denomination or to the denomination." Retired ministers who receive benefits from a denominational pension fund will be eligible in most cases to have some or all of their benefits designated in advance as a housing allowance. This is an attractive benefit for retired ministers that is not available with some other kinds of retirement plans. Retired ministers also can exclude from their gross income the rental value of a home (plus utilities) furnished to them by their church as a part of their pay for past services. A minister's surviving spouse cannot exclude a housing allowance or rental value of a parsonage unless the allowance or parsonage is for ministerial services performed.

SECA does not apply to the rental value of a parsonage or a housing allowance provided after a minister retires.

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

Section 403(b) Plans

Payments made by your church and your salary reduction contributions to a 403(b) plan are not reportable income for income tax or SECA purposes as long as the total amount credited to your retirement account does not exceed contribution limits under sections 415(c) and 402(g) of the tax code.

Contribution Limits

For 2018, total annual additions (employer, salary reduction, and tax-paid contributions) could not exceed the lesser of 100 percent of your compensation (excluding a minister's housing allowance) or $55,000. This rule is known as the section 415(c) limit. Excess contributions can result in income tax, additional taxes, and penalties. The effect of excess contributions depends on the type of excess contribution. The distributed excess amount may not be rolled over to another 403(b) plan or to an IRA.

✓ **New in 2019:** The limit on annual additions is $56,000 for 2019.

Minister's Housing Allowance and Contribution Limits

For 2018, the section 415(c) limit restricts 403(b) contributions to the lesser of 100 percent of compensation or $55,000. For 2019, this amount is $56,000. Does the term "compensation" include a minister's housing allowance? This is an important question for ministers, since the answer will determine how much can be contributed to a 403(b) plan. If the housing allowance is treated as compensation, then ministers will be able to contribute larger amounts. The tax code specifies that the term "compensation", for purposes of applying the section 415(c) limit to a 403(b)(3) plan, "means the participant's includible compensation determined under section 403(b)(3)." Section 403(b)(3) defines "compensation" to include "the amount of compensation which is received from the employer . . . and which is includible in gross income." Section 107 of the tax code specifies that a minister's housing allowance (or the annual rental value of a parsonage) is not included in the minister's gross income for income tax reporting purposes. Therefore, it would appear that the definition of "compensation", for purposes of computing the section 415(c) limit, would not include the portion of a minister's housing allowance that is excludable from gross income or the annual rental value of a parsonage. For many years the IRS website included the following question and answer addressing this issue:

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

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

☞ **Key Point:** Churches that include the housing allowance as compensation when calculating the amount of the church's contribution to 403(b) plans must perform an additional calculation to ensure the total contributions to the plan do not exceed the maximum contribution allowed under section 415(c).

Taxation of Distributions from a 403(b) Plan

Amounts you contribute through salary reduction, and the earnings attributable to these contributions, generally cannot be withdrawn before you reach age 59½, separate from service, die, or become disabled. In some cases of financial hardship, you may withdraw your own salary reduction contributions (but not the earnings on them) prior to the occurrence of any of the above events. A 403(b) plan may make hardship distributions only if permitted by the plan.

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

- The distributions are part of a series of substantially equal periodic payments made over your life or the lives of your beneficiaries and after you separate from service.

- The distributions are made after you separate from service in or after the year in which you reach age 55.
- The distributions do not exceed the amount of unreimbursed medical expenses that you could deduct for the current year.
- The distributions are made after your death or after you become disabled.
- The distributions are made to an alternate payee pursuant to a qualified domestic relations order.

The additional tax is computed on *Form 5329*.

☞ **Key Point:** You must receive all, or at least a certain minimum, of your interest accruing after 1986 in a 403(b) plan by April 1 of the calendar year following the later of the calendar year in which you become age 70½ or the calendar year in which you retire. This required minimum is called your required minimum distribution (RMD).

Salary Reduction Contributions (Section 402(g))

In addition to the section 415(c) limit, there is an annual limit on elective deferrals. The limit applies to the total of all elective deferrals contributed (even if contributed by different employers) for the year on your behalf to a variety of retirement plans, including 403(b) plans. Generally, you cannot defer more than an allowable amount each year for all plans covering you. For 2018 the allowable limit was $18,500. If you defer more than the allowable amount for a tax year, you must include the excess in your taxable income for that year.

✓ **New in 2019:** The dollar limit on annual elective deferrals increases to $19,000.

☞ **Key Point:** Church employees can make a special election that allows their employer to contribute up to $10,000 for the year, even if this is more than 100 percent of your compensation. The total contributions over your lifetime under this election cannot be more than $40,000.

The limit on elective deferrals increases for individuals who have attained age 50 by the end of the year. The additional amount that may be made is the lesser of (1) the applicable dollar amount or (2) the participant's compensation for the year reduced by any other elective deferrals of the participant for the year. The applicable dollar amount is $6,000 for 2018 and 2019. Catch-up contributions are not subject to any other contribution limits and are not taken into account in applying other contribution limits.

Qualified Scholarships

☞ **Key Point:** Qualified scholarships are excludable from taxable income.

Amounts received as a qualified scholarship by a candidate for a degree may be excluded from gross income. A qualified scholarship is any grant amount that, in accordance with the conditions of the grant, is used for tuition and course-related expenses. Qualified tuition and related expenses are those used for (1) tuition and fees required for the enrollment or attendance at an educational institution or (2) fees, books, supplies, and equipment required for courses of instruction at the educational institution. The scholarship need not specify that it is to be used only for qualified tuition and related expenses. All that is required is that the recipient uses the scholarship for such expenses and that the scholarship does not specify that it is to be used for non-qualified expenses (such as room and board). In addition to these requirements, the scholarship must meet the additional requirements if the recipient is an employee or a family member of an employee. Generally, the scholarship must be non-compensatory in nature and selected using non-employment-related criteria, and an independent committee must make the selection of the recipient. Additional requirements may also apply. The church should seek the advice of a CPA or tax attorney to determine the proper treatment of scholarships to employees and their children.

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

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

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

✍ **Example:** First Baptist Church establishes a scholarship fund for seminary students. Robert is a church member pursuing a master's degree at a seminary. The church votes to award him a scholarship of $2,500 for 2019. So long as Robert uses the scholarship award for tuition or other course-related expenses, he need not report it as income on his federal tax return. The better practice would be for the church to stipulate that the scholarship is to be used for tuition or other course-related expenses (for example, fees, books, supplies) or for the church to pay the expenses directly to the educational institution. This will ensure that the scholarship does not inadvertently become taxable income because its specific use was not designated and the recipient used it for non-qualified expenses. As long as amounts are paid through a qualified scholarship plan, the church is not required to report the scholarship on *Form 1099-MISC* to the recipient.

Sale or Exchange of Your Principal Residence

A taxpayer who is an individual may exclude up to $250,000 ($500,000 if married filing a joint return) of gain realized on the sale or exchange of a principal residence. To be eligible for the exclusion, the taxpayer must have owned and used the residence as a principal residence for at least two of the five years ending on the date of the sale or exchange. A taxpayer who fails to meet this requirement by reason of a change of place of employment, health, or (to the extent provided under regulations) unforeseen circumstances is able to exclude an amount equal to the fraction of the $250,000 ($500,000 if married filing a joint return) that is equal to the fraction of the two years that the ownership and use requirements are met. The exclusion under this provision may not be claimed for more than one sale or exchange during any two-year period unless the special provisions for unforeseen circumstances apply.

Line 2. Interest income: attach Schedule B if more than $1,500

Complete this line only if you had interest income. Tax-exempt interest income is reported on line 2a with taxable interest income reported on line 2b. If you had taxable interest income of more than $1,500, complete *Schedule B*.

Line 3. Dividend income: attach Schedule B if more than $1,500

Complete this line only if you had dividend income. If you had dividend income of more than $1,500, complete *Schedule B.*

Lines 4a and 4b. IRA, pension, and annuity income

You should receive a *Form 1099-R* showing the total amount of your pension and annuity payments before income tax or other deductions were withheld. This amount should be shown in Box 1 of *Form 1099-R*. Pension and annuity payments include distributions from 401(k) and 403(b) plans. Do not include the following payments; instead report them on line 1:

- Disability pensions received before you reach the minimum retirement age set by your employer.
- Corrective distributions (including any earnings) of excess salary deferrals or excess contributions to retirement plans. The plan must advise you of the year(s) the distributions are includible in income.

Many denominational pension funds annually designate 100 percent of pension and disability benefits paid to retired ministers as a housing allowance. In such cases the *Form 1099-R* may show that the taxable amount of the pension income is "not determined" if you check the box on line 2b. If you are a retired or disabled minister, you may exclude all or a portion of your pension or disability income from your gross income reported on line 4 of *Form 1040* if (1) you can document that the monies were actually spent on housing-related expenses during the tax year; (2) the amount excluded does not exceed the fair rental value of the home (furnished, plus utilities); and (3) the applicable pension board designated the retirement payments as housing allowance.

IRS *Publication 517* states: "If you are a retired minister, you can exclude from your gross income the rental value of a home (plus utilities) furnished to you by your church as a part of your pay for past services, or the part of your pension that was designated as a rental allowance. However, a minister's surviving spouse cannot exclude the rental value unless the rental value is for ministerial services performed."

☞ **Key Point:** A surviving spouse of a deceased minister cannot exclude any portion of the benefits received from their deceased spouse's 403(b) account as a housing allowance.

Line 5. 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 in 2018, you need to know whether or not these benefits are taxable. Here are several rules the IRS has formulated to assist Social Security beneficiaries in knowing if their benefits are taxable:

1. You should receive a *Form SSA-1099* showing in Box 3 the total Social Security benefits paid to you. Box 4 will show the amount of any benefits you repaid in 2018. If you received railroad retirement benefits treated as Social Security, you should receive a *Form RRB-1099*. Use the Social Security Benefits Worksheet in these instructions to see if any of your benefits are taxable.
2. How much, if any, of your Social Security benefits are taxable depends on your total income and marital status.

3. Generally, if Social Security benefits were your only income for 2018, your benefits are not taxable, and you probably do not need to file a federal income tax return.
4. If you received income from other sources, your benefits will not be taxed unless your modified AGI is more than the base amount for your filing status.
5. Your taxable benefits and modified AGI are computed on a worksheet in the instructions to *Form 1040*.
6. You can do the following quick computation to determine whether some of your benefits may be taxable:

   First, add one-half of the total Social Security benefits you received to all your other income, including any tax-exempt interest and other exclusions from income.

   Then, compare this total to the base amount for your filing status. If the total is more than your base amount, some of your benefits may be taxable.

   The 2018 base amounts are:

   - $32,000 for married couples filing jointly
   - $25,000 for single, head of household, qualifying widow/widower with a dependent child, or married individuals filing separately who did not live with their spouses at any time during the year
   - $0 for married persons filing separately who lived together during the year

For additional information on the taxability of Social Security benefits, see IRS *Publication 915 Social Security and Equivalent Railroad Retirement Benefits*. *Publication 915* is available at *IRS.gov*.

Line 6. Total income

Report total income on this line. This is the sum of the amounts reported on lines 1–5 of *Form 1040*, plus the additional categories of income reported on lines 10–22 of *Schedule 1 (Form 1040)*. The most important of these for ministers include:

1. **Line 12 (*Schedule 1*). Business income**

   Report self-employment earnings (from *Schedule C* or *Schedule C-EZ*). Self-employment earnings include:

   - Compensation reported to you on a *Form 1099-MISC*
   - Fees received directly from church members for performing personal services (such as weddings 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 of *Schedule 1 (Form 1040)* and then to line 6 (*Form 1040*).

2. **Line 13 (*Schedule 1*). Capital gains**

   Also report on line 13 capital gains or losses (attach *Schedule D*) from the sale of capital assets. These include stocks, bonds, and property. Gain or loss is reported on *Schedule D*. You also may have to file *Form 8949* (see the instructions to both forms for details). This amount, along with the other amounts reported on *Schedule 1 (Form 1040)*, is carried over to line 6 (*Form 1040*).

3. **Line 21 (*Schedule 1*). "Other income"**

   "Other income" is reported on line 21 of *Schedule 1 (Form 1040)* and carried over to line 6 (*Form 1040*). Other income includes the following items:

   - A canceled debt or a debt paid for you by another person (unless the person who canceled or paid your debt intended it to be a gift)
   - 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*)
   - Most prizes and awards
   - Some taxable distributions from a Health Savings Account (HSA) or Archer MSA (see IRS *Publication 969*)
   - Jury duty pay
   - Taxable benefits provided by the church but not included on *Form W-2* or *Form W-2c*. (Also remember to include these benefits on *Schedule SE* for the calculation of SECA.)

Step 5: Adjustments to Income

Line 7. Adjusted gross income

You may deduct certain adjustments from total income (line 6) to compute your AGI. Report the adjustments on lines 23 through 36 of *Schedule 1 (Form 1040)*. The total amount is subtracted from line 6 to compute AGI that is reported on line 7.

If you have no adjustments to income, enter the amount from line 6 on this line.

The two most relevant adjustments for ministers are the deduction for one-half of SECA and payments to an IRA. Both are summarized below.

Schedule 1 (Form 1040) line 27. One-half of self-employment tax

☞ **Key Point:** Every minister who pays SECA on ministerial income qualifies for this deduction. Some are not claiming it.

All ministers are self-employed for Social Security with respect to their ministerial income. They can deduct half of their actual SECA as an adjustment on line 27 of *Schedule 1 (Form 1040)*, whether or not they are able to itemize deductions on *Schedule A*.

Schedule 1 (Form 1040) line 32. Payments to an Individual Retirement Account (IRA)

An individual retirement arrangement, or IRA, is a personal savings plan which allows you to set aside money for retirement while offering you tax advantages. You can set up different kinds of IRAs with a variety of organizations, such as a bank or other financial institution, a mutual fund, or a life insurance company.

The original IRA is referred to as a **Traditional IRA.** A Traditional IRA is any IRA that is not a Roth IRA or a SIMPLE IRA. You may be able to deduct some or all of your contributions to a Traditional IRA. You may also be eligible for a tax credit equal to a percentage of your contribution. Amounts in your Traditional IRA, including earnings, generally are not taxed until distributed to you. IRAs cannot be owned jointly. However, any amounts remaining in your IRA upon your death can be paid to your beneficiary or beneficiaries.

To contribute to a Traditional IRA, you must be under age 70½ at the end of the tax year. You, or your spouse if you file a joint return, must have taxable compensation, such as wages, salaries, commissions, tips, bonuses, or net income from self-employment. Compensation does not include earnings and profits from property, such as rental income, interest and dividend income, or any amount received as pension or annuity income or as deferred compensation.

For 2018, if you file a joint return and your taxable compensation is less than that of your spouse, the most that can be contributed for the year to your IRA is the smaller of the following two amounts: (1) $5,500 ($6,500 if you are age 50 or older) or (2) the total compensation includible in the gross income of both you and your spouse for the year, reduced by your spouse's IRA contribution for the year to a Traditional IRA and any contributions for the year to a Roth IRA on behalf of your spouse.

✓ **New in 2019:** The maximum annual dollar contribution limit for IRA contributions increases to $6,000 for 2019. Also, the additional catch-up contribution limit for an individual who has attained age 50 before the end of the taxable year remains at $1,000.

All IRA contributions must be made by the due date of your tax return, not including extensions. This means that your 2018 IRA contribution must be made by April 15, 2019, even if you obtain an extension for filing this return.

Your allowable deduction may be reduced or eliminated, depending on your filing status, the amount of your income, and if you or your spouse are covered by an employer-provided retirement plan. The deduction begins to decrease (phase out) when your income rises above a certain amount and is eliminated altogether when it reaches a higher amount. The amounts vary depending on your filing status. If you were covered by an employer-provided retirement plan, then the deduction for contributions to your IRA are completely phased out when AGI reaches $121,000 (married filing jointly) or $73,000 (single). (For 2019, the limits are $123,000 (married filing jointly) and $74,000 (single).) If your spouse was covered by an employer-provided retirement plan at any time during 2018 and you made contributions to your IRA, your allowable IRA deduction is completely phased out when AGI reaches $199,000 (married filing jointly). (For 2019, the limit is $203,000 (married filing jointly).) See IRS *Publication 590*.

The *Form W-2* you receive from your church or other employer has a box used to show whether you were covered by a retirement plan during the year. The "Retirement Plan" box should have a mark in it if you were covered. Employer retirement plans include 403(b) tax-sheltered annuities.

Figure your deduction using the worksheets in the instructions to *Form 1040* or in *Publication 590*.

Individuals who cannot claim a deduction for an IRA contribution still can make non-deductible IRA contributions, subject to the lesser of $5,500 for 2018 (and $6,000 for 2019) or earned income limits. Earnings on these amounts continue to accumulate on a tax-deferred basis. When distributions are made from the IRA, special rules apply in figuring the tax on the distributions when both deductible and non-deductible contributions were made to the IRA. *Form 8606* is used to designate a contribution as non-deductible and must be filed, or the full amount of future withdrawals may be taxed. Withdrawals before age 59½ are subject to a 10 percent penalty tax that also applies to deductible IRA contributions.

Distributions from a Traditional IRA are fully or partially taxable in the year of distribution. Use *Form 8606* to figure the taxable portion of withdrawals. If you made only deductible contributions, distributions are fully taxable.

Distributions made prior to age 59½ may be subject to a 10 percent additional tax. You also may owe an excise tax if you do not begin to withdraw minimum distributions by April 1 of the year after you reach age 70½.

A **Roth IRA** differs from a Traditional IRA in several respects. A Roth IRA does not permit a deduction at the time of contribution. Regardless of your age, you may be able to establish and make non-deductible contributions to a Roth IRA. However, you may be limited in the amount of non-deductible contributions you may make to your Roth IRA due to your AGI. For those filing as married filing jointly, no contribution may be made to a Roth IRA if your AGI, as modified, is $199,000 or above ($203,000 for 2019). For those filing as single, no contribution may be made to a Roth IRA if your AGI, as modified, is $135,000 or above ($137,000 for 2019).

You do not report Roth contributions on your tax return. To be a Roth IRA, the account or annuity must be designated as a Roth IRA when it is set up. Like a Traditional IRA, a Roth IRA can be set up, but there are limitations on the amount that can be contributed and the time of year that contributions can be made. You do not include in your gross income qualified distributions or distributions that are a return of your regular contributions from your Roth IRA. Refer to *Publication 590* for additional information on Roth IRAs.

For information on conversions from a Traditional IRA to a Roth IRA, refer to *Publication 590*. No further contributions to a Traditional IRA are permissible in the year you reach age 70½ or for any later year, and distributions from a Traditional IRA must generally begin by April 1 of the year following the year in which you reach age 70½. However, you must receive at least a minimum amount for each year starting with the year you reach age 70½ (your "70½ year"). If you do not (or did not) receive that minimum amount in your 70½ year, then you must receive distributions for your 70½ year by April 1 of the next year. This means that you will have two required distributions in that year.

Even if you receive a distribution from your IRA before age 59½, you may not have to pay the 10 percent penalty if the distributions are not more than your qualified education expenses or you use the distributions to buy, build, or rebuild a first home. See IRS *Publication 590-B* for an explanation of exceptions to the age 59½ rule.

Charitable contributions. An IRA owner, age 70½ or over, can directly transfer, tax-free, up to $100,000 per year to an eligible charity. Distributions from employer-sponsored retirement plans, including SIMPLE IRA plans and simplified employee pension (SEP) plans, are not eligible. To qualify, the funds must be transferred directly by the IRA custodian to the eligible charity. Distributed amounts may be excluded from the IRA owner's income, resulting in lower taxable income for the IRA owner. However, if the IRA owner excludes the distribution from income, no deduction, such as a charitable contribution deduction on *Schedule A*, may be taken for the distributed amount.

To report a qualified charitable distribution on your *Form 1040* tax return, you generally report the full amount of the charitable distribution on the line for IRA distributions (line 4a, *Form 1040*). On the line for the taxable amount (line 4b, *Form 1040*), enter zero if the full amount was a qualified charitable distribution. Enter "QCD" next to this line. See the *Form 1040* instructions for additional information.

Not all charities are eligible. For example, donor-advised funds and supporting organizations are not eligible recipients.

Amounts transferred to a charity from an IRA are counted in determining whether the owner has met the IRA's RMD.

✍ **Example:** A church has a senior pastor who is 52 years old and a youth pastor who is 30 years old. The church does not participate in a retirement program for its staff. In 2019, the senior pastor can contribute $7,000 to an IRA (maximum annual contribution of $6,000 plus a catch-up contribution of $1,000), and the youth pastor can contribute $6,000.

Step 6: Tax Computation

Line 8. Itemized deduction or standard deduction

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

On line 8 you enter either your itemized deductions from *Schedule A* or a standard deduction amount. Itemized deductions are discussed under *Schedule A* in this guide. For 2018, the standard deduction amounts are as follows:

Filing Status	Standard Deduction Amount
Single	$12,000
Married filing jointly or qualifying widow(er)	$24,000
Married filing separately	$12,000
Head of household	$18,000

Line 9. Qualified business income deduction

Ministers who have income and expenses from business activities (conducted other than in their capacity as an employee of the church) and report their income on *Schedule C* may be entitled to a federal tax deduction of up to 20 percent of their qualified business income (QBI). This deduction is also referred to as the IRC section 199A deduction. Upon publication of this guide, it has been interpreted that the qualified business trade or business activities of a self-employed minister may be considered a "specified service trade or business". Thus, there may be an exception to the deductibility of the QBI deduction. If a minister's AGI (reported on line 7 of *Form 1040*) exceeds $157,500

($315,000 if married filing jointly), then the deduction may be limited; if AGI exceeds $207,500 ($415,000 if married filing jointly), then the QBI deduction is unavailable. See *Publication 535* for additional information.

Line 11. Compute tax

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

Step 7: Credits

A credit is a direct dollar-for-dollar reduction in your tax liability. It is much more valuable than deductions and exclusions, which merely reduce taxable income. On your 2017 *Form 1040*, tax credits were reported on lines 48–55. On your 2018 *Form 1040*, these (non-refundable) credits are reported on lines 48–55 of *Schedule 3*, and the total amount for all credits is carried over to line 12b of *Form 1040* (and check the box next to line 12b). The more common and important credits for ministers are the child tax credit, the credit for child and dependent care expenses, and the retirement savings credit. Each of these is addressed below.

Line 12a. Child tax credit

The TCJA temporarily increases the child tax credit to $2,000 per qualifying child. The credit is further modified to temporarily provide for a $500 non-refundable credit for qualifying dependents other than qualifying children (such as aging parents). The provision generally retains the present-law definition of "dependent".

☞ **Key Point:** The child tax credit is doubled, from $1,000 to $2,000 per qualifying child, beginning in 2018, and a new credit of $500 is established for non-child dependents, such as an aging parent.

However, the maximum amount refundable may not exceed $1,400 per qualifying child (calculated and reported on lines 17b and 17 on *Form 1040* from *Schedule 8812*). Additionally, in order to receive the child tax credit (i.e., both the refundable and non-refundable portions) a taxpayer must include a Social Security number for each qualifying child for whom the credit is claimed on the tax return. For these purposes, a Social Security number must be issued before the due date for the filing of the return for the taxable year. This requirement does not apply to a non-child dependent for whom the $500 non-refundable credit is claimed.

Further, the TCJA retains the present-law age limit for a qualifying child. As a result, a qualifying child is an individual who has not attained age 17 during the taxable year. The law also modifies the AGI phaseout thresholds. The credit begins to phase out for taxpayers with AGI in excess of $400,000 (for married taxpayers filing a joint return) and $200,000 (for all other taxpayers). These phaseout thresholds are not indexed for inflation.

These new provisions are effective for taxable years beginning after December 31, 2017, and expire for taxable years beginning after December 31, 2025, unless extended by Congress.

Line 12b Schedule 3 (Form 1040) line 49. Credit for child and dependent care expenses: attach Form 2441

Complete this line if you are eligible for a credit for child or dependent care expenses. See the instructions to *Form 1040* line 12b, for details and conditions. Please check the box next to line 12b. See IRS *Publication 972* for additional information.

Line 12b Schedule 3 (Form 1040) line 51. Retirement savings contributions credit (Saver's Credit)

If you make eligible contributions to certain eligible retirement plans or to an IRA, you may be able to take a tax credit. The amount of the Saver's Credit you can get is generally based on the contributions you make and your credit rate. Refer to *Publication 590* or the instructions for *Form 8880* for more information. If you are eligible for the credit, your credit rate can be as low as 10 percent or as high as 50 percent, depending on your AGI. The lower your income, the higher the credit rate; your credit rate also depends on your filing status. These two factors will determine the maximum credit you may be allowed to take. You are not eligible for the credit if your AGI exceeds a certain amount.

The credit is available with respect to elective deferrals to a 401(k) plan, a 403(b) annuity, a SIMPLE IRA, or a SEP; contributions to a Traditional or Roth IRA; and voluntary after-tax employee contributions to a 403(b) annuity or qualified retirement plan. The amount of the credit for 2018 is described in the following table:

Adjusted Gross Income			
Joint Returns	Heads of Household	Single Filers	Amount of Credit
$1–38,000	$1–28,500	$1–19,000	50% of eligible contributions up to $2,000 ($1,000 maximum credit)
$38,001–41,000	$28,501–30,750	$19,001–20,500	20% of eligible contributions up to $2,000 ($400 maximum credit)
$41,001–63,000	$30,751–47,250	$20,501–31,500	10% of eligible contributions up to $2,000 ($200 maximum credit)
over $63,000	over $47,250	over $31,500	0%

For married couples filing jointly, each spouse is eligible for the credit. Enter credit from *Schedule 3* on *Form 1040* line 12b; remember to check the box next to line 12b. For more information about this credit, see IRS *Form 8880* and *Publication 590*.

Step 8: Other Taxes

On the *Form 1040* for 2017, other taxes were reported on lines 57–63. On the 2018 *Form 1040*, other taxes are reported on lines 57–63 of *Schedule 4*, and the total of all taxes is carried over to line 14 of *Form 1040*.

Line 14. Other taxes

Report the following additional taxes on this line:

- **Self-employment tax**

Ministers are self-employed for Social Security with respect to their ministerial income. They compute their SECA on *Schedule SE* and report the tax on line 57 of *Schedule 4 (Form 1040)*. They report this and other taxes on line 14 of *Form 1040*.

- **Individual responsibility payment**

For 2018, you must either:

- Check the "Full-year health care coverage or exempt" box on the front of *Form 1040* to indicate that you, your spouse (if filing jointly), and anyone you can or do claim as a dependent had qualifying health care coverage or a coverage exemption that covered all of 2018 — or a combination of qualifying health care coverage and coverage exemption(s) for every month of 2018; or
- Make a shared responsibility payment if, for any month in 2018, you, your spouse (if filing jointly), or anyone you can or do claim as a dependent didn't have coverage and doesn't qualify for a coverage exemption. If you can claim any part-year exemptions or exemptions for specific members of your household, use *Form 8965*. This will reduce the amount of your shared responsibility payment. For more information, see the *Form 8965* instructions. This payment is reported on line 61 of *Schedule 4 (Form 1040)* and carried over to line 14 of *Form 1040*.

Step 9: Payments

On the *Form 1040* for 2017, payments were reported on lines 64–73. On the 2018 *Form 1040*, amounts representing federal income tax withholding are reported on line 16 of *Form 1040*, and other taxes are reported on lines 66–74 of *Schedule 5 (Form 1040)*. The total of these payments is carried over to line 17 of *Form 1040*. The two most important categories of tax payments are withheld taxes and estimated tax payments, as noted below.

Line 16. Federal income tax withheld

Ministers' wages based on the performance of ministerial services are exempt from federal income tax withholding. As a result, only those ministers who have entered into a voluntary withholding arrangement with their church will have income taxes withheld. The church should report the amount of voluntarily withheld taxes on the minister's *Form W-2*.

☞ **Key Point:** Ministers who enter into voluntary withholding arrangements will have federal and state income taxes withheld from their wages. However, a church does not withhold the employee's share of FICA, since ministers are self-employed for Social Security with respect to ministerial compensation. Ministers can request (on *Form W-4* or through other written instructions) that their church withhold an additional amount of income taxes to cover their SECA liability. These additional withholdings must be treated as income taxes withheld (on *Forms W-2* and *941*) rather than the employee's share of FICA. They constitute a credit that can be applied to both income taxes and SECA. Ministers still must complete *Schedule SE* to report their SECA liability.

Line 17 Schedule 5 (Form 1040) line 66. 2018 estimated tax payments

Compensation paid to ministers for ministerial duties is not subject to mandatory tax withholding. As a result, ministers must prepay their income tax and SECA using the quarterly estimated tax procedure, unless they have entered into a voluntary withholding agreement with their employing church. The estimated tax procedure is summarized in Part 2 of this guide in the section "How do ministers pay their taxes?" The total amount of estimated tax payments made to the IRS is reported as a payment of taxes on line 66 of *Schedule 5 (Form 1040)* and carried over with the other kinds of payments listed on *Schedule 5* to line 17 of *Form 1040*.

Line 17a. Earned income credit

The EIC 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 EIC do not claim it because it is so difficult to compute. In most cases, the amount of your EIC depends on (1) whether you have no qualifying child, one qualifying child, two qualifying children, or three or more qualifying children and (2) the amount of your earned income and modified AGI.

You may be able to claim the EIC for 2018 if (1) you do not have a qualifying child and you earned less than $15,270

($20,950 if married filing jointly); (2) a qualifying child lived with you and you earned less than $40,320 ($46,010 if married filing jointly); (3) two qualifying children lived with you and you earned less than $45,802 ($51,492 if married filing jointly); or (4) three or more qualifying children lived with you and you earned less than $49,194 ($54,884 if married filing jointly). The maximum EIC for 2018 is (1) $519 with no qualifying child; (2) $3,461 with one qualifying child; (3) $5,716 with two qualifying children; and (4) $6,431 with three or more qualifying children.

You can compute the credit yourself or the IRS will compute it for you. To figure the amount of your EIC, you must use the EIC Worksheet and EIC Table in the instructions for *Form 1040* line 17. 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.

The credit is reported on line 17a of *Form 1040*.

IRS *Publication 596* is a 41-page publication that explains the EIC. The 2017 edition (the most recent available at the time of publication of this text) states: "The rental value of a home or a housing allowance provided to a minister as part of the minister's pay generally isn't subject to income tax but is included in net earnings from self-employment. For that reason, it is included in earned income for the EIC" except for ministers who have opted out of SECA by filing a timely *Form 4361* exemption application with the IRS.

Excerpts from *Publication 596* confirm that ministers who are employees for income tax reporting purposes and who have not exempted themselves from SECA by filing a timely *Form 4361* with the IRS include their housing allowance or the fair rental value of a parsonage in computing earned income for purposes of the EIC.

But what about ministers who have exempted themselves from SECA by filing a timely *Form 4361* with the IRS? Do they include a housing allowance or the rental value of a parsonage in computing their earned income for purposes of the EIC? As noted above, *Publication 596* explicitly states, with regard to ministers who have filed *Form 4361*, that "a nontaxable housing allowance or the nontaxable rental value of a home is not earned income."

With respect to ministers who have filed a timely *Form 4361*, *Publication 596* states:

> Whether or not you have an approved *Form 4361*, amounts you received for performing ministerial duties as an employee count as earned income. This includes wages, salaries, tips, and other taxable employee compensation. [But] if you have an approved *Form 4361*, a non-taxable housing allowance or the non-taxable rental value of a home isn't earned income. Also, amounts you received for performing ministerial duties, but not as an employee, don't count as earned income. Examples include fees for performing weddings and honoraria for delivering speeches.

Ministers who are affected by this issue should consult their own tax advisor for help.

Step 10: Refund or Amount You Owe

After totaling your payments, you can calculate whether you owe the government or a refund is due you. If you owe a tax, be certain to enclose with your return a check in the amount you owe payable to the United States Treasury, or make the payment through your EFTPS account. Do not attach the check to your return, but include it with a *Form 1040-V*. If you file your return electronically, the payment may be sent in separately using the *Form 1040-V*. Include your daytime phone number and your Social Security number, and write "*Form 1040* for 2018" on the check. If you owe taxes, you also may have to pay an underpayment penalty (refer to line 23 of *Form 1040*).

If you have overpaid your taxes, you have two options: (1) Request a full refund by entering the requested amount on line 20a (and enter your bank's direct deposit information if desired), or (2) apply the overpayment to your 2019 estimated tax on line 21.

Step 11: Sign Here

You must sign and date the return at the bottom of page 1. If you are filing a joint return, your spouse must also sign the return. In the "your occupation" space, enter your occupation — **minister.** In prior years, the signature portion of the return was on page 2 of the *Form 1040*, but the redesigned form has the signature section on page 1.

OTHER FORMS AND SCHEDULES

Schedule A

☞ **Key Point:** If your itemized deductions exceed your standard deduction, you should report your itemized deductions on *Schedule A (Form 1040)*. This section will summarize the itemized deductions.

Step 1: Medical and Dental Expenses (lines 1–4)

You may deduct certain medical and dental expenses (for you, your spouse, and your dependents) if you itemize your deductions on *Schedule A*, but only to the extent that your expenses exceed 7.5 percent of your AGI. You must reduce your medical expenses by the amounts of any reimbursements you receive for those expenses before applying the 7.5 percent test. Reimbursements include amounts you receive from insurance or other sources for your medical expenses (including Medicare). It does not matter if the reimbursement is paid to the patient, the doctor, or the hospital.

The following items ARE deductible as medical expenses:

- Fees for medical services
- Fees for hospital services
- Meals and lodging at a hospital during medical treatment (subject to some limits)
- Medical and hospital insurance premiums that you pay (do not include amounts paid to health sharing arrangements)
- Special equipment
- Medicare Part A premiums you pay if you are exempt from Social Security and voluntarily elect to pay Medicare Part A premiums
- Medicare Part B premiums you pay
- Medicare Part D premiums you pay
- Medicare Supplement Insurance premiums you pay (or deducted from your pension)
- Long-term care insurance premiums, subject to certain limitations on the amount that may be deducted
- Special items (false teeth, artificial limbs, eyeglasses, hearing aids, crutches, etc.)
- Transportation for necessary medical care. For 2018, the standard mileage rate for medical travel was 18 cents per mile (it increases to 20 cents per mile for 2019).
- Medicines and drugs requiring a prescription, and insulin
- The portion of a life-care fee or founder's fee paid either monthly or in a lump sum under an agreement with a retirement home that is allocable to medical care
- Wages of an attendant who provides medical care
- The cost of home improvements if the main reason is for medical care
- Program to stop smoking
- Exercise expenses (including the cost of equipment to use in the home) if required to treat an illness (including obesity) diagnosed by a physician, the purpose of the expense is to treat a disease rather than to promote general health, and the taxpayer would not have paid the expense but for this purpose

The following items are NOT deductible as medical expenses:

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

Step 2: Taxes You Paid (lines 5–7)

In the past, individuals were permitted a deduction for certain taxes paid or accrued, whether or not incurred in a taxpayer's trade or business. These taxes were:

- State and local real property taxes
- State and local personal property taxes
- State and local income taxes

At the election of the taxpayer, an itemized deduction may be taken for state and local general sales taxes in lieu of the itemized deduction for state and local income taxes. This provision was added to address the unequal treatment of taxpayers in the seven states that do not have an income tax. Taxpayers in these states cannot take advantage of the itemized deduction for state income taxes. Allowing them to deduct sales taxes helps offset this disadvantage.

The TCJA allows taxpayers to claim an itemized deduction of up to $10,000 ($5,000 for married taxpayer filing a separate return) for the aggregate of:

- State and local property taxes
- State and local income taxes (or sales taxes in lieu of income taxes) paid or accrued in the taxable year

The new rules apply to taxable years 2018 through 2025.

Step 3: Interest You Paid (lines 8–10)

As a general rule, personal interest is not deductible. Qualified residence interest is not treated as personal interest and is allowed as an itemized deduction, subject to limitations. Qualified residence interest means interest paid or accrued during the taxable year on either acquisition indebtedness or home equity indebtedness. A qualified residence means the taxpayer's principal residence and one other residence of the taxpayer, selected to be a qualified residence. A qualified residence can be a house, condominium, cooperative, mobile home, house trailer, or boat.

Acquisition indebtedness is indebtedness incurred in acquiring, constructing, or substantially improving a qualified residence of the taxpayer and that secures the residence. The maximum amount treated as acquisition indebtedness is $1 million ($500,000 in the case of a married person filing a separate return). Acquisition indebtedness also includes indebtedness from the refinancing of other acquisition indebtedness but only to the extent of the amount (and term) of the refinanced indebtedness. For example, if the taxpayer incurs $200,000 of acquisition indebtedness to acquire a principal residence and pays down the debt to $150,000, the taxpayer's acquisition indebtedness with respect to the residence cannot thereafter be increased above $150,000 (except by indebtedness incurred to substantially improve the residence).

Home equity indebtedness is indebtedness (other than acquisition indebtedness) secured by a qualified residence. In order for interest related to home equity indebtedness to be considered as qualified residence interest, the proceeds must be used to buy, build, or substantially improve the residence that secures the loan. (Prior law did not restrict the use of the proceeds, but limited the total debt to $100,000.)

The TCJA provides that, in the case of taxable years beginning after December 31, 2017, and beginning before January 1, 2026, a taxpayer may treat no more than $750,000 as qualified residence loans, including acquisition indebtedness and qualifying home equity indebtedness ($375,000 in the case of married taxpayers filing separately). In the case of acquisition indebtedness incurred before December 15, 2017, this limitation is $1,000,000 ($500,000 in the case of married taxpayers filing separately).

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

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

Step 4: Gifts to Charity (lines 11–14)

Cash contributions to churches, schools, and most other public charities, which are U.S. organizations, are deductible up to 60 percent of AGI. Contributions of property are subject to different limitations. See IRS *Publication 526*. Contributions of cash or checks are reported on line 11, while contributions of non-cash property are reported on line 12. If you do not itemize deductions, you cannot deduct any of your charitable contributions.

The value of personal services is never deductible as a charitable contribution, but unreimbursed expenses incurred in performing services on behalf of a church or other charity may be. For example, if you drive to and from volunteer work on behalf of a charity, you may deduct the actual cost of gas and oil or you may claim the standard charitable mileage rate of 14 cents for each substantiated mile (for 2018 and 2019). Unreimbursed travel expenses incurred while away from home (whether within the United States or abroad) in the course of donated services to a tax-exempt religious or charitable organization are deductible as a charitable contribution. There are two ways to do this.

An individual performing the charitable travel can keep track of his or her travel expenses and then claim a charitable contribution for the total on *Schedule A*. (A letter acknowledging the individual's service should be obtained from the charity.) Or, the individual could provide his or her church or charity with a travel report substantiating all travel expenses. In such a case, the church or charity could issue the individual a charitable contribution receipt for the total amount of the substantiated travel expenses. Travel expenses that can be receipted include airfare, lodging, meals, and incidental expenses.

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

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

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

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

There are limits on the amount of a contribution that can be deducted. Generally, cash contributions to churches, schools, and other public charities are deductible up to a maximum of 60 percent of AGI. In some cases, contributions that exceed these limits can be carried over and claimed in future years. Some charitable contributions are limited to 20 percent or 30 percent of AGI, depending on the recipient and the form of the contribution.

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

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

Charitable contributions must be properly substantiated. Individual cash contributions of less than $250 may be substantiated by a canceled check or a receipt from the charity. Special rules govern the substantiation of individual contributions of cash or property of $250 or more. The donor must substantiate these contributions with a qualifying receipt from the charity including a listing of the contributions and a statement that there were no goods or services provided in exchange for the contributions. These rules are further explained in the supplement to this guide entitled *Federal Reporting Requirements for Churches*.

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

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

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

Step 5: Casualty and Theft Losses (line 15)

Under prior law, a taxpayer could claim an itemized deduction for any loss sustained during the taxable year, not compensated by insurance or otherwise. For individual taxpayers, deductible losses had to be incurred in a trade or business or other profit-seeking activity or consist of property losses arising from fire, storm, shipwreck, or other casualty, or from theft. Personal casualty or theft losses were deductible only if they exceeded $100 per casualty or theft. In addition, aggregate net casualty and theft losses were deductible only to the extent they exceeded 10 percent of an individual taxpayer's AGI.

The TCJA temporarily modifies the deduction for personal casualty and theft losses. Taxpayers may claim a personal casualty loss (subject to the limitations described above) only if the loss was attributable to a disaster declared by the president of the United States under the *Disaster Relief and Emergency Assistance Act*.

The above-described limitation is effective for losses incurred in taxable years 2018 through 2025.

NOTE: Job Expenses and Most Other Miscellaneous Deductions

Under prior law, individuals could claim itemized deductions for certain miscellaneous expenses. Certain of these expenses were not deductible unless, in aggregate, they exceeded 2 percent of the taxpayer's AGI. The deductions described below were subject to the aggregate 2 percent floor:

- Appraisal fees for a casualty loss or charitable contribution
- Casualty and theft losses from property used in performing services as an employee
- Clerical help and office rent in caring for investments
- Hobby expenses, but generally not more than hobby income
- Investment fees and expenses

- Safe deposit box rental fees, except for storing jewelry and other personal effects
- Trustee's fees for an IRA, if separately billed and paid
- Tax preparation expenses
- Unreimbursed employee business expenses (see below)
- Job search expenses in the taxpayer's present occupation
- Licenses and regulatory fees
- Passport fees for a business trip
- Tools and supplies used in the taxpayer's work

Unreimbursed employee business expenses subject to the 2 percent AGI floor included such items as:

- Overnight out-of-town travel
- Local transportation
- Meals (subject to a 50 percent AGI floor)
- Entertainment (subject to a 50 percent AGI floor)
- Home office expenses
- Business gifts
- Dues to professional societies
- Work-related education
- Work clothes and uniforms if required and not suitable for everyday use
- Malpractice insurance
- Subscriptions to professional journals and trade magazines related to the taxpayer's work
- Equipment and supplies used in the taxpayer's work

The TCJA suspends all miscellaneous itemized deductions subject to the 2 percent floor under present law. As a result, taxpayers may not claim the above-listed items as itemized deductions for the taxable years to which the suspension applies.

This provision is effective for taxable years 2018 through 2025 unless extended by Congress.

The elimination of an itemized deduction for most expenses, including unreimbursed employee business expenses, will hit some clergy hard. Some have suggested that this impact can be minimized if a church reimburses employee business expenses under an accountable expense reimbursement arrangement. To be accountable, a church's reimbursement arrangement must comply with all four of the following rules:

- Expenses must have a business connection — that is, the reimbursed expenses must represent expenses incurred by an employee while performing services for the employer.
- Employees are reimbursed only for expenses for which they provide an adequate accounting within a reasonable period of time (not more than 60 days after an expense is incurred).
- Employees must return any excess reimbursement or allowance within a reasonable period of time (not more than 120 days after an excess reimbursement is paid).
- The income tax regulations caution that in order for an employer's reimbursement arrangement to be accountable, it must meet a "reimbursement requirement" in addition to the three requirements summarized above. The reimbursement requirement means that an employer's reimbursements of an employee's business expenses come out of the employer's funds and not by reducing the employee's salary.

The basis for this workaround is that while the TCJA eliminated "all miscellaneous itemized deductions that are subject to the 2 percent floor under present law" (including unreimbursed employee business expenses), it did not modify or repeal section 62(a)(2)(A) of the tax code, which excludes from tax employer reimbursements of employee business expenses under an accountable plan (defined above).

Schedule B

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

Step 1: Interest Income (lines 1–4)

List (on line 1) the name of each institution or individual that paid you taxable interest if you received more than $1,500 of taxable interest in 2018. Be sure the interest you report on line 1 corresponds to any *Forms 1099-INT* you received from such institutions. Do not include tax-exempt interest. Interest income is carried over to line 2b of *Form 1040*.

Step 2: Dividend Income (lines 5–6)

List (on line 5) the name of each institution that paid you dividends if you received more than $1,500 in dividends in 2018. Be sure the dividends you report on line 5 correspond to any *Forms 1099-DIV* you received from such institutions. Dividend income is carried over to line 3b of *Form 1040*.

Step 3: Foreign Accounts and Foreign Trusts (lines 7–8)

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

Schedule C

☞ **Key Point:** Most ministers who serve local churches or church agencies are employees for federal income tax purposes with respect to their church salary. They report their church salary on line 1 of *Form 1040* and receive a *Form W-2* from the church. They do not report their salary as self-employment earnings on *Schedule C*.

☞ **Key Point:** Use *Schedule C* to report income and expenses from ministerial activities you conduct other than in your capacity as a church employee. Examples would be fees for guest speaking in other churches and fees received directly from church members for performing personal services, such as weddings and funerals.

➤ **Recommendation:** Some ministers are eligible to use the simpler *Schedule C-EZ*.

Step 1: Introduction

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

Step 2: Income (lines 1–7)

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

Step 3: Expenses (lines 8–27)

▲ **Warning:** Many ministers continue to report their income taxes as self-employed. One perceived advantage of doing so is the ability to deduct business expenses on *Schedule C* (and avoid the non-deductibility of unreimbursed and non-accountable reimbursed employee business expenses as itemized deductions on *Schedule A*). This advantage is often illusory. Most ministers, if audited by the IRS, would be reclassified as employees and their *Schedule C* deductions disallowed. This could result in substantial additional taxes, penalties, and interest. The best way for ministers to handle their business expenses is through an accountable expense reimbursement arrangement as an employee of the church.

Report any business expenses associated with your self-employment earnings on lines 8 through 27. For example, if you incur transportation, travel, or other expenses in the course of performing self-employment activities, you deduct these expenses on lines 8 through 27 of *Schedule C*. Self-employed persons can deduct only 50 percent of business meals and meals associated with entertainment.

☞ **Key Point:** The TCJA provides that no deduction is allowed with respect to (1) an activity generally considered to be entertainment, amusement, or recreation; (2) membership dues with respect to any club organized for business, pleasure, recreation, or other social purposes; or (3) a facility or portion thereof used in connection with any of the above items. Thus, the provision repeals the present-law exception to the deduction disallowance for entertainment, amusement, or recreation that is directly related to (or, in certain cases, associated with) the active conduct of the taxpayer's trade or business (and the related rule applying a 50 percent limit to such deductions). Taxpayers may still generally deduct 50 percent of the food and beverage expenses associated with operating their trade or business (e.g., meals consumed by employees on work travel). For amounts incurred and paid after December 31, 2017, and until December 31, 2025, the TCJA expands this 50 percent limitation to expenses of the employer associated with providing food and beverages to employees through an eating facility that meets requirements for de minimis fringe benefits and for the convenience of the employer. This new law does not affect the taxation of reimbursement of entertainment expenses. As long as the church has adopted and followed an accountable expense reimbursement plan, the minister does not include reimbursement of entertainment expenses in his taxable income.

Since self-employed ministers list only their net self-employment earnings (that is, after deducting all business and professional expenses) as a component of gross income on line 6 of *Form 1040* (line 7 if claiming adjustments), they in effect are able to deduct 100 percent of their business and professional expenses even though they cannot deduct business expenses as an itemized deduction on *Schedule A*.

☞ **Key Point:** In the past, one of the reasons the audit rate was higher for self-employed taxpayers was that only 30 percent of all taxpayers had sufficient itemized expenses to use *Schedule A*. If the IRS could reclassify taxpayers from self-employed to employee status, it generated more tax dollars since only 30 percent of taxpayers could itemize deductions on *Schedule A*. Business expenses that could have been claimed by a self-employed taxpayer on *Schedule C* were lost if a taxpayer was reclassified as an employee and had insufficient expenses to itemize on *Schedule A*.

Report self-employment income from *Schedule C* on *Schedule 1 (Form 1040)* line 12, and carry over this and other items of additional income reported on *Schedule 1 (Form 1040)* to line 6 of *Form 1040* (line 7 if you are claiming adjustments).

Schedule C-EZ

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

- You had business expenses associated with your trade or business of $5,000 or less in 2018.
- You use the cash rather than the accrual method of accounting.
- You did not have an inventory at any time during the year.
- You did not have a net loss from your trade or business.
- You had only one business as a sole proprietor.
- You had no employees.
- You do not use *Form 4562* to compute a depreciation deduction with regard to your trade or business.
- You do not claim a deduction for the business use of your home.

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

Schedule SE

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

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

Step 1: Section A (line 2)

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

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

Add the following to your church salary:

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

And then deduct the following:

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

Unreimbursed and non-accountable reimbursed expenses. The clear implication of the tax code and IRS Revenue Ruling 80-110 is that unreimbursed business expenses, and reimbursed business expenses under a non-accountable plan, are deductible by pastors in computing their SECA liability even if they are not able to deduct these expenses in computing their income tax liability. This understanding is clearly reflected in IRS *Publication 517*. This position is also reflected in the following statement in the instructions to *Schedule SE*:

> If you were a duly ordained minister who was an employee of a church and you must pay SE [SECA] tax, the unreimbursed business expenses that you incurred as a church employee are not deductible as an itemized deduction for income tax purposes. However, when figuring SE tax, subtract on line 2 the allowable expenses from your self-employment earnings and attach an explanation.

Step 2: Section A (line 4)

Ministers (and other taxpayers who are self-employed for Social Security) can reduce their taxable earnings by 7.65 percent, which is half the FICA paid by employers and employees. To do this, multiply net earnings from self-employment times 0.9235 on line 4. SECA is paid on the reduced amount.

Step 3: Section A (line 5)

SECA for 2018 is computed on this line. The SECA rate for 2018 is 15.3 percent, which consists of the following two components:

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

For 2018, the 2.9 percent Medicare tax applied to all net earnings from self-employment regardless of amount. The 12.4 percent Social Security tax applied to only the first $128,400 of net self-employment earnings.

Form 2106

☞ **Key Point:** In the past *Form 2106* was used by employees to compute employee business expenses claimed on *Schedule A*. For most taxpayers this form is now obsolete because of the suspension of an itemized deduction for employee business expenses on *Schedule A*. *Form 2106* is now used only by Armed Forces reservists, qualified performing artists, fee-basis state or local government officials, and employees with impairment-related work expenses.