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.

The 2019 *Form W-2* and *Form W-3* are identical to the 2018 forms. However, note the following:

- The Affordable Care Act (ACA) requires employers to report the cost of employer-sponsored health coverage in Box 12 using code DD. However, transitional relief applies to certain employers and certain types of plans. This relief applies until the IRS publishes additional guidance. Any guidance that expands the reporting requirements will apply only to calendar years that start at least six months after the guidance is issued. The transitional relief applies to employers filing fewer than 250 *Forms W-2* for the previous calendar year.
- Penalties for failure to file and failure to furnish, intentional disregard of filing and intentional disregard for payee statement requirements have increased due to adjustments for inflation. The higher penalty amounts apply to returns required to be filed after December 31, 2019. See the instructions to *Form W-2* for more information.
- Information about any future developments affecting *Forms W-2* and *W-3* and their instructions (such as legislation enacted after they are released) will be posted at *IRS.gov/FormW2*.
- The due date for filing *Copy A* of 2019 *Form W-2* and the *W-3* transmittal form with the SSA is January 31, 2020, whether you file using paper forms or electronically.
- Extensions of time to file *Form W-2* with the SSA are no longer automatic. You may request one 30-day extension to file *Form W-2* by submitting a complete application on *Form 8809 Application for Extension of Time to File Information Returns*, including a detailed explanation of why you need additional time and signed under penalties of perjury. The IRS will grant the extension only in extraordinary or catastrophic circumstances. This does not affect extensions of time to furnish *Forms W-2* to employees.
- To aid employers' efforts to protect employees from identity theft, the IRS has issued regulations permitting employers to voluntarily truncate employees' SSNs on copies of *Forms W-2* that are furnished to employees so that the truncated SSNs appear as IRS truncated Taxpayer Identification Numbers (TTINs). The new regulation will apply to returns, statements, and other documents required to be filed or furnished after December 31, 2020, except for *Forms W-3* and SSA copies of *Forms W-2*, which will apply beginning on July 3, 2019. See the instructions to *Form W-2* for details.
- All personal exemptions were repealed after 2017, and so there is no way to claim them on the 2019 *Form 1040*.

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

☞ **Key Point:** 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 Social Security taxes 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. These forms may be obtained at certain local post offices or IRS offices. 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 *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 Court's decision was to invalidate laws and constitutional provisions in several 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 in the space provided in the "Filing Status" section at the top of *Form 1040*. If you filed a joint return for 2018 and you are filing a joint return for 2019 with the same spouse, be sure to enter your names and SSNs in the same order as on your 2018 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.

For taxpayers with foreign mailing addresses, spaces have been added to include the name of the foreign country/province/state and a foreign postal code.

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 2019 *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 1–7 (including amounts carried over from *Schedule 1* lines 1–9). 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, including the following:

- 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 exceeding $50,000
- 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 or does not have to account for the funds in an arrangement similar to an accountable expense reimbursement plan
- 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 the church
- Love gifts

☞ **Key Point:** The IRS can assess intermediate sanctions in the form of substantial excise taxes against ministers who benefit from an excess benefit transaction. Sanctions apply only to a minister who is a "disqualified person" (meaning an officer, director, or other control party, as well as relatives of such persons). In some cases the

IRS can assess additional penalties against members of a church board that approved an excess benefit transaction. 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 were 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. You, the taxpayer, have the ultimate responsibility to report all taxable income even if your church does not properly report the income.

In addition to what is reported on *Form W-2* (or *Form W-2c*), line 1 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). IRS *Publication 517* states: "Include this amount in the total on *Form 1040*, line 1. On the dotted line next to line 1, enter 'Excess allowance' and the amount."

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 excludible 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 as gifts 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 excludible from taxable income. Income earned before distributions of proceeds is generally taxable as income.

Employer-paid group 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 excludible 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 excludible 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; for plan years beginning in 2020, the compensation amount rises to $130,000.

☞ **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.

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

Housing Allowance

☞ **Key Point:** The housing allowance was challenged in federal court as an unconstitutional preference for religion. In 2019, a federal appeals court rejected the challenge and affirmed the constitutionality of the housing allowance.

The most important tax benefit available to ministers who own or rent their homes is the housing allowance exclusion. Ministers who own or rent their 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 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 fair 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."

States vary in the tax treatment of the housing allowance, so 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 their church, the actual housing expenses, or the fair rental value of a minister's home, furnished, plus utilities)

- Mortgage payments on a loan to purchase or improve your home (include both interest and principal)
- Rent
- Real estate taxes
- Property insurance
- Utilities (electricity, gas, water, trash pickup, landline telephone charges, etc.)
- 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*. IRS *Publication 517* states: "Include this amount in the total on *Form 1040*, line 1. On the dotted line next to line 1, enter 'Excess allowance' and the amount."
- 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 home 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 2019 compensation as a housing allowance. Pastor D's housing expenses for 2019 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, and 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 2019. These expenses include mortgage principal and interest, property taxes, utilities, insurance, and repairs. The church designated (in advance) $12,000 of Pastor Y's 2019 compensation as a housing allowance. Pastor Y is able to itemize expenses on *Schedule A*. 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 2019, Pastor H discovers that his church failed to designate a housing allowance for him for 2019. He asks his church to pass a resolution retroactively granting the allowance for

2019. Such a resolution is ineffective, and Pastor H will not be eligible for any housing allowance exclusion in 2019.

☞ **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 three conditions are met: (1) The recipient is a Minister for Tax Purposes (as defined above); (2) the allowance is compensation for services performed in the exercise of ministry; and (3) the allowance is properly designated by the church.

Churches sometimes neglect to designate a housing allowance in advance of a new calendar year. For example, a church board may discover in March 2020 that it failed to designate a housing allowance for its pastor for 2020. It is not too late to act. The church should immediately designate a portion of its minister's remaining compensation for 2020 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 2018 board meeting (i.e., "for 2019 and future years"), it would not matter that the church neglected to designate a minister's 2020 allowance until March 2020, since the previous designation would have carried over. Such safety net designations are not a substitute for annual housing allowances (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:** 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 such as GuideStone 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 fair rental value of a home (furnished, plus utilities) provided 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 fair rental value of a parsonage unless the allowance or parsonage is for ministerial services performed.

SECA does not apply to the fair 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 2019, 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 $56,000. 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 2020:** The limit on annual additions is $57,000 for 2020.

Minister's Housing Allowance and Contribution Limits

For 2019, the section 415(c) limit restricted 403(b) contributions to the lesser of 100 percent of compensation or $56,000. For 2020, this amount is $57,000. 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 fair 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 either the portion of a minister's housing allowance that is excludible from gross income or the annual fair 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 employer discretionary contributions and employee salary reduction contributions — 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.

☞ **Key Point:** As this publication was going to print, the IRS issued final regulations addressing early distributions from a 403(b) plan based on hardship. In general, the regulations make it easier to qualify for hardship distributions. Consult with a tax professional for additional information.

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 that is includible 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 deferral contributions. The limit applies to the total of all elective deferrals contributed (even if contributed through 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 2019, the allowable limit was $19,000. 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 2020:** The dollar limit on annual elective deferrals increases to $19,500.

☞ **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 was $6,000 for 2019 and is $6,500 for 2020. 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 excludible 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. In addition, an independent committee must make the selection of the recipient. Additional requirements may also apply. The church should seek the advice of a CPA, EA, 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

who is pursuing a master's degree at a seminary. The church votes to award him a scholarship of $2,500 for 2020. 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, or 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 these requirements 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. Qualified dividend income is reported on line 3a with all dividend income reported on line 3b. If you had dividend income of more than $1,500, complete *Schedule B*.

Lines 4a and 4c. *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 *Form 1099-R* may show that the taxable amount of the pension income is "not determined" by checking 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) GuideStone designated the retirement payments as housing allowance. Report the gross amount(s) on lines 4a and/or 4c and the taxable amount(s) on lines 4b and/or 4d.

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 he or she performs or performed."

☞ **Key Point:** Surviving spouses of deceased ministers 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 2019, 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 2019. Use the *Social Security Benefits Worksheet* in IRS *Publication 915* 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 2019, 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 2019 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

Lastly, report the calculated taxable amount on line 5b.

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. Capital gain (or loss)

Report on line 6 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).

☞ **Key Point:** *Schedule D* is for reporting capital gains and losses from investments. *Schedule 1* line 3 ("other gains or losses") is for reporting sales of capital assets, such as equipment that is used in a business.

Line 7a. Other income

Income not reported on lines 1 through 6 on *Form 1040* is reported on *Schedule 1*, with the total reported on *Form 1040* line 7a. The most important of these for ministers includes the following:

1. Line 3 (*Schedule 1*). Business income

Report self-employment earnings (from *Schedule C*). 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 3 of *Schedule 1* and then carry the amount over to line 7a (*Form 1040*).

2. Line 8 (*Schedule 1*). "Other income"

"Other income" is reported on line 8 of *Schedule 1* and carried over to line 7a (*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
- Recapture of a charitable contribution deduction if the charitable organization disposes of the donated property within three years of the contribution
- 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.)

Line 7b. Total income

Report total income on this line. This is the sum of the amounts reported on lines 1–7a of *Form 1040*, plus the additional categories of income reported on lines 1–9 of *Schedule 1*.

Step 5: Adjustments to Income

Lines 8a and 8b. Adjusted gross income

You may deduct certain adjustments from total income (line 7b) to compute your AGI. Report the adjustments on lines 10–22 of *Schedule 1*. The adjustment amount from line 22 of *Schedule 1* is reported on line 8a of *Form 1040*; it is then subtracted from line 7b to compute AGI that is reported on line 8b.

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

Line 14 (Schedule 1). 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 14 (*Schedule 1*), whether or not they are able to itemize deductions on *Schedule A*.

Line 19 (Schedule 1). Payments to an Individual Retirement Account (IRA)

An Individual Retirement Account, 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 2019, 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) $6,000 ($7,000 if you are age 50 or older) or (2) the total compensation includible in the gross income of both you and your spouse for the year, reduced by your spouse's IRA contribution for the year to a Traditional IRA and any contributions for the year to a Roth IRA on behalf of your spouse. (The contribution limits remain unchanged for 2020.)

All IRA contributions must be made by the due date of your tax return, not including extensions. This means that your 2019 IRA contribution must be made by April 15, 2020, even if you obtain an extension for filing this return.

✍ **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 2020, 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.

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 $123,000 (married filing jointly) or $74,000 (single). (For 2020, the limits are $124,000 (married filing jointly) and $75,000 (single).)

If your spouse was covered by an employer-provided retirement plan at any time during 2019 and you made contributions to your IRA, your allowable IRA deduction is completely phased out when AGI reaches $203,000 (married filing jointly). (For 2020, the limit is $206,000 (married filing jointly).) (See IRS *Publication 590-A*.) 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-A*.

Individuals who cannot claim a deduction for an IRA contribution still can make non-deductible IRA contributions, subject to the lesser of $6,000 (for 2019 and 2020) 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 in 2019 if your AGI, as modified, is $203,000 or above. For those filing as single, no contribution may be made to a Roth IRA if your AGI, as modified, is $137,000 or above. (For 2020, the Roth IRA contribution is phased out totally when AGI is $206,000 for taxpayers married filing jointly and $139,000 for singles and head of household filers.)

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-A* for additional information on Roth IRAs.

For information on conversions from a Traditional IRA to a Roth IRA, refer to *Publication 590-A*. 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 (QCD) 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, enter zero if the full amount was a QCD. 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.

☞ **Key Point:** The QCD does need a qualifying receipt from the recipient charity with the mandated "no goods or services statement". However, a church may include the gift on the IRA owner's regular giving statement in an attempt to fulfill this requirement. Care should be taken not to take a deduction for the QCD if it is included on the regular giving statement. Best practice is for the recipient charity or church to issue a separate statement for the gift.

Step 6: Tax Computation

Line 9. 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 9, 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 2019, the standard deduction amounts are as follows:

Filing Status	Standard Deduction Amount
Single	$12,200
Married filing jointly or qualifying widow(er)	$24,400
Married filing separately	$12,200
Head of household	$18,350

Line 10. Qualified business income deduction

Ministers who have income 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. Section 199A limits the deduction to the lesser of:

- 20 percent of the QBI less one-half of SECA directly related to the QBI, the self-employed health insurance deduction, and the self-employed qualified plan contribution deduction related to the qualified business or
- 20 percent of taxable income before the QBI deduction less net capital gains.

Upon publication of this guide, it has been interpreted that the qualified 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 8b of *Form 1040*) exceeds $160,700 ($321,400 if married filing jointly) for 2019, then the deduction may be limited; if AGI exceeds $210,700 ($421,400 if married filing jointly) for 2019, then the deduction is unavailable. Attach either *Form 8995* or *8995-A* and possibly *Schedules A*, *B* and/or *C* (*Form 8995-A*), as needed.

See *Publication 535* for additional information.

Line 12a. 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 2019 *Form 1040*, the child tax credit and the credit for other dependents (family tax credit) are reported on line 13a. The non-refundable credits (i.e., credits that do not generate a tax refund if the credit amount exceeds taxable income) are reported on lines 1–7 of *Schedule 3*, and the total amount for all credits is carried over to line 13b of *Form 1040*.

The more common and important credits for ministers are the child tax credit, the family tax credit, the credit for child and dependent care expenses, and the retirement savings credit. Each of these is addressed below.

Line 13a. 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), also known as the family tax credit. The provision generally retains the present-law definition of "dependent".

However, the maximum amount refundable may not exceed $1,400 per qualifying child. Additionally, in order to receive the child tax credit (i.e., both the refundable and non-refundable portion), a taxpayer must include an SSN for each qualifying child for whom the credit is claimed on the tax return. For these purposes, an SSN 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 (in the case of 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 13b (Form 1040) Schedule 3 line 2. 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 13b for details and conditions.

See IRS *Publication 972* for additional information.

Line 13b (Form 1040) Schedule 3 line 4. 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-A* 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 plan; 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 2019 is described in the following table:

Adjusted Gross Income			
Joint Returns	**Heads of Household**	**Single Filers**	**Amount of Credit**
$1–$38,500	**$1–$28,875**	**$1–$19,250**	50% of eligible contributions up to **$2,000** (**$1,000** maximum credit)
$38,501–$41,500	**$28,876–$31,125**	**$19,251–$20,750**	20% of eligible contributions up to **$2,000** (**$400** maximum credit)
$41,501–$64,000	**$31,126–$48,000**	**$20,751–$32,000**	10% of eligible contributions up to **$2,000** (**$200** maximum credit)
more than **$64,000**	more than **$48,000**	more than **$32,000**	0%

For married couples filing jointly, each spouse is eligible for the credit.

For more information about this credit, see IRS *Form 8880* and *Publication 590-A*.

Step 8: Other Taxes

Line 15 (Form 1040) Schedule 2 line 10. Other taxes

On *Form 1040* for 2019, "other taxes" are derived from line 10 of *Schedule 2*, and the total of all taxes is carried over to line 15 of *Form 1040*. These include SECA, which ministers must pay on ministerial income (unless exempt).

Step 9: Payments

On the 2019 *Form 1040*, amounts representing federal income tax withholding are reported on line 17. Other tax payments are reported on *Schedule 3* and reported on line 18d of *Form 1040*. The two most important categories of tax payments are withheld taxes and estimated tax payments, as noted below.

Line 17. 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, if applicable) 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 expected 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 18 (Form 1040 line 18d) Schedule 3 line 8. 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 by using the quarterly estimated tax procedure, unless they have entered into a voluntary withholding agreement with their employing church. The estimated tax procedure is summarized 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 8 of *Schedule 3* and carried over with the other kinds of payments listed on *Schedule 3* to line 18d of *Form 1040*.

Line 18a. Earned income credit (EIC)

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 and are at least age 25, one qualifying child, two qualifying children, or three or more qualifying children and (2) the amount of your earned income, investment income, and modified AGI.

You may be able to claim the EIC for 2019 if you have investment income of $3,600 or less **AND** (1) you do not have a qualifying child, you're at least age 25, and you earned less than $15,570 ($21,370 if married filing jointly); (2) a qualifying child lived with you and you earned less than $41,094 ($46,884 if married filing jointly); (3) two qualifying children lived with you and you earned less than $46,703 ($52,493 if married filing jointly); or (4) three or more qualifying children lived with you and you earned less than $50,162 ($55,952 if married filing jointly). The maximum EIC for 2019 is (1) $529 with no qualifying child; (2) $3,526 with one qualifying child; (3) $5,828 with two qualifying children; and (4) $6,557 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 18a. 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 18a of *Form 1040*.

IRS *Publication 596* is a 40-page publication that explains the EIC. The 2018 edition (the most recent available at the time of publication of this text) states, in general: "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 fair 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 a timely *Form 4361*, that "a non-taxable housing allowance or the non-taxable 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 (line 23) or a refund is due you (line 20). 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 *Form 1040-V*. Include your daytime phone number and your SSN and write "*Form 1040* for 2019" on the memo line of the check. If you owe taxes, you also may have to pay an underpayment penalty (refer to line 24 of *Form 1040*).

If you have overpaid your taxes, you have two options: (1) request a full refund or (2) apply the overpayment to your 2020 estimated tax.

Step 11: Sign Here

You must sign and date the return at the bottom of page 2. If you are filing a joint return, your spouse must also sign the return. In the "your occupation" space, enter your occupation — **minister.**

If you or your spouse has been the victim of identity theft, the IRS will issue you an Identity Protection PIN that must also be entered in this section of the return.

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*. This section will summarize the itemized deductions.

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

You may deduct certain medical and dental expenses (for yourself, your spouse, and your dependents) if you itemize your deductions on *Schedule A*, but only to the extent that your expenses exceed 10 percent of your AGI. You must reduce your medical expenses by the amounts of any reimbursements you

receive for those expenses before applying the 10 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
- 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 that are 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 2019, the standard mileage rate for medical travel was 20 cents per mile (it has decreased to 17 cents for 2020)
- 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:

- The cost of diet food
- 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 taxpayers 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 2019 through 2025.

Some states attempted to assist taxpayers in avoiding the above limitations by creating state-run charities that would grant tax credits in exchange for charitable contributions that would qualify for a tax deduction. The IRS issued regulations stating that to the extent a tax credit was granted, the charitable contribution would not be deductible.

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

As a general matter, 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 that is incurred in acquiring, constructing, or substantially improving a qualified

residence of the taxpayer and that secures the residence. Note the following two rules:

1. Limit on Loans Taken out on or Before December 15, 2017

For qualifying debt taken out on or before December 15, 2017, you can deduct only home mortgage interest up to $1 million ($500,000 if you are married filing separately) of that debt. The only exception is for loans taken out on or before October 13, 1987 (see IRS *Publication 936* for more information about loans taken out on or before October 13, 1987).

See *Publication 936* to figure your deduction if you have loans taken out on or before December 15, 2017, that exceed $1 million ($500,000 if you are married filing separately).

2. Limit on Loans Taken out After December 15, 2017

For qualifying debt taken out after December 15, 2017, you can deduct only home mortgage interest up to $750,000 ($375,000 if you are married filing separately) of that debt. If you also have qualifying debt subject to the $1 million limitation discussed above, the $750,000 limit for debt taken out after December 15, 2017, is reduced by the amount of your qualifying debt subject to the $1 million limit. An exception exists for certain loans taken out after December 15, 2017, but before April 1, 2018. If the exception applies, your loan may be treated in the same manner as a loan taken out on or before December 15, 2017. See IRS *Publication 936* for more information about this exception. See *Publication 936* to figure your deduction if you have loans taken out after October 13, 1987, that exceed $750,000 ($375,000 if you are married 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.

☞ **Key Point:** Points are not currently deductible when paid in association with the refinancing of the home. These points must be amortized over the life of the new mortgage.

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

Cash contributions to churches, schools, and most other public charities that 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 2019 and 2020). Unreimbursed travel expenses incurred while away from home (whether within the United States or abroad) in the course of donated services to a tax-exempt religious or charitable organization are deductible as a charitable contribution. There are two ways to do this.

Individuals performing the charitable travel can keep track of their own travel expenses and then claim a charitable contribution for the total on *Schedule A*. (A letter acknowledging the individual's service should be obtained from the charity.) Or, these individuals could provide their church or charity with a travel report substantiating all travel expenses. In such a case, the church or charity could issue the individual a charitable

contribution receipt for the total amount of the substantiated travel expenses. Travel expenses that can be receipted include airfare, lodging, meals, and incidental expenses.

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

✍ **Example:** Pastor J goes on a trip to Europe. He is in Europe for 10 days and conducts one-hour 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.

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

☞ **Key Point:** It is the responsibility of the donor to confirm that all donations claimed are supported by qualifying receipts. The consequence of failure is a loss of any contribution not supported by a qualifying receipt. This error cannot be corrected if discovered after the tax return is filed. Some churches and charities fail to issue qualifying receipts, so donors must be vigilant in meeting this requirement.

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 under the Disaster Relief and Emergency Assistance Act. This limitation is effective for losses incurred in taxable years 2018 through 2025.

NOTE: Job Expenses and Most Other Miscellaneous Deductions

Employee business expenses that are either unreimbursed or reimbursed by an employer under a non-accountable arrangement are no longer deductible by an employee. This provision of the TCJA is effective for taxable years 2018 through 2025 unless extended by Congress.

The elimination of an itemized deduction for unreimbursed employee business expenses will hit some clergy hard. Some have suggested that this impact can be minimized if a church reimburses employees' 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:

1. Expenses must have a business connection — that is, the reimbursed expenses must represent expenses incurred by an employee while performing services for the employer.

2. 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).

3. 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).

4. 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 the fact 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 and employee expenses reimbursed under a non-accountable plan), 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 2019. Be sure the interest you report on line 1 corresponds to any *Forms 1099-INT* you received from such institutions or individuals. Do not include tax-exempt interest. Taxable 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 2019. Be sure the dividends you report on line 5 correspond to any *Forms 1099-DIV* you received from such institutions. Ordinary 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.

☞ **Key Point:** The IRS has discontinued the simplified *Schedule C-EZ* for 2019 and future years. Persons who used *Schedule C-EZ* in the past will now use *Schedule C*.

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)

▲ **Caution:** 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 "self-employed" 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.

Report any business expenses associated with your self-employment earnings on lines 8–27. For example, if you incur transportation, travel, or other expenses in the course of performing self-employment activities, you deduct these expenses on lines 8–27 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 through 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 fringes 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 *Form 1040*, 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*.

Report self-employment income from *Schedule C* to *Schedule 1* line 3 and carry over this and other items of additional income reported on *Schedule 1* to line 7a of *Form 1040*.

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, baptisms, funerals, etc.
- Self-employment earnings from outside businesses

- Annual fair 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 a 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 have retired
- Housing allowance provided to you after you have retired
- 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 tax [SECA], 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.

Due to the confusion surrounding this issue, ministers are encouraged to consult with a tax professional for guidance.

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 by 0.9235 on line 4. SECA is paid on the reduced amount.

Step 3: Section A (line 5)

SECA for 2019 is computed on this line. The SECA rate for 2019 is 15.3 percent, which consists of the following two components:

1. A Medicare hospital insurance (HI) tax of 2.9 percent

2. An old-age, survivor, and disability (Social Security) tax of 12.4 percent

For 2019, the 2.9 percent Medicare HI tax applied to all net earnings from self-employment regardless of amount. For 2019, the 12.4 percent Social Security tax applied to only the first $132,900 of net self-employment earnings. (For 2020, the maximum earnings subject to Social Security tax are $137,700.)

Form 8959 Additional Medicare Tax

Beginning in 2013, the ACA increased the employee portion of the Medicare HI tax by an additional tax of 0.9 percent on wages received in excess of certain amounts. This additional tax applies to ministers subject to SECA. Unlike FICA taxes, this additional tax is on the combined wages of a taxpayer and the taxpayer's spouse, in the case of a joint return. The threshold amount is $250,000 in the case of a joint return or surviving spouse and $200,000 for single persons. The $250,000 and $200,000 amounts are not adjusted for inflation and remain the same for 2020.

Ministers who are part of a two-earner family may be subject to this additional tax and should plan accordingly. Each working spouse may have wages and self-employment income of less than $250,000, but when added together, if the total exceeds the threshold, they may be subject to the tax. This additional tax should be considered in preparing estimated tax payments or withholding instructions.

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.