

New IRS Audit Guidelines for Ministers

In April 2009 the IRS released the new audit guidelines for ministers. Now this doesn't necessarily mean that ministers will be targets of audits in 2010 but it could be a signal that ministers could be a target group in the near future. Therefore now is the time to be proactive and get your house in order before that time comes.

The areas that the new guidelines focus on include:

- Definition of a minister
- Minister employment status
- Minister income/ how income is reported
- Housing/parsonage allowance
- Reporting of business expenses
- SECA tax

Let us address each issue separately in order to receive a clearer understanding.

Definition of a Minister

To be considered a minister, a person must:

- be a duly ordained, commissioned, or licensed minister of a church
- provides ministration of sacerdotal functions (communion, foot washing, baby dedication, etc.)
- conduct religious worship
- control, conduct, and maintenance of religious organizations agencies of such organizations), under the authority of a religious body constituting a church or denomination.

It use to be that proving you were a duly ordained, commissioned, or licensed minister was enough to be classified as a minister. The IRS is beginning to tighten the criteria and ministers must now prove that they meet at least one of the other 3 requirements. The reason for this tightening is because of tax benefits ministers receive such as housing/parsonage allowance.

The ministers that this will impact the most will be associate ministers and specialized ministers (ex.: Worship Pastor, Church Administrator, Children's Pastor, Youth Pastor, etc.). These pastors' roles in worship and church business will be reviewed rather deeply to make sure they do actually meet at least one of the other 3 requirements.

Minister Employment Status

Ministers are a rare breed because they have a dual employment status. They are considered employees for income tax purposes but self employed for social security and medicare purposes. Since they are considered employees for income tax purposes, they report their unreimbursed expenses on Schedule A however they are subject to a 2% of adjusted gross income ceiling and alternative minimum tax.

You might not agree that you are an employee of the church since you basically set your own schedule. To verify your employee status you may wish to review this 20-factor employment status test that the IRS has developed.

IRS 20-Factor Test

1. Instructions. Is the worker required to comply with instructions about when, where, and how to work? If so, check EE; if not, check SE.
2. Training. Is the worker trained by an experienced employee or by other means? If so, check EE, if not check SE.
3. Integration. Are the worker's services integrated into the employer's business operations? If so, check EE; if not, check SE.
4. Services rendered personally. Must services be rendered personally by the worker? If so, check EE. If the worker may hire a substitute to perform the work without the church's knowledge or consent, check SE.
5. Hiring, supervising, and paying assistants. Does the church hire, supervise, and pay assistants to assist the worker? If so, check EE. If the worker hires, supervises, and pays his or her own assistants, check SE.
6. Continuing relationship. Is there a continuing working relationship between the church and worker? If so, check EE; if not, check SE.
7. Setting hours of work. Does the employer establish set hours of work? If so, check EE. Is the worker a "master of his own time"? If so, check SE.
8. Full time required. Must the worker devote full time to the church's business? If so, check EE. If the worker is hired "by the job" and may offer his or her services to other employers, check SE.
9. Doing work on employer's premises. If the worker must perform his or her duties on the church's premises, check EE. If not, check SE.
10. Order or sequence of work. If the worker must perform services in an order or sequence set by the church, check EE. If not, check SE.
11. Oral or written reports. If the worker is required to submit regular oral or written reports to the employer, check EE. If not, check SE.
12. Payment by hour, week, month. If the worker is paid by the hour, week, or month, check EE. If paid by the job on a lump-sum basis (even if paid in installments), check SE.
13. Payment of business expenses. Does the church pay the worker's business expenses? If so, check EE; if not, check SE.
14. Furnishing of tools and materials. If the church furnishes tools and materials for the worker's use, check EE. If the worker provides his or her own tools and materials, check SE.
15. Significant investment. Does the church furnish all necessary facilities (equipment and premises)? If so, check EE; if not, check SE.
16. Realization of profit or loss. May the worker realize a profit or suffer a loss as a result of his or her services? If so, check SE; if not, check EE.

If more EEs are checked, then you are definitely an employee of the church. Please keep in mind that the courts consider the following points when determining the employment relationship between two parties:

1. The degree of control exercised by the principal over the details of the work;

2. Which party invests in the facilities used in the work;
3. The opportunity of the individual for profit or loss;
4. Whether or not the principal has the right to discharge the individual;
5. Whether the work is part of the principal's regular business;
6. The permanency of the relationship; and
7. Relationship the parties believe they are creating.

The IRS states that one factor does not dictate the outcome. However, the majority of the time ministers will be determined to be employees.

Minister Income/ How income is reported

A minister's income includes, but is not limited to:

- Compensation from the employing church or church agency for personal services
- Bonuses or special gifts
- Expense allowances for travel, transportation, or other business expenses received under a nonaccountable plan

One of the new areas of investigation will be whether a gift is truly a gift or compensation for services. The guidelines state: "Compensation for services in whatever form received is definitely included in income." The burden of proof as to whether income is a gift or compensation is born by the taxpayer. Therefore keep good records of all gifts and honorariums. It could help save you tax dollars.

Since ministers are considered employees for income tax purposes, the IRS will be checking to make sure you are receiving Form W-2 at year's end. Therefore, if you are receiving a Form 1099-MISC from the church, this needs to be changed with the reporting of your 2009 income.

Housing/Parsonage Allowance

How pastors calculate and claim their housing allowance will be investigated. The method for calculating the amount of housing allowance is based on the LEAST of:

1. The amount actually used to provide a home,
2. The amount officially designated as a housing allowance, or
3. The fair rental value (FRV) of the home, including furnishings and appurtenances such as a garage plus the cost of utilities.

If the FRV of the home is \$18,000 but the actual amount to maintain the home was only \$15,000, the pastor can only claim a housing allowance of \$15,000 since it is the LEAST of the FRV and the actual costs. The remaining \$3,000 is taxable income and should be reported in Box 1 of the pastor's Form W-2.

This is the area in which pastor's may be hurting themselves if they are claiming higher housing allowances than they are actually being able to prove. If they are audited and the IRS does not agree with the amount of the qualified housing allowance, the pastor may be responsible to pay income taxes on the difference. So make sure to set the housing allowance at the LEAST of the three items stated above.

Keep in mind that the IRS states that the housing allowance must be included in the minister's gross income in the taxable year in which it is received.

When calculating a parsonage allowance the fair market rental value is used to determine the appropriate parsonage allowance. The parsonage allowance cannot be more than the reasonable pay for the ministerial services performed.

Reporting of business expenses

Since ministers are employees they can claim any expenses on Schedule A of their return provided that the expenses are:

1. unreimbursed employee business expenses (that is, expenses for which the minister is not reimbursed under an accountable reimbursement system) and
2. "nonaccountable" reimbursed business expenses.

It is better for the church to establish an accountable reimbursement system since under this arrangement there will be no need for limitations on deductibility of expenses. To meet the IRS regulations for an accountable reimbursement system the pastor must:

- substantiate all expenses with receipts
- turn in receipts in a timely manor (120 days)
- return amounts in excess of substantiated expenses within a reasonable period of time.

If a pastor has an expense account that they receive no matter if they substantiate the amounts actually spent, then that violates the accountable reimbursement system and all of the funds are taxable income.

Example: The pastor has a \$3,000 continue education expense account but only actually substantiates \$1,500 with receipts. So long as the pastor does not receive the remaining \$1,500 the reimbursement meets the accountable reimbursement system regulations. If the pastor receives the remaining \$1,500 as a bonus, then this violates the accountable reimbursement system regulations and the entire \$3,000 is taxable income and must be reported in Box 1 of Form W-2.

According to the IRS guidelines: "If the church has a salary reduction arrangement which "reimburses" the minister for employee business expenses by reducing his or her salary, the arrangement will be treated as a nonaccountable plan because it does not meet the reimbursement requirement of the accountable reimbursement system."

It is essential for the pastor to keep accurate records on all expenses and when/how they are reimbursed. It cannot be emphasized enough the necessity for pastors to keep accurate records of all income and expenses. These records can help save the pastor tax dollars.

The main expenses that the IRS will be focusing on include:

- Transportation
- Travel
- Business use of home

- Supplies, Publications
- Dues
- Clothes
- Long distance phone calls

The strongest emphasis will be on business use of home. Since the church provides the pastor with an office, the minister will be hard pressed to prove the necessity of a home office. Since the minister already receives a housing allowance for which they do not pay income tax, the IRS may be looking at the business use of home as double dipping since it reduces the amount of taxable income. If you are currently claiming business use of home for ministry purposes, it will be your responsibility to prove why it is essential to have a home office. It will be very hard to prove.

Also keep in mind too that ordinary street clothes and suits you purchase to wear while doing ministry are not deductible. You may only claim long distance phone calls directly related to your ministry.

The IRS will be reviewing how much you can actually claim as expenses in relationship to your housing allowance. To calculate the amount of deductible expenses, the following equation must be used:

$$\text{Allowable housing allowance} / \text{total ministry income} = \text{nontaxable income percentage}$$

$$\text{Total business expenses} \times \text{nontaxable income percentage} = \text{nondeductible expenses}$$

$$\text{Total business expenses} - \text{nondeductible expenses} = \text{deductible expenses}$$

Example: The pastor receives a salary of \$36,000, an exempt housing allowance of \$18,000 and an auto expense allowance of \$6,000 for his services as an ordained minister. The pastor incurs business expenses as follows: auto, \$7,150; vestments, \$350; dues, \$120; publications and supplies, \$300; totaling \$7,920. His nondeductible expenses are computed as follows:

$$\$18,000 / \$60,000 = 0.30$$

$$\$7,920 \times 0.30 = \$2,376$$

$$\$7,920 - 2,376 = \$5,544 \text{ deductible expenses}$$

SECA Tax

Since ministers are considered self employed for social security and medicare purposes, they are required to pay the Self Employment Contributions Act (SECA) tax. This amounts to 15.3% of all income including housing allowance. These funds should be paid in quarterly estimated tax payments. There is a possibility for the church to pay this for the pastor but if the church does, then the amount paid should be reported in Box 1 of the pastor's Form W-2. If the church agrees to pay the SECA tax, they should give the pastor a check quarterly for the pastor to mail in under their own social security number.

No pastor should have FICA taxes withheld. On a pastor's Form W-2, Boxes 3, 4, 5, and 6 should always remain blank.

Should you have any questions about the new guidelines or you need help getting your house in order please feel free to contact:

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