

HOW PRESBYTERIAN CHURCHES CAN HELP MAKE THE PASTOR'S SALARY S-T-R-E-T-C-H FURTHER (without costing the church more)

by
Clint McCoy*

A Way of Caring for the Minister. Session and Personnel Committee members' awareness of the ways income allocation can benefit a pastor, without any disadvantage to the church, opens a door to caring for the pastor's well-being in a special, tangible way. Many persons enjoy exclusions from taxable income through contributions to a group pension and major medical program, travel reimbursements if the job requires mobility, reimbursements for continuing education, etc. There are additional exclusions that may be legally claimed by ministers (and others who are provided housing by an employer). Each \$1000 of income legally excluded from federal income tax may reduce the minister's tax obligation by \$150 or more. That legitimate savings becomes part of the pastor's disposable income.

Ministers who are called to serve congregations associated with denominations [such as the Presbyterian Church (USA)], for whom contributions are made to a denominational pension plan, are treated as *employees* by the IRS for the purpose of calculating federal income tax. This means these ministers must receive a W-2 from the church. However, for the purpose of Social Security, ministers are treated as *self-employed*, meaning that they must remunerate the federal government 15.3% of the combined value of their adjusted gross income and housing to the IRS for Social Security purposes (unless they have legally exempted themselves from Social Security), filing a Schedule SE.

Ministers earning over \$600 annually from one source, for whom pension payments are *not* made by the organization being served, should be given a form 1099 by the church treasurer by the end of January in the succeeding year. This form is given to ministers who are considered self-employed both for federal income tax and Social Security purposes. These ministers will file a Schedule C for self-employment as well as a Schedule SE.

* The author, Executive Presbyterian of the Presbytery of Northern New York, PC(USA) may be reached at <pbynny-clint@northnet.org>. He is neither a tax attorney nor a Certified Public Accountant. Persons who have tax questions, or who desire more in depth information, are advised to consult a CPA or tax attorney knowledgeable about clergy and church taxes.

Some exclusions to taxable income are described below, with explanations:¹

- Housing, Furnishings and Utility Allowance
 - Manse Furnishings Allowance (where manse and utilities are already provided)
 - 403(b) retirement plan.
 - Medical reimbursement plan
 - An accountable reimbursement plan for qualified expenses.

Additionally, if the church claims that an expense is required for the conduct of ministry, *but the church is unwilling to pay for it*, a pastor treated as an employee (receiving a W-2) for federal tax purposes may deduct (but not exclude) those costs on his/her Schedule A itemized personal deductions, although they must total at least 2% of income in order to be counted.

Furthermore, some other factors are discussed with a view to assist congregation leaders' consideration of a variety of additional compensation matters: Board of Pensions' Social Security off-set; salary reduction agreements as pastoral contributions or tithe, disability agreements, and a list of forms and their uses by treasurer or other financial officers of the church.

A. Housing, Furnishing and Utility Allowance

Income specified by a church for housing-related expenses, if used specifically for those expenses, may be excluded from a minister's federal income tax (although it must be included as income for the purposes of calculating a minister's Self-employment tax for Social Security purposes). It is best if the pastor substantiates and projects housing, utility and furnishing costs in order to establish a basis to assist the session in making a proper determination of the amount that should be excluded from the total compensation. Items that may be included in calculating the excludable total include: down payment; mortgage payments; real estate taxes; property insurance; utilities (electricity, water, gas, trash pickup, local telephone charges); furnishings and appliances (purchases or repairs); remodeling or structural repairs, yard maintenance; improvements, household maintenance items (cleansers, light bulbs, paint, pest control, etc.); homeowners' association dues, other miscellaneous household expenses (Hammar, 165).

Note: The minister will need to keep careful records, including receipts verifying expenses, in the event that there is an audit by the IRS. The session will need to put in its minutes, before the exclusion is considered legitimate, the amount that is specified for housing. Allocations for housing expense that can not be documented may be subject to income tax.

In the Presbyterian Church (USA) the Board of Pensions uses 30% as a rule of thumb for determining "fair housing value." Based on this norm, many presbyteries establish a minimum cash salary, and then add 30% plus the cost of utilities, in order to calculate a housing allowance.

¹ For an in-depth treatment of these and other tax issues affecting clergy and churches, see the definitive guide *Church Law and Tax Report: Church & Clergy Tax Guide* by Richard R. Hammar, published annually in a revised edition by Christian Ministry Resources, PO Box 2301, Matthews, NC 28106. Specific references to Hammar's work in this paper are noted by a text reference to Hammar, followed by the page number in the *Church & Clergy Tax Guide, 2000 edition*.

This may be an unreasonably *small* amount of the total to designate for housing. A minister is permitted by the IRS to take the actual costs for housing that are not considered excessive. In those years when particularly large expenses are planned (e.g. painting the house; erecting a new deck; building a garage; remodeling the bathroom; buying a new house with a large down payment), these costs may be excluded from income if minister and session plan ahead to establish the exclusion in writing. This can be a huge benefit to the minister without cost to the church. In presbyteries where it is customary to establish a minimum cash salary plus 30% housing, plus utilities, in calculating what the Board of Pensions calls Effective Salary, it makes sense to take the total Effective Salary and reallocate the percentages so that the best advantage can be taken to allocate actual costs according to the actual projected housing expenses, noting the allocation in the Session minutes.

The housing allowance established is not reported as taxable income to the IRS on the minister's W-2; however it is noted in box 14 of the W-2. (If the minister is in the Presbyterian Pension and Benefits Plan, he/she is considered an employee for federal income tax purposes, and must receive a W-2; however the minister is considered self-employed for Social Security purposes).

The minister must declare any Housing Allowance, which is not used for housing, as income for Federal Income Tax purposes.

The housing allowance must be included in income for Self-employment tax (Social Security) purposes.

Procedural Advice for Treasurers: Because the minister is responsible for declaring taxable income when the housing allowance exceeds actual expenses for housing, a regular check for housing may be written per payment agreement with the pastor. Salary and housing may be included in the same check if your bookkeeping system permits the separation of these expenses in operating statements; otherwise, make the salary and housing payable in separate checks.

B. Manse (Parsonage) Furnishings Allowance

Usually referred to as a "Parsonage Allowance" in the parlance of tax consultants and other church traditions, a manse furnishings allowance may be provided by the employing congregation. The allowance is excludable from the minister's taxable income, except for the Self-employment tax for Social Security purposes. Furnishings may include furniture, curtains and other household appointments, any appliances that belong to the pastor, local telephone expenses, cleaning supplies, etc. As with the Housing Allowance noted in "A" above, the Manse Furnishings Allowance is reported in box 14 of the W-2, but is not reported as taxable income for federal income tax purposes. The Manse Allowance must be included, however, in the total salary on which Self-employment tax for Social Security is calculated.

C. Home Equity Allowance for Minister Living in Manse.

Because ministers who live in a manse do not have the privilege of accruing home equity, since they do not own the home, some churches will set aside an amount annually in a home equity

allowance, to compensate. On the surface, this is taxable income. However, if the home equity is considered to be for retirement purposes, then a contribution to the 403(b) retirement plan (discussed below) would provide an equity allowance by default, and would be considered exclusionary.

D. 403(b) Retirement Plan

The church may exclude, from the total of a minister's income, amounts contributed directly by the church to a qualified tax deferred annuity plan, otherwise known as a 403(b) retirement plan. Since 1997 this exclusion has been available to ministers considered employees *and* self-employed for federal income tax purposes. Established through a bank, stockbroker, insurance company, pension service or other qualified financial institution, a 403(b) plan is intended to benefit the pastor in retirement. The money placed in the 403(b) plan is not taxed when earned; and the income generated from it remains untaxed until it is withdrawn. The immediate benefit of such a plan to a pastor is that he/she usually receives \$300 or more in tax savings for every \$1000 he/she saves for retirement in any year. Neither federal income tax or Self-employment tax (for Social Security) are paid on the amount paid directly by the employer (church) into the 403(b) plan. (Pastors and churches should be aware that a reduced payment to the Social Security System will in all likelihood mean a somewhat smaller benefit through Social Security at retirement).

If the pastor participates in a 403(b) plan, the church must report the participation by checking the "Pension plan" box on the W-2 given to the pastor and IRS at the end of the year, and report in box 13 of the W-2 the total elective deferral of income that has been excluded from the salary. (Hammar 349)

IRS publication 571 provides worksheets for calculating the 403(b) exclusion. Generally speaking, the limit for exclusion may be calculated by multiplying 20% of "includible compensation" times years of service, less the amounts previously excluded, less any excess contributions. (Hammar 347) If you are fearful the pastor has excluded too much, utilize IRS publication 571.

Procedural Advice for Treasurers: The minister will be able to give you information about the name of the institution to which the 403(b) should be contributed. When opening the account, there will be forms to be filled out to establish the account on the minister's behalf. Payment should be made on a regular basis, as authorized by the session, to the institution that will be custodian of the minister's 403(b) account.

E. Accountable Reimbursements

Accountable reimbursement plans provide exclusions from taxable income that must be independently established from salary. The IRS does *not* permit a reimbursable expense plan to be used to *reduce* an employee's salary. While reimbursing expenses by salary reduction is not illegal, the IRS does not consider such a plan "accountable." In an accountable plan, the church must establish salary and reimbursable expenses at the beginning of any year using separate motions to establish the salary from any reimbursable expense lines. Some examples of costs that can be reimbursed through an accountable plan are: professional expenses; office supplies; vestment purchase and cleaning; books and periodicals, etc.

Unless a reimbursement plan is intended to be unlimited in nature, a cap on reimbursable expenses must be established. Since the reimbursement does not technically belong to the minister, but to the church, the reimbursable account is "use or lose" in nature; the minister is not entitled to any unused balance. If any unused balance is paid to the minister, *all* reimbursements in that category then become subject to federal income tax and Self-employment tax (Hammar 215-235).

The church does not report reimbursable expenses on the W-2 at all.

Procedural Advice for Treasurers: All reimbursements must be paid through a voucher system or other system that demonstrates accountability. The church should keep the records on file; the minister would be wise to keep copies of all records as well. Poor record keeping could result in a large tax liability for the minister if he/she is unable to document the source of income as a legitimate reimbursement, and if the IRS determines that reimbursements are not accountable in nature.

F. Medical Insurance Premiums.

"Medical insurance premiums paid by an employer for employees (and their spouses and dependents) are excludable from taxable income," *although this exclusion is not available to self-employed individuals*. Church employees' health insurance premiums may be paid directly to the insurer by the church, or may be reimbursed to employees if the employees are required to show proof that they incurred the medical expense themselves. In other words, the church must treat this exclusion as an "accountable" business expense. (Hammar 140).

Procedural Advice for Treasurers: All reimbursements must be paid through a voucher system or other system that demonstrates accountability.

G. Cafeteria Plans, including a Flexible Spending Arrangement (FSA).

Cafeteria plans are *written* plans established by an employer that allow employees to choose between cash (taxable) and a menu of nontaxable, qualified benefits. Utilizing a cafeteria plan, a minister is not taxed on the noncash benefits received because he/she refuses the right to receive the taxable cash benefit. The cafeteria plan must present the employee with a *choice* between the cash or one or more noncash fringe benefits. Employer contributions to a cafeteria plan are not taxable, even if they are funded through salary reductions. This makes such plans attractive to employees. However, cafeteria plans are complex, and the church must report this kind of fringe benefit to the IRS on Form 5500, Schedule F, annually. Richard Hammar, one of the most knowledgeable tax consultants for churches and ministers, recommends that a church that desires to establish a cafeteria plan should consult with a tax attorney or Certified Public Accountant (Hammar 148-154).

H. Minister's Schedule A Deductible Business Expenses.

Some business expenses can be claimed by a minister, who is considered an employee, as itemized deductions on Schedule A, and listed on form 2106. The conditions for doing so are difficult to meet: the church will have to vouch that it required the expense of the minister and refused to reimburse it. This is not an exclusion that decreases tax obligation as a consequence; rather it is an itemized *deduction*.

I. Board of Pensions-authorized Social Security Off-Set

The Board of Pensions of the Presbyterian Church (USA) permits a church to exempt from Effective Salary up to one-half an amount equal to the Self-employment tax paid by a minister, roughly calculated at 7.65% of the salary on which Self-employment tax is paid. While this means a congregation need not pay the annual premiums to the Board of Pensions on this portion of a minister's salary, the minister is required to claim the Social Security off-set as cash, both for federal income tax and for Self-employment tax purposes. This provides a break for the church on pension payments; but it does not add to the minister's future pension benefits, and provides no income tax exclusion.

Procedural Advice for Treasurers: The Social Security off-set must be recorded separately when reporting compensation to the Board of Pensions, but for federal income tax and Social Security purposes, the off-set may be included with the salary and reported on the minister's W-2 as such.

J. Salary Reduction Agreement as Deductible Charitable Contribution: *Don't go there! Not illegal, but not recommended.*

While the IRS will very likely recognize that a written agreement that stipulates that an amount withheld from salary, for the purpose of the minister's making a tax deductible contribution to the church, is a valid because it conforms to the constructive receipt doctrine established in income tax regulation 1.451-2(a) that says that income not actually reduced to a taxpayer's possession is still constructively received by him/her (Hammer 120), such a paper transaction is not the best way to contribute to the financial well being of the church. In such a case, the minister's W-2 will include the *total* of the actual and "paper" (donated) income, increasing the tax liability before the charitable contribution is deducted for tax purposes. There is little tax advantage to the minister, and the church must pay pension and medical dues on the total, including the "paper" income reported on the W-2. It is better if the actual money is paid to the minister, and the charitable contribution to the church is made separately.

While courts have ruled that a taxpayer who refused income was not liable for any tax obligation on the portion of income he did not receive (Hammer 120), income refusal is a practice that can have a detrimental impact in the long run, may be confusing to a congregation, and may establish behavioral precedents unwelcomed by a minister's successors. Income refusal by a minister whose Effective Salary is above the median will mean reduced retirement benefit for that minister. The salary reduction requires the amendment of salary report forms submitted to the Board of Pensions, or an altering of salary reported to the presbytery, unless the salary is originally reported as having been negotiated to the level from which no charitable contributions will be made to the church.

K. Disability Agreement

It is a good idea for a session to establish a written Disability Policy. The Board of Pensions will reimburse its members at 60% of their salary after ninety days' disability; however a church may express pastoral care for a minister by paying all or part of the disability from the time it is declared until a specific end period. For instance, a church may elect to establish a policy that it will pay its minister 100% of salary for the first 90 days of disability, and then remunerate to the pastor, for not more than nine additional months, sick pay in an amount equivalent to the balance between the minister's salary and disability payments received from the Board of Pensions. Such disability payments are normally considered taxable income, however "such payments *may* be excluded from income under section 105 of the Code in the case of ministers who report their federal income taxes as employees," as part of a medical reimbursement plan (Hammar 114, emphasis added). In the event of disability, it is advisable for the session and minister to consult a tax attorney concerning disability income, being advised whether and how much may be excluded from taxable income.

L. Honoraria

Gifts from a congregation to a minister are considered taxable income if they come from the organization (much like a bonus), and ought to be included in W-2 box #1 as salary. Honoraria from individuals must be declared by the minister as income as well; however ministers are acting in a self-employed capacity when they accept honoraria from individuals for services performed at funerals, weddings and the like. Honoraria is not filtered through the congregation's books, but is given directly to the minister, who declares it as self-employment income by using a Schedule C when filing income tax. Some professional expenses can be deducted on the Schedule C, for instance, books, vestments, robe cleaning and the like. Self-employment tax is also calculated by including honoraria paid to the minister.

When the minister desires that all honoraria be returned to the church, rather than accepting honoraria personally and then contributing a like amount to the church (which would require declaring the honoraria as self-employment income and then deducting the contribution to the church as a charitable deduction under itemized deductions, Schedule A), the minister may recommend that honoraria be contributed as a donation directly to the church by the donor so that the minister incurs no federal tax or Self-employment tax liability.

M. Basic IRS Forms for Treasurers

Form 941 Employer's Quarterly Federal Tax Return. Churches in which the minister is the only employee are not required to file Form 941. However a church with more employees will need to file this form which lists total wages paid and income withheld for federal taxes, Medicare and Social Security. Furthermore, if the minister and church agree that the church will withhold a portion of the minister's income for tax purposes, a Form 941 must be filed with the IRS quarterly.

Form W-4 Employee's Withholding Allowance Certificate. The minister lists the number of allowances for personal deductions in order to permit calculation of the amount to be withheld for tax liability. It is on Form W-4, line 6, that a minister can indicate an extra amount to be deducted with each pay period towards Self-employment tax for Social Security. *The treasurer reports this on Form 941 as federal taxes paid, not as social security!*

Form W-2 Wage and Tax Statement. A minister who is considered an employee by IRS rules *must* be issued a W-2 in January, with which to report income from the preceding year to federal, state and local government. For a minister, boxes #1 and #2 are filled out, indicating salary paid and any tax amount withheld and paid to the IRS. Social Security and Medicare boxes are left blank. Contributions to a 403(b) retirement plan are reported in box #13; housing allowance (or manse furnishing allowance) is reported in box #14. If the pastor is covered under the Board of Pensions' Pension and Benefits Plan, or participates in a 403(b) retirement plan, the "pension" box at the bottom of the W-2 should be checked.

Form 1099-MISC. Report of Miscellaneous Non-employee compensation. Any person who is not considered an employee, who receives more than \$600 in taxable income from the church, must receive a 1099-MISC, reporting the compensation.

SAMPLE SALARY ALLOCATION AND TAX CONSEQUENCES

A SAMPLE:

	Standard Salary & 30% Housing Package	Comparable Sample Package with Exclusions	Comparable Package with Manse &
Exclusions			
Cash Salary	\$25,000	\$16,500	\$16,500
Housing & Utilities	7,500	12,000	7,500. (value)
Manse Furnishings Allowance	-----	-----	4,500
403(b) Tax Deferred Comp.		2,000	2,000
Accountable Reimbursements (use or lose)			
Medical Supplement*	0	0	0
Books		1000	1000
Vestments		200	200
Professional Expenses		<u>800</u>	<u>800</u>
Effective Salary (Board of Pensions)	\$32,500	\$30,500	\$30,500
Total Income Reported on W-2	\$25,000	\$16,500	\$16,500
Total Self-employment Income Reported by the minister	\$32,500	\$28,500	\$28,500

Note: * The church may reimburse medical plan deductibles and co-pays directly to the minister, on a use or lose basis [see "F" on page 6 and Hammar, p. 140]. By Board of Pensions rule, such payments are to be reported to the Board of Pensions as part of Effective Salary in the subsequent year.