Retirement Planning for Pastors

Building Sustainable Financial Security Through Ministry Career

Dual Tax Status, Self-Employment Tax, & Church Retirement Plans (2025 Updated)

Church Clergy Tax Management & Compliance

Today's Agenda

- Why Pastors Need Specialized Retirement Planning
- Dual Tax Status: Self-Employment & Income Tax
- Social Security Decision: Opt-In or Opt-Out
- Solo 401(k) Plans: 2025 Limits & Strategies
- 403(b) Church Retirement Plans
- SEP-IRA vs. Other Options
- Housing Allowance in Retirement (Critical!)
- Retirement Readiness Assessment

Why Pastors Need Specialized Retirement Planning

- **Dual Tax Status:** Pastors are both employees AND self-employed (unique IRS classification)
- **Self-Employment Tax (SECA):** Must pay 15.3% SE tax on ministerial income (12.4% Social Security + 2.9% Medicare)
- **Housing Allowance Advantage:** Housing allowance excludes from income tax BUT subject to SE tax (unless opt-out)
- **Social Security Election:** Ordained clergy can opt out (Form 4361) - IRREVERSIBLE decision (mostly)
- **Church Plan Access:** Can access specialized church retirement plans (403(b), SEP-IRA) with housing allowance continuation
- **Limited Employer Match:** Many churches cannot afford 401(k) matching; self-directed savings essential
- **No Paid Leave Planning:** Many pastors get no vacation/sick leave; retirement must replace full income

The Self-Employment Tax Burden (2025)

- **Rate:** 15.3% on net self-employment income (12.4% Social Security + 2.9% Medicare)
- **Social Security Cap:** Social Security tax applies to first $168,600 of income (2025 limit)
- **Medicare Tax:** 2.9% applies to ALL self-employment income (plus 0.9% Additional Medicare Tax if income exceeds $200k single/$250k MFJ)
- **Example Impact:** Pastor earning $60,000 pays ~$9,180 SE tax vs. employee who pays ~$5,100
- **Housing Allowance Complication:** Even excluded housing allowance subject to SE tax
- **Deduction Available:** Can deduct 1/2 SE tax from income tax, but full SE tax owed regardless
- **Why This Matters:** Higher retirement savings needed due to higher tax burden reducing take-home pay

Social Security Decision: The Form 4361 Choice

- **Eligibility:** Only ordained/licensed/commissioned clergy can file Form 4361 (Application for Self-Employment Tax Exemption)
- **Savings:** Avoids paying 12.4% Social Security tax (but still owe 2.9% Medicare if not ordained)
- **Example Savings:** Pastor earning $60,000 saves $7,440 by opting out (12.4% x $60,000)
- **IRREVERSIBLE:** Once filed, cannot reverse decision (Congress exploring limited exception via Clergy Act)
- **No Social Security Benefits:** Lost opportunity to earn Social Security credits toward retirement/disability benefits
- **Key Decision:** Must weigh tax savings NOW vs. Social Security benefits LATER (typically needs 40 credits to qualify)
- **Strategy:** Many pastors opt out BUT earn non-ministerial income to qualify for Social Security

Solo 401(k): 2025 Contribution Limits & Strategy

- **Total Limit (Under 50):** $70,000 aggregate ($23,500 employee + ~$46,500 employer profit-sharing)
- **Age 50-59 or 64+:** $77,500 total ($31,000 employee + catch-up $7,500 + employer)
- **NEW Age 60-63:** $81,250 total ($34,750 employee deferral including additional $11,250 catch-up)
- **Employer Contribution:** Up to 25% of net self-employment income (solo prop: ~20% after SE tax deduction)
- **Deadline:** Employee deferrals by Dec 31; employer contributions by tax return due date (inc. extensions)
- **Compliance:** Filing requirement if balance exceeds $250,000 (Form 5500-EZ)
- **Best For:** Pastors with side income (consulting, writing, speaking) want maximum tax-deferred savings

Solo 401(k) Real-World Example

Pastor (Age 48)

- Church salary: $50k
- Side consulting: $20k
- Total income: $70k
- **Solo 401(k) Contribution:**
- Employee deferral: $23,500
- Employer: ~$9,000 (25% of consulting after SE tax)
- Total: $32,500

Pastor (Age 56)

- Church salary: $50k
- Side consulting: $20k
- Total income: $70k
- **Solo 401(k) Contribution:**
- Employee deferral: $31,000 ($23.5k + $7.5k catch-up)
- Employer: ~$9,000 (25% of consulting)
- Total: $40,000

403(b): Church-Sponsored Retirement Plans

- **What It Is:** Tax-deferred annuity/retirement plan for tax-exempt organization employees (churches, nonprofits)
- **2025 Limits:** Same as 401(k) ($70k under 50, $77.5k age 50-59/64+, $81.25k age 60-63 with catch-up)
- **Best Feature:** Can be NON-ERISA (avoiding costly compliance requirements like nondiscrimination testing, Form 5500)
- **Flexibility:** Church can discriminate (different contributions for pastor vs. other staff) if non-ERISA
- **Employer Contributions:** Church can contribute up to 25% of salary (matching or discretionary)
- **Tax Savings:** Pre-tax contributions reduce both income tax AND self-employment tax (huge advantage!)
- **Housing Allowance Continuation:** CRITICAL - housing allowance CAN continue in retirement from church-sponsored 403(b) only

SEP-IRA: Simplified Pension for Small Churches

- **What It Is:** Simplified Employee Pension (SEP-IRA) - easy setup, employer-only contributions
- **2025 Limit:** Employer contributes up to 25% of compensation or $70,000, whichever is less
- **Advantage:** Minimal administrative burden (no annual compliance testing, Form 5500, or plan documents required)
- **Housing Allowance Limitation:** Only applicable to ACTUAL SALARY (housing allowance excluded from calculation)
- **Example:** Pastor earning $50k total ($25k salary + $25k housing) - church only contributes on $25k = max $6,250 (25%)
- **Vesting:** 100% immediate vesting (employee owns contributions immediately)
- **Housing in Retirement:** Cannot continue housing allowance from SEP-IRA (must use church-sponsored plan)

Retirement Plan Comparison: Which Plan Fits?

403(b) ✅ BEST

- Highest limits
- Non-ERISA option
- Housing in retirement
- SE tax savings

SEP-IRA (Good)

- Minimal admin
- Easy setup
- No compliance
- Housing limited

Housing Allowance in Retirement: THE CRITICAL ADVANTAGE

- **How It Works:** Pastor can exclude housing allowance portion from retirement plan distributions (not subject to income tax)
- **Example Savings:** $30k annual distribution = $15k housing allowance + $15k taxable income = only $15k taxed
- **Tax Savings:** At 22% tax rate: saves $3,300/year in taxes on $15k housing allocation
- **Requirements:** MUST be from church-SPONSORED PLAN (403(b), church 401(k), church pension - NOT IRA)
- **Designation CRITICAL:** Church must designate housing allowance amount BEFORE retirement year begins
- **DANGER:** Rolling 403(b) into IRA loses housing allowance benefit forever (irreversible)
- **Planning:** Coordinate retirement plan selection with housing allowance continuation strategy

Housing Allowance: Maximum Eligible Amount

- **Three-Prong Test:** Lesser of (1) actual housing costs, (2) fair rental value, or (3) amount designated by church
- **Housing Costs Include:** Rent/mortgage, property tax, utilities, insurance, maintenance, furnishings
- **Fair Rental Value:** Professional appraisal showing what house would rent for if rented to stranger
- **Furnished Value Component:** Often overlooked - includes furniture, appliances, decorations (5-10% of rental value)
- **Example Calculation:** Fair rental value $2,000/mo + furnished value $150 = $25,800/year eligible housing
- **Excess Limitation:** Cannot exceed amount actually used for housing (no surplus allocation)
- **Mandatory Review:** Must review annually to ensure designation matches actual costs

Catch-Up Contributions: Age 50+ Maximization

- **Standard Catch-Up (Age 50+):** Additional $7,500 employee deferral (total $31,000 for 403(b)/401(k))
- **NEW Enhanced Catch-Up (Age 60-63):** Additional $11,250 (total $34,750) - new for 2025!
- **Aggregate Limit Example:** Age 56 pastor can contribute $31,000 employee + ~$46,500 employer = $77,500 total (403(b))
- **Age 60-63 BONUS:** Can contribute $34,750 employee + employer contributions = potentially $81,250+ total
- **Strategic Window:** Ages 60-63 is CRITICAL make-up period before mandatory retirement (consider working longer)
- **Solo 401(k) Catch-Up:** Same rules apply - age 50+ can add $7,500 (or $11,250 if 60-63)
- **Action Item:** Ensure church 403(b) plan allows catch-up contributions (some older plans don't)

Investment Strategy: Asset Allocation by Age

- **Ages 35-45:** Aggressive (70-80% stocks, 20-30% bonds) - long timeline, recover from downturns
- **Ages 45-55:** Moderate-aggressive (60% stocks, 40% bonds/conservative) - transition phase
- **Ages 55-65:** Moderate (50% stocks, 50% bonds/stable value) - reduce volatility, stabilize near retirement
- **Ages 65+:** Conservative-moderate (30-40% stocks, 60-70% bonds/fixed income) - income generation focus
- **Target-Date Funds:** Consider for simplicity (automatically adjusts allocation as you age)
- **Rebalancing:** Annual rebalancing to maintain target allocation (especially important mid-career)
- **No Guarantees:** Past performance doesn't guarantee future results; consult financial advisor on individual risk tolerance

Retirement Readiness: How Much Is Enough?

- **25x Rule of Thumb:** Retire when savings = 25x annual expenses (4% safe withdrawal rate)
- **Example:** Need $60k/year to live = need $1.5M saved ($60k x 25)
- **By Age 30:** Have 1x annual salary saved (e.g., $60k salary = $60k saved)
- **By Age 40:** Have 3x annual salary saved
- **By Age 50:** Have 6x annual salary saved
- **By Age 60:** Have 10x annual salary saved (approaching ready)
- **Housing Allowance Factor:** Housing allowance in retirement reduces required portfolio size significantly

Building Retirement Income: Three-Legged Stool

Leg 1: Social Security

- Estimated $1,800-2,500/month (if opted in)
- Inflation adjusted
- Lifetime benefit

Leg 2: Retirement Savings

- Church 403(b)/401(k)
- Solo 401(k) (side income)
- Personal IRA/Roth

Leg 3: Housing Allowance

- Tax-free from church
- Reduces taxable income
- Provides housing security

Common Retirement Planning Mistakes Pastors Make

❌ Mistake

- No retirement savings
- Rolling 403(b) to IRA
- Ignoring SE tax impact
- No documentation of housing

✅ Solution

- Start 403(b) ASAP
- Keep in church plan
- Pre-tax 403(b) reduces SE tax
- Annual appraisal & designation

How to Get Church 403(b): Implementation Guide

- **Step 1:** Pitch to church board - explain benefits (pastor security, staff morale, tax-efficient)
- **Step 2:** Select provider (Fidelity, Vanguard, American Funds, or denominational plan)
- **Step 3:** Decide non-ERISA vs. ERISA (non-ERISA simpler - recommend for most churches)
- **Step 4:** Determine contribution structure (matching, discretionary, employee-only)
- **Step 5:** Prepare plan document and adoption agreement (provider handles this)
- **Step 6:** Board approval and implementation (establish payroll deductions)
- **Timeline:** Can implement same calendar year (before December 31 for that year)

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Pre-Retirement Planning Checklist (5 Years Before)

- ☐ Calculate total retirement savings needed (25x rule of thumb)
- ☐ Review Social Security statement (ssa.gov account)
- ☐ Estimate Social Security benefit if claimed at 62, 67, 70
- ☐ Confirm church 403(b) plan allows housing allowance continuation
- ☐ Get professional appraisal of housing value (fair rental + furnished)
- ☐ Coordinate 403(b) withdrawal strategy with housing allowance designation
- ☐ Review investment allocation - transition to more conservative mix
- ☐ Consider meeting with tax advisor on withdrawal sequencing strategy

Pre-Retirement Checklist Continued

- ☐ Plan Medicare enrollment strategy (age 65, coordinate with coverage)
- ☐ Consider catch-up contributions in final working years
- ☐ Update estate planning documents (will, beneficiaries, power of attorney)
- ☐ Explore part-time or interim ministry options to extend income
- ☐ Review health insurance options in retirement (COBRA, ACA, retiree coverage)
- ☐ Calculate Required Minimum Distributions (RMDs) starting age 73 (2024 law change)
- ☐ Meet with financial advisor to finalize retirement budget
- ☐ Communicate retirement timeline to church board (succession planning)

Case Study: Pastor's Complete Retirement Plan

Scenario: Pastor Bob, age 45, $60k salary, married

- **Action Plan:** (1) Start church 403(b) at $15k/year employee + $12k church match
- **Income Benefit:** Saves $8,190 in self-employment tax ($27k x 30.4% effective SE tax rate)
- **By Age 50:** $150k saved (20 years @ $7.5k growth)
- **By Age 60:** $500k+ saved (increases to $40k/year contributions with church match)
- **By Age 65:** $750k+ saved with 5-year catch-up boost
- **Retirement Income:** $750k @ 4% = $30k/year + $24k Social Security + $18k housing allowance = $72k/year tax-deferred
- **Tax Result:** Only $30k taxable income (due to housing allowance benefit) at ~7% effective rate = $2,100 taxes

Key Takeaways: Retirement Success for Pastors

- Pastors face unique dual tax status requiring specialized planning
- Church 403(b) is BEST option for maximum retirement security + housing allowance continuation
- Pre-tax contributions reduce BOTH income tax AND self-employment tax (massive advantage)
- Housing allowance in retirement cuts taxes by 25-30% (NEVER roll 403(b) to IRA)
- Catch-up contributions (ages 50+) are essential to make up for early low savings
- Social Security decision (Form 4361 opt-out) is irreversible - understand implications
- Early action (starting in 30s/40s) compounds to substantial retirement security
- Documentation & professional guidance ensure compliance and maximize benefits

Ready to Retire Securely?

Start 403(b) Today • Plan Housing Allowance • Maximize Tax Benefits

Next: Independent Contractors & 1099 Classification

Thank You

Secure Your Retirement • Protect Your Family • Serve With Confidence

Contact: Church Clergy Tax Management & Compliance

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