



## **Taxation for Ministers**

### **A Practical Guide**

In 1913 federal income taxes were ratified, signed into law and imposed on all U.S. citizens. In 1921, Congress, the Courts and the Internal Revenue Service all agreed that a “Minister of the Gospel”, should receive certain tax benefits beyond the general population. For tax reporting purposes you are a “Minister of the Gospel” if you meet all of the following criteria:

- You must be ordained, licensed or commissioned, as a minister, through a church, religious organization, or parachurch ministry. For the purposes of this guide, I will refer to each of these entities as a church.
- A minister includes priests, rabbis, imams, and similar members of the clergy. For the purposes of this guide, I will refer to each of these occupations as ministers.
- A minister must generally perform the following functions:
  1. Administration of sacraments
  2. Religious worship, administration
  3. Be under the authority of a church.
- For the following discussions social security tax and self-employment tax are basically considered to be the same tax. Social security tax is paid by the employee and the employer equally, self-employment tax is paid solely by the minister.

Therefore, once you meet the above criteria you must retain an association with a church to which you are accountable and oversees your activities.

## **Federal income taxes:**

All U.S. citizens are required to file an annual income tax return (form 1040) and report their worldwide income, not just income received and or earned while in the states. For income tax reporting purposes ministers are taxed as follows:

- Generally, the U.S. government imposes two types of taxes on their citizens. The first tax is an income tax and the second is the social security or self-employment tax.
- Ministers are generally considered to be employees for federal income tax reporting purposes and thus must file an annual income tax return, (form 1040).
- Ministers are considered self-employed for social security purposes and must pay self-employment tax on their gross wages including any housing allowance received, unless they have filed to be exempt from self-employment tax by filing form 4361 with the IRS.
- Therefore, the employing church does not treat the minister as an employee for social security withholding purposes.
- Generally, the employing church must issue a W-2 to the minister at year end showing net taxable wages, any income tax withholdings and any housing allowance paid.
- Even though ministers are considered employees for income tax purposes, ministers are considered self-employed for social security taxes. Therefore, ministers must pay self-employment taxes on their wages including their housing allowance payments unless they have elected to be exempt.
- A minister may claim a housing allowance as part of their compensation which is exempt from income tax reporting.

Therefore, their taxable wages for W-2 reporting purposes only reflect their net wages paid after subtracting the housing allowance.

- A minister who has elected to be exempt from the self-employment tax, may elect to have federal and or state income tax withheld from their wages by their church employer. This is done to cover any income taxes which may be due on their net taxable wages when they file their annual tax form 1040.

## **When to file a tax Return:**

As a U.S. citizen you are required to file an annual tax return by April 15<sup>th</sup> of the following year, based on all taxable income received and earned in the calendar year. However, if you are residing outside of the U.S. (on the regular due date of your return), you are allowed an automatic 2-month extension to file your return without requesting an extension. If you use a calendar year, the regular due date of your return is April 15, and the automatic extended due date would be June 15. If the due date falls on a Saturday, Sunday, or legal holiday, the due date is delayed until the next business day. This applies to all U.S. citizens residing abroad, not just ministers.

To effectively obtain this automatic extension, I would advise you file your tax return stating your foreign address on your personal tax return. This will assist the IRS in granting the extension, which will hopefully avoid a late filing notice from their office.

## **How to File:**

The following tax filing status options are available to be claimed when filing a US individual income tax return.

1. Single
2. Married Joint

3. Married Filing Separate
4. Head of Household.
5. Surviving spouse.

Generally, the single or married joint filing status are claimed when filing a US tax return. However, you may consider filing as Head of Household if you meet the following criteria:

1. You paid more than half the cost of maintaining a home for the year.
2. Your home was the main home of your child, stepchild, or foster child for more than half the year.
3. If your spouse was a nonresident alien at any time during the year and you don't choose to treat your nonresident spouse as a resident alien. However, your spouse isn't a qualifying person for head of household purposes. You must have another qualifying person and meet the other tests to be eligible to file as head of household.
4. If you qualify to file as head of household, your tax rate will usually be lower than the rates for single or married filing separately. You will also receive a higher standard deduction than if you file as single or married filing separately.

## **Taxation of Ministers:**

An ordained, licensed, or commissioned minister who performs ministerial services is treated as a self-employed person for social security tax reporting purposes. This means when a pastor is employed by a church they are only to be treated as employees for income tax wage reporting purposes. The church employer should issue a W-2 for all wage payments received by you. Note, only the following boxes are reported on the W-2.

W-2 box#1 – Only report net taxable wages paid after applying any housing allowance deduction claimed.

W-2 box#2 – This is generally blank except if the minister elects to have federal income tax withholding on their net wages. If the

minister has **not** elected out of self-employment tax by filing tax form 4361, I would advise the following:

- Electing to have your church employer withhold income tax on your wages to cover any income and self-employment tax due, or
- File quarterly estimated vouchers, (1040ES) so that any income tax and self-employment tax which is estimated to be due is paid prior to year-end.
- Note, currently the self-employment tax rate is 15.3% on all wages received including any housing allowance received or the fair market value of the parsonage used,
- Again, self-employment tax is due on all payments received including base pay, a housing allowance or parsonage allowance, medical payment reimbursements, (unless part of a qualified medical insurance reimbursement account) and any tips and gifts received through the church.

W-2 box f: This box contains your address. You may want to use your home address in the states to avoid listing your foreign address.

W-2 box #14: This is where you state your excluded housing allowance received, or parsonage allowance value received.

W-2 box#16 – If applicable report state wages paid while residing in the U.S.

W-2 box#17 – Report state income tax withholdings on the state wages received.

Note: If the minister is residing abroad box 16 and 17 will be blank.

Remember: Generally, ministers are employees for income tax wage reporting purposes. Ministers are to report their wage payments on form 1040. However, under certain circumstances ministers may be treated as self-employed for income tax reporting purposes and therefore, report wage payments on schedule “C” as a self-employed minister. This treatment is rare for ministers as most ministers serve only one church.

## Special Exemptions and deductions just for Ministers:

Ministers have been granted two special tax benefits under the Internal Revenue code as follows:

### 1. Housing allowance and parsonage exclusion, (IRC section 107)

*The Internal Revenue, (Code Section 107) reads as follows:*

*In the case of a **minister** of the gospel, gross income does not include—*

*(1) the rental value of a home furnished to him as part of his compensation; or*

*(2) the rental allowance paid to him as part of his compensation, to the extent used by him to rent or provide a home and to the extent such allowance does not exceed the fair rental value of the home, including furnishings and appurtenances such as a garage, plus the cost of utilities.*

Much overlooked and generally incorrectly computed, this housing and or value of a parsonage allowance only applies to ministers. To correctly compute this deduction, you must first determine the **lessor of the following limit computations** at the end of the year:

1. Compute your total housing costs for the year including mortgage payments, real estate taxes, insurance, appliances, household items, utilities, and maintenance, then compare this to the following,
2. The fair rental value of your fully furnished house plus utilities, then compare this to the following,
3. Reasonable compensation for your ministry services.

The allowed housing deduction **will be the lower** of the three computations computed above.

At the beginning of each tax year, you are required to provide an estimate of the anticipated lower of the three computations to your church employer. Your employer is to proportionally apply this estimate amount over your annual pay periods and exclude that amount as taxable wages from each income tax wage reporting period. To be able to exclude the housing allowance from income, the minister's employing church organization must officially designate the housing allowance as such before paying it to the minister.

At tax time a reconciliation must be made between the housing allowance received to the three limits above. If your housing allowance received through your church is greater than any of the following:

- Your reasonable compensation
- The fair rental value of the home plus utilities, or
- Your actual expenses directly relating to providing the home

Then you must include this excess amount as additional taxable wages on the form 1040. If it is less, then you do not make any further adjustments on your tax return.

If you own your home, you may still claim deductions for mortgage interest and real property taxes on schedule "A" of your tax return.

Remember: A minister of the Gospel is a licensed, commissioned, or ordained minister who performs ministerial services as an employee. Once you pass this test you can exclude from your taxable compensation a parsonage allowance, or a housing allowance provided, if used to rent or otherwise provide a home for you or your family. This estimate of a projected annual housing allowance should be determined at the beginning of each tax year and provided to the church for wage reporting purposes.

A minister who is furnished with a parsonage may exclude from gross income the fair rental value of the parsonage, including utilities.

Further clarification was provided by the Rick Warren IRS case, (United States Court of Appeals, Ninth Circuit. Richard D. Warren; Elizabeth K. Warren, Petitioners-Appellees, v. Commissioner of Internal Revenue, Respondent-Appellant. No. 00-71217. Decided: August 26, 2002) and later signed into law by President Bush which reads as follows:

*Since 1921, pastors and other religious leaders have been able to deduct from federal taxes a portion of their income for housing. The new law is intended to preserve the exemption by amending the Internal Revenue Code to make clear the allowance **should not exceed** the “fair rental value” of a house, including furnishings, accessories and utilities.*

*While the bill would not settle the issue of constitutionality, its supporters believe it will end the Ninth Circuit’s threat to the allowance by codifying the “fair rental value” language formerly used by the Internal Revenue Service. The legislation would provide a way for both sides in the Ninth Circuit case to resolve the dispute. It would not prevent a future challenge to the allowance’s constitutionality, however.*

**Note, the fair rental value of a parsonage or the housing allowance is excludable only for income tax purposes. A minister who has not filed IRS form 4361 to be exempt from self-employment tax must include the parsonage or housing allowance as additional taxable income for your self-employment tax computation.**

## **2. Exemption from Self-employment tax, (also called Social Security tax on wages)**

For normal **non-ministry** wage reporting purposes, the IRS requires your non-church employer to withhold income tax and social security taxes on your wage payments. However, a licensed, commissioned, or ordained minister who performs ministerial services as an employee of the church may request an exemption from self-employment tax for your ministerial earnings.



Payments made to you as a minister are payments to a self-employed person. If you meet the tests mentioned above, (as a minister) and are performing sacerdotal duties for the church or organization your employer is only to report to the IRS your base net wage payments, (net of your housing allowance) and any income tax withholdings. They are not to withhold and remit any social security payments from your wages.

Since ministers are self-employed for social security tax purposes, they must separately pay self-employment tax on their wages when they file their tax return at year-end on IRS schedule SE. However, they are allowed to be exempt from self-employment tax for only their ministry related wages based on any of the following positions:

- You are opposed to public Social Security coverage, or
- You have not taken a vow of poverty.
- Ministers can't request an exemption for economic reasons.

To request the exemption, you must file;

**Form 4361, (Application for Exemption From Self-Employment Tax for Use by Ministers, Members of Religious Orders and Christian Science Practitioners) with the IRS.**

**You must file form 4361 by the due date of your income tax return (including extensions) by the second tax year in which you have net earnings from self-employment of at least \$400.**

This rule applies if any part of your net earnings from each of the two years came from the performance of ministerial services. The two years don't have to be consecutive. The exemption is granted if the IRS approves your application. Once granted, the exemption is irrevocable.

Note: I have experienced a 50/50 split on this issue with the ministers I have served. If you file form 4361 for the exemption, be sure to save for retirement through some other means. If you have filed this exemption request, you will not be eligible to receive social security benefits at age 62 or Medicare benefits at age 65 unless

you have paid social security taxes from **non-ministry** related employment.

I would recommend if you filed the exemption request, please also supplement your present or future income with non-ministry wages by paying in social security taxes so that you may qualify for Medicare benefits at age 65.

## **Foreign Earned income deduction:**

If you are residing in a foreign country, you may be entitled to exclude from taxation your taxable wages received while residing in a foreign country. This applies to wages paid by any U.S. entity or foreign entity while you are abroad. You must file form 2555 with your 1040 tax return.

To claim these benefits, you must have **foreign earned income**, your tax home must be in a **foreign country**, and you must be **one of the following**:

- A U.S. citizen who is a bona fide resident of a foreign country or countries for an uninterrupted period that includes an entire tax year,
- A U.S. resident alien who is a citizen or national of a country with which the United States has an income tax treaty in effect and who is a bona fide resident of a foreign country or countries for an uninterrupted period that includes an entire tax year, or
- A U.S. citizen or a U.S. resident alien who is physically present in a foreign country or countries for at least 330 full days during any period of 12 consecutive months.

However, I would recommend **not filing this form** under the following conditions:

1. Your foreign address must be stated on the form. If you are concerned about stating your foreign address do not submit the form. Note, form 2555 only is filed with the IRS and it is a crime if your personal information becomes public. You may

want to consider claiming a housing allowance instead. However, a housing allowance may only exclude a portion of your foreign wages received.

2. If you file form 2555 you cannot also claim any of the following:

- **Additional child tax credit.** The IRS allows taxpayers to claim a credit for all children under the age of 17, which is called the Child Credit. The entire child credit is first computed on tax form 8812. The credit is first applied against an income tax due on your tax return. If there is an excess child credit unused it is generally a refundable credit on your tax return. However, if you claim either the foreign earned income exclusion or the housing deduction the additional child credit **is lost and is not refundable**.
- **Earned income credit.** You can't take the earned income credit if you claim either the foreign earned income exclusion or the election to be exempt from self-employment tax. However, if neither apply the earned income credit is fully allowed. See IRS publication, (Military and clergy rules for the Earned Income Tax Credit, go to; <https://www.irs.gov/credits-deductions/individuals/earned-income-tax-credit/military-and-clergy-rules-for-the-earned-income-tax-credit> )
- **Foreign tax credit or deduction.** You can't take a credit or deduction for foreign taxes paid or accrued on income that is excluded under either of the above exclusions. If all your foreign earned income is excluded, you can't claim a credit or deduction for the foreign taxes paid or accrued on that income. If only part of your income is excluded, you can't claim a credit or deduction for the foreign taxes allocable to the excluded income. See Pub. 514 for details on how to figure the amount allocable to the excluded income.
- **IRA deduction.** If you claim either of the above exclusions, special rules apply in figuring the amount of your IRA deduction. For details, see Pub. 590-A.

## **How to claim the Earned Income Credit:**

This is interesting. You are allowed to claim the Earned income credit if your exempt organization issues you a W-2. The calculation for the Earned income credit includes W-2 wages. Even if you filed form 4361 your W-2 wages qualify. However, your non-taxable housing allowance payments are not considered wages for the Earned income credit calculation. Also, if you are issued a 1099 from your church or non-profit organization and wages are not reported on a W-2 those payments do not qualify as wages for the earned income credit.

## **Retirement plans available and allowed:**

Ministers like other U.S. taxpayers need to save for retirement. This is true especially for ministers who have filed for 4361 and are exempt from paying self-employment tax on their ministry wages. Therefore, I strongly urge you to consistently contribute to a qualified retirement plan or other non-qualified investment account for retirement income that you can draw on in the future.

The allowed qualified retirement plans, (see IRS publication on Types of retirement plans, ( <https://www.irs.gov/retirement-plans/plan-sponsor/types-of-retirement-plans>) as follows:

### **1. Roth account:**

- a. Contributions are not current tax deductions but when distributions occur the distributions are tax free. Under current law, if you are under 50 years old your limit is \$7,000. If over 50 your limit is \$8,000. Note, your limit is reduced if your earned income is under the above limits. There is no age limit on allowed contributions to a Roth account.

## **2. Traditional IRA account:**

- a. Contributions are currently tax deductible and have the same limits as Roth accounts for above. However, under current law, at age 73 you must begin to liquidate the account into taxable income based on the RMD rules.

## **3. Church 403(b) account:**

- a. Under current law you may be able to contribute up to \$23,000 into this account if you are under 50 years old. If over 50 your limit is \$31,000 and if 60 to 63 your limit is \$34,750.

## **4. Self-employed retirement accounts:**

- a. See; (<https://www.irs.gov/retirement-plans/retirement-plans-for-self-employed-people>)

Daniel Padden, CPA/PFS

[dan@missions.tax](mailto:dan@missions.tax)

609-304-1266

### References:

- 2024 Church & Clergy Tax Guide (Book)  
<https://store.churchlawandtax.com/2024-church-clergy-tax-guide-book/>
- IRS topic #417, Earnings for Clergy