Welcome!
Ministers graduating from seminary are well-prepared to lead and teach on theological matters. But few enter the pastorate equipped to handle the myriad tasks of managing ministry finances and taxes, much less filing their own clergy taxes.

Church treasurers face a similar challenge. Often they are volunteers who have an acumen for numbers, but may not know the nuances of tax law as it relates to the church and clergy.

In this month’s edition of Church Finance Today, I focus on three of the most confusing tax issues for ministers—whether to pay taxes and Social Security as an employee or self-employed, and how to file estimated taxes. There are many more issues new ministers and treasurers need to know about taxes, but these represent three of the most common questions I get every year.

To learn about the other most frequently asked questions, see my new eBook, Essential Guide to Law and Tax for New Ministers (available at YourChurchResources.com).

Blessings as you embark on a new year in ministry!

Richard R. Hammar

Ministers and treasurers must be familiar with the tax rules that apply to clergy. Unfortunately, seminary training rarely equips new ministers with this information, and church treasurers often don’t know about the unique tax laws that apply to clergy. This information gap means ministers and treasurers frequently handle clergy income and the payment of related taxes incorrectly, and they fail to take advantage of the tax benefits that are available to ministers.

For instance, ministers are eligible for five special tax rules with respect to services they perform in the exercise of their ministry. These include (1) not paying federal income taxes on the portion of their church compensation designated in advance by their church as a housing allowance (limitations apply), (2) not paying federal income taxes on the annual rental value of a parsonage provided by their church, (3) being exempt from “self-employment taxes” (Social Security taxes paid by the self-employed) if several conditions are met, (4) being considered self-employed for Social Security (if not exempt), and (5) having ministers’ wages exempt from income tax withholding.

In order to qualify for these tax savings, however, you must meet the IRS’s definition of a “minister.” The IRS applies a five-factor test to determine whether an individual qualifies as a minister for federal income tax purposes. In general, for individuals to enjoy the five special tax rules summarized above, they must satisfy two main requirements: they must be a minister, and they must be engaged in the exercise of ministry.

Assuming you clear these IRS hurdles for establishing whether or not you’re a minister for federal tax purposes, you then need to know how to file taxes properly to ensure you receive the benefits available to you.

In this article, we focus on three of the most perennially perplexing tax issues for clergy. While there are many more we could cover, these are the three that pose confusion and uncertainty for many ministers and church treasurers, new and seasoned.

1. Should a Minister Report Income Taxes as an Employee or as Self-Employed?
The question of whether ministers should report their federal income taxes as an employee or as self-employed is a significant one. Most new ministers should report their federal income taxes as employees, because they will be considered employees under the tests currently used by the IRS and the
Many new (and even veteran) ministers are surprised to learn that their employment status for income tax purposes has no bearing on their employment status for Social Security taxes.

SHOULD A MINISTER “OPT OUT” OF SOCIAL SECURITY?

Ministers may elect to opt out of Social Security, but you need to understand the rules and implications before making such a decision. Ministers can exempt themselves from self-employment taxes for Social Security with respect to services they perform in the exercise of ministry by filling a timely Form 4361 with the IRS. The exemption is available only if a minister is opposed on the basis of religious considerations to the acceptance of Social Security benefits rather than to payment of the tax. Several conditions apply.

3. How Does a Minister Pay Taxes?

The federal income tax is a “pay as you go” tax. This means that you must pay your tax as you earn income during the year. There are two ways to do this—quarterly estimated tax payments and tax withholding.

Ministers must prepay their income taxes and self-employment taxes using the estimated tax procedure, which can be confusing. Nonetheless, it’s important to understand how to calculate and pay estimated taxes to avoid significant tax liabilities.

Generally, you should make estimated tax payments if your estimated tax for this year will be $1,000 or more and the total amount of income tax that will be withheld from your income will be less than the lesser of (1) 90 percent of your tax liability for the current year, or (2) 100 percent of your tax liability for the previous year (if it covered all 12 months of the year). If you are required to pay estimated taxes, but fail to do so, you will be subject to an “underpayment penalty.” Since the penalty is figured separately for each quarterly period, you may owe a penalty for an earlier payment period even if you later paid enough to make up the underpayment. If you did not pay enough tax by the due date of each of the payment periods, you may owe a penalty even if you are due a refund when you file your income tax return!

The 4-step procedure for paying estimated taxes

Complying with the estimated tax procedure is easier than it seems. Here are the four steps you need to follow:

Step 1—Obtain a copy of IRS Form 1040-ES prior to April 15 of the current year.

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DONATING A HOUSE

What are the rules for valuing property?

By Richard R. Hammar

Q: A member recently donated his home to our church. Are there specific rules for the church to value this property, or does the burden rest upon the donor to assign value?

A: Generally, if a claimed deduction for an item or group of similar items of donated property is more than $5,000, the donor must obtain a qualified appraisal by a qualified appraiser, and attach a "qualified appraisal summary" (Section B of IRS Form 8283) to the tax return on which the contribution is claimed. There are some exceptions to these rules. For example, a donor does not need an appraisal if the donated property is nonpublicly traded stock of $10,000 or less; a vehicle (including a car, boat, or airplane) for which the deduction is limited to the gross proceeds from its sale; and certain publicly traded securities. But there is no exception that applies to the donation of a member's home.

The income tax regulations define a qualified appraisal as an appraisal that (1) is "made, signed, and dated" by a "qualified appraiser"; (2) is made no earlier than 60 days prior to the date of the appraised property was donated; (3) does not involve a prohibited appraisal fee (i.e., based on a percentage of the appraised value or on the amount allowed as a deduction); and (4) includes 12 items of information. In addition, a qualified appraisal must be prepared in accordance with generally accepted appraisal standards and any regulations or other guidance prescribed by the IRS.

A donor must also complete an appraisal summary and enclose it with the tax return on which the charitable contribution deduction is claimed. The appraisal summary is a summary of the qualified appraisal and is made on Section B (side 2) of IRS Form 8283. If the amount of a contribution of property other than cash, inventory, or publicly traded securities exceeds $500,000 (if art, $20,000), the qualified appraisal must be attached to the donor's tax return. For purposes of the dollar thresholds, property and all similar items of property donated to one or more charities are treated as one property.

The instructions for Form 8283 caution that "your deduction generally will be disallowed if you fail to attach a required Form 8283 to your return or get a required appraisal and complete Section B of Form 8283." Numerous Tax Court cases have denied charitable contribution deductions to donors who failed to strictly comply with these rules. Many of these cases have been described in this newsletter.

In conclusion, if the member of your church who donated a home to the church failed to obtain a qualified appraisal by a qualified appraiser within 60 days of the date of the donation, then no charitable contribution deduction will be allowed. While compliance with these substantiation rules technically is the donor's responsibility, the fact is that many donors are not familiar with these substantiation rules and may blame the church if they lose a tax deduction for donated property because of noncompliance with the rules. As a result, it is a "best practice" for church-es to assist members who express an interest in donating property that may be valued at more than $5,000 by informing them of the qualified appraisal requirement, providing them with the instructions to Form 8283 (available on the IRS website), and encouraging them to seek the assistance of a tax professional.

To submit a question for consideration in a future Q&A, email: CFeditor@ChristianityToday.com.

Step 2–Compute estimated taxes. Calculate your estimated tax for the current year by estimating adjusted gross income and then subtracting estimated adjustments, deductions, exemptions, and credits. Multiply estimated taxable income times the applicable tax rate contained in the Tax Rate Schedule reproduced on Form 1040-ES. Include your estimated Social Security tax on the worksheet if you are not exempt, and include your housing allowance exclusion in computing your estimated earnings subject to the self-employment tax.

Step 3–Pay estimated taxes in quarterly installments. If estimated taxes (federal income taxes and self-employment taxes) are more than $1,000 for the current year, and the total amount of taxes to be withheld from your compensation is less than the lesser of (1) 90 percent of your tax liability for the current year, or (2) 100 percent of your tax liability for the previous year, then you must pay one-fourth of your total estimated taxes in four quarterly installments (by April 15 for January 1 to March 31; by June 15 for April 1 to May 31; by September 15 for June 1 to August 31; and by January 15 for September 1 to December 31). If the due date for making an estimated tax payment falls on a Saturday, Sunday, or legal holiday, the payment will be on time if you make it on the next business day.

Payment vouchers. You must send each payment to the IRS, accompanied by one of the four payment vouchers contained in Form 1040-ES.

Starting a job in mid-year. A minister who becomes liable for estimated tax payments midway through a year should submit a payment voucher by the next filing deadline accompanied by a check for a prorated portion of the entire estimated tax liability for the year.

Changing your quarterly payments. Changes in your income, deductions, credits, or exemptions may make it necessary for you to refigure your estimated tax and adjust your remaining quarterly payments accordingly.

Step 4–Compute actual taxes. After the close of the year, compute your actual tax liability on Form 1040. Only then will you know your actual income, deductions, exclusions, and credits. Estimated tax payments rarely reflect actual tax liability. Most taxpayers' estimated tax payments are either more or less than actual taxes as computed on Form 1040 (usually less).

Overpayment. If you overpaid, you can elect to have the overpayment credited against your first quarterly estimated tax payment of the following year or spread
out in any way you choose among any
or all of your next four quarterly install-
ments. Alternatively, you can request a
refund of the overpayment.

Underpayment. If you underpaid your
estimated taxes you may have to pay a
penalty. The penalty is computed sepa-
rate for each quarterly payment period.
Contrary to popular belief, payment of
your entire estimated tax liability with
your Form 1040 will not relieve you of
the penalty if you did not pay the estimated
income tax due earlier in the year.

Form 2210. You can use Form 2210 to
see if you owe a penalty and to figure
the amount of the penalty. If you owe a
penalty and do not attach Form 2210 to
your Form 1040, the IRS will compute
your penalty and send you a bill. You do
not have to fill out a Form 2210 or pay
any penalty if either of two conditions
apply: (1) your total tax less income tax
withheld is less than $1,000, or (2) you
had no tax liability last year and you were
a United States citizen or resident for
the entire year. The IRS can waive the
underpayment penalty if the underpayment
was due to casualty, disaster, or other
unusual circumstance and it would be
inequitable to impose the penalty.

Special rule for high-income taxpay-
ers. A high-income taxpayer with adjusted
gross income for the previous year of at
least $150,000 cannot avoid the underpay-
ment penalty by paying estimated taxes for
the current year of at least 100 percent of
last year’s tax. For such persons, the “100
percent rule” is replaced with a 110 percent
rule, meaning that they will be subject to
an underpayment penalty unless they have
paid estimated taxes for the current year of
at least the lesser of (1) 90 percent of the
current year’s actual tax liability, or (2) 110
percent of last year’s actual tax liability.

Voluntary withholding
Ministers who report their income taxes as
an employee may request “voluntary with-
holding” of their income taxes and self-
employment taxes by filing a Form W-4
with the church. A self-employed minister
is free to enter into an “unofficial” with-
holding arrangement whereby the church
withholds a portion of his or her compensa-
tion each week and deposits it in a church
account, and then distributes the balance
to the minister in advance of each quarterly
estimated tax payment due date.

This article summarizes three of the most
confusing tax issues for clergy and church
treasurers. You can learn more about
many other critical law and tax topics in
my new eBook Essential Guide to Law and
Tax for New Ministers. My annual Church
& Clergy Tax Guide is another must-have
reference for all clergy and churches.

WE NEED YOUR HELP!
Take the new
compensation survey.

We’re gathering compensation informa-
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Thank you in advance for being part of
this critical research.

—Richard R. Hammar

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