# Chapter 6 PARSONAGES AND HOUSING ALLOWANCES

***Joseph established it as a law concerning land in Egypt—still in force today—that a fifth of the produce belongs to Pharaoh. It was only the land of the priests that did not become Pharaoh's.***

*Genesis 47:26*

## CHAPTER HIGHLIGHTS

- **PARSONAGES** Ministers who live in a church-owned parsonage that is provided rent-free as compensation for ministerial services do not include the annual fair rental value of the parsonage as income in computing their federal income taxes. The annual fair rental value is not deducted from the minister's income. Rather, it is not reported as additional income anywhere on Form 1040 (as it generally would be by nonclergy workers).

- **PARSONAGE ALLOWANCES** Ministers who live in a church-provided parsonage do not pay federal income taxes on the amount of their compensation that their employing church designates in advance as a parsonage allowance, to the extent that the allowance represents compensation for ministerial services and is used to pay parsonage-related expenses such as utilities, repairs, and furnishings.

- **HOUSING ALLOWANCES** Ministers who own their home do not pay federal income taxes on the amount of their compensation that their employing church designates in advance as a housing allowance, to the extent that the allowance represents compensation for ministerial services, is used to pay housing expenses, and does not exceed the fair rental value of the home (furnished, plus utilities). Housing-related expenses include mortgage payments, utilities, repairs, furnishings, insurance, property taxes, additions, and maintenance. Ministers who rent a home or apartment do not pay federal income taxes on the amount of their compensation that their employing church designates in advance as a housing allowance, to the extent that the allowance represents compensation for ministerial services and is used to pay rental expenses and does not exceed the fair rental value of the home (furnished, plus utilities).

- **DESIGNATING AN ALLOWANCE** Parsonage and housing allowances should be (1) adopted by the church board or congregation, (2) in writing, and (3) in advance of the calendar year. However, churches that fail to designate an allowance in advance of a calendar year should do so as soon as possible in the new year (though the allowance will only operate prospectively). In designating housing allowances, churches should keep in mind that the nontaxable portion of a housing allowance cannot exceed the fair rental value of a minister's home (furnished, plus utilities). Therefore, nothing will be accomplished by designating allowances significantly above this limit.

- **SAFETY NET HOUSING ALLOWANCES** Churches should consider adopting a "safety net" allowance to protect against the loss of this significant tax benefit due to the inadvertent failure by the church to designate an allowance.

- **EQUITY ALLOWANCES** Churches should consider adopting an appropriate "equity allowance" for ministers who live in church-owned parsonages.

- **AMENDING THE ALLOWANCE** Churches can amend an allowance during the year if the original allowance proves to be too low. But the amended allowance will only operate prospectively.

- **NO RETROACTIVE APPLICATION** Under no circumstances can a minister exclude any portion of an allowance retroactively designated by a church.

- **SOCIAL SECURITY** A housing allowance and the annual rental value of a parsonage are exclusions only for federal income tax reporting. Ministers cannot exclude a housing allowance (or the annual fair rental value of a parsonage) when computing their self-employment (Social Security) taxes unless they are actually retired. The tax code specifies that the self-employment tax does not apply to "the rental value of any parsonage or any parsonage allowance provided after the [minister] retires." *IRC 1402(a)(8).*

- **PENSION FUNDS** In some cases a church pension plan may designate a housing allowance for retired ministers.

- **REPORTING** Housing allowances are not required to be reported on a minister's Form W-2, but many churches do so by reporting the allowance (or the annual rental value of a parsonage) in box 14. The instructions to Form W-2 say this regarding box 14: "You may use this box for any information that you want to give to your employee. Label each item. Examples include . . . a minister's parsonage allowance and utilities."

Box 14 is used by employers to communicate information to their employees and is ignored by the IRS. This is one way for a church to remind a minister of the amount of the church-designated housing allowance. IRS Publication 517 contains a comprehensive clergy tax filing illustration that includes a minister's housing allowance in box 14. So, while some churches use box 14 to report a minister's housing allowance, this is optional and not required. Further, a church does not need to issue two checks—one for salary and one for housing allowance.

- **SETTING THE ALLOWANCE** There is no limit on the amount of a minister's compensation that can be designated by a church as a housing allowance (assuming that the minister's compensation is reasonable in amount). However, for ministers who own their home, a church ordinarily should not designate a housing allowance significantly above the fair rental value of the minister's home, since the nontaxable portion of a housing allowance cannot exceed this amount.

## IMPORTANT NOTICE: CURRENT STATUS OF PARSONAGE AND HOUSING ALLOWANCE EXCLUSIONS

On November 22, 2013, federal district court judge Barbara Crabb of the District Court for the Western District of Wisconsin struck down the ministerial housing allowance as an unconstitutional preference for religion. *Freedom From Religion Foundation, Inc., v. Lew, 983 F. Supp. 2d 1051 (W.D. Wis. 2013).* The ruling was in response to a lawsuit brought by the Freedom From Religion Foundation (FFRF) and two of its officers challenging the constitutionality of the housing allowance and the parsonage exclusion. The federal government, which defended the housing allowance, since it is a federal statute, asked the court to dismiss the lawsuit on the ground that the plaintiffs lacked standing to pursue their claim in federal court.

Standing is a constitutional requirement of any plaintiff in a federal case and generally means that a plaintiff must have suffered some direct injury as a result of a challenged law. The Wisconsin court concluded that the plaintiffs had standing on the ground that they would have been denied a housing allowance exclusion had they claimed one on their tax return. The government appealed this ruling to a federal appeals court—the Seventh Circuit Court of Appeals in Chicago.

On November 13, 2014, the appeals court issued its ruling reversing the Wisconsin court's decision. *Freedom From Religion Foundation, Inc., v. Lew, 773 F.3d 815 (7th Cir. 2014).* It concluded that the plaintiffs lacked standing to pursue their challenge to the housing allowance. The plaintiffs had asserted that they had standing due to their "injury" of being denied a tax-free housing allowance should they claim one on their tax returns. But the appeals court refused to base standing on theoretical injury. It concluded: "Only a person that has been denied such a benefit can be deemed to have suffered cognizable injury. The plaintiffs here have never been denied the parsonage exemption because they have never requested it; therefore, they have suffered no injury."

It suggested that this deficiency could be overcome if the FFRF's officers filed tax returns claiming a housing allowance that was later rejected by the IRS in an audit: "The plaintiffs could have sought the exemption by excluding their housing allowances from their reported income on their tax returns and then petitioning the Tax Court if the IRS were to disallow the exclusion. Alternatively, they could have . . . paid income tax on their housing allowance, claimed refunds from the IRS, and then sued if the IRS rejected or failed to act upon their claims."

The FFRF responded to the appeals court's ruling by designating a housing allowance for two of its officers. The officers reported their allowances as taxable income on their tax returns and thereafter filed amended tax returns seeking a refund of the income taxes paid on the amounts of their designated housing allowances. The FFRF claims that in 2015 the IRS denied the refunds sought by its officers (one of whom had died and was represented by her executor).

Having endeavored to correct the standing problem, the FFRF renewed its legal challenge to the housing allowance in the federal district court in Wisconsin, where the litigation began. Eight developments are noteworthy:

First, on October 6, 2017, judge Barbara Crabb of the federal district court for the Western District of Wisconsin again ruled that the ministerial housing allowance is an unconstitutional preference for religion. *Gaylor v. Mnuchin, (W.D. Wis. 2017).* Judge Crabb observed:

> *[The housing allowance] violates the establishment clause because it does not have a secular purpose or effect and because a reasonable observer would view the statute as an endorsement of religion.*
>
> *Although defendants try to characterize [the housing allowance] as an effort by Congress to treat ministers fairly and avoid religious entanglement, the plain language of the statute, its legislative history and its operation in practice all demonstrate a preference for ministers over secular employees. Ministers receive a unique benefit . . . that is not, as defendants suggest, part of a larger effort by Congress to provide assistance to employees with special housing*

> *needs. A desire to alleviate financial hardship on taxpayers is a legitimate purpose, but it is not a secular purpose when Congress eliminates the burden for a group made up of solely religious employees but maintains it for nearly everyone else. Under my view of the current law, that type of discriminatory treatment violates the establishment clause.*

Judge Crabb acknowledged that

> *Congress could have enacted a number of alternative exemptions without running afoul of the First Amendment. For example, Congress could have accomplished a similar goal by allowing any of the following groups to exclude housing expenses from their gross income: (1) all taxpayers; (2) taxpayers with incomes less than a specified amount; (3) taxpayers who live in rental housing provided by the employer; (4) taxpayers whose employers impose housing-related requirements on them, such as living near the workplace, being on call or using the home for work-related purposes; or (5) taxpayers who work for nonprofit organizations, including churches.*

★ **KEY POINT** Perhaps of most interest was Judge Crabb's suggestion that the tax code be amended to apply to taxpayers "who work for tax exempt organizations under § 501(c)(3) and are on call at all times." Such an amendment would cover most clergy, but few enough employees of secular charities to be feasible as a matter of tax policy.

Second, Judge Crabb stayed the enforcement of her ruling until the end of October so that the parties could submit briefs on appropriate remedies for the plaintiffs. It is likely, though not certain, that when the issue of remedies is resolved, the judge will do what she did in her earlier decision in 2014 and stay enforcement of the ruling pending an appeal. However, this is not certain, so ministers and churches should be alert to developments.

Third, a ruling by the Seventh Circuit Court of Appeals would apply to ministers in that circuit, which includes the states of Illinois, Indiana, and Wisconsin. It would become a national precedent binding on ministers in all states if affirmed by the U.S. Supreme Court—an unlikely outcome because the Supreme Court accepts less than 1 percent of all appeals. Note, however, that the IRS would have the discretion to follow or not follow such a ruling in other circuits and might be inclined to follow it to promote consistency in tax administration.

Fourth, churches should continue to designate housing allowances for their ministers for 2018 and future years until the housing allowance is conclusively declared unconstitutional. This could occur in various ways, including the following: (1) Judge Crabb's ruling is not appealed by the government, and the IRS applies it nationally; (2) Judge Crabb's ruling is appealed to the Seventh Circuit Court of Appeals, the court affirms Judge Crabb's ruling, and the IRS elects to apply it nationally; or (3) the U.S. Supreme Court accepts an appeal of the appellate court's ruling and determines that the housing allowance is an unconstitutional preference for religion in violation of the First Amendment. Ministers should understand that claiming a housing allowance exclusion while this litigation is pending poses a risk that the exclusion may be disallowed, and an amended tax return would need to be filed. Ministers should be prepared for this outcome, though it is unlikely that the housing allowance will be declared unconstitutional retroactively. Again, be alert to future developments.

Fifth, the U.S. Department of Justice, which defends the constitutionality of federal legislation (such as the housing allowance), filed a brief with the court asking it to dismiss the FFRF's challenge to the constitutionality of the parsonage exclusion. The Department of Justice noted that section 107 of the tax code grants tax exclusions both for the rental value of parsonages provided to clergy as compensation for the performance of ministerial services and for housing allowances provided to clergy who own or rent their home. But since none of the FFRF's officers were living in housing owned by the FFRF, they lacked standing to challenge the constitutionality of section 107's exclusion of the rental value of church-owned parsonages.

The court, noting that the FFRF had not opposed this argument, issued a summary judgment dismissing the FFRF's challenge to the constitutionality of the parsonage exclusion.

Sixth, the Department of Justice brief states that "the United States does not contest plaintiffs' standing to sue under section 107(2)" (i.e., the housing allowance). This concession means that the appeals court will have the opportunity to address the merits of the FFRF's constitutional challenge to the housing allowance. The appeals court ultimately may rule that the housing allowance is constitutional. Or it may decide that it is not. Either way, the ruling likely will be appealed to the U.S. Supreme Court.

Seventh, in conclusion, ministers and churches should be aware that the housing allowance is under attack. Judge Crabb's ruling may be affirmed on appeal and applied nationwide by the IRS. Should that occur, three actions will need to be implemented quickly:

(1) Ministers will experience an immediate increase in income taxes. As a result, they should be prepared to increase their quarterly estimated tax payments to reflect the increase in income taxes in order to avoid an underpayment penalty. Note that there will be no effect on self-employment taxes for which the housing allowance is not tax-exempt.
(2) Many churches will want to increase ministers' compensation to offset the financial impact. Such an increase could be phased out over a period of years to minimize the impact on the church.

(3) Ministers should not consider the housing allowance in assessing the affordability of a new home unless and until the courts conclusively reject the constitutional challenge to the allowance.

Eighth, on January 19, 2017, the federal district court in Wisconsin granted a request by two pastors and the Diocese of Chicago and Mid-America of the Russian Orthodox Church (the "intervenors") to intervene in the case in support of the constitutionality of the housing allowance. The intervenors filed a motion for summary judgment and made several arguments in support of the housing allowance, including those given below. While these arguments were rejected by Judge Crabb, they may be deemed persuasive by the appeals court in the event of an appeal.

### Standing

The intervenors noted that the Constitution limits the jurisdiction of the federal courts to "Cases" and "Controversies," and "no Case or Controversy exists if the plaintiff lacks standing to challenge the defendant's alleged misconduct." To establish standing, plaintiffs bear the burden of demonstrating a "concrete injury" that is traceable to the challenged action of the defendant and that is likely to be redressed by a favorable judicial decision.

In this case, the plaintiffs were seeking only prospective relief. "They do not seek a refund of any taxes that they paid in the past; instead, they seek a nationwide injunction striking down [the housing allowance] prospectively." To obtain this relief, it is not enough to show "past exposure to illegal conduct." Instead, they must show "continuing, present adverse effects" that would be remedied by an injunction. The intervenors' brief asserted that the plaintiffs

> *have failed to demonstrate any continuing harm that would be remedied by an injunction. In fact, the available evidence suggests that they will not suffer continuing harm. According to an FFRF press release, although [the FFRF officers] were denied a refund in 2012, their request for a refund in 2013 was granted. They have produced no evidence suggesting that they will again be denied a refund in the future. Thus, absent a sufficient likelihood that [the FFRF officers] will again be wronged in a similar way, [they are] no more entitled to an injunction than any other citizen of [the United States]; and a federal court may not entertain a claim by any or all citizens who no more than assert that certain practices of [the IRS] are unconstitutional.*

### Housing allowance consistent with historical understanding of the First Amendment

The plaintiffs' primary claim was that the housing allowance violated the Establishment Clause of the First Amendment, which provides that Congress shall make no law respecting an establishment of religion. The intervenors' brief noted that in its most recent Establishment Clause decision, the Supreme Court reaffirmed that "the Establishment Clause must be interpreted by reference to historical practices and understandings." *Town of Greece v. Galloway, 134 S. Ct. 1811 (2014)*. The brief continues:

> *So what does history have to say about the tax treatment of churches and ministers . . . ? While the Establishment Clause prohibits the types of direct financial support that prevailed in colonial establishments—land grants, direct grants from the treasury, and compulsory "tithes" to support churches and ministers—it does not bar the tax exemption at issue here. Such exemptions were common at the time of the Founding and actually further the core Establishment Clause goals of alleviating government burdens on religion, avoiding discrimination among churches, and avoiding entanglement between church and state.*

### Housing allowance consistent with the Supreme Court's Texas Monthly decision

In 1989 the U.S. Supreme Court, in a plurality decision, invalidated a sales tax exemption that applied exclusively to "periodicals . . . that consist wholly of writings promulgating the teaching of [a] faith" and "books that consist wholly of writings sacred to a religious faith." *Texas Monthly, Inc. v. Bullock, 489 U.S. 1 (1989)*. The Court concluded that the sales tax exemption violated the Establishment Clause because it constituted a "subsidy exclusively to religious organizations." The Court's central holding was that a religious tax exemption would be constitutional only if it were part of a broader scheme that provided benefits to "a large number of nonreligious groups as well." The intervenors' brief explains: "Here, the parsonage allowance is distinguishable from the tax exemption struck down in *Texas Monthly* in important ways. First, unlike *Texas Monthly*, where the tax exemption for religious literature stood alone, the parsonage allowance is coupled with numerous tax exemptions for nonreligious housing allowances." These include:

- exemptions for any nonreligious employee who receives lodging for the convenience of his employer [tax code § 119(a)].
- any nonreligious employee living in a foreign camp [tax code § 119(c)].
- any nonreligious employee of an educational institution [tax code § 119(d)].
- any nonreligious member of the uniformed services [tax code § 134].
- any nonreligious government employee living overseas [tax code § 912].
- any nonreligious citizen living abroad [tax code § 911].
- any nonreligious employee temporarily away from home on business [tax code §§ 162, 132].

The brief argues that "it is as if, in *Texas Monthly*, the state had coupled the tax exemption for religious literature with a tax exemption for business literature, scientific literature, educational literature, travel literature, and government literature. That would not

be a form of preferential support for religious messages; it would be a form of putting religious messages on the same footing as many other secular messages."

"In short," the brief continues,

> *Congress has enacted a broad package of tax benefits designed to relieve workers who face unique, job-related housing requirements. The default rule is § 119(a)(2), which establishes a demanding, case-by-case test requiring all employees to demonstrate that their lodging is provided for the convenience of their employer. But Congress also relaxed this default rule in a variety of situations where the type of work, the burdens on housing, or a non-commercial working relationship make it likely that the lodging was intended to benefit the employer.*

★ **KEY POINT** The FFRF suggested that these related exemptions for housing expenses apply only to a small number of secular groups. But according to Congressional estimates, the annual value of these exemptions vastly exceeds the benefit provided by the housing allowance to clergy.

The federal government suggested in a reply brief to the FFRF lawsuit in Wisconsin that it is conceivable that the FFRF officers *could* qualify for a housing allowance because "the IRS does not require that an individual maintain theistic beliefs in order to perform functions that may be considered the duties of a minister of the gospel." This view finds support in a 1961 ruling by the Supreme Court. *Torasco v. Watkins, 367 U.S. 488 (1961).* In the *Torasco* case, the Court observed that "religions" need not be based on a belief in the existence of God: "[N]either [a state nor the federal government] can constitutionally pass laws or impose requirements which aid all religions as against nonbelievers, and neither can aid those religions based on a belief in the existence of God as against those religions founded on different beliefs."

The Court added that "among religions in this country which do not teach what would generally be considered as a belief in the existence of God are Buddhism, Taoism, Ethical Culture, Secular Humanism and others." In *United States v. Seeger*, 380 U.S. 163 (1965), the Supreme Court interpreted the phrase "religious training and belief" to include a sincere and meaningful belief that "occupies a place in the life of its possessor parallel to that filled by the orthodox belief in God of one who clearly qualifies for the exemption. Where such beliefs have parallel positions in the lives of their respective holder we cannot say that one is 'in relation to a Supreme Being' and the other is not." In *Welsh v. United States*, 398 U.S. 333 (1970), the Supreme Court equated purely moral or ethical convictions with "religious" belief.

### *The tax code's special treatment of ministers and churches*

The intervenors claimed that "in many cases, the First Amendment not only permits special solicitude for churches, but requires it. In particular, the First Amendment (1) restricts government interference in the relationship between churches and ministers; (2) forbids government entanglement in religious questions; and (3) prohibits government discrimination among denominations. These three values—church autonomy, non-entanglement, and non-discrimination—are reflected throughout the tax code in specific protections for churches, none of which are available to secular non-profits."

For example, several provisions protect the relationship between churches and ministers by exempting churches from paying or withholding certain types of taxes. The brief cites the following:

- Churches are not required to withhold federal income taxes from ministers in the exercise of ministry. *IRC 3401(a)(9).*
- Churches are exempt from Social Security and Medicare taxes for wages paid to ministers in the exercise of ministry; instead, ministers are uniformly treated as self-employed. *IRC 1402(c)(4), 1402(e), 3121(b)(8).*
- Churches are exempt from state unemployment insurance funds authorized by the Federal Unemployment Tax Act. *IRC 3309(b)(1).*

Other provisions protect church autonomy by exempting churches from disclosing information: churches and certain related entities are not required to file Form 990, which discloses sensitive financial information. *IRC 6033(a)(3).*

Still others reduce entanglement by offering unique procedural protections:

- Churches receive special procedural protections when subjected to a tax audit. *IRC 7611.*
- Churches need not petition the IRS for recognition of their tax-exempt status under section 501(c)(3). *IRC 508(a), (c)(1)(A).*

Still others modify tax provisions so that they apply neutrally among various church polities:

- Churches can maintain a single church benefits plan exempt from ERISA for employees of multiple church affiliates, regardless of common control, and for ministers, regardless of their employment status. *IRC 414(e).*
- Churches can include ministers in 403(b) contracts (a type of tax-deferred benefit) even if ministers do not qualify as employees. *IRC 403(b)(1)(A)(iii).*
- Churches can provide certain insurance to entities with common religious bonds, even if those entities are not structured to meet normal common control tests. *Treas. Reg. § 1.502-1(b).*

The intervenors' brief concludes: "In short, the tax code does not treat churches and ministers as ordinary employers and employees. Rather,

Congress has crafted numerous tax provisions that apply only to churches and ministers. These provisions, like [the housing allowance] reduce entanglement and prevent discrimination among religions."

### The housing allowance and the reduction of entanglement

Any governmental law or policy that fosters excessive entanglement between church and state is suspect under the Establishment Clause. The intervenors' brief argued that the housing allowance "is far less entangling than the next best alternative—which is applying the notoriously difficult [convenience of the employer] standard of section 119 to ministers." Section 119 of the tax code exempts from tax lodging that is (1) furnished by an employer for an employee, (2) furnished in kind, (3) on the business premises of the employer, (4) for the convenience of the employer, and (5) a condition of employment.

The brief explains:

> *Section 119 is extremely difficult, if not impossible, to apply to ministers. First, it requires the minister to qualify as an "employee" under IRS rules. This, in turn, requires the government to tax differentially depending on internal matters of church polity. If the minister belongs to a denomination that gives him broad autonomy or exposes him to significant economic risk, he may fail this test and be considered self-employed. Some decisions suggest that United Methodist Council ministers would qualify as employees, but Assembly of God [sic] and various Pentecostal ministers would not. Even if a minister qualified as an employee, a section 119 exemption would be unavailable if one entity provided the housing (such as the congregation), but a different entity qualified as the "employer" (such as the diocese)—thus pressuring churches to make ministers answerable to those paying them.*
>
> *Once these threshold concerns are overcome, section 119 still requires the government to decide whether a minister's housing was "furnished for the convenience of the employer" as "a condition of his employment." This, in turn, requires the government to decide whether the lodging is truly necessary "to enable him properly to perform the duties of his employment."*
>
> *Section 107 [the housing allowance] by contrast, recognizes that the government cannot decide which uses of a minister's home are "necessary" to the mission of the church and which are not. It asks only whether the employee is functioning as a minister. This is an inquiry courts have been conducting for decades—not only in the tax context, but also under the First Amendment "ministerial exception." Indeed, it is an inquiry that the Supreme Court itself said was constitutionally required just five years ago.* Hosanna-Tabor Evangelical Lutheran Church & School v. E.E.O.C., 565 U.S. 171 (2012).

To summarize, the plaintiffs' argument contradicts core Establishment Clause values. If the housing allowance is eliminated, "the taxation of ministers would no longer be governed by a bright-line rule; instead, it would be governed by the notoriously fact-intensive standard of section 119. The result would be deep, church–state entanglement—with IRS officials forced to answer religious questions about the relationship between churches and ministers and the way ministers use their homes."

### The Lemon test

The intervenors claimed that the housing allowance satisfies the Supreme Court's 1971 ruling in *Lemon v. Kurtzman*, 403 U.S. 602 (1971). In *Lemon*, the Supreme Court ruled that for a statute to survive an Establishment Clause challenge, (1) it "must have a secular legislative purpose," (2) "its principal or primary effect must be one that neither advances nor inhibits religion," and (3) it "must not foster an excessive government entanglement with religion." The intervenors claimed that this test was satisfied:

> *Section 107(2) has the valid secular purpose of ensuring fair treatment of ministers' housing costs under the convenience of the employer doctrine, reducing government burdens on the exercise of religion, reducing entanglement between church and state, and eliminating discrimination among religions. Its primary effect is to accomplish precisely these goals. And applying section 107 reduces both enforcement and borderline entanglement. Furthermore, section 107 sends a message of neutrality with respect to religion, not endorsement. Just as Congress took the unique circumstances of many secular groups into account when it codified other applications of the convenience of the employer doctrine, so it did with ministers and section 107.*

### Widespread harm

While not an argument for upholding the constitutionality of the housing allowance, the intervenors' brief pointed out that a ruling in favor of the plaintiffs

> *would produce widespread harm. Hardest hit would be small churches which would be forced to curtail vital ministries and, in some cases, shut down. But the harm would not be limited to small churches. The illogic of plaintiffs' argument threatens scores of longstanding federal and state tax provisions, all of which have been designed to protect the separation of church and state. Fortunately, none of this needs to happen. Plaintiffs lack standing to seek an injunction, because, despite any dispute over their 2012 taxes, the IRS has eliminated any continuing harm by granting their request for a refund of 2013 taxes. But even if the court reaches the merits, it should hold that section 107 is not only permissible under the Establishment Clause, but desirable. Accordingly, the Court should grant summary judgment to defendants on all of plaintiffs' claims.*

### Conclusions

Should the Freedom From Religion Foundation and its two officers ultimately prevail in their quest to strike down the housing allowance

as an unconstitutional preference for religion, what would be the impact? If Judge Crabb's ruling is affirmed on appeal by the Seventh Circuit Court of Appeals, this would only apply to ministers in that circuit, which includes the states of Illinois, Indiana, and Wisconsin. It would become a national precedent binding on ministers in all states if affirmed by the United States Supreme Court—an unlikely outcome because the Supreme Court accepts less than 1 percent of all appeals. Note, however, that the IRS would have the discretion to follow or not follow such a ruling in other circuits and might be inclined to follow it nationwide to promote consistency in tax administration.

In conclusion, ministers and churches should be aware that the housing allowance remains under attack and one day may be invalidated. Should that occur, three actions will need to be implemented quickly:

First, ministers will experience an immediate increase in income taxes. As a result, they should be prepared to increase their quarterly estimated tax payments to reflect the increase in income taxes in order to avoid an underpayment penalty. Note that there will be no effect on self-employment taxes for which the housing allowance is not tax-exempt.

Second, many churches will want to increase ministers' compensation to offset the financial impact. Such an increase could be phased out over a period of years to minimize the impact on the church.

Third, ministers should not consider the housing allowance in assessing the affordability of a new home unless and until the courts conclusively reject the constitutional challenge to the allowance.

# INTRODUCTION

The three most common housing arrangements for ministers are (1) living in a church-provided parsonage, (2) renting a home or apartment, or (3) owning a home. The tax code provides a significant benefit to each housing arrangement. The rules are summarized below:

- **Parsonages.** Ministers who live in a church-provided parsonage that is provided as compensation for ministerial services do not include the annual rental value of the parsonage as income in computing their federal income taxes.
- **Parsonage allowances.** Ministers who live in a church-provided parsonage do not pay federal income taxes on the amount of their compensation that their employing church designates in advance as a parsonage allowance, to the extent that the allowance represents compensation for ministerial services; is used to pay parsonage-related expenses such as utilities, repairs, and furnishings; and does not exceed the fair rental value of the parsonage (furnished, plus utilities).
- **Housing allowances (minister rents a home or apartment).** Ministers who rent a home or apartment do not pay federal income taxes on the amount of their compensation that their employing church designates in advance as a housing allowance, to the extent that the allowance represents compensation for ministerial services, is used to pay rental expenses, and does not exceed the fair rental value of the home (furnished, plus utilities).
- **Housing allowances (minister owns the home).** Ministers who own their home do not pay federal income taxes on the amount of their compensation that their employing church designates in advance as a housing allowance, to the extent that the allowance represents compensation for ministerial services, is used to pay housing expenses, and does not exceed the fair rental value of the home (furnished, plus utilities). Housing-related expenses include mortgage payments, utilities, repairs, furnishings, insurance, property taxes, additions, and maintenance.

These rules (summarized in Table 6-1) represent the most significant tax benefits enjoyed by ministers. Yet many ministers either fail to claim them or do not claim enough. In some cases this results from tax advisers who are unfamiliar with ministers' taxes.

Because the rules for ministers living in church-owned parsonages differ from the rules that apply to ministers who own or rent their home, this chapter will be divided into two sections. See "Parsonages" on page 245 for a summary of the requirements for obtaining the full benefit available to ministers who live in a church-owned parsonage. The rules that apply to ministers who rent or own their homes are considered under "Owning or Renting Your Home" on page 253.

# A. PARSONAGES

★ **KEY POINT** Ministers who live in a church-owned parsonage that is provided as compensation for ministerial services do not include the fair rental value of the parsonage as income in computing their federal income taxes. The fair rental value is not deducted from the minister's income. Rather, it is not reported as additional income anywhere on Form 1040 (as it generally would be by nonclergy workers).

★ **KEY POINT** Ministers who live in a church-provided parsonage do not pay federal income taxes on the amount of compensation their employing church designates in advance as a parsonage allowance, to the extent that the allowance represents

**TABLE 6-1**

## TAX CONSEQUENCES OF VARIOUS CLERGY HOUSING ARRANGEMENTS

| RULE | EXPLANATION |
|---|---|
| Parsonage | Annual fair rental value of a church-owned parsonage provided rent-free to a minister as compensation for ministerial services is excluded from income in computing federal income taxes. |
| Parsonage allowance | Ministers who live in a church-provided parsonage do not pay federal income taxes on the amount of their compensation that their employing church designates in advance as a parsonage allowance, to the extent the allowance represents compensation for ministerial services; is used to pay parsonage-related expenses such as utilities, repairs, and furnishings; and does not exceed the fair rental value of the parsonage (furnished, plus utilities). |
| Rental allowance | Ministers who rent a home or apartment do not pay federal income taxes on the amount of their compensation that their employing church designates in advance as a housing allowance, to the extent the allowance represents compensation for ministerial services; is used to pay rental expenses; and does not exceed the fair rental value of the home (furnished, plus utilities). |
| Housing allowance | Ministers who own their home do not pay federal income taxes on the amount of their compensation that their employing church designates in advance as a housing allowance, to the extent the allowance is used to pay housing expenses and does not exceed the fair rental value of the home. |

compensation for ministerial services and is used to pay parsonage-related expenses such as utilities, repairs, and furnishings.

# 1. OVERVIEW

Since 1921 ministers have been permitted to exclude from their gross income for income tax purposes the annual fair rental value of a church-owned parsonage provided to them rent-free as part of their compensation for services rendered to the church. Congress has never explained the justification for this rule. Presumably, it is based on the principle that the rental value of lodging furnished rent-free to an employee on an employer's business premises should be excluded from gross income if it is furnished "for the convenience of the employer" and the employee must accept such lodging in order to adequately perform his or her duties. *IRC 119.*

Section 107 of the tax code says simply that "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."

Note the following four considerations.

### *Minister of the gospel*

The rental value of a parsonage and a parsonage allowance are nontaxable fringe benefits for ministers. The definition of *minister* for federal tax purposes is addressed in Chapter 3.

### *Compensation for the exercise of ministry*

The annual rental value of a parsonage and the portion of a minister's compensation designated in advance by his or her employing church as a parsonage allowance are excluded from income in computing federal income taxes only if they represent compensation for services performed in the exercise of ministry. The income tax regulations specify that the parsonage or parsonage allowance must be "provided as remuneration for services which are ordinarily the duties of a minister of the gospel." In other words, the parsonage and "parsonage allowance" exclusions are available only if

- the recipient is a minister of the gospel, and
- the benefit is made available to the minister as compensation for services which are ordinarily the duties of a minister of the gospel.

These eligibility requirements are addressed in Chapter 3.

### *An exclusion*

A parsonage allowance and the annual rental value of a church-provided parsonage are exclusions from gross income rather than deductions in computing or reducing adjusted gross income. As a result, they are not reported on Form 1040. Many ministers find this confusing and think they are not receiving a tax benefit unless they can deduct something on their tax return. In fact, some ministers erroneously deduct the annual rental value of a parsonage. This practice clearly violates federal tax law.

Keep in mind that virtually any other worker who receives rent-free use of an employer-provided home must include the annual rental value of the home in his or her gross income in computing both income taxes and Social Security taxes. Ministers, however, do not. This is a significant benefit. As noted below, the annual rental value of a parsonage (and any additional parsonage allowance designated by a church) must be included in self-employment earnings on Schedule SE (Form 1040) in computing a minister's Social Security tax liability.

**EXAMPLE** Frank lives in Chicago and works for a large company. His employer wants to transfer Frank to a Los Angeles office for two years and then return him to Chicago. The company allows Frank to live in a home it owns in Los Angeles for the two-year term. The annual rental value of the home provided to Frank rent-free is income to him in computing both income tax and Social Security tax. So if Frank's annual salary is $50,000 and the annual rental value of the Los Angeles home is $15,000, Frank's employer must report compensation of $65,000 on Frank's Form W-2.

**EXAMPLE** Same facts as the preceding example except that Frank is a minister who leaves a church in Chicago to accept a pastoral position in Los Angeles and that the Los Angeles church provides him with rent-free use of a church-owned parsonage. Frank's W-2 income (assuming that he is an employee) would be only $50,000 (not $65,000). The annual rental value of the home is not reported as taxable income. This is a significant benefit compared to the previous example involving an employee who was not a minister, and it will result in a tax savings of several thousand dollars. Some ministers erroneously deduct the rental value of their parsonage from their taxable income. For example, assume that Frank instructs his church treasurer to reduce his W-2 income by $15,000 so that only $35,000 is reported. This practice clearly violates federal law and should be avoided. The tax benefit is that Frank does not have to report the annual rental value of the home ($15,000) as income in addition to his $50,000 salary. Note that Frank would have to pay Social Security taxes on the rental value of the parsonage (assuming that he is not exempt from Social Security coverage).

### *Valuing the exclusion*

Section 107 excludes the annual rental value of a parsonage provided rent-free to a minister as compensation for ministerial services as well as an allowance paid to a minister that is used to pay expenses incurred in maintaining the parsonage (e.g., utilities, repairs, furnishings). Ministers who live in a church-owned parsonage do not report the annual rental value of the parsonage as income, and the church is not required to declare an allowance in the amount of the annual rental value of the parsonage. The exclusion is automatic. However, if the minister incurs any expenses in living in the parsonage, he or she may exclude them only to the extent that they do not exceed a parsonage allowance declared in writing and in advance by the church board. See Illustration 6-1 for an example of a parsonage allowance designation.

**ILLUSTRATION 6-1**

## PARSONAGE ALLOWANCE DESIGNATION FOR MINISTERS WHO LIVE IN A CHURCH-OWNED PARSONAGE

The following resolution was duly adopted by the board of directors of First Church at a regularly scheduled meeting held on December 15, 2017, a quorum being present:

Whereas, section 107 of the Internal Revenue Code permits a minister of the gospel to exclude from gross income the rental value of a parsonage furnished to him as part of his compensation, and a church-designated parsonage allowance paid to him as part of his compensation, to the extent the allowance represents compensation for ministerial services; is used to pay parsonage-related expenses such as utilities, repairs, and furnishings; and does not exceed the fair rental value of the parsonage (furnished, plus utilities); and

Whereas, Pastor John Smith is compensated by First Church exclusively for services as a minister of the gospel; and

Whereas First Church provides Pastor Smith with rent-free use of a church-owned parsonage as compensation for services that he renders to the church in the exercise of his ministry; and

Whereas, as additional compensation to Pastor Smith for services that he renders to the church in the exercise of his ministry, First Church also desires to pay Pastor Smith an amount to cover expenses he incurs in maintaining the parsonage; therefore, it is hereby

Resolved, that the annual compensation paid to Pastor Smith for calendar year 2018 shall be $50,000, of which $5,000 is hereby designated as a parsonage allowance pursuant to section 107 of the Internal Revenue Code; and it is further

Resolved, that the designation of $5,000 as a parsonage allowance shall apply to calendar year 2018 and all future years unless otherwise provided by this board; and it is further

Resolved, that as additional compensation to Pastor Smith for calendar year 2018 and for all future years unless otherwise provided by this board, Pastor Smith shall be permitted to live in the church-owned parsonage located at 123 Main Street, and that no rent or other fee shall be payable by Pastor Smith for such occupancy and use.

**EXAMPLE** Pastor W lives rent-free in a church-owned parsonage having an annual rental value of $12,000 in 2017. The church expects Pastor W to incur some expenses in living in the parsonage, so it provides him with an allowance of $300 each month. His salary (not including the monthly allowance) was $45,000 in 2017. On his 2017 federal income tax return, Pastor W would not report the annual rental value of the parsonage ($12,000) as income, even though the church never designated that amount as a parsonage allowance. However, he would have to report the total monthly allowances ($3,600) as income unless the church board declared a parsonage allowance in writing and in advance of at least $3,600. The rental value of the parsonage and parsonage allowance are taxable in computing self-employment taxes. *Eden v. Commissioner, 41 T.C. 605 (1961). See also Revenue Ruling 59-350.*

**EXAMPLE** Pastor R lives rent-free in a church-owned parsonage having an annual rental value of $12,000 in 2017. The church pays the utilities charged to the parsonage, which amount to $3,000 for 2017. The IRS *Tax Guide for Churches and Religious Organizations* specifies that "a minister who is furnished a parsonage may exclude from income the fair rental value of the parsonage, including utilities." In effect, the church is designating this amount as a parsonage allowance each month by paying it. While the $3,000 does not represent taxable income to Pastor R for income tax reporting, it does for self-employment (Social Security) tax reporting; so Pastor R must add the $3,000 to self-employment earnings in computing the self-employment tax. The annual rental value of the parsonage ($12,000) is also subject to the self-employment tax.

**EXAMPLE** IRS Publication 517 contains the following example: Pastor Roger Adams receives an annual salary of $39,000 as a full-time minister. The $39,000 includes $5,000 that is designated as a rental allowance to pay utilities. His church owns a parsonage that has a fair rental value of $12,000 per year. The church gives Pastor Adams the use of the parsonage. He isn't exempt from SE tax. He must include $51,000 ($39,000 plus $12,000) when figuring his net earnings for SE tax purposes. The results would be the same if, instead of the use of the parsonage and receipt of the rental allowance for utilities, Pastor Adams had received an annual salary of $51,000 of which $17,000 ($5,000 plus $12,000) per year was designated as a rental allowance.

**TIP** Churches should declare a parsonage allowance in advance of each calendar year for any minister who lives in a parsonage to cover any miscellaneous expenses the minister may incur while living in the parsonage. The allowance should be declared in writing and be incorporated into the minutes of the board or other group that designates it. Churches failing to declare a parsonage allowance before January 1 need not wait until the following year to act. The declaration is effective from the date of its enactment. Therefore, a church failing to declare a parsonage allowance until March of 2018 (for 2018) can still provide its minister with an important tax benefit for the remainder of the year. However, note that if the courts find the housing allowance to be an unconstitutional preference for religion, this will eliminate the parsonage allowance exclusion (as noted above).

## 2. DESIGNATING A PARSONAGE ALLOWANCE

Ministers who live in a church-provided parsonage often incur expenses in maintaining the parsonage. Common examples include utilities, repairs, insurance, and furnishings. The portion of a minister's compensation that is designated in advance by the church as a parsonage allowance is not subject to federal income taxes, to the extent the allowance represents compensation for ministerial services; is used to pay parsonage-related expenses such as utilities, repairs, and furnishings; and does not exceed the fair rental value of the parsonage (furnished, plus utilities).

The income tax regulations specify that the designation of the allowance may be contained in "an employment contract, in minutes of or in a resolution by a church or other qualified organization or in its budget, or in any other appropriate instrument evidencing such official action." The regulations further provide that "the designation . . . is a sufficient designation if it permits a payment or a part thereof to be identified as a payment of rental allowance as distinguished from salary or other remuneration." *Treas. Reg. 1.107-1(b).*

In other words, the designation must simply distinguish a part of the minister's compensation as a parsonage allowance. This can be done by giving a minister two separate checks—one designated as salary and the other as the parsonage allowance. This approach is not necessary, since a church that has designated a portion of a minister's compensation as a parsonage allowance has thereby made the required identification, and it is free to issue a minister one check per pay period that combines both salary and the parsonage allowance.

The church's designation should be in writing, although if a board orally agrees to a specific allowance and neglects to make a written record of its action, it could draft an appropriate record of its action at a later time, dated as of the earlier meeting. *Kizer v. Commissioner, T.C. Memo. 1992-584.*

★ **KEY POINT** Section 35 of *Robert's Rules of Order Newly Revised* (11th ed., 2011) recognizes a motion to "amend something previously adopted" as an incidental main motion by which a deliberative body can change an action previously taken or ordered. This would include amending the minutes of a church board meeting to reflect a parsonage allowance *that in fact was adopted* but that was not reflected in the original minutes.

The Tax Court has ruled that an oral designation is sufficient, since "there is no requirement that the designation be in writing." *Liban v. Commissioner, 44 T.C.M. 370 (1982).* This practice should be avoided, however, since it will always create problems of proof.

A parsonage allowance should be designated by the same body (a board or the membership) that approves compensation. A parsonage allowance must be designated in advance, since it is nontaxable only to the extent it is used to pay parsonage-related expenses. Ideally, a parsonage allowance should be designated in advance of each new year. A sample resolution that accomplishes this is set forth in Illustration 6-6 on page 281. If a church fails to designate a parsonage allowance before the start of a new year, it is not lost for the entire new year. Rather, the church can designate a parsonage allowance at any time during the year, for the remainder of that year. To illustrate, if a church discovers on March 10, 2018, that it has not yet designated a parsonage allowance for its pastor for that year, it can do so on that date for the remainder of the year.

**TIP** Many ministers who live in a parsonage are unaware that they do not pay tax on that portion of their salary that is designated in advance by their church as a parsonage allowance (to the extent it is used to pay parsonage-related expenses). Such an allowance costs the church nothing, but it provides a minister with a significant tax benefit.

**EXAMPLE** A minister reduced his taxable income by the amount of a parsonage allowance. The IRS audited the minister and determined that he was not eligible for a parsonage allowance, since no evidence existed that the church had ever designated one. The Tax Court agreed. It noted that the minister had the "burden of proving that the amount at issue was properly designated as a rental allowance by official church action before payment" and concluded that "the record is devoid of any such evidence." *Logie v. Commissioner, T.C. Memo. 1998-387.*

## 3. REASONABLE IN AMOUNT

An additional requirement, not mentioned in section 107, is that the annual rental value of a parsonage (or a parsonage allowance declared by a church) must be reasonable in amount. *IRC 501(c)(3).* Providing a minister with a parsonage (or parsonage allowance) that is excessive in amount may constitute unreasonable compensation. Such a finding could jeopardize the tax-exempt status of the church. It also could trigger intermediate sanctions against the minister and the church board members who approved the transaction. Intermediate sanctions are excise taxes the IRS can assess as a result of an "excess benefit transaction" favoring a director or officer. See "General Considerations" on page 125 for a discussion of unreasonable compensation and intermediate sanctions.

The IRS *Tax Guide for Churches and Religious Organizations* states that "a minister who is furnished a parsonage may exclude from income the fair rental value of the parsonage, including utilities. However, the amount excluded cannot be more than the reasonable pay for the minister's services."

**EXAMPLE** A federal court noted that a prominent televangelist lived in a parsonage and also received a housekeeping and maintenance allowance and a housing allowance, despite the fact that his ministry paid all of his utilities and other housing expenses. Such payments clearly were above any reasonable parsonage-related expenses, in the court's judgment. This case illustrates that ministers who live in a parsonage and who pay none of the expenses of maintaining the parsonage are not eligible for a parsonage allowance exclusion. *Heritage Village Church and Missionary Fellowship, Inc., 92 B.R. 1000 (D.S.C. 1988).*

## 4. ELIGIBILITY FOR BOTH THE PARSONAGE EXCLUSION AND PARSONAGE ALLOWANCE

A reasonable basis exists for the conclusion that ministers who live in a church-owned parsonage can exclude from gross income not only the annual rental value of the parsonage but also a parsonage allowance designated by the church, to the extent the allowance represents compensation for ministerial services; is used to pay parsonage-related expenses such as utilities, repairs, and furnishings; and does not exceed the fair rental value of the parsonage (furnished, plus utilities). This conclusion is supported by the following precedent:

### *IRS Publication 517*

The current edition of IRS Publication 517 (Social Security and Other Information for Members of the Clergy and Religious Workers) clearly recognizes that ministers who live in a church-provided parsonage may have some of their compensation designated in advance by their employing church as a parsonage allowance: "You can exclude from gross income the fair rental value of a house or parsonage, including utilities, furnished to you as part of your earnings. However, the exclusion cannot be more than the reasonable pay for your services. *If you pay for the utilities, you can exclude any allowance designated for utility costs, up to your actual cost*" (emphasis added). IRS Publication 517 includes the following example.

**EXAMPLE** Rev. Joanna Baker is a full-time minister. The church allows her to use a parsonage that has an annual fair rental value of $24,000. The church pays her an annual salary of $67,000, of which $7,500 is designated for utility costs. Her actual utility costs during the year were $7,000. For income tax purposes, Rev. Baker excludes $31,000 from gross income ($24,000 fair rental value of the parsonage plus $7,000 from the allowance for utility costs). She will report $60,000 ($59,500

salary plus $500 of unused utility allowance). Her income for SE tax purposes, however, is $91,000 ($67,000 salary + $24,000 fair rental value of the parsonage).

### *Revenue Ruling 59-350*

In Revenue Ruling 59-350 the IRS ruled that a minister who lived in a church-owned parsonage could exclude from gross income that portion of his salary that was designated in advance by his employing church as a parsonage allowance. The IRS observed:

> *[A] minister of the gospel who is furnished a parsonage rent-free may exclude a rental allowance to the extent used by him to pay for utilities so long as the employing church or church organization designates a part of his remuneration as a rental allowance. . . .*
>
> *Therefore, a minister of the gospel is permitted to exclude from his gross income, under section 107(1) of the Code, the rental value of a home furnished him as part of his compensation and, in addition, may exclude from his gross income, under section 107(2) of the Code, the "designated" rental allowance, to the extent expended for utilities.*
>
> *Accordingly, [if] a minister of the gospel who is provided a home rent-free by a church or other qualified organization as part of his compensation . . . pays for his utilities, [and] an amount of his compensation is designated as a "rental allowance" to cover the cost of his utilities, he may exclude from his gross income not only the rental value of the home but also the amount of the "rental allowance" to the extent used by him to pay for his utilities.*

### *Revenue Ruling 63-156*

In Revenue Ruling 63-156 the IRS stated:

> *A retired minister of the gospel is furnished rent-free use of a home pursuant to official action taken by the employing qualified organization in recognition of his past services which were the duties of a minister of the gospel in churches of his denomination. In addition, he is paid a rental allowance, within the meaning of section 107(2) of the Internal Revenue Code of 1954, for utilities, maintenance, repairs and other similar expenses directly related to providing a home.*
>
> *The rental value of the home furnished to the retired minister as part of his compensation for past services is excludable from his gross income under section 107(1) of the Code. Also, the rental allowance paid to him as part of his compensation for past services is excludable under section 107(2) of the Code, to the extent used by him for expenses directly related to providing a home.*

These precedents clearly support the view that ministers who live in church-owned parsonages can exclude from gross income not only the annual rental value of the parsonage but also a parsonage allowance designated by the church, to the extent it is used to pay for parsonage expenses.

## 5. SOCIAL SECURITY

Ministers cannot exclude a housing allowance (or the annual fair rental value of a parsonage) when computing their self-employment (Social Security) taxes unless they are retired. The tax code specifies that the self-employment tax does not apply to "the rental value of any parsonage or any parsonage allowance provided after the [minister] retires." *IRC 1402(a)(8).*

Therefore, in computing the Social Security tax on Schedule SE of Form 1040, nonretired ministers who live in a church-owned parsonage must *include* the annual rental value of the parsonage as income on line 2 (of either the short or long Schedule SE, whichever applies). A minister also must include as income any parsonage allowance paid by the church to cover miscellaneous expenses in maintaining the parsonage.

## 6. RENTAL VALUE OF A PARSONAGE

Ministers who have not exempted themselves from paying self-employment (Social Security) tax on their ministerial income must report any parsonage allowance and the annual rental value of a parsonage as income when reporting self-employment taxes on Schedule SE (Form 1040).

The rental value of a parsonage is a question to be determined in each case on the basis of the evidence. Some have suggested that a fair approximation of the monthly rental value of a home can be computed simply by taking 1 percent of the home's fair market value. For example, if a home has a fair market value of $200,000, its monthly rental value would be $2,000 ($200,000 × 1 percent) and its annual rental value would be $24,000. This method may yield accurate results in some cases, but it will yield inaccurate results in others. Generally, it yields excessive rental values. This approach has never been endorsed by the IRS or any court.

★ **KEY POINT** The IRS audit guidelines for ministers instruct agents that "determining the fair rental value [of a parsonage] is a question of all facts and circumstances based on the local market, but the church and minister have often already agreed on a figure and can provide documentary evidence."

★ **KEY POINT** The IRS provided some indication of how it will determine a home's fair rental value in a series of four letter rulings issued in 2004. The IRS observed, "In the agent's report, she determined an annual amount of $X as rental value for the property. . . . She stated: 'Calling a property management company

and asking about the house determined this rental value, I did not identify the address; rather I used the information about the house, how many acres, square footage and area, etc.' The rental value was $X per month. This appears correct as the other houses owned and operated by Pastor B and the church were consistent with this value. The other rentals were not as spacious, nor did they have the amenities consistent with this property. In addition, the other rentals were in [an adjacent county] as opposed to [this county], which has a higher rental value. Those houses were being rented for approximately $Y/month." *IRS Private Letter Rulings 200435019, 200435020, 200435021, 200435022.*

**EXAMPLE** Pastor T lives in a church-owned parsonage. He is not exempt from Social Security coverage. In an effort to avoid any increase in Pastor T's Social Security tax liability, the church agrees to "rent" the parsonage to Pastor T for $1 each year. Pastor T then lists only $1 as the parsonage's rental value on his Schedule SE in computing his Social Security tax liability. This practice will not achieve its desired savings in Social Security taxes, since a minister must include the annual rental value of a church-provided parsonage as income on Schedule SE. The annual rental value of the parsonage is not $1. Rather, it is what houses of comparable size and quality in the same vicinity would rent for in an arm's-length transaction.

**EXAMPLE** A minister was provided with a parsonage, and in addition, a portion of his annual compensation was designated a parsonage allowance to assist him in paying utilities, furnishings, and other miscellaneous expenses. The annual rental value of a parsonage is taxable in computing a minister's self-employment (Social Security) tax. The minister claimed that this amount includes any parsonage allowance designated by the church. As a result, he reduced his parsonage's annual rental value by the parsonage allowance designated by his church in computing his self-employment tax. The Tax Court ruled that this was improper, noting that the minister had "not proven that the stipulated annual rental value of the parsonage already includes amounts designated or received in cash relating to the utility and other household expenses of the parsonages." *Radde v. Commissioner, T.C. Memo. 1997-490 (1997).*

Some churches in high-cost areas purchase a parsonage in order to make housing available to their minister. However, the rental value of such parsonages often is very high, resulting in large increases in the minister's self-employment taxes. For example, assume that a church purchased a parsonage several years ago that currently is worth several hundred thousand dollars and that has an annual rental value of $25,000. A minister who lives in such a parsonage would need to add the full $25,000 annual rental value in computing his or her earnings subject to the self-employment tax. This will result in an increase in self-employment taxes of nearly $4,000 (without taking into account any available deductions).

While this is a significant tax increase, keep in mind the following considerations:

- The minister is still receiving a significant income tax benefit (the $25,000 is not taxable for income tax purposes).
- The minister occupies a home of substantial value.
- Lower-cost accommodations may be much farther away from the church.
- Ministers pay the full 15.3-percent self-employment rate only on earnings up to a specified amount ($128,700 for 2018), and they pay only the 2.9-percent Medicare component of self-employment taxes on all net earnings from self-employment in excess of this amount. So, to the extent that the annual rental value of the parsonage boosts the minister's earnings above $128,700 for 2018, the excess is only subject to the 2.9-percent Medicare tax.

**EXAMPLE** Pastor H excluded a parsonage allowance from his reportable income though his employing church had never designated a portion of his compensation as a parsonage allowance. The Tax Court ruled that Pastor H was not entitled to exclude the allowance, since it had not been designated by his church prior to the time of its payment. *Hoelz v. Commissioner, 42 T.C.M. 1037 (1981).*

## 7. EQUITY ALLOWANCES

Ministers who live in church-owned parsonages experience a significant disadvantage—they do not acquire equity in a home. To illustrate, assume that Pastor E lives in church-owned parsonages throughout his 35-year career as a minister. When Pastor E retires, he must vacate the parsonage he is occupying, and he has no equity interest in any of the parsonages he has occupied that can be used to acquire a retirement home. If Pastor E had owned homes throughout his career, he would have accumulated equity in the amount of his combined principal mortgage payments plus any appreciation in the value of the homes he owned. At retirement, not only would Pastor E have a home in which he could remain, but he also would have accumulated a significant equity interest.

Some churches have helped ministers who live in parsonages avoid or at least reduce the adverse economic impact of this housing arrangement by providing them with an equity allowance over and above their stated compensation. This allowance is designed to partially or wholly compensate the minister for the lost opportunity of accumulating equity in a home.

Since the purpose of such an allowance is to assist the minister in obtaining suitable housing at retirement, it is important that the allowance not be available to the minister until retirement. One way churches can accomplish this is to deposit the annual equity

## IRS TAX GUIDE FOR CHURCHES

The current edition of the IRS *Tax Guide for Churches and Religious Organizations* contains summaries of several rules that pertain to churches and ministers. The guide contains the following statements regarding parsonages and parsonage allowances:

- A minister's gross income does not include the rental value of a home (a parsonage) provided, or the rental allowance paid, as part of his or her compensation for services performed that are ordinarily the duties of a minister.
- A minister who is furnished a parsonage may exclude from income the fair rental value of the parsonage, including utilities. However, the amount excluded cannot be more than the reasonable pay for the minister's services.
- A minister who receives a parsonage or rental allowance excludes that amount from his income. The portion of expenses allocable to the excludable amount is not deductible. This limitation, however, does not apply to interest on a home mortgage or real estate taxes, nor to the calculation of net earnings from self-employment for SECA tax purposes.
- The fair rental value of a parsonage or housing allowance is excludable from income only for income tax purposes. These amounts are not excluded in determining the minister's net earnings from self-employment for Self-employment Contributions Act (SECA) tax purposes. Retired ministers who receive either a parsonage or housing allowance are not required to include such amounts for SECA tax purposes.

allowance in a tax-favored retirement program not currently accessible to the minister. Such an arrangement can mitigate the economic hardship faced by many ministers who reside in a church-owned parsonage. However, since an equity allowance ordinarily does not compensate a minister for actual costs incurred in living in a parsonage, it is not excludable from income as a parsonage allowance.

**TIP** Churches should consider adopting an appropriate equity allowance for ministers who live in church-owned parsonages.

**CAUTION** Section 409A of the tax code imposes strict new requirements on most nonqualified deferred compensation plans (NQDPs). IRS regulations define an NQDP broadly, to include any plan that provides for the deferral of compensation. This definition is broad enough to cover some forms of equity allowances, depending on how they are structured by a church. As a result, any church that is considering an equity allowance should contact a tax attorney to have the arrangement reviewed to ensure compliance with both section 409A and the regulations. Such a review will protect against the substantial penalties the IRS can assess for noncompliance. It also will help clarify whether a deferred compensation arrangement is a viable option in light of the limitations imposed by section 409A and the final regulations. See "Section 409A" on page 517 for more information.

## 8. IRS AUDIT GUIDELINES FOR MINISTERS

The IRS has issued audit guidelines for its agents to follow when auditing ministers. The guidelines provide agents with the following information regarding parsonages and parsonage allowances:

> *Internal Revenue Code section 107 provides an exclusion from gross income for a "parsonage allowance" . . . . The term "parsonage allowance" includes church provided parsonages, rental allowances with which the minister may rent a home and housing allowances with which the minister may purchase a home. A minister can receive a parsonage allowance for only one home. . . .*
>
> *The value of the "allowed" parsonage allowance is not included in computing the minister's income subject to income tax and should not be included in W-2 wages. However, the parsonage allowance is subject to self-employment tax along with other earnings. If a church-owned parsonage is provided to the minister, instead of a housing allowance, the fair rental value of the housing must be determined. Determining the fair rental value is a question of all facts and circumstances based on the local market, but the church and minister have often already agreed on a figure and can provide documentary evidence.*
>
> *The [parsonage allowance] exclusion only applies if the employing church designates the amount of the parsonage allowance in advance of the tax year. The designation may appear in the minister's employment contract, the church minutes, the church budget, or any other document indicating official action. An additional requirement . . . is that the fair rental value of the parsonage or parsonage allowance is not more than reasonable pay for the ministerial services performed.*

The audit guidelines contain the following example:

**EXAMPLE** A is an ordained minister. She receives an annual salary of $36,000 and use of a parsonage which has an annual rental value of $800 a month, including utilities. She has an accountable plan for other business expenses such as travel. A's gross income for arriving at taxable income for federal income tax purposes is $36,000, but for self-employment tax purposes it is $45,600 ($36,000 salary + $9,600 annual rental value of parsonage).

★ **KEY POINT** The audit guidelines assist IRS agents in the examination of ministers' tax returns. They alert agents to the key questions to ask and provide background information along with the IRS position on a number of issues. It is of utmost importance that ministers be familiar with these guidelines.

★ **KEY POINT** It is unfortunate that the guidelines state that the housing allowance "only applies if the employing church designates the amount of the allowance in advance of the tax year," since this statement is not true. The tax code does not impose such a requirement. It is true that a church's housing allowance designation cannot be made retroactively. But this does not mean it has to be made in advance of a tax year. To illustrate, many churches fail to designate a housing allowance by the end of a calendar year and discover the omission a few months into the new year. The church can still designate a housing allowance for the minister for the remainder of the new year. Unfortunately, unless the guidelines are amended, IRS agents may unnecessarily disallow housing allowance exclusions under these facts. A strict interpretation of the audit guidelines would preclude ministers who are called to a church in midyear from receiving a housing allowance, since the allowance would not be designated "in advance of the tax year." This is clearly an incorrect result.

## 9. PARSONAGES PROVIDED TO RETIRED MINISTERS

The tax status of parsonages and parsonage allowances provided to retired ministers is addressed under "Housing Allowances" on page 530.

# B. OWNING OR RENTING YOUR HOME

▲ **CAUTION** See the important notice at the beginning of this chapter addressing the status and implications of the constitutional challenge to the housing allowance.

Ministers who own their home do not pay federal income taxes on the amount of their compensation that their employing church designates in advance as a housing allowance, to the extent that the allowance represents compensation for ministerial services, is used to pay housing expenses, and does not exceed the fair rental value of the home (furnished, plus utilities). Housing-related expenses include mortgage payments, utilities, repairs, furnishings, insurance, property taxes, additions, and maintenance.

Many ministers rent their home. The apostle Paul did so for a brief time. Acts 28:30 states: "For two whole years Paul stayed there in his own rented house and welcomed all who came to see him."

Ministers who rent a home or apartment do not pay federal income taxes on the amount of their compensation that their employing church designates in advance as a housing allowance, to the extent that the allowance represents compensation for ministerial services and is used to pay rental expenses such as rent, furnishings, utilities, and insurance.

## 1. OVERVIEW

The previous section addressed parsonages and parsonage allowances. Most ministers, however, do not live in a parsonage. Instead, they either own or rent a home. This section will address the tax rules that apply to these ministers. The tax code uses the term *rental allowance* for allowances paid to ministers who either rent or own their home. This terminology is confusing, so this text uses the term "housing allowance" for ministers who either rent or own their home.

★ **KEY POINT** The IRS audit guidelines for ministers state that the term *parsonage allowance* includes "church provided parsonages, rental allowances with which the minister may rent a home and housing allowances with which the minister may purchase a home."

Section 107 of the tax code specifies that "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."

Following are four important considerations to note:

- The housing allowance is available only to a *minister of the gospel*. This term is defined in Chapter 3.
- A housing allowance must represent compensation for *services performed in the exercise of ministry*. This term is defined in Chapter 3.
- The housing allowance is an *exclusion* from gross income rather than a deduction in computing or reducing adjusted

**ILLUSTRATION 6-2**

## HOUSING ALLOWANCE DESIGNATION FOR MINISTERS WHO OWN THEIR HOME

The following resolution was duly adopted by the board of directors of First Church at a regularly scheduled meeting held on December 15, 2017, a quorum being present:

Whereas, ministers who own their home do not pay federal income taxes on the amount of their compensation that their employing church designates in advance as a housing allowance, to the extent that the allowance represents compensation for ministerial services, is used to pay housing expenses, and does not exceed the fair rental value of the home (furnished, plus utilities); and

Whereas, Pastor John Smith is compensated by First Church exclusively for services as a minister of the gospel; and

Whereas, First Church does not provide Pastor John Smith with a parsonage; therefore, it is hereby

Resolved, that the total compensation paid to Pastor John Smith for calendar year 2018 shall be $50,000, of which $15,000 is hereby designated as a housing allowance; and it is further

Resolved, that the designation of $15,000 as a housing allowance shall apply to calendar year 2018 and all future years unless otherwise provided by this board.

gross income. As a result, it is not reported on Form 1040. In effect, the housing allowance is claimed by not reporting it as income. As will be explained later, if the actual housing allowance exclusion is less than the church-designated allowance, the minister will need to report the difference as additional income on his or her federal tax return. This assumes that the church reduced the minister's Form W-2 or 1099-MISC income by the amount of the allowance. Note further that the actual housing allowance exclusion must be reported as self-employment earnings on a nonretired minister's Schedule SE (Form 1040) in computing Social Security taxes, assuming the minister has not applied for and received an approved exemption from Social Security coverage.

- A housing allowance is nontaxable in computing a minister's federal income taxes only if the following requirements are met: (1) the allowance is designated in advance by official action of the church board or congregation; (2) the allowance is used by the minister to pay for housing-related expenses; and (3) in the case of ministers who own or rent their home, the allowance does not exceed the fair rental value of the minister's home (furnished, plus utilities). See Illustration 6-2 for an example of a church-designated housing allowance.

★ **KEY POINT** Parsonage and housing allowances should be (1) adopted by the church board or congregation, (2) recorded in written form (such as minutes), and (3) designated in advance of the calendar year. However, churches that fail to designate an allowance in advance of a calendar year should do so as soon as possible in the new year. The allowance will operate prospectively.

## 2. DESIGNATING THE HOUSING ALLOWANCE

★ **KEY POINT** The tax code limits the nontaxable portion of a church-designated housing allowance for ministers who own their home to the fair rental value of the home (furnished, plus utilities). Churches should keep this limit in mind when designating housing allowances. There is no benefit in designating allowances above this limit. To the contrary, designating a housing allowance substantially above this limit can create problems, since ministers often wrongly assume that the entire allowance is nontaxable even though it exceeds their home's fair rental value (furnished, plus utilities). This error can lead to additional taxes in the event of an audit.

### *In general*

The income tax regulations specify that the designation of the allowance may be contained in "an employment contract, in minutes of or in a resolution by a church or other qualified organization or in its budget, or in any other appropriate instrument evidencing such official action."

The regulations further provide that "the designation . . . is a sufficient designation if it permits a payment or a part thereof to be identified as a payment of rental allowance as distinguished from salary or other remuneration." *Treas. Reg. 1.107-1(b).* In other words, the designation must simply distinguish a part of the minister's compensation as a housing allowance. This can be done by giving a minister two separate checks—one designated as salary and the other as the housing or rental allowance. But this approach is not necessary, since a church that has designated a portion of a minister's compensation as a housing or rental allowance has thereby made the required identification, and it is free to issue a minister one check per pay period that combines both salary and the housing allowance.

The church's designation should be in writing, although if a board orally agrees to a specific allowance and neglects to make a written record of its action, it could draft an appropriate record of its action at a later time, dated as of the earlier meeting. *Kizer v. Commissioner, T.C. Memo. 1992-584.*

The Tax Court has ruled that an oral designation is sufficient, since "there is no requirement that the designation be in writing." *Libman v. Commissioner, 44 T.C.M. 370 (1982).* This practice should be avoided, however, since it will always create problems of proof.

★ **KEY POINT** Section 35 of *Robert's Rules of Order Newly Revised* (11th ed., 2011) recognizes a motion to "amend something previously adopted" as an incidental main motion by which a deliberative body can change an action previously taken or ordered. This would include amending the minutes of a church board meeting to reflect a housing allowance *that in fact was adopted* but that was not reflected in the original minutes.

**EXAMPLE** A traveling evangelist was denied any housing allowance exclusion despite his insistence that various churches in which he had conducted services had orally designated a portion of his compensation as a housing allowance. The Tax Court noted that there was no evidence of such designations and that the minister's testimony was "marred by numerous inconsistencies." *Holland v. Commissioner, 47 T.C.M. 494 (1983).*

In summary, if your church board orally designated (in advance) a portion of your compensation as a housing or rental allowance, you should go ahead and claim the exclusion. The church board could "memorialize" its earlier action in a written resolution if your return is audited and your allowance questioned. Such a practice is not recommended.

### *In advance*

Many churches fail to designate a housing allowance by the end of a calendar year for a variety of reasons and discover the omission a few weeks or months into the new year. Is it too late to do so for that year? According to the IRS regulations, the church can still designate a housing allowance for the minister for the remainder of the new year. The regulations state that a housing allowance "means an amount paid to a minister to rent or otherwise provide a home if such amount is designated as rental allowance pursuant to official action taken . . . *in advance of such payment* by the employing church or other qualified organization" (emphasis added). *Treas. Reg. 1.107-1(b).* Similarly, IRS Publication 1828 states that "the minister's church or other qualified organization must designate the housing allowance pursuant to official action taken *in advance* of the payment."

As a result, a housing allowance only operates prospectively, never retroactively. This principle is a corollary of the requirement that a housing allowance is nontaxable only to the extent that it is used to pay for housing expenses. This requirement would be compromised if housing allowances could be designated retroactively, after housing expenses are incurred and paid. In such a case, some or all of the allowance would not be used to pay for housing expenses.

Unfortunately, the IRS audit guidelines for ministers incorrectly state that the housing allowance exclusion "only applies if the employing church designates the amount of the parsonage allowance *in advance of the tax year*" (emphasis added). It is unfortunate that the IRS audit guidelines for ministers contradict the IRS regulations and IRS Publication 1828. The regulations are more authoritative than the audit guidelines, but many IRS agents will follow the guidelines when auditing ministers, and this will result in the unnecessary denial of a housing allowance exclusion to ministers whose church failed to designate an allowance until after the start of the year.

▲ **CAUTION** Under no circumstances can a minister exclude any portion of a housing allowance that was retroactively designated by a church.

▲ **CAUTION** In some cases retroactive designations of a housing allowance may violate the Sarbanes–Oxley Act (see "The Sarbanes–Oxley Act" on page 271).

**EXAMPLE** A pastor performed ministerial services for a congregation that provided him with a monthly rental allowance. The pastor excluded the amount of the housing allowance from his gross income each year in question. The pastor and his employing church later asked the IRS if they could amend the amount of the housing allowance to reflect the true cost of providing the home. The church claimed that the amount of the rental allowance was selected without understanding its legal consequences. The IRS rejected the church's request. It observed, "The church is attempting to increase the amount of the pastor's rental allowance through official action taken after payments were made. The tax code and regulation are clear in the treatment of rental allowances for ministers of the gospel. The church must designate the amount of its minister's rental allowance before the minister receives payment for his services. The church may not retroactively increase the amount of the taxpayer's rental allowance. The minister properly excluded from his gross income the amount of his compensation that was designated as rental allowance by his church in advance of payment." *IRS Technical Advice Memorandum 8120007 (1981).*

**EXAMPLE** In preparing his income tax return for 2017, Pastor H discovers that his church failed to designate a housing allowance for 2017. He asks his church board to pass a resolution retroactively granting the allowance for 2017. Such a resolution is ineffective, and Pastor H will not be eligible for any housing allowance in 2017. *Hoelz v. Commissioner, 42 T.C.M. 1037 (1981); Ling v. Commissioner, 200 F. Supp. 282 (D.D.C. 1962).*

**EXAMPLE** Pastor K was paid a salary by his church, but no portion of the salary was designated by the church as a housing allowance. The Tax Court ruled that Pastor K was not able to exclude any part of the expenses incurred in owning and maintaining his home as a housing allowance, since the church had not

## HOUSING EXPENSES TO INCLUDE WHEN COMPUTING YOUR HOUSING ALLOWANCE EXCLUSION

Ministers who own their homes should take the following expenses into account in computing their housing allowance exclusion:

- down payment on a home;
- payments (including prepayments) on a mortgage loan to purchase or improve your home (including both interest and principal);
- real estate taxes;
- property insurance;
- utilities (electricity, gas, water, trash pickup, local telephone charges, etc.);
- furnishings and appliances (purchase and repair);
- structural repairs and remodeling;
- yard maintenance and improvements;
- maintenance items (household cleansers, light bulbs, pest control, etc.); and
- homeowners association dues.

designated any portion of Pastor K's compensation as a housing allowance. *Eden v. Commissioner, 41 T.C. 605 (1964).*

**EXAMPLE** A church board orally discussed a new minister's compensation package with him and agreed to pay him a salary of $30,000, out of which $6,250 was designated as a housing allowance. The board's housing allowance designation was not recorded in the church minutes or in any other writing. The IRS audited the minister and denied any housing allowance exclusion on the ground that no allowance had been properly designated.

The Tax Court disagreed and ruled that the minister was eligible for a housing allowance in the amount of $6,250. It observed: "It is clear that there was discussion about a parsonage allowance for [the minister], and that all of the members of the board of directors [of the church] who testified recollected that he was taking a cut in total compensation to come to their church. The recording secretary, the person whose obligation it was to keep the minutes of the various meetings, had a clear recollection of the discussion and thought that [the minister] was to receive the same amount as a parsonage allowance that he received at [his former church]." The court referred to a 1982 decision (*Libman v. Commissioner*) in which it ruled that "there is no requirement that the parsonage allowance designation be in writing. Rather, we held, the designation requirement is satisfied upon satisfactory proof of official action." In the present case, the court concluded that there was sufficient evidence of a proper designation, in advance of the year in question, though never committed to writing. Accordingly, the minister was entitled to the housing allowance exclusion. *Kizer v. Commissioner, T.C. Memo. 1992-584.*

**EXAMPLE** The IRS ruled that a pastor was not entitled to a housing allowance because there was no evidence that his employing church had designated an allowance for the year in question. In 1982 the church board adopted a motion stating simply that "the pastor's housing allowance for 1982 will be $10,000." The pastor claimed a housing allowance of $10,000 in the following year, although the church had not designated such an allowance. The pastor and church maintained that it was their understanding that the 1982 allowance was effective for future years until there was a salary change. As a result, the pastor claimed a $10,000 allowance in 1983. The church board, in 1984, adopted a resolution stating that "the pastor's salary and housing allowance for 1984 will be the same as 1983."

The IRS concluded, "You have not furnished any information or documents that show that the church designated a portion of your compensation as rental allowance for the year 1983 pursuant to official action taken in advance of your payments for 1983. In 1984, the church made a retroactive designation that $10,000 of your 1983 compensation was a rental allowance. However, this does not satisfy the requirement of [the tax regulations] that the designation must be made before the payments are made. Accordingly, we conclude that because the rental allowance for 1983 was not designated by official action before it was paid to you, you may not exclude $10,000 from your gross income." *IRS Private Letter Ruling 8511075.*

**EXAMPLE** The Tax Court noted that gross income does not include, in the case of a minister of the gospel, "the rental allowance paid to him as part of his compensation, to the extent used by him to rent or provide a home." *IRC 107.* In order for a minister to be eligible for this exclusion, the following requirements must be met: "(1) the home or rental allowance must be provided as remuneration for services which are ordinarily the duties of a minister of the gospel; (2) before the payment of this rental allowance, the employing church or other qualified organization must designate the rental allowance pursuant to official action, which may be evidenced in an employment contract or by any other appropriate instrument; and (3) the designation must be sufficient in that it clearly identifies the portion of the minister's salary that is the rental allowance." *Treas. Reg. 1.107–1(a) and (b).*

The court noted that "there is no evidence that a rental allowance was designated in an official action between the church and pastor. In fact . . . the church never considered the mortgage

payments made on the pastor's behalf to be parsonage allowances. Accordingly, he is not entitled to exclude mortgage payments the church made on his behalf as a parsonage allowance under section 107." *T.C. Memo. 2013-177 (2013).*

### *Who designates the allowance*

Section 1.107-1(b) of the income tax regulations provides that the term *housing allowance* means an amount paid to a minister to rent or otherwise provide a home if such amount is designated as a housing allowance pursuant to official action taken in advance of the payment of such amounts by "the employing church or other qualified organization."

**EXAMPLE** An ordained minister was employed as a chaplain by a municipal police department. The police department's chaplaincy program was established through its joint efforts with a local federation of churches. The minister claimed that amounts designated by the federation as a housing allowance were excludable from his gross income. The IRS maintained that because the minister was employed by the city and not by the federation, the city was the only "other qualified organization" eligible to designate a housing allowance. Since it failed to do so, the minister was not eligible for a housing allowance. The Tax Court reversed the IRS determination and ruled that the minister was entitled to a housing allowance. It noted that as a police chaplain, the minister was under the direct supervision of the chief of police. However, the federation retained supervision over his ecclesiastical performance and maintained day-to-day contact with him and other chaplains. The federation was also involved in the operation of the police chaplaincy program. If a problem arose concerning a police chaplain, a police department official usually would contact the federation to resolve the problem. When a vacancy occurred for a chaplain, the federation assumed primary responsibility for finding a qualified person to fill the vacancy.

The federation annually designated a specific amount of the minister's salary in advance as a housing allowance even though his salary was paid by the city. The city neither provided him with a home nor designated any portion of his salary as a housing allowance.

The Tax Court concluded that the federation was an "other qualified organization" within the meaning of section 1.107-1(b) of the regulations and that its designation of a portion of his salary as a housing allowance was valid. The Tax Court based its decision on the "constant and detailed involvement of the federation" in the city's police chaplaincy program. The IRS later acquiesced in the court's ruling on the ground that the federation's responsibilities toward the chaplaincy program were similar to those of an employer and that the federation was closely involved with the police department in its employer-employee relationship with the ministers. *Boyd v. Commissioner, 42 T.C.M. 1136 (1981).*

## 3. FAILURE TO DESIGNATE A TIMELY HOUSING ALLOWANCE

Some churches fail to designate a housing allowance for their ministers. This practice denies ministers an important tax benefit. If your church fails to designate a housing allowance prior to January 1 for the new year, it should designate an allowance as soon as possible. The housing allowance will be effective from the date it is declared for the remainder of the year. See "Designating a parsonage allowance" on page 248.

### *Matching allowances and expenses*

Assume that Pastor B receives monthly compensation of $4,000 from First Church, that Pastor B owns or rents his home, that First Church fails to designate a housing allowance for Pastor B for 2018, and that the church board belatedly takes action on November 1, 2018, to designate Pastor B's entire remaining compensation for 2018 ($8,000) as a housing allowance. How large a housing allowance exclusion can Pastor B claim? At the very least, he will be able to exclude housing expenses incurred in November and December. But what if his housing expenses amount to only $2,000 in November and December? Can Pastor B apply the rest of the housing allowance ($6,000) to housing expenses incurred in months prior to November? This question has never been addressed by the IRS or the courts.

Section 107 of the tax code provides that the housing allowance exclusion covers "the rental allowance paid to [a minister] as part of his compensation *to the extent used by him to rent or provide a home*" (emphasis added). This language suggests that the housing expenses must be paid out of the designated allowance, meaning that Pastor B (in the above example) would only be able to exclude housing expenses incurred in November and December.

### *A broader interpretation*

Some interpret section 107 more broadly and claim that the critical event is the designation of a portion of Pastor B's salary as a housing allowance. Once an allowance is declared (even if later in the year), there is no reason why it should not be allocated to expenses incurred in prior months of the same year. Under this broader interpretation of section 107, the church's belated action would permit Pastor B to exclude his remaining salary of $4,000 from his gross income as a housing allowance exclusion (assuming his actual expenses in owning or maintaining his home are at least this amount for the year), resulting in a substantial savings in income taxes.

The main problem with this approach is that a housing allowance is nontaxable only to the extent it is used to pay for housing expenses. By November, Pastor B has already paid for most of his housing expenses for the first 10 months of the year (mortgage payments, utilities, insurance, taxes, etc.), and so it impossible for him to use the $8,000 allowance designated in November for these expenses.

Ministers who adopt this broader interpretation must recognize that such a position has never been approved by the IRS or the courts, and it is an aggressive position that should not be adopted without professional advice.

**EXAMPLE** An administrator of a Jewish synagogue was not eligible for a housing allowance, since there was no evidence that a housing allowance had ever been properly designated for him. *Haimowitz v. Commissioner, T.C. Memo. 1997-40 (1997); McCurry v. Commissioner, 56 T.C.M. 253 (1988).*

## 4. THE CLERGY HOUSING ALLOWANCE CLARIFICATION ACT OF 2002

★ **KEY POINT** Congress enacted the Clergy Housing Allowance Clarification Act in 2002. This Act amended the tax code to limit the nontaxable portion of a church-designated housing allowance for ministers who own their home to the fair rental value of the home (furnished, plus utilities). As a result, ministers who own a home do not include the portion of their salary designated in advance by their church as a "housing allowance" as income in computing their federal income taxes, to the extent it is used to pay for expenses incurred in owning the home, such as mortgage payments, utilities, repairs, property taxes, property insurance, and furnishings and does not exceed the fair rental value of the home.

### *Background*

For many years, section 107 of the tax code stated that "in the case of a minister of the gospel, gross income does not include . . . the rental allowance paid to him as part of his compensation, to the extent used by him to rent or provide a home." This language required little explanation. The portion of a minister's church-designated housing allowance that was used to pay for housing-related expenses was nontaxable for federal income tax reporting purposes. Stated differently, ministers could exclude from taxable income the lesser of (1) the church-designated housing allowance, or (2) the actual amount of housing-related expenses paid during the year.

In 1971 the IRS imposed an additional limitation: the nontaxable portion of a church-designated housing allowance could not exceed the fair rental value of the minister's home (furnished, plus utilities). *Revenue Ruling 71-280.* As a result, a housing allowance was nontaxable only to the extent it was used to pay for housing expenses and did not exceed the fair rental value of the home (furnished, plus utilities).

The IRS offered various arguments to defend the annual rental value test, including the following: (1) the rental value test prevents ministers who own their homes from receiving a greater tax benefit than those who live in a church-provided parsonage; (2) the rental value test prevents ministers from acquiring expensive homes; and (3) the rental value test prevents ministers with other sources of income from acquiring more expensive homes by allocating a larger amount of their church compensation to a nontaxable housing allowance.

### *The Warren case*

The United States Tax Court ruled in 2000 that a housing allowance is nontaxable for income tax reporting so long as it is used to pay for housing-related expenses. *Warren v. Commissioner, 114 T.C. 23 (2000).* The court threw out the annual "fair rental value" test the IRS adopted in 1971. The IRS appealed the *Warren* case to the ninth circuit federal court of appeals in California. On March 5, 2002, a three-judge panel of the court issued a surprising decision. Two of the panel's three judges issued an order asking the parties, and a law professor, to submit additional briefs to the court addressing the following issues:

- Does the court have the authority to consider the constitutionality of the housing allowance?
- If so, should the court exercise that authority?
- Is the housing allowance constitutional under the First Amendment's nonestablishment of religion clause?

In referring to the housing allowance, the court observed that "it appears that no similar exemption is afforded any member of any other profession, whether serving a for-profit or non-profit institution." This off-hand comment left little doubt that the court had made up its mind that the housing allowance was unconstitutional. This conclusion was reinforced by the court's reference to the following quotation from an earlier Supreme Court case: "When government directs a subsidy exclusively to religious organizations that is not required by the free exercise [of religion] clause and that either burdens non-beneficiaries markedly or cannot reasonably be seen as removing a significant state-imposed deterrent to the free exercise of religion . . . it provides unjustifiable awards of assistance to religious organizations and cannot but convey a message of endorsement to slighted members of the community." *Texas Monthly, Inc. v. Bullock, 489 U.S. 1 (1989).*

### *Clergy Housing Allowance Clarification Act*

In response to this threat to the housing allowance, the Clergy Housing Allowance Clarification Act of 2002 (H.R. 4156) was introduced in the House of Representatives. It was enacted on April 16, 2002, by a vote of 408 to 0. The Senate unanimously enacted the same bill on May 2. President George W. Bush signed it into law on May 20.

The Act had one purpose—to amend the tax code to reinstate the fair rental value limit on ministers' housing allowances so that the IRS would dismiss its appeal of the *Warren* case and thereby deprive the federal appeals court of the opportunity to address the constitutionality of the housing allowance on its own initiative.

As amended, section 107 now reads: "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."

The Act had the desired effect. The IRS agreed to dismiss the appeal of the *Warren* case, and the federal appeals court eventually issued an order formally dismissing the case.

**EXAMPLE** A retired pastor had $50,000 distributed from his retirement account in 2017 and had the entire amount designated as a housing allowance. The pastor used the distribution for a down payment on a new home and other housing-related expenses. The fair rental value of the home (furnished, plus utilities) was $20,000. The nontaxable portion of the retired pastor's $50,000 housing allowance is limited to $20,000 (the fair rental value of his home). As a result, $30,000 of the housing allowance is taxable in computing income taxes.

## 5. FAIR RENTAL VALUE

The Clergy Housing Allowance Clarification Act of 2002 amended the tax code to limit the nontaxable portion of a housing allowance for ministers who own or rent their home to the annual fair rental value of the home furnished, plus utilities). While the Act imposes a fair rental value limit, it does not explain what this means. The IRS has provided no help. Its audit guidelines for ministers instruct agents that "determining the fair rental value of a home is a question of all facts and circumstances based on the local market" and that "the church and minister have often already agreed on a figure and can provide documentary evidence."

In summary, ministers have been given no guidance by Congress, the IRS, or the courts regarding the meaning of "fair rental value." Here are three ways some ministers attempt to define this term:

- **Realtor's informal opinion.** Some ministers have a realtor drive by their home and provide an informal estimate as to the rental value of the home. Usually this will result in a range of possible values (e.g., "between $700 and $1,000 per month"). The realtor should be asked to provide his or her opinion in a signed letter that the minister can later use in the event of an audit. Given the refusal by the IRS to define the term "fair rental value," it is reasonable to assume that an IRS auditor would accept this method as reasonable.
- **Appraisal.** A minister could obtain a formal rental value from a local real estate appraiser. This approach is expensive and, in many cases, will not be significantly different than a realtor's informal opinion. It is another option to consider.
- **The 1-percent rule.** Some have suggested that a fair approximation of the monthly rental value of a home can be computed simply by taking 1 percent of the home's fair market value. For example, if a home has a fair market value of $100,000, then its monthly rental value would be $1,000 ($100,000 × 1 percent), and its annual rental value would be $12,000. This method will yield accurate results in some cases but inaccurate results in others. Generally, this approach yields excessive rental values. It has never been endorsed by the IRS or the courts.

★ **KEY POINT** The IRS provided some indication of how it will determine a home's fair rental value in a series of four letter rulings issued in 2004. The IRS observed, "In the agent's report, she determined an annual amount of $X as rental value for the property. . . . She stated: 'Calling a property management company and asking about the house determined this rental value, I did not identify the address; rather I used the information about the house, how many acres, square footage and area, etc.' The rental value was $X per month. This appears correct as the other houses owned and operated by Pastor B and the church were consistent with this value. The other rentals were not as spacious, nor did they have the amenities consistent with this property. In addition, the other rentals were in [an adjacent county] as opposed to [this county], which has a higher rental value. Those houses were being rented for approximately $Y/month." *IRS Private Letter Rulings 200435019, 200435020, 200435021, 200435022.*

### *Homes owned less than one year*

One question that is not addressed by the tax code or by the IRS or the courts is whether the fair rental value limit should be prorated if a minister owns a home for less than one year. Consider an example. Pastor Tim accepts a pastoral position with a church in June 2018 and purchases a new home that he occupies for the last six months of the year. The church pays him a salary and a housing allowance. Assume that the annual fair rental value of the home is $15,000. However, since Pastor Tim only occupied the home for six months of the year, the rental value of the home for those months was $7,500.

When Pastor Tim computes the nontaxable amount of his church-designated housing allowance for 2018, does the fair rental value limit refer to the *annual* fair rental value ($15,000) of his home or the *prorated* fair rental value for the portion of the year he occupied the home ($7,500)?

While the IRS has not addressed this question, it is likely that it would use a prorated rental value limit in calculating Pastor Tim's housing allowance exclusion. Here's why. For many years the tax

code excluded the rental value of a parsonage from a minister's taxable income, but not a housing allowance designated by a church. This changed in 1954, when Congress amended the tax code (section 107) to make church-designated housing allowances nontaxable in computing income taxes to the extent they are used to pay housing expenses. A committee report explained this change as follows:

> *Under present law, the rental value of a home furnished a minister of the gospel as a part of his salary is not included in his gross income. This is unfair to those ministers who are not furnished a parsonage, but who receive larger salaries (which are taxable) to compensate them for expenses they incur in supplying their own home. Your committee has removed the discrimination in existing law by providing that the present exclusion is to apply to rental allowances paid to ministers to the extent used by them to rent or provide a home.*

According to this language, the housing allowance exclusion was created to eliminate the tax code's former preference for ministers who reside in a parsonage. In the above example, this would mean that Pastor Tim's computation of his home's fair rental value should only be for the six months he lived there, since if he had lived in a church-provided parsonage, he would have occupied it for only six months. On the other hand, if Pastor Tim can use his home's fair rental value for the entire year as his limitation, this puts him in a *more favorable position* than he would have been in had he occupied the parsonage for six months.

Logically, then, the fair rental value should be prorated to reflect the portion of the year a minister actually occupies a home. This will result in more taxes (because of a lower rental value limit). Any official guidance will be reported in future editions of this tax guide.

### Furniture

The tax code specifies that the nontaxable portion of a housing allowance (for ministers who own their home) cannot exceed "the fair rental value of the home, including furnishings and appurtenances such as a garage, plus the cost of utilities." Ministers and their tax advisors have interpreted this language in two ways:

(1) Some assume that "the rental value of the home, including furnishings" refers to the fair rental value of a *furnished* home. To illustrate, assume that a home has an annual fair rental value of $15,000 if unfurnished, but an annual fair rental value of $16,000 if it includes furnishings. The fair rental value limit refers to the $16,000 value.

(2) Some have argued that "the rental value of the home, including furnishings" means the fair rental value of a home *without* furnishings *plus* the fair rental value of rented furniture. To illustrate, assume that a home has an annual fair rental value of $15,000 if unfurnished and an annual fair rental value of $16,000 if it includes furnishings. However, the cost of renting furniture for the entire home is $5,000 per year. Therefore, "the rental value of the home, including furnishings," means the rental value of the unfurnished home ($15,000) plus the rental value of furnishing the home ($5,000), for a total rental value of $20,000. Obviously, this interpretation results in a much higher rental value, and this means that in many cases the housing allowance exclusion will be larger, resulting in lower taxes for the minister.

Neither the IRS nor any court has addressed this issue in a published ruling. Until definitive guidance is provided, the second option should be viewed as an aggressive tax position that likely would be rejected by the IRS in an audit, and it should not be used without the advice of a tax professional.

## 6. AMOUNT OF HOUSING ALLOWANCE

★ **KEY POINT** The tax code limits the nontaxable portion of a church-designated housing allowance for ministers who own or rent their home to the fair rental value of the home (furnished, plus utilities). As a result, ministers who own or rent a home do not include the portion of their salary designated in advance by their church as a housing allowance as income in computing their federal income taxes, to the extent it is used to pay for expenses incurred in owning or renting the home (i.e., mortgage payments, rental payments, utilities, repairs, property taxes, property insurance, and furnishings) and does not exceed the fair rental value of the home (furnished, plus utilities).

### Method of determination

Some churches simply declare a percentage (e.g., 40 percent) of a minister's salary as a housing allowance. This practice should be avoided, since it bears no correlation to actual housing expenses. Others declare a monetary amount based on a minister's projected expenses for the year. In either case, the church should make a separate designation for each minister on staff (churches can designate housing allowances for all ministers on staff).

The allowance should be designated each year for each minister. General designations for several unspecified ministers are not adequate. In some cases it is appropriate for a church to designate a minister's entire church compensation as a housing allowance. For example, assume that Don is a minister of a small, mission church that is only able to pay him $5,000 per year. Assume further that Don works a part-time secular job to support himself. If Don has at least $5,000 of housing expenses, it would seem perfectly reasonable and appropriate for his church to designate his entire salary as a housing allowance. No court (or the IRS) has ever ruled that a housing allowance designated by a church cannot be fully claimed

# DESIGNATING A MINISTER'S ENTIRE SALARY AS A HOUSING ALLOWANCE

***Question.*** We have a part-time associate pastor who has asked the church to designate his entire salary as a housing allowance. Do we need to issue him a W-2 form at the end of the year reporting no income?

***Answer.*** This is a surprisingly complex question. Here's why. Until 1974, section 6051 of the federal tax code required a Form W-2 to be issued to (1) each employee from whom income, Social Security, or Medicare tax is withheld or (2) each employee from whom income tax would have been withheld if the employee had claimed no more than one withholding allowance or had not claimed exemption from withholding on Form W-4. Churches were not required to issue a W-2 to pastors under this provision since their wages are exempt from tax withholding.

In 1974 Congress enacted a massive pension law (the Employee Retirement Income Security Act, or ERISA). This law added the following phrase to section 6051: "Every employer engaged in a trade or business who pays remuneration for services performed by an employee, including noncash payments, must file a Form W-2 for each employee." Unfortunately, the legislative history contains no explanation of why this language was added. In any event, it was broad enough to require churches to issue a Form W-2 to ministers even though they are not subject to tax withholding.

The 1974 amendment created some ambiguities, and the stated question highlights one of them. Read literally, the revised section 6051 requires a church to issue a Form W-2 to a minister even though all of the minister's income is designated as a housing allowance, no amount is shown in box 1 (wages), and no withholdings of income taxes or Social Security or Medicare taxes are reported. Why? Because the church is an employer "engaged in a trade or business who pays remuneration for services performed by an employee, including noncash payments." Of course, submitting to the IRS a Form W-2 that identifies a minister by name and Social Security number but has blank boxes for income and withholdings is not consistent with the purpose of the form, which is to report wages and withholdings to the IRS to ensure that the correct amount of taxes are paid. This purpose is not furthered by submitting blank forms. This, however, does not necessarily mean that a church is relieved of obligation to issue a Form W-2.

In 2000 the IRS addressed the question of whether election workers should be issued W-2 forms. Election workers are individuals who are generally employed to perform services for states and local governments at election booths in connection with national, state, or local elections. Government agencies typically pay election workers a set fee for each day of work. The IRS quoted section 6051 of the tax code and concluded that this section "does not require reporting of compensation that is not subject to withholding of FICA tax or income tax. . . . Section 6051 requires reporting of compensation subject to either FICA tax or income tax withholding. No reporting is required . . . for items of income that are not subject to withholding of FICA tax or income tax. If an election worker's compensation is subject to withholding of FICA tax, reporting is required by section 6051 regardless of the amount of compensation." *IRS Revenue Ruling 2000-6.*

This ruling suggests that a church may not be required to issue a W-2 to a part-time pastor whose entire income is designated as a housing allowance.

The IRS operates a centralized call site to answer questions about reporting information on W-2 forms. If you have any questions about completing a Form W-2, call the IRS at 1-866-455-7438, Monday through Friday, 8:30 a.m. to 4:30 p.m. Eastern time.

by a minister who has secular earnings. There is no requirement that ministers allocate their housing expenses to their church and secular earnings on a pro rata basis.

Some churches designate a housing allowance in the amount of a minister's actual housing expenses. This practice should be avoided, since it may not satisfy the requirement that housing allowances be designated in advance. Under this approach there is no way to know how much of a minister's compensation is a housing allowance until *after* expenses are incurred. This is not consistent with the income tax regulations.

## *Limitations*

The IRS has stated that there are no limitations on how much of a minister's compensation can be designated by his or her employing church as a housing allowance. However, as noted above, this means little, since the nontaxable portion of a church-designated housing allowance for ministers who own or rent their home cannot exceed the lesser of (1) actual housing expenses, or (2) the fair rental value of the home (furnished, plus utilities).

In addition, the IRS has ruled that a housing allowance may not be excluded by a minister to the extent that it represents "unreasonable

## TELEPHONE EXPENSES

Can ministers include the costs of both personal and business use of a home telephone in computing their housing allowance exclusion? Unfortunately, the tax code and regulations do not answer this question, and it has never been addressed by either the IRS or any court. So a definitive answer is not possible.

In a 1955 ruling, the IRS concluded that telephone expenses are a utility expense to which a housing allowance can be applied. *Letter Ruling 5509169250A.* While this ruling was a private letter ruling that cannot be cited as precedent in other cases, it remains the only instance in which the IRS has addressed the application of housing allowance to telephone expenses. This ruling makes sense. Section 107 of the tax code provides that the portion of a minister's church compensation that is designated as a housing allowance is not included in computing taxable income (for income tax reporting) to the extent that it is used to pay for housing-related expenses and, for ministers who own or rent their homes, does not exceed their home's annual fair rental value. There is no requirement that the housing expenses be business related. All that is required is that the expenses be incurred to rent or provide a home. To illustrate, ministers can use a housing allowance to pay for mortgage payments, property insurance, property taxes, electricity, natural gas, and water despite the fact that the vast majority of these expenses are incurred for purely personal reasons having nothing to do with the conduct of the minister's profession. They are excludable not because they are business related but because they are housing related. They are necessary and customary expenses for anyone who owns a home. Under this analysis, a housing allowance could be applied to the expenses incurred in maintaining a local land-line telephone so long as reasonably necessary to provide a home.

Clearly, the use of a land-line telephone for local calls (the base charge) is indispensable to a minister's home. Therefore, an argument could be made that such telephone expenses are includible in the housing allowance calculation (whether for business or personal use). Such expenses are like electricity expenses—they are reasonably necessary to provide a home, and as a result they are includible in their entirety in the housing allowance calculation despite the fact that a substantial portion of such expenses are not business related. This was the conclusion reached by the IRS in its 1955 ruling.

But it is far from clear that this same reasoning would apply to cell phones, which, unlike all of the other expenses mentioned previously, are mobile and not physically connected to the minister's home. As a result, applying a housing allowance to a cell phone should be viewed as an aggressive tax position, unsupported by any existing precedent, that should not be adopted without the advice of a tax professional. This is true even for those ministers who use a cell phone exclusively and do not have a land-line telephone in their home.

compensation" for the minister's services. *Revenue Ruling 78-448.* For example, a televangelist whose ministry designates hundreds of thousands of dollars of his compensation each year as a housing allowance would likely have the reasonableness of the allowance challenged by the IRS in the event of an audit. Providing a minister with a housing allowance (or parsonage) that is excessive in amount may constitute unreasonable compensation. Such a finding could jeopardize the tax-exempt status of the church or ministry. Further, the allowance may constitute an excess benefit transaction, triggering intermediate sanctions against the pastor (and the board members who approved it) in the form of substantial excise taxes. See "General Considerations" on page 125 for a discussion of unreasonable compensation and intermediate sanctions.

★ **KEY POINT** No limit has been placed on the amount of a minister's compensation that can be designated by a church as a housing allowance (assuming that the minister's compensation is reasonable in amount). However, a church ordinarily should not designate for a minister who owns or rents a home a housing allowance that is significantly above the minister's housing expenses or the fair rental value of the home (furnished, plus utilities), since the minister will not be able to exclude more than the lower of these amounts in computing federal income taxes.

**EXAMPLE** The Tax Court ruled that the portion of a pastor's salary designated by his church as a housing allowance was not subject to income taxation despite the fact that it comprised most of his compensation. The pastor was employed by a small church that paid him an annual compensation of $13,500, of which $13,000 ($250 per week) was designated as a housing allowance. The IRS audited the pastor's tax return. It conceded that the church had designated the allowance, but disallowed it because the pastor had failed to prove that the allowance in fact was spent on housing expenses.

The Tax Court reversed the IRS determination and ruled that the pastor was entitled to exclude the housing allowance from his taxable income. It noted that the pastor had "credibly testified

that the housing allowance provided by [the church] was insufficient to cover his mortgage expenses and utilities. In this respect [he] testified that his mortgage payment alone was approximately $1,000 per month before refinancing. Consequently, we find that the $13,000 per year parsonage allowance he received was used to provide a home. Accordingly, the $13,000 annual housing allowance . . . is not includable in petitioners' gross income."

In the past, some have questioned whether most or all of a pastor's compensation can be designated as a housing allowance. It is worth noting that neither the IRS nor the Tax Court questioned the housing allowance in this case on the ground that it comprised over 95 percent of the pastor's total church compensation. *Holmes v. Commissioner, T.C. Summary Opinion 2010-42 (2010).*

## 7. AMOUNT A MINISTER MAY CLAIM AS A HOUSING ALLOWANCE EXCLUSION

The housing allowance designated by a church is not necessarily exempt from tax in computing federal income taxes. Section 107 of the tax code specifies that a housing allowance is excluded from income tax only to the extent it is used for actual expenses incurred by the minister in owning or renting a home and does not exceed the fair rental value of the home (furnished, plus utilities).

For ministers who own their homes, actual expenses include:

- down payment on a home;
- payments (including prepayments) on a mortgage loan to purchase or improve your home (including both interest and principal);
- real estate taxes;
- property insurance;
- utilities (electricity, gas, water, trash pickup, local telephone charges);
- furnishings and appliances (purchase and repair);
- structural repairs and remodeling;
- yard maintenance and improvements;
- appurtenances;
- maintenance items (household cleansers, light bulbs, pest control, etc.); and
- homeowners association dues.

★ **KEY POINT** In 2007 the Tax Court characterized Internet expenses as utility expenses. This suggests that a housing allowance may be used to pay for Internet expenses (e.g., Internet access, cable television). *Soholt v. Commissioner, T.C. Summary Opinion 2007-49 (2007), relying on Verma v. Commissioner, T.C. Memo. 2001-132.* Neither the IRS nor the Tax Court has addressed this issue, so ministers should check with a tax professional about the application of a housing allowance to these expenses. In addition, the same analysis of telephone expenses (see below) could be applied to Internet access fees.

★ **KEY POINT** While not directly relevant to the computation of expenses in the context of ministers' housing allowances, IRS Form 433-A (Collection Information Statement for Wage Earners and Self-employed Individuals) includes utilities in the calculation of monthly housing expenses and defines utilities to include "gas, electricity, water, fuel, oil, other fuels, trash collection, telephone, cell phone, cable television and internet services." Form 433-A is used to obtain current financial information necessary for determining how a wage earner or self-employed individual can satisfy an outstanding tax liability.

If actual expenses exceed the church-designated allowance and the fair rental value of the home, the minister can only exclude the allowance. This illustrates why churches should always be liberal in designating housing allowances.

In Publication 517 the IRS states the rule as follows:

> *If you own your home and you receive as part of your salary a housing or rental allowance, you may exclude from gross income the smallest of:*
>
> - *The amount actually used to provide a home,*
> - *The amount officially designated as a rental allowance, or*
> - *The fair rental value of the home, including furnishings, utilities, garage, etc.*

**EXAMPLE** Pastor C is paid a salary of $40,000 for year 2018. The church board designates $25,000 of this amount as a housing allowance. In February Pastor C purchases a new home and makes a down payment of $15,000. Assume that he has additional housing expenses of $7,000 for the year and that the fair rental value of the home (furnished, including utilities) is $10,000 for the portion of the year he occupied it. Pastor C's housing allowance is nontaxable only to the extent it does not exceed actual housing expenses or the rental value of his home. Stated differently, the amount of the housing allowance that is excluded in computing federal income taxes is the lowest of the following three amounts: (1) the church-designated housing allowance ($25,000); (2) actual housing expenses ($22,000); or (3) the rental value of the home ($10,000). Since the rental value is the lowest amount, this is the amount of Pastor C's housing allowance that is nontaxable.

**EXAMPLE** Pastor L's roof collapsed during a snowstorm late in 2017. Knowing repairs would cost $5,000 and that he incurs about $10,000 of additional housing expenses per year, Pastor L has the church board designate $15,000 of his 2018 salary of $40,000

as a housing allowance. Assume that the fair rental value of the home (furnished, including utilities) is $10,000. Pastor L's nontaxable housing allowance would be the least of the following three amounts: (1) the church-designated housing allowance ($15,000); (2) actual housing expenses ($15,000); or (3) the rental value of the home ($10,000). Since the rental value is the lowest amount, this is the amount of Pastor L's housing allowance that is nontaxable.

**EXAMPLE** A church board is considering the 2018 compensation package for Pastor B. It decides on total compensation of $30,000. Pastor B informs the board that she will have ordinary housing expenses of $10,000 but that she also will be incurring remodeling expenses of an additional $10,000. The board is uncomfortable designating two-thirds of Pastor B's total compensation as a housing allowance. If the fair rental value of the home is significantly lower than $20,000, there is no advantage in designating a housing allowance of this amount.

## 8. HOME EQUITY LOANS, SECOND MORTGAGE LOANS, AND REFINANCING

What happens to ministers who own their homes after they pay off their home mortgage loan? Are they still eligible for a housing allowance, and if so, for what expenses? Can they include the annual fair rental value of their home in computing their housing allowance exclusion?

Ministers who own their home may still claim a housing allowance exclusion (assuming they otherwise qualify), but since the exclusion may never exceed the actual expenses incurred in owning or maintaining a home, it will be reduced (often significantly) when the home mortgage loan is paid off. Ministers still will incur some expenses (e.g., utilities, repairs, improvements, furnishings, property taxes, and insurance) to which a housing allowance can be applied. But since the annual rental value of the home is not an actual expense, it cannot be included in computing the exclusion. *Swaggart v. Commissioner, 48 T.C.M. 759 (1984).*

In the past some ministers who had paid off their homes obtained a home equity loan (secured by a new home mortgage) and included the mortgage payments (principal and interest) in computing their housing allowance exclusion. The IRS has ruled that this practice is not permissible unless the home equity loan was obtained for direct housing-related expenses. The fact that the loan is secured by a mortgage on the home is not enough. *IRS Letter Ruling 9115051.* The Tax Court has agreed with this conclusion. *Rasmussen v. Commissioner, T.C. Memo. 1994-311.* The court observed:

> *Exemptions from gross income are to be construed narrowly . . . and [federal law does not] provide for the exclusion of payments on loans secured by a home if they are not used to "provide a home." The proceeds of the church loans were used to pay personal expenses of [the pastor and his wife] unrelated to their home. Thus, even assuming that the loans were secured by the [pastor's home, he has] not shown that the portion of the parsonage allowance used to repay the church loans was used for the maintenance or purchase of the home. On the record before us, we hold that [the pastor and his wife] have not proven that the portion of the parsonage allowance used to repay the church loans was used to provide a home as required by [federal law].*

★ **KEY POINT** The Tax Court has concurred with an IRS private letter ruling that ministers cannot consider loan repayments as a housing expense in computing their housing allowance exclusion unless the loan is used for direct housing-related expenses. If the loan is for personal items such as a new car, a child's education, or medical expenses, it is not converted into a housing expense because it is secured by a mortgage on the minister's home.

A related and more difficult question is how to calculate a housing allowance when a minister adds to an existing home mortgage. For example, assume that a minister refinances a home mortgage and increases the indebtedness, or obtains a second mortgage loan on top of an existing home mortgage loan, or obtains a home equity loan. What are the tax consequences in these cases if the additional mortgage debt is obtained to finance expenses not directly related to the home (e.g., education, medical care, vacations, or a new car)? In each of these cases, the minister has a preexisting mortgage loan that was obtained solely to facilitate the purchase of the home. Unfortunately, neither the IRS nor any court has addressed this question. As noted above, both the IRS and the Tax Court have addressed what happens when a minister's home is paid off and the minister obtains a subsequent home mortgage loan to finance personal expenses such as medical care and education. Obviously, these rulings provide a reasonable basis for concluding that some form of allocation would be required when a minister adds to an existing mortgage debt for nonhousing expenses.

To illustrate, if a minister has an outstanding home mortgage loan in the amount of $50,000 and then obtains a second mortgage loan in the amount of $25,000 for various personal expenses, the mortgage interest payments allocable to the first loan could be considered in computing the minister's housing allowance exclusion, while the interest paid on the second mortgage loan would not. It would be easy to make such allocations in the case of a second mortgage loan or a home equity loan. The more difficult case involves refinancing. It is likely that the IRS and the courts would again apply some type of allocation rule. One possibility would be to make an allocation at the time of the refinancing. For example, if a minister with a $50,000 home mortgage debt refinances the indebtedness and increases it to $75,000, and if the additional $25,000 debt is used for personal expenses, then two-thirds of the interest payments could be allocated to the home and be included in computing the

housing allowance exclusion, while one-third of the interest payments would be allocated to personal expenses and would not be included. Future rulings may provide further clarification.

## 9. HOUSING ALLOWANCES, DOWN PAYMENTS, AND MORTGAGE LOAN PREPAYMENTS

In the past it was much harder for taxpayers to avoid tax on the gain from the sale of a home. As a result, ministers often attempted to minimize or avoid taxes by having gain from the sale of a former home designated as a housing allowance and applied to the down payment on a new home. This practice is rarely used today because the tax code eliminates any tax on gain from a former home if the home was owned and occupied for at least two of the previous five years (gain may be partially excluded from tax even if the home was owned and occupied for less than two years). For married couples, up to $500,000 of gain is excluded (up to $250,000 for single persons).

Because of this liberal provision, the gain most ministers realize from the sale of a former home is not taxed. However, this is not always the case. For example, a minister may have owned and occupied a home for less than two of the previous five years, resulting in some of the gain from the sale of the home being taxable. In high-cost areas, some ministers may realize gain from the sale of a home that exceeds the $250,000/$500,000 exclusion limits. Can ministers minimize or avoid tax on the gain from the sale of a former home by having it designated as a housing allowance and applying it to the down payment on a new home? In the past, when the rules for excluding gain on the sale of a home were much more restrictive, a number of courts addressed this question. Those cases are still relevant today whenever ministers try to exclude gain from the sale of a former home by having it designated as a housing allowance. Consider the following precedent:

### *The Marine case (1967)*

In 1967 the Tax Court addressed the question of whether a pastor can apply his housing allowance to housing expenses paid out of the gain from the sale of his former home. *Marine v. Commissioner, 47 T.C. 609 (1963).* A church's board of trustees adopted the following resolution: "For the [current] year and thereafter unless modified, all payments to Pastor Fred are to be considered rental allowance unless the payments exceed $20,000."

During the year, Pastor Fred received compensation of $13,500 from the church. In July he purchased a new home for $18,500. He made a cash deposit of $500 on the property at the time of signing the contract of sale. The balance was provided by a one-year mortgage loan of $18,000, which Pastor Fred received from a local bank. In August Pastor Fred sold his former home for $16,500. Of this amount, $15,000 was withheld from Pastor Fred at closing and paid over to his bank in partial satisfaction of the $18,000 mortgage loan. Pastor Fred paid an additional $3,000 in expenses associated with the ownership of his home (monthly mortgage payments, utilities, furnishings, insurance, and property taxes).

In preparing his federal income tax return for the year, Pastor Fred did not report any taxable income. He assumed that his entire salary of $13,500 was nontaxable, since the church had designated this entire amount as a housing allowance and he incurred housing expenses well in excess of this amount. The IRS audited Pastor Fred and determined that the housing allowance could be applied only to the $3,000 that he paid out of his own funds for housing expenses. The IRS refused to allow Pastor Fred to apply his housing allowance to the $15,000 proceeds from the sale of his former home that was used to pay down the mortgage loan on his new home. Pastor Fred appealed to the Tax Court.

The Tax Court agreed with the IRS that Pastor Fred could only apply his housing allowance to the $3,000 of out-of-pocket housing expenses he incurred in 1963. The court noted that the tax code originally only allowed ministers to exclude from taxable income the annual rental value of a parsonage. In 1954 the code was amended to allow ministers to exclude the portion of their income designated by their employing church as a housing allowance, to the extent it is used to pay for housing expenses. The reason for the 1954 amendment, noted the court, was to eliminate the prior law's discrimination against ministers who were not provided with a parsonage and who had to use their own income to provide a home. As a result, in enacting the 1954 code, "Congress not only continued to provide that the rental value of a house furnished to a minister would not be included in gross income, but also added a further provision that a rental allowance paid to a minister as part of his compensation was excludable from gross income to the extent used by him to rent or provide a home." The court concluded:

> *Plainly, the purpose of the new provision was to equalize the situation between those ministers who received a house rent free and those who were given an allowance that was actually used to provide a home. There certainly does not appear to be any intention to place ministers of the second category in a favored position. Yet, if Pastor Fred were to prevail here, his entire compensation for 1963 would escape taxation, a result that seems clearly contrary to the underlying purpose of the statute. And the words of the statute itself explicitly preclude that result, for it provides that the rental allowance is excludable from a minister's gross income only "to the extent used by him to rent or provide a home." The circumstance that Pastor Fred's entire compensation was artificially designated as a rental allowance pursuant to the statement signed by the board of trustees of the church cannot in fact convert into a rental allowance that which was plainly compensation for services, nor does it appear on this record that to the extent that the IRS refused to treat his compensation as an excludable rental allowance*

> *such compensation was actually "used by him to rent or provide a home." On the facts before us Pastor Fred did not use his entire 1963 compensation of $13,500 to rent or provide a home. True, he purchased a new residence in 1963 at a price which exceeded that amount. But the great bulk of that price was paid out of the proceeds of sale of his old residence.*

The court's decision in the *Marine* case was based squarely on the principles of *discrimination* and *source* of income. Each principle is addressed below.

### Discrimination

The court concluded that allowing ministers who own their homes to have their entire salary designated as a housing allowance would violate the purpose of the 1954 tax code amendment that sought to achieve equality between ministers who live in parsonages and those who own or rent their home. If ministers could have all or most of their church compensation designated as a housing allowance, they would be in a better position than ministers who live in church-owned parsonages.

The IRS applied this reasoning in a 1971 ruling that imposed the fair rental value limit on the nontaxable amount of ministers' housing allowances. *Revenue Ruling 71-280.* This ruling was repudiated by the Tax Court in a 2000 decision. *Warren v. Commissioner, 114 T.C. 23 (2000).* However, the IRS position was incorporated into the Clergy Housing Allowance Clarification Act of 2002 that was enacted by Congress and that reinstated the fair rental value limit as a matter of law (as noted above).

### Source

The court concluded that Pastor Fred's housing allowance could not be applied to proceeds from the sale of a home that he applied to the mortgage loan on his new home, since these proceeds were not compensation received for the performance of ministerial services. In other words, the source of funds used to pay for a minister's housing expenses must be compensation earned by the minister in the exercise of ministry. This is a correct statement. The income tax regulations specify that "in order to qualify for the exclusion, the home or rental allowance must be provided as remuneration for services which are ordinarily the duties of a minister of the gospel." Note that in the *Marine* case the $15,000 used to pay down the mortgage loan could be unequivocally traced to the proceeds from the sale of Pastor Fred's former home because the sales proceeds were withheld from him at closing and paid directly to his bank to be applied to his mortgage loan. There was no question that the mortgage loan prepayment was paid out of the sales proceeds and not out of Pastor Fred's church salary. Therefore, the housing allowance could not be applied to any of those proceeds.

But what if the sales proceeds had *not* been withheld from Pastor Fred at closing? What if they were paid to Pastor Fred directly, he deposited them in his bank account, and he later used some or all of them to make a large down payment on his new home or pay down the mortgage loan on a new home? In such a case there would be no way to trace the $15,000 to the proceeds from the sale of Pastor Fred's former home. The proceeds and Pastor Fred's church salary would be commingled, making it difficult, if not impossible, to determine the source of the funds used to pay down the mortgage loan. It would be just as reasonable to assume that the source of the mortgage loan prepayment was Pastor Fred's housing allowance as the proceeds from the sale of his home. There are two important qualifications to this view, however.

***Other income.*** This view assumes a source of income in addition to the housing allowance. If a pastor's entire church compensation is designated as a housing allowance and the pastor has no other source of income (including a spouse's income), then it would be impossible to claim that the entire housing allowance should be nontaxable, even if the pastor had expenses of that much or more. After all, what income did the pastor use for living expenses? However, when a pastor has income in addition to a church salary, it makes a larger housing allowance more defensible.

***Matching expenses to income.*** Housing allowances are nontaxable in computing federal income taxes only to the extent they are used to pay for housing expenses. The income tax regulations specify that "a rental allowance must be included in the minister's gross income in the taxable year in which it is received, to the extent that such allowance is not used by him during such taxable year to rent or otherwise provide a home." Does this requirement mean there must be a strict matching of housing allowances with actual housing expenses?

To illustrate, what if Pastor Fred had sold his former home in January and used $15,000 of the proceeds to make a down payment on a new home on January 31? By January 31 Pastor Fred has received only one-twelfth of his housing allowance for the year ($1,125). Can he only apply this amount to his down payment, or may he include the housing allowances he receives for the entire year ($13,500)? In other words, are housing allowances compared with housing expenses on an annual basis, or must allowances be matched with expenses on an ongoing basis throughout the year?

The following arguments and precedent clearly demonstrate that any matching is done annually. Consider the following points:

- The IRS has never required strict matching in any ruling involving a housing allowance.
- The IRS does require strict matching in its audit guidelines for ministers.
- The IRS does not require strict matching in Publication 517 (a publication addressing tax issues for ministers).
- No court has ever required strict matching in any case involving a housing allowance.

- Ministers will almost always violate a strict matching requirement with respect to some housing expenses. To illustrate, assume that Pastor J is paid on the second and fourth Fridays each month and that he makes his monthly mortgage and utilities payments on the first business day of each month. Under such an arrangement, Pastor J's monthly mortgage payment for January will occur before his first paycheck for the month. The important point to note is that Pastor J had received no income (or housing allowance) for the new year when he paid the mortgage and utility bills. He cannot match the payment of these housing expenses to his housing allowance.

  Does this mean he cannot consider these expenses when computing the nontaxable portion of his housing allowance at the end of the year when he prepares his tax return? Neither the IRS nor any court has ever ruled that a housing allowance cannot be applied to housing expenses incurred in January (or any other month) prior to the receipt of a housing allowance of equal or greater value. The focus is on housing expenses incurred throughout the year and whether the housing allowance designated by the church for the year is sufficient to cover these expenses.

  Many other examples could be given. For example, what about a minister who incurs remodeling expenses or repairs of several thousand dollars in January that are far in excess of the housing allowance distributed in that month? Again, neither the IRS nor any court has ever suggested that these expenses must be matched to the housing allowance actually paid in January. Common sense, then, indicates that strict matching of housing allowances and housing expenses is not required. Doing so would be far too impractical and would lead to absurd results. Instead, the focus is on housing expenses incurred throughout the year and on a minister's church-designated housing allowance for the year.
- In 1984 the full Tax Court made these comments about the matching of housing expenses to housing allowances: "Section 1.107-1(c) [of the income tax regulations] provides that, for the allowance to be excludable, the use of the allowance to rent or provide a home must be in the taxable year in which the allowance is received. . . . The statute and the regulation appear to require an expenditure (or conceivably some equivalent action which may constitute a use) of an amount received as compensation in the same year." *Reed v. Commissioner, 82 T.C. 208 (1984).*
- Section 1.107-1(c) of the income tax regulations specifies that "a rental allowance must be included in the minister's gross income in the taxable year in which it is received, *to the extent that such allowance is not used by him during such taxable year to rent or otherwise provide a home*" (emphasis added). This language clearly applies an annual comparison of housing allowances to housing expenses. There is no need to match on a more frequent basis specific housing expenses with housing allowances actually received. So, for example, if a minister pays a monthly mortgage payment and utility bill in the first week of January, before receiving his first paycheck (including housing allowance) for the year, this does not prevent him from applying his housing allowances to these expenses when computing his taxes for the year. He need not match housing allowances actually received to the expenses paid on a daily, weekly, or monthly basis. It is done annually.
- IRS Publication 517 states that "if you own your home and you receive as part of your salary a housing or rental allowance, you may exclude from gross income the smallest of the amount actually used to provide a home, the amount officially designated as a rental allowance, or the fair rental value of the home, including furnishings, utilities, garage, etc." No suggestion is made here of matching housing expenses to housing allowance payments. Quite to the contrary, this language clearly indicates that the housing allowance is applied to housing expenses on an annualized basis. At the end of the year, ministers determine the nontaxable portion of their housing allowance by adding up all of the housing expenses they incurred during the year (subject to the annual fair rental value limitation).
- Section 461 of the tax code specifies that "the amount of any deduction or credit allowed by this subtitle shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income." The income tax regulations specify that "generally, under the cash receipts and disbursements method in the computation of taxable income, all items which constitute gross income (whether in the form of cash, property, or services) are to be included for the taxable year in which actually or constructively received. Expenditures are to be deducted for the taxable year in which actually made." *Treas. Reg. 1.461-1(c).*

**EXAMPLE** A church designates $24,000 of Pastor T's 2018 compensation as a housing allowance. Pastor T resigns from the church on June 30, 2018. At the time of Pastor T's resignation, he had received half of his $24,000 housing allowance ($12,000) but had only incurred $10,000 in housing expenses. Can he apply the unused allowance ($2,000) to housing expenses incurred in the second half of the year, following his resignation? The preceding analysis suggests that he can. Also, note that the key consideration is that the $2,000 unused allowance represents compensation for ministerial services performed by Pastor T during the course of his employment in the first half of the year. Section 1.107-1(c) of the income tax regulations specifies that "a rental allowance must be included in the minister's gross income in the taxable year in which it is received, *to the extent that such allowance is not used by him during such taxable year to rent or otherwise provide a home*" (emphasis added). This language explicitly allows a housing allowance that constituted compensation for ministerial services to be excluded from a minister's taxable income if used to pay housing expenses during the same year.

### *Revenue Ruling 71-280 (1971)*

Four years after the *Marine* decision, the IRS ruled that the nontaxable portion of a housing allowance for ministers who own their homes can never exceed the fair rental value of the home. *Revenue Ruling 71-280.* The IRS based its ruling squarely on the *Marine* case. It concluded:

> *It is indicated in the Senate Report that Congress intended only to remove the discrimination in the existing law and did not intend to create a new discrimination in favor of another group by placing ministers who receive rental allowances in a better position than ministers who receive rent free homes. Consequently, a minister cannot exclude his entire compensation by the mere act of having it designated as a rental allowance.* Marine v. Commissioner, 47 T.C. 609 (1967).

As a result, ministers who own their homes can only exclude housing expenses to the extent that they do not exceed *either* the church-designated allowance *or* the fair rental value of the home plus the cost of utilities. The fair rental value test was adopted by the IRS to eliminate any discrimination between ministers who live in parsonages and those who are purchasing a home. It was repudiated by the Tax Court in 2000. *Warren v. Commissioner, 114 T.C. 23 (2000).* However, it was later reinstated as an amendment to section 107 of the tax code by the Clergy Housing Allowance Clarification Act of 2002. See "The Clergy Housing Allowance Clarification Act of 2002" on page 258.

★ **KEY POINT** While no direct matching of housing allowances and housing expenses is required, this does not mean that housing allowances can be designated retroactively. A housing allowance must be designated in advance. This is simply another way of saying that a housing allowance is nontaxable only to the extent it is used to pay for housing expenses. This requirement cannot be met if a housing allowance is designated retroactively. In summary, while the matching of housing allowances and housing expenses is done on an annual basis, this assumes that the housing allowance was designated in advance. If a housing allowance is not designated until the middle of the year, it can be applied only to housing expenses incurred from that date through the end of the year.

**EXAMPLE** M is a retired minister who rents a home. In December 2017 she informed her denominational pension board that she wanted a lump-sum distribution from her account of $100,000 in 2018, and she wanted the entire distribution to be designated as a housing allowance. M uses the distribution as a down payment on a new home in July 2018. She pays her living expenses with Social Security benefits and investment income. Assume that the rental value of the new home is $12,000 for the months it is occupied by M in 2018. What is the nontaxable portion of M's housing allowance? According to the *Marine* case, the nontaxable portion of the housing allowance would be limited to the rental value of the home for the months M occupied it in 2018 ($12,000). This is the same result dictated by Revenue Ruling 71-280, IRS Publication 517, and section 107 of the tax code as amended by the Clergy Housing Allowance Clarification Act of 2002.

**EXAMPLE** A church board is considering the 2018 compensation package for Pastor N. It decides on total compensation of $60,000. Pastor N asks the board to designate this entire amount as a housing allowance. He informs the board that he will have ordinary housing expenses of $15,000 but that he also will be purchasing a new home in 2018 and plans to make a large down payment (with the sale proceeds from his prior residence) of $45,000. Pastor N's spouse is employed as a college professor, and the couple plans on using her salary for living expenses in 2018. Pastor N later uses the entire $60,000 to pay for housing expenses in 2018. Assume that the rental value (including utilities) of the former and new homes, during the months Pastor N occupies them, is $12,000. What is the nontaxable portion of Pastor N's housing allowance? Section 107 of the tax code, as amended by the Clergy Housing Allowance Clarification Act of 2002, limits the nontaxable portion of a housing allowance for ministers who own their home to the fair rental value of their home (furnished, plus utilities). As a result, the housing allowance is nontaxable only if it is used to pay for housing expenses and does not exceed the annual rental value of the home. In this case, this means that the nontaxable housing allowance is limited to $12,000 (fair rental value).

## 10. AMENDING THE HOUSING ALLOWANCE

What if a church designates $10,000 of a minister's 2018 compensation as a housing allowance based on reasonable estimates of the minister's anticipated expenses, and the minister trades homes later in the year and incurs much greater housing expenses? Can the church amend its housing allowance designation?

While neither the IRS nor any court has addressed this question, it seems reasonable to conclude that the church can amend its housing allowance designation during the course of the year if changed circumstances render the allowance inadequate. Any change would only operate prospectively.

★ **KEY POINT** Churches can amend a housing allowance if the allowance proves to be too low. However, the amended allowance will only operate prospectively.

## 11. THE "DOUBLE DEDUCTION"

Ministers who own their homes and who itemize their deductions are eligible to deduct mortgage interest and property taxes on Schedule A, even though such items were excluded as part of the housing allowance exclusion. This is the so-called double deduction. *IRC 265.*

The IRS audit guidelines for ministers state that even though a minister's home mortgage interest and real estate taxes have been paid with money excluded from income as a housing allowance, he or she "may still claim itemized deductions for these items."

## 12. HOUSING EXPENSES PAID DIRECTLY BY A CHURCH

Some churches pay part or all of a minister's housing expenses directly. Can such payments be treated as a nontaxable housing allowance? It could be argued that by agreeing to pay for a minister's housing expenses, a church is, in effect, designating a housing allowance (in advance) in the amount of the expenses it paid. But the Tax Court has reached the opposite conclusion. A minister received a weekly "living allowance" from his church. He kept no records reflecting how these allowances were spent. In addition, his church paid his housing expenses (including mortgage payments, utilities, and furnishings). The court ruled that the weekly allowances were taxable and could not be classified as a nontaxable housing allowance. It observed:

> *[The minister and his spouse] have not substantiated that any of their weekly allowances were used "to rent or provide a home." In fact, the record reveals that [the church] directly paid for such expenses. Moreover, the regulations require that prior to payment of a rental allowance, the employing church must designate the rental allowance in an employment contract or other appropriate instrument so as to clearly identify the portion of the minister's salary that is the rental allowance. As [the minister and his spouse] had no written agreement with the church concerning this matter, they have failed to comply with the regulations. Accordingly, for the years in issue, we hold that the weekly allowances received by petitioners must be included in their gross incomes.* Pollard v. Commissioner, 48 T.C.M. 1303 (1984).

Based on this case, a church that pays a minister's housing expenses directly should designate in advance the amount it pays as a housing allowance, in addition to any other housing allowance it declares.

## 13. SAFETY NET ALLOWANCES

Many churches do not limit housing allowances to a particular calendar year. For example, if a church intends to designate $12,000 of its senior pastor's salary in 2018 as a housing allowance, its designation could state that the allowance is effective for calendar year 2018 *and all future years unless otherwise provided*. This clause may protect the pastor in the event that the board neglects to designate an allowance prior to the beginning of a future year.

A church also would be wise to have a "safety net" designation to cover midyear changes in personnel, delayed designations, and other unexpected contingencies. To illustrate, such a designation could simply state that a specified percentage (e.g., 40 percent) of the compensation of all ministers on staff, regardless of when hired, is designated as a housing allowance for the current year and all future years unless otherwise specifically provided.

Such safety net designations should not be used as a substitute for annual housing allowance designations for each minister. They are simply a means of protecting ministers against inadvertent failures by the church board to designate a timely housing allowance.

★ **KEY POINT** Churches should consider adopting a "safety net" allowance to protect against the loss of this significant tax benefit due to the inadvertent failure by the church to designate a timely allowance.

## 14. OWNING TWO HOMES

In 2010 the United States Tax Court ruled that a minister could apply a housing allowance to expenses incurred in owning two homes. The court acknowledged that section 107 of the tax code, which contains the housing allowance exclusion, refers to a minister's "home" in the singular, but it concluded that this did not limit the application of a housing allowance to only one home.

In 2012 a federal appeals court reversed the Tax Court's opinion and limited the application of a minister's housing allowance to expenses incurred in only one home (the principal residence). *Driscoll v. Commissioner, 669 F.3d 1309 (11th Cir. 2012).* The United States Supreme Court declined to review the case on appeal, leaving the appeals court's ruling intact.

The appeals court conceded that the tax code states that singular terms also include their plural forms, but it noted that this rule did not apply if "the context indicates otherwise." Therefore, the "singular includes the plural provision" should only apply if the context of the housing allowance reasonably supports such an application. The court concluded that it did not, for two reasons:

First, the word *home* is defined by the dictionary as "the house and grounds with their appurtenances habitually occupied by a family; one's principal place of residence; domicile." The court concluded that the word *home* according to this definition "has decidedly singular connotations."

Second, the court concluded that the history of the parsonage and housing allowance exclusions provided additional context for the term *home*. It noted that congressional committee reports describing the parsonage and housing allowance exclusions consistently use

singular expressions ("a dwelling house," "a home," and "the home"), demonstrating that Congress intended for the parsonage and housing allowance exclusions to apply to only one home.

In further support for its conclusion, the court stressed that income exclusions should be "narrowly construed," and therefore "we do not believe that this court should construe any ambiguity in [the tax code] to favor a more expansive reading of the parsonage allowance income exclusion."

Many ministers own two homes. In many cases, this is due to the fact that the minister has accepted a call in another community, purchases a home in that community, but has not yet sold the prior home. In some cases the minister has not moved but decides to purchase a new home in the same community and is in the process of selling the former home. The Tax Court's decision in the *Driscoll* case suggested that these ministers, at least in some cases, might be able to apply a housing allowance to the expenses of owning both homes. That option has been eliminated by the federal appeals court's recent ruling.

Many churches have their pastors fill out a housing expense form each year that lists anticipated housing expenses for the following year. The church board uses this form to declare pastors' housing allowances. It would be prudent to amend this form to clarify that it should only list expenses incurred in owning a principal residence, and not a second home.

## 15. SEVERANCE PAY

Can a church designate some or all of a minister's severance pay as a housing allowance? This question is addressed under "Severance pay" on page 180.

## 16. RETIRED MINISTERS

Retired ministers are eligible for a housing allowance exclusion if certain conditions are met. However, the surviving spouse of a deceased minister is not eligible for the exclusion unless he or she also is a minister who otherwise qualifies. See "Ministers' Spouses" on page 121 and "Housing Allowances" on page 530 for details. IRS Publication 517 states: "If you are a retired minister, you exclude from your gross income the rental value of a home (plus utilities) furnished to you by your church as a part of your pay for past services, or the part of your pension that was designated as a rental allowance. However, a minister's surviving spouse cannot exclude the rental value unless the rental value is for ministerial services he or she performs or performed."

Many ministers move into a retirement home following their retirement from ministry. Two costs are often associated with such living arrangements: (1) a lump-sum entrance fee, and (2) monthly or annual maintenance fees. The IRS has ruled that a lump-sum entrance fee paid by a retired minister to gain admission to a retirement community cannot be prorated over several years and claimed as a housing expense in those years. It can only be treated as a housing expense in the year it is actually paid. *IRS Letter Ruling 8348018 (1983); IRS Technical Advice Memorandum 8039007 (1980).*

What about monthly or annual maintenance fees? Can a retired minister's housing allowance (designated by a pension board) be applied to these fees? That depends. Section 107 of the tax code allows ministers to exclude from gross income the portion of their compensation designated in advance as a housing allowance, to the extent the allowance is used to "rent or provide a home." The regulations define this language as follows: "Circumstances under which a rental allowance will be deemed to have been used to rent or provide a home will include cases in which the allowance is expended (1) for rent of a home, (2) for purchase of a home, and (3) for expenses directly related to providing a home. Expenses for food and servants are not considered for this purpose to be directly related to providing a home."

As a result, a retired minister's housing allowance can be applied to any portion of a monthly maintenance fee charged by a retirement home that is "an expense directly related to providing a home." The regulations prohibit housing allowances from being applied to the costs of "food and servants"; therefore a housing allowance could not be applied to any portion of a maintenance fee that goes to food or housekeeping expenses.

## 17. TRAVELING EVANGELISTS

Traveling evangelists are entitled to a housing allowance exclusion if they maintain a permanent home and have local churches in which they conduct religious meetings declare in advance a portion of their compensation as a housing allowance. *See Revenue Ruling 64-326.* The requirement that each church designate a portion of an evangelist's compensation as a housing allowance is certainly an inconvenience, but it is well worth it. The Tax Court has rejected the contention of one evangelist that such a requirement impermissibly discriminates against evangelists. *Warnke v. Commissioner, 641 F. Supp. 1083 (D.C. Ky. 1986).*

Some evangelists have created nonprofit corporations. One of the justifications sometimes given for this procedure is to enable the evangelist to avoid the inconvenience of having each church designate a portion of his or her compensation as a housing or rental allowance—the idea being that the corporation can designate a portion of the evangelist's annual income as a housing allowance in a single action. See Chapter 3 for a discussion of which organizations can designate housing allowances.

Other evangelists have churches designate all of their compensation as a housing allowance during the first months of the year and then do not bother with allowances for the last several months of the year. A potential problem with this arrangement is that if evangelists have churches designate their entire compensation as a housing allowance, there will be no taxable income to report on a Form 1099-MISC, and an evangelist theoretically could avoid the reporting of any income.

To ensure accountability, it is recommended that churches issue evangelists and other guest speakers a Form 1099-MISC if paying them compensation (net of substantiated travel expenses) of $600 or more. Include a housing allowance designated by the church in computing the $600 amount, but also provide the evangelist or guest speaker with a written housing allowance designation on the church's stationery to confirm the housing allowance amount.

## 18. SOCIAL SECURITY

Ministers cannot exclude a housing allowance (or the annual fair rental value of a parsonage) when computing their self-employment (Social Security) taxes unless they are retired. The tax code specifies that the self-employment tax does not apply to "the rental value of any parsonage or any parsonage allowance provided after the [minister] retires." *IRC 1402(a)(8).*

The IRS *Tax Guide for Churches and Religious Organizations* states: "The fair rental value of a parsonage or housing allowance is excludable from income only for income tax purposes. These amounts are not excluded in determining the minister's net earnings from self-employment for Self-employment Contributions Act (SECA) tax purposes. Retired ministers who receive either a parsonage or housing allowance are not required to include such amounts for SECA tax purposes."

Therefore, in computing the Social Security tax on Schedule SE of Form 1040, nonretired ministers must include the actual housing allowance exclusion as income on line 2 of either the short or long Schedule SE (whichever applies). *IRC 1402(a)(8); Treas. Reg. 1.1402(a)-11(a); Flowers v. Commissioner, T.C. Memo. 1991-542.*

★ **KEY POINT** A housing allowance and the annual rental value of a parsonage are exclusions only for federal income tax reporting. They must be included in a minister's self-employment earnings when computing the self-employment tax (the Social Security tax on self-employed persons) unless the minister is retired.

## 19. IMPACT ON BUSINESS EXPENSES

A United States Tax Court ruling may limit the deductibility of some business and professional expenses for ministers who exclude a portion of their church compensation from gross income as a housing or rental allowance. *Dalan v. Commissioner, T.C. Memo. 1988-106.* See "The Deason Rule" on page 354 for a full discussion of the potential ramifications of this decision.

## 20. THE SARBANES–OXLEY ACT

In 2002 Congress enacted the Corporate and Auditing Accountability, Responsibility and Transparency Act, more commonly known as the "Sarbanes–Oxley Act." The Act was designed to restore investor confidence in the financial markets by holding companies issuing stock to much higher standards than previously done.

Most of the Act's provisions are amendments to the two main federal securities laws, the Securities Act of 1933 and the Securities Exchange Act of 1934. Churches are specifically exempted from these laws except for the antifraud provisions; so churches generally are not subject to most of the provisions of Sarbanes–Oxley.

A few provisions of the Act are not amendments to federal securities law but instead are amendments to federal criminal law. Since no blanket exemption for churches is granted under federal criminal law, it is clear that churches are subject to these provisions. One of these provisions amends federal criminal law to include the following new crime:

> *Whoever knowingly alters, destroys, mutilates, conceals, covers up, falsifies, or makes a false entry in any record, document, or tangible object with the intent to impede, obstruct, or influence the investigation or proper administration of any matter within the jurisdiction of any department or agency of the United States . . . or in relation to or contemplation of any such matter or case, shall be fined under this title, imprisoned not more than 20 years, or both.*

A number of requirements must be met in order to trigger liability for destruction or falsification of documents:

- an alteration, destruction, mutilation, or falsification of a record or document must take place;
- the alteration, destruction, mutilation, or falsification must be "knowing" (i.e., intentional); and
- the act must be done with the intent to impede, obstruct, or influence the investigation or proper administration of any matter within the jurisdiction of any department or agency of the United States "or in relation to or contemplation of any such matter."
- Just what is the "proper administration of any matter within the jurisdiction of any department or agency of the United States . . . or in relation to or contemplation of any such matter"? The Act does not define this language, but numerous federal court rulings have interpreted this same language in other contexts. These decisions clarify that this terminology "must be given a broad, nontechnical meaning"; pertains