2014 Tax Return Preparation and Federal Reporting Guide

MINISTERS' TAX GUIDE FOR 2013 RETURNS

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GuideStone® Financial Resources

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This information considered accurate at time of publication. If changes occur, they will be corrected in the online version of the *Ministers' Tax Guide* at *www.GuideStone.org.*

This publication is intended to provide a timely, accurate and authoritative discussion of tax reporting compliance and the impact of recent changes in the tax laws. It is not intended as a substitute for legal, accounting or other professional advice. If legal, tax or other expert assistance is required, the services of a competent professional should be sought. Although we believe this book provides accurate information, there may be changes resulting from IRS or judicial interpretations of the Tax Code, new tax regulations or technical corrections that occurred after the printing of this edition that are not reflected in the text.

Welcome to the *Tax Return Preparation and Federal Reporting Guide* for ministers and churches. We're privileged to provide you with this useful guide to help you prepare your federal income tax forms.

This year's tax guide is once again written by noted attorney and CPA, Richard Hammar, and has been edited by our legal and compliance teams to address the tax issues that impact the ministers we are so privileged to serve.

In addition to this helpful guide, you can find further information on the IRS website, *www.IRS.gov*. For specific tax advice, you'll want to consult an accountant or an attorney who is familiar with the intricacies of ministers' taxes.

Additional copies of this free booklet may be ordered through our customer relations specialists by calling **1-888-98-GUIDE** (1-888-984-8433) weekdays from 7 a.m. to 6 p.m. CST. You can also download this booklet in part or in its entirety for free by visiting *www.GuideStone.org/TaxGuide.*

Once again, we are thankful to serve you with the annual *Ministers' Tax Guide,* and we hope it will be a great service to you. May God bless you in your ministry in 2014 and beyond!

Sincerely,

O.S. Hawkins
President – Chief Executive Officer
GuideStone Financial Resources of the Southern Baptist Convention

Table of Contents

Key points from the housing allowance ruling

What churches and ministers must know about the decision in Wisconsin.

By Richard R. Hammar, J.D., LL.M., CPA

On November 22, 2013, U.S. District Judge Barbara Crabb in the Western District of Wisconsin (a President Carter appointee) struck down the ministerial housing allowance as an unconstitutional preference for religion. The ruling was in response to a lawsuit brought by the Freedom From Religion Foundation (FFRF) challenging the constitutionality of the housing allowance and the parsonage exclusion.

Judge Crabb stayed the decision, pending an appeal to the Seventh Circuit Court of Appeals in Chicago. Here are five things church leaders should note about this ruling:

1. Federal district court in Wisconsin rules housing allowance is an unconstitutional preference for religion

The Wisconsin court concluded that the housing allowance exclusion under Section 107(2) is an unconstitutional preference for religion, since the same benefit is not provided to other taxpayers. The court relied on a 1989 decision by the U.S. Supreme Court in which the Court ruled that a Texas statute exempting from the state sales tax periodicals and books "published or distributed by a religious faith" was an unconstitutional preference for religion (*Texas Monthly, Inc. v. Bullock, 489 U.S. 1 (1989))*. The Supreme Court concluded that tax exemptions that include religious organizations "must have an overarching secular purpose that equally benefits similarly situated non-religious organizations." To illustrate, the exemption of church property from taxation is constitutionally permissible because state laws exempt a wide range of non-religious properties from taxation. In contrast, the housing allowance applies only to ministers.

The Wisconsin court conceded that there are other provisions in the tax code that recognize housing allowances and it referred specifically to state department employees and the military. It noted that the Supreme Court in the *Texas Monthly* decision acknowledged that a tax exemption benefiting religious groups could survive a challenge under the establishment clause if the exemption was "conferred upon a wide array of nonsectarian groups as well." However, the Supreme Court "rejected the argument that it was enough to point to a small number of secular groups that could receive a similar exemption for a different reason."

2. "Parsonage allowance" not ruled unconstitutional by Wisconsin federal court

While the FFRF challenged the constitutionality of both Sections 107(1) (parsonage allowance) and 107(2) (housing allowance), it ultimately narrowed its challenge to Section 107(2) which relates to housing allowance for ministers not living in parsonages. The parsonage exclusion remains unchallenged.

3. Effective date and an appeal

The court ruled that the IRS and Department of the Treasury should not enforce Section 107(2). But it added that its ruling "shall take effect at the conclusion of any appeals ... or the expiration of the deadline for filing an appeal, whichever is later." An appeal by the IRS and Department of the Treasury has been filed.

It is possible that a federal appeals court will reverse the Wisconsin court's ruling and uphold the constitutionality of the housing allowance. If so, it won't be the first time a ruling by Judge Crabb was reversed on appeal. In 2011, a three-judge panel of the Seventh Circuit Court of Appeals unanimously reversed her opinion that the National Day of Prayer violates the First Amendment ban on the establishment of religion.

Further, substantial arguments support the constitutionality of the housing allowance. Of course, those arguments are not dispositive, as the Wisconsin case demonstrates. But they were given short shrift by Judge Crabb and her perspective may not be shared by the appeals court. It is also possible that the appeals court will revisit the issue of standing and conclude that the FFRF lacks standing to prosecute the case.

4. Application in other states

A ruling by a federal district court judge in Wisconsin is not binding on other courts and does not apply to ministers in other states. If the ruling is affirmed by the Seventh Circuit Court of Appeals, it would apply only to ministers in that circuit (Illinois, Indiana and Wisconsin).

5. Housing allowances for 2014

Churches should continue to designate housing allowances for ministerial employees for 2014, and church pension plans should continue to designate housing allowances for retired ministers. Such allowances will continue to be valid in all states outside of the Seventh Circuit (Illinois, Indiana and Wisconsin) and to ministers in the Seventh Circuit so long as the district court's ruling is reversed on appeal or the appeals court does not render an opinion in 2014.

Conclusions

What can churches and ministers do to minimize the impact of the Wisconsin court's ruling? Consider the following:

- Monitor developments in this case. Any developments will be reported on the GuideStone website.
- Remember that the Wisconsin court postponed its ruling while an appeal is pending, so churches affected by that court's ruling should continue to designate housing allowances.
- A ruling by a federal district court judge in Wisconsin is not binding on other courts and does not apply to ministers in other states. If the ruling is affirmed by the Seventh Circuit Court of Appeals, it would apply only to ministers in that circuit (Illinois, Indiana and Wisconsin). It would become a national precedent binding on ministers in all states only if affirmed by the U.S. Supreme Court (an unlikely outcome, since the Court receives 10,000 appeals each year and accepts 75 to 80 of them).

Part 1. Introduction

How to use this guide

This guide contains the basic information you need to complete your 2013 federal income tax return. It gives special attention to several forms and schedules and the sections of each form most relevant to ministers. It also includes a section on *Federal Reporting Requirements*, which begins on page 69, designed to help churches comply with their federal tax reporting requirements.

> ☞ **Key Point:** Congress, the courts or the IRS may cause tax changes at any time, in some cases retroactively. This guide includes only the law in effect at the time of preparation. Be certain to refer to the final instructions on *Form 1040* when completing your tax return.

This guide is divided into the following sections:

- **Part 1: Introduction —** This section reviews tax highlights for 2013 and presents several preliminary questions you should consider before preparing your tax return.
- **Part 2: Special Rules for Ministers —** In this section, you learn whether or not you are a minister for tax purposes, whether you are an employee or self-employed for both income tax and Social Security purposes and how you pay your taxes.
- **Part 3: Step-By-Step Tax Return Preparation —** This section explains how to complete the most common tax forms and schedules for ministers.
- **Part 4: Comprehensive Examples and Sample Forms —** This section shows a sample tax return prepared for an ordained minister and spouse and for a retired minister and spouse.
- **Federal Reporting Requirements for Churches —** This section provides assistance to churches (especially treasurers and bookkeepers) in filing federal tax forms.

Tax highlights for 2013

Taxpayer Relief Act of 2012

In the early hours of 2013 Congress enacted the American Taxpayer Relief Act of 2012 (ATRA or the "Act") in order to avoid the so-called "fiscal cliff." The Act has two major features — an increase in the tax rates paid by the wealthiest Americans and an extension of several tax benefits scheduled to expire at the end of 2011 or 2012.

Some expiring tax benefits were not extended. Most notably, Congress chose not to extend the so-called payroll tax "holiday" that reduced the Social Security taxes for both employees and the self-employed for the past two years. This resulted in a tax increase for three out of every four Americans in 2013. Those sections of the Act having the greatest relevance to churches and church staff are summarized below.

1. Permanently repeals the itemized deduction limitation for certain taxpayers

In 1990, Congress enacted legislation requiring certain itemized deductions, including charitable contributions, to be reduced by 3% of a taxpayer's adjusted gross income over $100,000 (adjusted annually for inflation), but not by more than 80%. In 2001, Congress enacted a law that phased out this limit by one-third in 2006 and 2007, by two-thirds in 2008 and 2009, and by 100% in 2010. The American Taxpayer Relief Act of 2012 permanently extended the repeal of this limit on income at or below $250,000 (individual filers) and $300,000 (married filing jointly) for taxable years beginning after December 31, 2012.

> ☞ **Key Point:** The $250,000 and $300,000 amounts are adjusted annually for inflation beginning in 2014.

2. Permanently repeals the personal exemption phaseout for certain taxpayers

In order to determine taxable income, an individual reduces adjusted gross income by any personal exemptions, deductions and either the applicable standard deduction or itemized deductions. Personal exemptions generally are allowed for the taxpayer, his or her spouse and any dependents. For 2013, the amount deductible for each personal exemption is $3,900. This amount is adjusted annually for inflation.

In the past, this exemption was phased out as a result of the Personal Exemption Phaseout ("PEP") for taxpayers with adjusted gross income (AGI) above a certain level. The American Taxpayer Relief Act of 2012 permanently repeals the PEP for income at or below $250,000 (individual filers) and $300,000 (married filing jointly) for tax years beginning after December 31, 2012.

> ☞ **Key Point:** The $250,000 and $300,000 amounts are adjusted annually for inflation beginning in 2014.

3. Permanently extends the 2001 modifications to the child tax credit

Generally, taxpayers with income below certain threshold amounts may claim the child tax credit to reduce federal income tax for each qualifying child under the age of 17. In 2001, Congress increased the credit from $500 to $1,000 and expanded refundability. The amount that may be claimed as a refund was 15% of earnings above $10,000. The American Taxpayer Relief Act of 2012 permanently extends these provisions for taxable years beginning after December 31, 2012.

4. Permanently extends marriage penalty relief

In the past, when two persons were married, they often paid more taxes than if they had remained single. This discrepancy is known as the "marriage penalty." This penalty arose in several contexts, including the following: (1) a married couple's combined income often put them in a higher tax bracket than if they had remained single; (2) the standard deduction for a married couple was less than the standard deductions for two single persons; and (3) the earned income tax credit penalized married couples since their combined income placed them in or above the phaseout ranges for the credit. In 2001, Congress reduced the marriage penalty in the following ways:

1. **Income tax rates**
   It increased the 15% income tax rate bracket for a married couple filing a joint return to twice the size of the corresponding rate for a single person filing a single return.
2. **The standard deduction**
   The standard deduction for married persons filing jointly was increased to twice the standard deduction for single persons.
3. **The earned income tax credit**
   In the past, the earned income credit penalized some individuals because they received a smaller earned income credit if they were married than if they were not married. This was due to the fact that the combined income of married couples made it more likely that they would enter or exceed the phaseout limits that reduce the amount of the credit due to higher earned income. In order to minimize this penalty, Congress enacted legislation in 2001 that increased the beginning and ending of the earned income credit phaseout for married couples filing a joint return by $3,000, adjusted annually for inflation.

   The American Taxpayer Relief Act of 2012 extends the marriage penalty relief for the standard deduction, the 15% bracket and the earned income tax credit (EITC) for taxable years beginning after December 31, 2012.

5. Permanently extends the expanded exclusion for employer-provided educational assistance

An employee may exclude from gross income up to $5,250 for income and employment tax purposes per year of employer-provided education assistance. Prior to 2001, this incentive was temporary and only applied to undergraduate courses. In the past, Congress expanded this provision to cover both undergraduate and graduate education and extended the expanded exclusion through 2012. The American Taxpayer Relief Act of 2012 permanently extends the changes to this provision for taxable years beginning after December 31, 2012.

6. Permanently extends the expanded dependent care credit

The dependent care credit allows a taxpayer a credit for an applicable percentage of child-care expenses for children under age 13 and disabled dependents. In the past, Congress increased the amount of eligible expenses from $2,400 for one child and $4,800 for two or more children to $3,000 and $6,000, respectively. The American Taxpayer Relief Act of 2012 permanently extends the changes to the dependent care credit.

7. Permanent estate, gift and generation-skipping transfer tax relief

In the past, Congress phased out the estate and generation-skipping transfer taxes so that they were fully repealed in 2010 and lowered the gift tax rate to 35% and increased the gift tax exemption to $1 million for 2010. In 2010, Congress set the exemption at $5 million per person with a top tax rate of 35% for the estate, gift and generation-skipping transfer taxes for two years, through 2012. The exemption amount was indexed beginning in 2012 and was $5.25 million for persons dying in 2013. The American Taxpayer Relief Act of 2012 makes permanent the indexed exclusion amount and indexes that amount for inflation going forward, but sets the top tax rate to 40% for estates of decedents dying after December 31, 2012.

8. Permanently extends capital gains and dividend rates

Under prior law, the capital gains and dividend rates for taxpayers below the 25% tax bracket were equal to 0 percent. For those in the 25% bracket and above, the capital gains and dividend rates were 15 percent. These rates expired at the end of 2012. Upon expiration, the rates for capital gains become 10% and 20%, respectively, and dividends are subject to the ordinary income rates.

The American Taxpayer Relief Act of 2012 extends the lower capital gains and dividends rates on income at or below $400,000 (individual filers) and $450,000 (married filing jointly) for taxable years beginning after December 31, 2012. For income in excess of $400,000 (individual filers) and $450,000 (married filing jointly), the rate for both capital gains and dividends will be 20 percent.

☞ **Key Point:** The $400,000 and $450,000 amounts are adjusted annually for inflation beginning in 2014.

☞ **Key Point:** The effective tax rate for many high-income taxpayers will be 23.8% because of the 20% capital gains and dividends tax rate plus the new 3.8% tax on investment income that was a feature of the Affordable Care Act (the health care reform legislation).

9. Temporarily extends the American Opportunity Credit

The American Opportunity Tax Credit is available for up to $2,500 of the cost of tuition and related expenses paid during the taxable year. Under this tax credit, taxpayers receive a tax credit based on 100% of the first $2,000 of tuition and related expenses (including course materials) paid during the taxable year and 25% of the next $2,000 of tuition and related expenses paid during the taxable year. Forty percent of the credit is refundable. This tax credit is subject to a phaseout for taxpayers with adjusted gross income in excess of $80,000 ($160,000 for married couples filing jointly).

The American Taxpayer Relief Act of 2012 extends the American Opportunity Tax Credit for five additional years, through 2017.

10. Temporarily extends the "third-child" EITC

Under prior law, working families with two or more children qualified for an earned income tax credit (EITC) equal to 40% of the family's first $12,570 of earned income. In 2009, Congress increased the earned income tax credit to 45% for families with three or more children and increased the beginning point of the phaseout range for all married couples filing a joint return (regardless of the number of children) to lessen the marriage penalty.

The American Taxpayer Relief Act of 2012 extends for five additional years, through 2017, the 2009 expansions that increased the EITC for families with three or more children and increased the phaseout range for all married couples filing a joint return.

11. Permanently extends refund and tax credit disregard for means-tested programs

Prior law ensured that the refundable components of the EITC and the Child Tax Credit did not make households ineligible for means-tested benefit programs and included provisions stating that these tax credits did not count as income in determining eligibility (and benefit levels) in means-tested benefit programs, and also did not count as assets for specified periods of time. Without them, the receipt of a tax credit would put a substantial number of families over the income limits for these programs in the month that the tax refund is received. A 2010 law disregarded all refundable tax credits and refunds as income for means-tested programs through 2012.

The American Taxpayer Relief Act of 2012 permanently extends this provision for any amount received after December 31, 2012.

12. Permanently extends AMT patch

Under prior law a taxpayer received an exemption of $33,750 (individuals) and $45,000 (married filing jointly) under the alternative minimum tax (AMT). Prior law also did not allow non-refundable personal credits against the AMT.

The American Taxpayer Relief Act of 2012 increased the exemption amounts for 2012 to $50,600 (individuals) and $78,750 (married filing jointly) and for future years indexes the exemption and phaseout amounts for inflation. For 2013, the exemption amounts were $51,900 (individuals) and $80,800 (married filing jointly). The Act also allows non-refundable personal credits against the AMT. These changes are effective for taxable years beginning after December 31, 2011.

13. Deduction for certain expenses of elementary and secondary school teachers

The American Taxpayer Relief Act of 2012 extends for two years the $250 above-the-line tax deduction for teachers and other school professionals for expenses paid or incurred for books, supplies (other than non-athletic supplies for courses of instruction in health or physical education), computer equipment (including related software and service), other equipment and supplementary materials used by the educator in the classroom.

14. Deduction for state and local general sales taxes

Congress enacted legislation in 2004 providing that, at the election of the taxpayer, an itemized deduction may be taken for state and local general sales taxes in lieu of the itemized deduction for state and local income taxes. Taxpayers have two options with respect to the determination of the sales tax deduction amount. They can deduct the total amount of general state and local sales taxes paid by accumulating receipts showing general sales taxes paid or they can use tables created by the IRS. The tables are based on average consumption by taxpayers on a state-by-state basis, taking into account filing status, number of dependents, adjusted gross income and rates of state and local general sales taxation.

Taxpayers who use the tables may, in addition, deduct eligible general sales taxes paid with respect to the purchase of motor vehicles, boats and other items specified by the IRS. Sales taxes for items that may be added to the tables would not be reflected in the tables themselves.

This provision was added to address the unequal treatment of taxpayers in the nine states that assess no income tax. Taxpayers in these states cannot take advantage of the itemized deduction for state income taxes. Allowing them to deduct sales taxes will help offset this disadvantage.

This deduction was scheduled to expire after 2005, but Congress extended it through 2009 and again through 2011.

The American Taxpayer Relief Act of 2012 extends for two years (through 2013) the election to take an itemized deduction for state and local general sales taxes in lieu of the itemized deduction permitted for state and local income taxes.

15. Above-the-line deduction for qualified tuition-related expenses

Under prior law, taxpayers could claim an above-the-line tax deduction for qualified higher education expenses. The maximum deduction was $4,000 for taxpayers with AGI of $65,000 or less ($130,000 for joint returns). The maximum deduction was $2,000 for taxpayers with AGI of $80,000 or less ($160,000 for joint returns). The American Taxpayer Relief Act of 2012 extends the deduction to the end of 2013.

16. Tax-free distributions from IRAs for charitable purposes

Congress enacted legislation in 2006 allowing tax-free qualified charitable distributions of up to $100,000 from an IRA to a church or other charity. Note the following rules and conditions:

- A qualified charitable distribution is any distribution from an IRA directly by the IRA trustee to a charitable organization, including a church, that is made on or after the date the IRA owner attains age 70½.
- A distribution will be treated as a qualified charitable distribution only to the extent that it would be includible in taxable income without regard to this provision.
- This provision applies only if a charitable contribution deduction for the entire distribution would be allowable under present law, determined without regard to the generally applicable percentage limitations. For example, if the deductible amount is reduced because the donor receives a benefit in exchange for the contribution of some or all of his or her IRA account or if a deduction is not allowable because the donor did not have sufficient substantiation, the exclusion is not available with respect to any part of the IRA distribution.

This provision, which was scheduled to expire at the end of 2011, was extended for two more years (through 2013) by the American Taxpayer Relief Act of 2012.

The Affordable Care Act

Those provisions of the Affordable Care Act that involve taxation have the greatest relevance to churches and church staff and affect tax reporting in 2013 or future years are summarized below.

1. Limitation on health flexible spending arrangements (FSAs) under cafeteria plans

In order for a health FSA to be a qualified benefit under a cafeteria plan, the maximum amount available for reimbursement of incurred medical expenses of an employee, the employee's dependents and any other eligible beneficiaries with respect to the employee, under the health FSA for a plan year (or other 12-month coverage period), must not exceed $2,500. The $2,500 limitation is indexed to the CPI-U (consumer price index — urban areas) with any increase that is not a multiple of $50 rounded to the next lowest multiple of $50 for years beginning after 2012.

2. Modification of itemized deduction for medical expenses

This increases the adjusted gross income threshold for claiming the itemized deduction for medical expenses from 7.5% to 10%. Individuals age 65 and older would be able to claim the itemized deduction for medical expenses at 7.5% of adjusted gross income through 2016.

3. Additional hospital insurance tax on high-income taxpayers

This increases the hospital insurance tax rate by 0.9 percentage points on an individual taxpayer earning more than $200,000 ($250,000 for married couples filing jointly).

Other tax changes of interest to churches and church staff

There were several tax developments in 2013 that will affect tax reporting by both ministers and churches for 2013 and future years. Here is a rundown of some of the key provisions:

1. You may be able to claim the earned income credit for 2013 if (1) you do not have a qualifying child and you earned less than $14,340 ($19,680 if married); (2) a qualifying child lived with you and you earned less than $37,870 ($43,210 if married filing jointly); (3) two qualifying children lived with you and you earned less than $43,038 ($48,378 if married filing jointly); or (4) three or more qualifying children lived with you and you earned less than $46,227 ($51,567 if married filing jointly). The maximum earned income credit for

2013 is (1) $487 with no qualifying child; (2) $3,250 with one qualifying child; (3) $5,372 with two qualifying children; and (4) $6,044 with three or more qualifying children.

2. For contributions to a traditional IRA, the deduction phaseout range for an individual covered by a retirement plan at work begins at income of $95,000 for joint filers and $59,000 for a single person or head of household.

3. The dollar limit on annual elective deferrals an individual may make to a 403(b) retirement plan is $17,500 in 2013. It remains $17,500 for 2014.

4. The catch-up contribution limit on elective deferrals to a 403(b) retirement plan for individuals who had attained age 50 by the end of the year was $5,500 in 2013. It remains at $5,500 for 2014.

5. The IRS has announced that it will not issue private letter rulings addressing the question of "whether an individual is a minister of the Gospel for federal tax purposes." This means taxpayers will not be able to obtain clarification from the IRS in a letter ruling on their status as a minister for any one or more of the following matters: (1) eligibility for a parsonage exclusion or housing allowance; (2) eligibility for exemption from self-employment taxes; (3) self-employed status for Social Security; or (4) exemption of wages from income tax withholding. The IRS also has announced that it will not address "whether amounts distributed to a retired minister from a pension or annuity plan should be excludible from the minister's gross income as a parsonage allowance."

6. The standard business mileage rate was 56.5 cents per mile for business miles driven during 2013. The standard business mileage rate for 2014 is 56 cents per mile.

7. The IRS maintains that a minister's housing allowance is "earned income" in determining eligibility for the earned income credit for ministers who have not opted out of Social Security by filing a timely *Form 4361*. For ministers who have opted out of Social Security, the law is less clear and the IRS has not provided guidance.

8. Recent tax law changes will result in lower taxes and lower estimated tax payments for many taxpayers. Be sure your estimated tax calculations or withholdings take into account the most recent tax law changes.

9. Many churches employ retired persons who are receiving Social Security benefits. Persons younger than full retirement age may have their Social Security retirement benefits reduced if they earn more than a specified amount. Full retirement age (the age at which you are entitled to full retirement benefits) for persons born in 1943–1954 is 66 years. In the year you reach full retirement age, your monthly Social Security retirement benefits are reduced by $1 for every $3 you earn above a specified amount ($3,450 per month for 2014). No reduction in Social Security benefits occurs for income earned in the month full retirement age is attained (and all future months). Persons who begin receiving Social Security retirement benefits prior to the year in which they reach full retirement age will have their benefits reduced by $1 for every $2 of earned income in excess of a specified amount. For 2014 this annual amount is $15,480.

10. For 2013, the following inflation adjustments took effect:

- The amounts of income you need to earn to boost you to a higher tax rate were adjusted for inflation.
- The value of each personal and dependency exemption, available to most taxpayers, increased to $3,900.
- The standard deduction is $12,200 for married couples filing a joint return and $6,100 for singles and married individuals filing separately. Nearly two out of three taxpayers take the standard deduction, rather than itemizing deductions, such as mortgage interest, charitable contributions and state and local taxes.
- Will Congress give ministers another opportunity to revoke an exemption from Social Security? It does not look likely, at least for now. No legislation is pending that would provide ministers with this option.
- The Freedom from Religious Foundation has challenged the constitutionality of the ministers' housing allowance in a federal court in Wisconsin. The case is pending.

Preliminary questions

Below are several questions you should consider before preparing your 2013 federal tax return.

Q. Must ministers pay federal income taxes?

A. Yes. Ministers are not exempt from paying federal income taxes.

Q. How much income must I earn to be required to file a tax return?

A. Generally, ministers are required to file a federal income tax return if they have earnings of $400 or more. Different rules apply to some ministers who are exempt from self-employment taxes.

Q. Can I use the simpler *Forms 1040A* or *1040EZ* rather than the standard *Form 1040?*

A. Most ministers must use the standard *Form 1040.*

Q. What records should I keep?

A. You should keep all receipts, canceled checks and other evidence to prove amounts you claim as deductions, exclusions or credits.

Q. What is the deadline for filing my federal income tax return?

A. The deadline for filing your 2013 federal tax return is April 15, 2014.

Q. What if I am unable to file my tax return by the deadline?

A. You can obtain an automatic six-month extension (from April 15 to October 15, 2014) to file your 2013 *Form 1040* if you file *Form 4868* by April 15, 2014 with the IRS service center for your area. Your *Form 1040* can be filed at any time during the six-month extension period. An extension only relieves you from the obligation to *file your return; it is not an extension of the obligation to pay your taxes*. You must make an estimate of your tax for 2013 and pay the estimated tax with your *Form 4868.*

Q. Should I prepare my own tax return?

A. The answer depends on your ability and experience in working with financial information and in preparing tax returns. Keep in mind: Ministers' taxes present a number of unique rules, but these rules are not complex. Many ministers will be able to prepare their own tax returns if they understand the unique rules that apply. These rules are summarized in this document. On the other hand, if you experienced unusual events in 2013, such as the sale or purchase of a home or the sale of other capital assets, it may be prudent to obtain professional tax assistance. The IRS provides a service called Taxpayer Assistance, but it is not liable in any way if its agents provide you with incorrect answers to your questions. Free taxpayer publications are available from the IRS and many of these are helpful to ministers.

➤ **Recommendation.** If you need professional assistance, here are some tips that may help you find a competent tax professional:

- Ask other pastors in your community for their recommendations.
- If possible, use a CPA who specializes in tax law and who is familiar with the rules that apply to ministers. A CPA has completed a rigorous educational program and is subject to strict ethical requirements.
- Ask local tax professionals if they work with ministers and, if so, with how many.
- Ask local tax professionals a few questions to test their familiarity with ministers' tax issues. For example, ask whether ministers are employees or self-employed for Social Security. Anyone familiar with ministers' taxes will know that ministers always are self-employed for Social Security with respect to their ministerial duties. Or, ask a tax professional if a minister's church salary is subject to income tax withholding. The answer is no and anyone familiar with ministers' taxes should be able to answer this question.

Part 2. Special Rules for Ministers

Who is a minister for federal tax purposes?

☞ **Key Point:** The IRS has its own criteria for determining who is a minister for tax purposes.

The criteria the IRS uses to determine who is a minister are not necessarily the same as those used by churches and denominations. Whether or not one qualifies as a minister for tax purposes is a very important question, since special tax and reporting rules apply to ministers under federal tax law. These rules include:

- Eligibility for housing allowances
- Self-employed status for Social Security
- Exemption of wages from income tax withholding (ministers use the quarterly estimated tax procedure to pay their taxes, unless they elect voluntary withholding)
- Eligibility under very limited circumstances to exempt themselves from self-employment taxes

These special rules only apply with respect to services performed in the exercise of ministry.

✍ **Example:** Pastor J is an ordained minister at his church. In addition, he works a second job for a secular employer. Assume that Pastor J qualifies as a minister for federal tax purposes. Since his church duties constitute services performed in the exercise of ministry, the church can designate a portion of his compensation as a housing allowance. However, the secular employer cannot designate any portion of Pastor J's compensation as a housing allowance, since this work would not be service in the exercise of ministry.

According to the IRS, ministers are individuals who are duly ordained, commissioned or licensed by a religious body constituting a church or church denomination. They are given the authority to conduct religious worship, perform sacerdotal functions and administer ordinances or sacraments according to the tenets and practices of that church or denomination. If a church or denomination ordains some ministers and licenses or commissions others, anyone licensed or commissioned must be able to perform substantially all the religious functions of an ordained minister to be treated as a minister for Social Security purposes. See *IRS Publication 517*.

Are ministers employees or self-employed for federal tax purposes?

☞ **Key Point:** Most ministers are considered employees for federal income tax purposes under the tests currently used by the IRS and the courts and should receive a *Form W-2* from their church reporting their taxable income. However, ministers are self-employed for Social Security (with respect to services they perform in the exercise of their ministry).

Ministers have a *dual* tax status. For federal income taxes they ordinarily are employees, but for Social Security they are self-employed with regard to services performed in the exercise of ministry. These two rules are summarized below:

1. **Income taxes.** For federal income tax reporting, most ministers are employees under the test currently used by the IRS. This means that they should receive a *Form W-2* from their church at the end of each year (rather than a *Form 1099*). It also means that they report their employee business expenses on Schedule A rather than on Schedule C. A few ministers are self-employed, such as some traveling evangelists and interim pastors. Also, many ministers who are employees of a local church are self-employed for other purposes. For example, the minister of a local church almost always will be an employee, but will be self-employed with regard to guest speaking appearances in other churches and services performed directly for individual members (such as weddings and funerals).

✍ **Example:** Pastor B is a minister at First Church. He is an employee for federal income tax reporting purposes with respect to his church salary. However, he is self-employed with respect to honoraria he receives for speaking in other churches and for compensation church members give him for performing personal services such as weddings and funerals. The church issues Pastor B a *Form W-2* reporting his church salary. Pastor B reports this amount as wages on line 7 of *Form 1040*. He reports his compensation and expenses from self-employment activities on Schedule C.

☞ **Key Point:** Most ministers will be financially better off when treated as employees because the value of various fringe benefits will be tax free, the risk of an IRS audit is substantially lower and reporting as an employee avoids the additional taxes and penalties that often apply to self-employed ministers who are audited by the IRS and reclassified as employees.

$ **Tax-savings tip.** Ministers and other church staff members should carefully review their *W-2* form to be sure that it does not report more income than was actually received. If an error was made, the church should issue a corrected tax form *(Form W-2c).*

The Tax Court Test. The United States Tax Court has created a seven-factor test for determining whether a minister is an employee or self-employed for federal income tax reporting purposes. The test requires consideration of the following seven factors: (1) the degree of control exercised by the employer over the details of the work; (2) which party invests in the facilities used in the work; (3) the opportunity of the individual for profit or loss; (4) whether or not the employer has the right to discharge the individual; (5) whether the work is part of the employer's regular business; (6) the permanency of the relationship; and (7) the relationship the parties believe they are creating. Most ministers will be employees under this test.

Social Security. The tax code treats ministers as self-employed for Social Security with respect to services performed in the exercise of their ministry — even if they report their income taxes as an employee. This means that ministers must pay self-employment taxes (Social Security taxes for the self-employed) unless they have filed a timely exemption application *(Form 4361)* that has been approved by the IRS. As noted below, few ministers qualify for this exemption.

☞ **Key Point:** While most ministers are employees for federal income tax reporting purposes, they are self-employed for Social Security with respect to services they perform in the exercise of their ministry. This means that ministers are not subject to the employee's share of Social Security and Medicare taxes, even though they report their income taxes as employees and receive a *Form W-2* from their church. Rather, they pay the self-employment tax (SECA).

Exemption from Social Security (self-employment) taxes

If ministers meet several requirements, they may exempt themselves from self-employment taxes with respect to their ministerial earnings. Among other things, the exemption application *(Form 4361)* must be submitted to the IRS within a limited time period. The deadline is the due date of the federal tax return for the second year in which a minister has net earnings from self-employment of $400 or more, any part of which comes from ministerial services. Further, the exemption is available only to ministers who are opposed on the basis of religious considerations to the acceptance of benefits under the Social Security program (or any other public insurance system that provides retirement or medical benefits). A minister who files the exemption application may still purchase life insurance or participate in retirement programs administered by non-governmental institutions (such as a life insurance company).

A minister's opposition must be to accepting benefits under Social Security (or any other public insurance program). Economic, or any other non-religious considerations, are not a valid basis for the exemption, nor is opposition to paying the self-employment tax.

The exemption is only effective when it is approved by the IRS. Few ministers qualify for exemption. Many younger ministers opt out of Social Security without realizing that they do not qualify for the exemption. A decision to opt out of Social Security is irrevocable. Congress did provide ministers with a brief "window" of time to revoke an exemption by filing *Form 2031* with the IRS. This opportunity expired in 2002 and has not been renewed.

An exemption from self-employment taxes applies only to ministerial services. Ministers who have exempted themselves from self-employment taxes must pay Social Security taxes on any non-ministerial compensation they receive. And, they remain eligible for Social Security benefits based on their non-ministerial employment assuming that they have worked enough quarters. Generally, 40 quarters are required. Also, the Social Security Administration has informed the author of this text that ministers who exempt themselves from self-employment taxes may qualify for Social Security benefits (including retirement and Medicare) on the basis of their spouse's coverage, if the spouse had enough credits. However, the amount of these benefits will be reduced by the so-called "windfall elimination provision." Contact a Social Security Administration office for details.

☞ **Key Point:** The amount of earnings required for a quarter of coverage in 2014 is $1,200. A quarter of coverage is the basic unit for determining whether a worker is insured under the Social Security program.

☞ **Key Point:** Ministers who work after they retire must pay Social Security tax on their wages (unless they exempted themselves from Social Security as a minister and they are employed in a ministerial capacity).

How do ministers pay their taxes?

☞ **Key Point:** Ministers must prepay their income taxes and self-employment taxes using the estimated tax procedure, unless they have entered into a voluntary withholding arrangement with their church with respect to federal income tax only.

As noted above, ministers' wages are exempt from federal income tax withholding. This means that a church does not have to withhold income taxes from a minister's paycheck. And, since ministers are self-employed for Social Security with respect to their ministerial services, a church does not withhold the employee's share of Social Security and Medicare taxes from a minister's wages. Ministers must prepay their income taxes and self-employment taxes using the estimated tax procedure, unless they have entered into a voluntary withholding arrangement with their church. Estimated taxes must be paid in quarterly installments. If your estimated taxes for the current year are less than your actual taxes, you may have to pay an underpayment penalty. You can amend your estimated tax payments during the year if your circumstances change. For example, if your income or deductions increase unexpectedly, you should refigure your estimated tax liability for the year and amend your remaining quarterly payments accordingly.

You will need to make estimated tax payments for 2014 if you expect to owe at least $1,000 in tax for 2014 after subtracting your withholding and credits and if you expect your withholding and credits to be less than the smaller of (1) 90% of the tax to be shown on your 2014 tax return, or (2) 100% of the tax shown on your 2013 tax return (110% if adjusted gross income exceeds $150,000). Your 2013 tax return must cover all 12 months.

The four-step procedure for reporting and prepaying estimated taxes for 2014 is summarized below.

Step 1. Obtain a copy of *IRS Form 1040-ES* for 2014 before April 15, 2014. You can obtain forms by calling the IRS toll-free forms hotline at 1-800-TAX-FORM (1-800-829-3676), or from the IRS website *(www.IRS.gov).* If you paid estimated taxes last year, you should receive a copy of your 2014 *Form 1040-ES* in the mail with payment vouchers preprinted with your name, address and Social Security number.

Step 2. Compute your estimated tax for 2014 using the *Form 1040-ES* worksheet. Ministers' quarterly estimated tax payments should take into account both income taxes and self-employment taxes.

Step 3. Pay one-fourth of your total estimated taxes for 2013 in each of four quarterly installments as follows:

For the Period	Due Date
January 1–March 31	April 15, 2014
April 1–May 31	June 16, 2014
June 1–August 31	September 15, 2014
September 1–December 31	January 15, 2015

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

If the due date for making an estimated tax payment falls on a Saturday, Sunday or legal holiday, the payment will be on time if you make it on the next day that is not a Saturday, Sunday or legal holiday. You must send each payment to the IRS, accompanied by one of the four payment vouchers contained in *Form 1040-ES.*

Step 4. After the close of 2014, compute your actual tax liability on *Form 1040.* Only then will you know your actual income, deductions, exclusions and credits. If you overpaid your estimated taxes (that is, actual taxes computed on *Form 1040* are less than all of your estimated tax payments plus any withholding), you can elect to have the overpayment credited against your first 2014 quarterly estimated tax payment or spread it out in any way you choose among any or all of your next four quarterly installments. Alternatively, you can request a refund of the overpayment. If you underpaid your estimated taxes (that is, your actual tax liability exceeds the total of your estimated tax payments plus any withholding), you may have to pay a penalty.

☞ **Key Point:** Ministers who report their income taxes as employees can request that their employing church voluntarily withhold income taxes from their wages. Simply furnish the church with a completed *W-4* (withholding allowance certificate). Since ministers are not employees for Social Security with respect to ministerial compensation, the church does not withhold the employee's share of Social Security and Medicare taxes. However, ministers can request on *Form W-4* (line 6) that an additional amount of income tax be withheld to cover their estimated self-employment tax liability for the year. The excess income tax withheld is a credit that is applied against the minister's self-employment tax liability. Many churches understandably withhold Social Security and Medicare taxes in addition to income taxes for a minister who requests voluntary withholding. Such withholding must be reported as income tax withheld.

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