



## Market Segment Specialization Program



# Ministers

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## MINISTERS

### OVERVIEW

Several potential examination issues are prevalent on ministers' tax returns:

1. The first issue that must be determined is whether the minister is an employee or an independent contractor. This is primarily a factual question. *Professional & Executive Leasing, Inc. v. Commissioner*, 862 F.2d 751, 753 (9th Cir. 1988; *James v. Commissioner*, 25 T.C. 1296, 1300 (1956); *Hand v. Commissioner*, 16 T.C. 1410 (1951).

The distinction between an employee and an independent contractor in this context must be made on common law grounds. *United States v. Webb, Inc.*, 397 U.S. 179, 183 (1970). See also IRC section 3121(d)(2); Treas. Reg. sections 31.3121(d)-1(c) and 31.3401(c)-1. In determining whether a worker is an employee, "employer control over the manner in which the work is performed, 'either actual or the right to it, is the basic test.'" *General Investment Corp. v. United States*, 823 F.2d 337, 341 (9th cir. 1987, (quoting *Air Terminal Cab, Inc. v. United States*, 478 F.2d 575, 579 (8th Cir.), cert. denied, 414 U.S. 909 (1973)). Actual control need not be exercised by the employer, provided the employer has the right to control the employee when it is appropriate and necessary.

The control test must be applied only after taking into account the nature of the work to be performed. When the worker is a professional, such as a minister, the extent of control necessary for the professional to qualify as an employee is less than that necessary for a nonprofessional worker performing routine and mechanical duties. See *James v. Commissioner*, 25 T.C. 1296 (1956). The absence of the need to control the manner in which the minister conducts his or her duties should not be confused with the absence of the right to control. The right to control contemplated by the common law as an incident of employment requires only such supervision as the nature of the work requires. *McGuire v. United States*, 349 F.2d 644, 646 (9th Cir. 1965).

2. Although they are generally considered employees under the common law rules, payment for services as a minister is considered income from self employment and is not subject to FICA taxes or income tax withholding (if the employer and employee agree, an election can be made to have income taxes withheld). "Even though a minister may receive a Form 1099-MISC for the performance of services, he or she may be a common law employee and should in fact be receiving a Form W-2. In those very limited cases in which a minister is an independent contractor, such as in the case of a traveling evangelist, the issuance of a Form 1099-MISC is appropriate."
3. A minister may elect exemption from self-employment tax under these circumstances:
  - a. As a member of a religious order who has taken a vow of poverty, or
  - b. By seeking exemption based on an opposition to receiving social security benefits due to religious principles. This is discussed in detail later.
4. A minister is frequently provided a parsonage or is paid a housing allowance, which is exempt from income tax under section 107 of the Code. However, the fair rental value of the housing or parsonage is included in the computation of self-employment tax. There are four provisions in the Internal Revenue Code that are unique to ministers. These provisions include: (1) the IRC section 107 exclusion (for income tax purposes only) for housing allowances or the fair rental value of church-owned parsonages provided to the minister rent-free; (2) the exemption of some ministers from social security coverage; (3) treatment of ministers (who are not exempt) as self-employed for social security tax purposes with respect to ministerial services; and (4) exemption of ministerial wages from income tax withholding (unless elected by the minister).

#### **WHO QUALIFIES FOR SPECIAL TAX TREATMENT AS A MINISTER**

1. To qualify for the special tax provisions available to ministers, an individual must be a "minister" and must perform services "in the exercise of his ministry." Treas. Reg. section 1.107-1(a) incorporates the rules of Treas. Reg. section

1.1402(c)-5 in determining whether the individual is performing the duties of a minister of the gospel.

2. Treas. Reg. 1.1402(c)-5 requires that an individual be a "duly ordained, commissioned, or licensed minister of a church." In *Salkov v. Commissioner*, 46 T.C. 190 (1966), the Tax Court, in holding that a Jewish cantor was a minister eligible for the IRC section 107 housing allowance, interpreted that phrase to be disjunctive. It stated that the purpose of the requirement was to exclude self-appointed ministers, not to limit the benefits only to the ordained. Accordingly, it concluded that the petitioner qualified because he was commissioned by, and was a duly qualified member of the Cantors Assembly of America, which functions as the official cantorial body for the Conservative branch of the Jewish religion in America, and because he was selected by a representative Conservative congregation to perform the functions of cantor.
3. Treas. Reg. section 1.1402(c)-5(b)(2) provides that service performed by a minister in the exercise of the ministry includes:
  - a. Ministration of sacerdotal functions;
  - b. Conduct of religious worship;
  - c. Control, conduct, and maintenance of religious organizations (including the religious boards, societies, and other integral agencies of such organizations), under the authority of a religious body constituting a church or denomination.
4. Treas. Reg. section 1.1402(c)-5(b)(2) also provides that whether service performed by a minister constitutes conduct of religious worship or ministration of sacerdotal functions depends on the tenets and practices of the particular religious body constituting the church or denomination.
5. Treas. Reg. section 1.107-1(a) also provides examples of specific services considered duties of a minister, including:
  - a. Performance of sacerdotal functions;
  - b. Conduct of religious worship;

- c. Administration and maintenance of religious organizations and their integral agencies;
  - d. Performance of teaching and administrative duties at theological seminaries.
6. The duties performed by the individual are also important to the initial determination whether he or she is a duly ordained, commissioned, or licensed minister. Because religious disciplines vary in their formal procedures for these designations, whether an individual is "duly ordained, commissioned, or licensed" depends on these facts and circumstances.
- a. In *Salkov v. Commissioner, supra*, and *Silverman v. Commissioner*, 57 T.C. 727 (1972), the Tax Court, in holding that a cantor of the Jewish faith was a duly ordained, commissioned, or licensed minister, looked, in each case, to the systematic manner the cantor was called to his ministry and the ecclesiastical functions he carried out in concluding that he was a minister within the meaning of IRS Section 107.
  - b. In Rev. Rul. 78-301, 1978-2 C.B. 103, the IRS followed the Tax Court decisions in *Salkov* and *Silverman* and held that a Jewish cantor who is not ordained but has a bona fide commission and is employed by a congregation on a full-time basis to perform substantially all the religious worship, sacerdotal, training, and educational functions of the Jewish denomination's religious tenets and practices is a minister of the gospel within the meaning of IRS section 107. Rev. Rul. 78-301 revoked and modified prior Revenue Rulings to the extent that they required that an individual must be invested with the status and authority of an ordained minister fully qualified to exercise all of the ecclesiastical duties of a church denomination to be considered ministers under IRC sections 107 and 1402.
  - c. In *Knight v. Commissioner* 92 T.C. 199 (1989), the Tax Court considered whether a licentiate of the Cumberland Presbyterian Church (a status that was less than full ordination), who had not filed a timely exemption from self-employment tax, was a duly ordained, commissioned, or licensed minister in the exercise of required duties who was thus liable for self-employment tax. The

petitioner argued that he was not formally ordained as a minister and could not administer church sacraments or participate in church government. Thus, he could not be a minister subject to IRC section 1402(c). The court rejected this view, and looked at all the facts. In concluding that he was a licensed minister, it cited the facts that he was licensed by the church, he conducted worship services, and he was considered by the church to be a spiritual leader.

- d. In contrast, the Tax Court held in *Lawrence v. Commissioner*, 50 T.C. 494 (1968), that a "minister of education" in a Baptist church was not a "duly ordained, commissioned, or licensed" minister for purposes of IRS section 107. The petitioner held a Master's Degree in Religious Education from a Baptist Theological Seminary, but was not ordained. Although his church "commissioned" him after he assumed the position, the court interpreted the commissioning to be for tax purposes, as it did not result in any change in duties. Most significant, however, was the court's analysis of petitioner's duties or rather, the duties he did not perform. He did not officiate at Baptisms or the Lord's Supper, two Ordinances that closely resembled sacraments, nor did he preside over or preach at worship services. The court concluded that the evidence did not establish that the prescribed duties of a minister of education were equivalent to the duties of a Baptist minister.

#### INCOME TO BE REPORTED

A minister usually receives compensation from the employing church or church agency for personal services but may also receive bonuses or "special gifts." In addition, the minister may receive fees paid directly from parishioners for performing weddings, funerals, baptisms, and masses. All are includible in gross income, along with expense allowances for travel, transportation, or other business expenses received under a non-accountable plan. If the church or church agency pays amounts in addition to salary to cover the

minister's self-employment tax or income tax, these are also includible in gross income.<sup>1</sup>

Fees for weddings, funerals, etc., which are given directly to the church rather than to the minister are not considered compensation to the minister. Contributions made to or for the support of individual missionaries to further the objectives of their missions are includible in gross income.<sup>2</sup>

A minister's compensation package often includes a parsonage allowance, that is, the use of church owned housing, a housing allowance, or a rental allowance. This is treated differently for income tax and self-employment tax purposes, and is discussed in detail in the next section.

### **THE PARSONAGE ALLOWANCE**

IRC section 107 provides an exclusion from gross income for a "parsonage allowance," housing specifically provided to a minister of the gospel. This includes the rental value of a home furnished to him or her as part of compensation or a rental allowance, to the extent that the payment is used to rent or provide a home. The term "parsonage allowance" includes church provided parsonages, rental allowance 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 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 an 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 exclusion under IRC section 107 only applies if the employing church designates the amount of the parsonage

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<sup>1</sup> Revenue Ruling 68-507.

<sup>2</sup> Revenue Ruling 68-67.

allowance in advance of the tax year.<sup>3</sup> 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 for purposes of IRC section 107 is that the fair rental value of the parsonage or parsonage allowance must be reasonable in amount.

The amount of the parsonage allowance excludible from gross income is the LEAST of:

1. The amount actually used to provide a home,
2. The amount officially designated as a housing allowance, or
3. The fair rental value (FRV) of the home, including furnishings, utilities, garage, etc.<sup>4 5</sup>

The following examples illustrate the application of these rules. For simplification, assume that mortgage payments include property taxes and insurance.

#### **Example 1**

A is an ordained minister. She receives an annual salary of \$36,000 and use of a parsonage which has a FRV 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 FRV of parsonage).

#### **Example 2**

B, an ordained minister, is vice president of academic affairs at Holy Bible Seminary. His compensation package includes a salary of \$80,000 per year and a \$30,000 housing allowance. His housing costs for the year

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<sup>3</sup> Treas. Reg. section 1.107-1(b).

<sup>4</sup> Treas. Reg. 1.107-1(c).

<sup>5</sup> Revenue Ruling 71-280.

included mortgage payments of \$15,000, utilities of \$3,000, and \$3,600 for home maintenance and new furniture. The fair rental value of the home, as furnished, is \$18,000 per year.

The three amounts for comparison are:

- a. Actual expenses of \$21,600 (\$15,000 mortgage payments + \$3,000 utilities + \$3,600 other costs)
- b. Designated housing allowance of \$30,000
- c. FRV plus utilities of \$21,000 (\$18,000 + \$3,000 utilities)

B may exclude \$21,000 from gross income but must include in income the other \$9,000 of the housing allowance. The entire \$30,000 will be considered in arriving at net self-employment income.

### **Example 3**

C is an ordained minister and has been in his church's employ for the last 20 years. His salary is \$40,000 and his designated parsonage allowance is \$15,000. C's mortgage was paid off last year. During the tax year he spent \$2,000 on utilities, and \$3,000 on real estate taxes and insurance. The FRV of his home, as furnished, is \$750 a month.

The three amounts for comparison are:

- a. Actual housing costs of \$5,000 (\$2,000 utilities + \$3,000 taxes and insurance)
- b. Designated housing allowance of \$15,000
- c. FRV + utilities of \$11,000 (\$9,000 FRV + \$2,000 utilities)

C may only exclude his actual expenses of \$5,000 for Federal income tax purposes. He may not exclude the FRV of his home even though he has paid for it in previous

years.<sup>6</sup> \$1,500 will be included in the computation of net self-employment income.

#### **Example 4**

Assume the same facts as in Example 3, except that C takes out a home equity loan and uses the proceeds to pay for his daughter's college tuition. The payments are \$300 per month. Even though he has a loan secured by his home, the money was not used to "provide a home" and can't be used to compute the excludible portion of the parsonage allowance. The results are the same as for Example 3.

#### **Example 5**

D is an ordained minister and received \$40,000 in salary plus a designated housing allowance of \$12,000. He spent \$12,000 on mortgage payments, \$2,400 on utilities, and \$2,000 on new furniture. The FRV of his home as furnished is \$16,000. D's exclusion is limited to \$12,000 even though his actual cost (\$16,400) and FRV and utilities (\$18,400) are more. He may not deduct his housing costs in excess of the designated allowance.

#### **Example 6**

E's designated housing allowance is \$20,000. She and her husband live in one half of a duplex which they own. The other half is rented. Mortgage payments for the duplex are \$1,500 per month. E's utilities run \$1,800 per year, and her tenant pays his own from a separate meter. During the year E replaced carpeting throughout the structure at a cost of \$6,500 and did minor repairs of \$500. E must allocate her mortgage costs, carpeting, and repairs between her own unit and the rental unit in determining the amount of the excludible parsonage allowance. Amounts allocable to the rented portion for mortgage interest, taxes, etc., would be reported on

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<sup>6</sup> *Swaggart v. Commissioner*, T. C. Memo. 1984-409.

Schedule E as usual. Her actual costs to provide a home were \$14,300 (\$9,000 mortgage payments, \$1,800 utilities, and \$3,500 for half the carpeting and repairs). The FRV for her unit is the same as the rent she charges for the other half, which is \$750 a month, and she estimates that her furnishings add another \$150 per month to the FRV. Her FRV plus utilities is \$12,600 (\$10,800 FRV + \$1,800 utilities). E may exclude \$12,600 for Federal income tax purposes.

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.<sup>7</sup> The sale of the residence is treated the same as that of other taxpayers, even though it may have been completely purchased with funds excluded under IRC section 107.

A retired minister may receive part of his or her pension benefits as a designated parsonage allowance based on past services. If so, the "least of" rules apply.<sup>8</sup>

Trustees of a minister's retirement plan may designate a portion of each pension distribution as a parsonage allowance excludable under IRC section 107. The minister may claim that the amount is both excludable from income as a parsonage allowance under IRC section 107 and excludable from self-employment income for Self-Employment Contribution Act (SECA) purposes.

Under IRC section 1402(a)(8), a minister is required to include amounts designated as a parsonage allowance per IRC section 107 in calculating his or her earnings from self-employment for SECA purposes. Any amount so designated is not taxed under IRC section 402 as a distribution from a qualified plan. Because amounts received by a retired minister as a parsonage allowance relate to the performance of prior services as a minister, they are includible in net earnings from self employment and are subject to self-employment tax.

Because expenses attributable to earning income which is exempt from tax are not ordinarily deductible, a minister's business expenses related to his or her earnings must be allocated and become partially

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<sup>7</sup> Revenue ruling 87-32.

<sup>8</sup> Revenue ruling 75-22.

nondeductible.<sup>9</sup> This is discussed in detail in the next section.

Exhibit 1 provides a worksheet for the computation of the amount that is excludible as a parsonage allowance.

## **BUSINESS EXPENSES**

Employee business expenses: Ministers who are employees may deduct the following expenses on Schedule A as miscellaneous expenses subject to the 2 percent floor: (1) unreimbursed employee business expenses (that is, expenses for which the minister is not reimbursed under an IRS section 62(c) accountable plan) and (2) "nonaccountable" reimbursed business expenses.

The limitations on deductibility of employee business expenses may be avoided if the church adopts an "accountable plan." An accountable plan is an arrangement that meets all the requirements of Treas. Reg. section 1.62, that is, business connection (deductibility under IRC section 162), substantiation within a reasonable period of time, and return of amounts in excess of substantiated expenses within a reasonable period of time. The regulations provide two safe harbor methods under the reasonable period of time requirement.

If an arrangement meets all the requirements for an accountable plan, the amounts paid under the arrangement are excluded from the minister's gross income and are not required to be reported on his or her Form W-2. If, however, the arrangement does not meet one or more of the requirements, all payments under the arrangement are included in the minister's gross income and are reported as wages on the Form W-2, even though no withholding at the source is required.

If the church has a salary reduction arrangement which "reimburses" the minister for employee business expenses by reducing his or her salary, the arrangement will be treated as a nonaccountable plan because it does not meet the reimbursement requirement of Treas. Reg. section 1.62-2(d). See Treas. Reg. section 1.62-2(j), Ex. 2. This is the result regardless of whether a specific portion of the minister's compensation is designated for employee expenses or whether the portion of the compensation to be treated as the expense allowance varies from pay

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<sup>9</sup> IRC section 265.

period to pay period depending on the minister's expenses. As long as the minister is entitled to receive the full amount of annual compensation, regardless of whether or not any employee business expenses are incurred during the taxable year, the arrangement does not meet the reimbursement requirement.

A minister may deduct ordinary and necessary business expenses. However, if a minister's compensation includes a parsonage allowance which is exempt from income under IRC section 107, that portion of the expenses allowable to this tax-exempt income is not deductible, per IRC section 265.<sup>10 11 12</sup>

Before this allocation is made, the total amount of business expenses must be determined. Ministers are subject to the same substantiation requirements as other taxpayers.

Typical business expenses for ministers include the following:

**Transportation.** Many ministers receive a nonaccountable auto allowance, which is includible in income. Transportation costs which may be deductible include trips for hospital and nursing home visits, attendance at conferences, or other church business. However, trips to and from church are considered nondeductible commuting expenses.<sup>13</sup>

**Travel.** A minister may incur travel away from home occasionally for special conferences or other duties out of the area. The same rules regarding the deductibility of meals, entertainment, and lodging apply as for other taxpayers.

**Business Use of Home.** In order for a home to qualify as a principal place of business under IRC section 280A(c)(1)(A), the functions performed and the time spent at each location where the trade or business is conducted are the primary considerations and must be compared to determine the relative importance of each. *Sohman v. Commissioner*, 113 S. Ct. 701 (1993). The

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<sup>10</sup> *Deason v. Commissioner*, 42 T.C. 465.

<sup>11</sup> *Dalan v. Commissioner*, T.C. Memo. 1988-106.

<sup>12</sup> *McFarland v. Commissioner*, T.C. Memo. 1992-440.

<sup>13</sup> *Hamblen v. Commissioner*, 78 T.C. 53.

church often provides an office on the premises for the minister, so the necessity of an office in the home should be questioned closely. Furthermore, since the total cost to provide the home is used in computing the exempt housing allowance, home office deductions for taxes, insurance, mortgage interest, etc. would be duplications. (Note that itemized deductions are allowable for mortgage interest and taxes. <sup>14</sup>)

**Supplies, Publications.** Ministers may incur some out-of-pocket costs for office supplies and job-related books and periodicals for which they are not reimbursed. This may be more common in small churches. Increasingly, ministers are using computers for writing sermons, correspondence, and record-keeping. Personal use should be determined.

**Dues versus Contributions.** Ministers often pay a small annual renewal fee to maintain their credentials, which constitutes a deductible expense. However, ministers' contributions to the church are not deductible as business expenses. They may argue that they are expected to donate generously to the church as part of their employment. This is not sufficient to convert charitable contributions to business expenses. The distinction is that charitable contributions are given to a qualifying organization (such as a church) for the furtherance of its charitable activities. Dues, on the other hand, are usually paid with the expectation that a financial benefit will result to the individual, as in a realtor's multilist dues or an electrician's union dues. A minister's salary and benefits are not likely to directly depend on the donations made to the church. They may still be deducted as contributions on Schedule A but may not be used as a business expense to reduce self-employment tax.

**Other Expenses.** A minister may incur expenses for special vestments that would qualify as "uniforms." Their reasonable cost and care would be deductible. Ordinary street clothes or suits for church are not deductible. Unreimbursed long distance phone calls made for business purposes are deductible.

Once total business expenses have been determined, the nondeductible portion can be computed using the following formula. Exhibit 2 provides a computation worksheet.

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<sup>14</sup> Revenue Ruling 87-32.

**Formula:**

1. 
$$\frac{\text{Exempt housing allowance or FRV of parsonage}}{\text{Total ministry income}^*} = \text{Nontaxable Income \%}$$
  
\* Includes salary, fees, expense allowances under nonaccountable plans, plus the housing allowance or parsonage FRV.
2. 
$$\text{Total business expenses} \times \text{nontaxable income \%} = \text{Expenses to be allocated to nontaxable income}$$
  
$$= \text{Nondeductible expenses}$$

These examples illustrate the computation:

**Example 7**

F receives a salary of \$36,000, an exempt housing allowance of \$18,000 and an auto expense allowance of \$6,000 for his services as an ordained minister. F incurs business expenses as follows: auto, \$7,150; vestments, \$350; dues, \$120; publications and supplies, \$300; totalling \$7,920. His nondeductible expenses are computed as follows:

\$18,000 housing allowance  
----- = 30%  
Nontaxable Income  
\$60,000 total ministry income  
(\$36,000 salary + \$18,000 housing  
+ \$6,000 car allowance)

Total business expenses	\$7,920
Nontaxable income %	<u>x 30%</u>
Nondeductible expenses	\$2,376

Total business expenses	\$7,920
Nondeductible expenses	<u>(2,376)</u>
Deductible expenses	\$5,544

F's deductible expenses are reported as Schedule A miscellaneous deductions since his church considers him an employee and issues a W-2. These expenses, along with any other miscellaneous deductions are subject to a further reduction of 2 percent of his adjusted gross income.

**Example 8**

G received a salary of \$12,000, a housing allowance of \$9,000, and earned \$3,000 for various speaking engagements, weddings, funerals, etc., all related to her ministry. She reports her salary as "wages" on page 1 of her Form 1040 and her fees on Schedule C. Because her actual housing costs (\$6,000) were less than her housing allowance and the FRV of her home for the year, she must include \$3,000 of her housing allowance as "other income" for income tax purposes. Her total business expenses are \$4,500. The computation of deductible expenses is shown below:

\$6,000 (housing allowance actually exempt from income tax)	
-----	= 25% Nontaxable
\$24,000 (\$12,000 salary + \$9,000 housing + \$3,000 fees)	income
Total expenses \$4,500 x 25% = \$1,125 = nondeductible expenses	
Total expenses \$4,500 - \$1,125 = \$3,375 = deductible expenses.	

Note that this \$3375 would further be allocable between Schedule A miscellaneous deductions (related to salary) and Schedule C (related to other fees).<sup>15</sup> However, as you will see in the next section, this allocation will not change G's self-employment tax, since all ministry income and ministry expenses are included in the computation, regardless of where they are reported on the return for income tax purposes. The allocation between Schedule A and Schedule C will also affect any AGI-dependent computations.

Occasionally a minister may receive no compensation for services. In this case, any actual out-of-pocket costs are deductible as charitable contributions.<sup>16 17</sup>

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<sup>15</sup> Revenue Ruling 80-110.

<sup>16</sup> Revenue Ruling 69-645.

<sup>17</sup> *Gibson v. Commissioner*, T. C. Memo. 1981-668.

## SELF-EMPLOYMENT TAX: EXEMPTION

Ministerial services are covered by social security provisions under the Self Employment Contributions Act (SECA). Earnings for these services are subject to self-employment tax unless:<sup>18</sup>

1. The minister is a member of a religious order whose members have taken a vow of poverty, or
2. The minister has requested, and the IRS has approved, an exemption from self-employment tax.

To claim exemption from self-employment tax, a minister must:

1. Be an ordained, commissioned, or licensed minister of a church or denomination.<sup>19</sup>
2. File Form 4361. This is an application for exemption from self-employment tax for use by ministers, members of religious orders, and Christian Science practitioners.
3. Be conscientiously opposed to public insurance (Medicare/Medicaid and Social Security benefits) because of religious beliefs.<sup>20</sup>
4. File for exemption for reasons other than economic.
5. Notify the church or order that he or she is opposed to public insurance.
6. Establish that the organization that ordained, licensed, or commissioned the minister is a tax-exempt religious organization.
7. Establish that the organization is a church.
8. Sign and return the statement that the IRS mails to him or her to verify that he or she has requested an exemption based on the grounds listed on the statement (See Exhibit 3).

Form 4361 must be filed by the due date of the Form 1040 (including extensions) for the second tax year in

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<sup>18</sup> IRC section 1402(e).

<sup>19</sup> Revenue Ruling 78-301.

<sup>20</sup> Treas. Reg. section 1.1402(e)-51.

which at least \$400 in self-employment ministerial earnings was received. The 2 years do not have to be consecutive.

An approved Form 4361 is effective for all tax years after 1967 for which a minister received \$400 or more of self-employed income for ministerial services.

The exemption from self-employment tax applies only to services performed as a minister. The exemption does not apply to other self-employment income.

To determine if a minister is exempt from self-employment tax, request that he or she furnish a copy of the approved Form 4361 if it is not attached to the return. If the taxpayer cannot provide a copy, order a transcript for the year under examination. The ADP and IDRS Information handbook shows where the ministers' self-employment exemption codes are located on the transcripts and what the codes mean. Transcripts will not show exemption status prior to 1988.

If the transcript does not show a MIN SE indicator and the taxpayer still claims that he or she is exempt from self-employment tax, the Taxpayer Relations Branch at the Service Center where the Form 4361 was filed can research this information and provide the taxpayer with a copy. The Social Security Administration in Baltimore also can provide the information on exemption for an individual.

#### **Example 9**

H has ministerial earnings of \$400 in 1990 and \$1800 in 1991. He has until April 15, 1992 (if no extension has been filed) to file Form 4361. If the approved Form 4361 is not received by the due date for the 1990 return, the self-employment tax for 1990 is still due by that date. If he later receives the approved 4361, he may amend his 1990 return.

#### **Example 10**

J earned \$500 in 1989, \$300 in 1990, and \$6,000 in 1991 from her ministry. She has until April 15, 1992 (if no extension has been filed) to file Form 4361. If the approval of the exemption is not received by April 15, 1990, J must pay the self-employment tax with her 1989 return, but may

amend it after the exemption is approved. J may file a claim for refund (an amended tax return) within 3 years from the time the return was filed or within 2 years from the time the tax was paid, whichever is later.

**Example 11**

K, ordained in 1990, has \$7,500 in net earnings as a minister in both 1990 and 1991. He files Form 4361 on March 5, 1992. If the exemption is granted, it is effective for 1990 and all following years.

**Example 12**

L, an ordained minister, has applied for and received exemption from self-employment tax for his services as a minister. In 1991 he has ministerial income of \$12,000 and income from his shoe repair business, a sole proprietorship, of \$9,000. He must compute self-employment tax on the \$9,000.

**COMPUTING SELF-EMPLOYMENT TAX**

If an exemption from self-employment tax is not applied for, or is not granted, self-employment tax must be computed on ministerial earnings. To compute self-employment tax, allowable trade or business expenses are subtracted from gross ministerial earnings, then the appropriate rate is applied.

Include the following items in gross income for self-employment tax:

1. Salaries and fees for services, including offerings and honoraria received for funerals, baptisms, etc.
2. Any cash housing allowance or utility allowances.
3. FRV of a parsonage, if provided, including the cost of utilities and furnishings provided.
4. Any amounts received for business expenses treated as paid under a nonaccountable plan, such as an auto allowance.

### **Example 13**

M receives a salary from the church of \$20,000. His parsonage allowance is \$12,000. The church withholds Federal income tax (by mutual agreement) and issues him a Form W-2. He has unreimbursed employee business expenses (before excluding nondeductible amounts attributable to his exempt income) of \$5,200. His net earnings for self-employment tax are \$26,800 ( $\$20,000 + \$12,000 - \$5,200$ ). Note that all of M's unreimbursed business expenses are deductible for self-employment tax purposes, although the portion attributable to the exempt housing allowance is not deductible for Federal income tax purposes. Section 265 of the Internal Revenue Code regarding the allocation of business expenses related to exempt income relates to income tax computations but not self-employment tax computations.

### **Example 14**

G, as shown in Example 8, computes her self-employment taxable income as follows:

\$12,000 salary plus \$9,000 housing allowance plus \$3,000 Schedule C income less (\$4,500) total business expenses equals \$19,500 self-employment income.

**NOTE:** IRS Publication 517, Social Security For Members of the Clergy and Religious Workers is a very useful guide for taxpayers and as a quick reference.

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Exhibit 1

EXCLUSION OF PARSONAGE ALLOWANCE  
UNDER INTERNAL REVENUE CODE SECTION 107

A. HOME OWNED OR RENTED/ HOUSING ALLOWANCE RECEIVED:

The exclusion is limited to the least of:

1. Amount designated as housing allowance \_\_\_\_\_
2. Amount actually used to provide a home:
  - Rent \_\_\_\_\_
  - House payments \_\_\_\_\_
  - Furnishings \_\_\_\_\_
  - Repairs \_\_\_\_\_
  - Insurance, Taxes \_\_\_\_\_
  - Utilities \_\_\_\_\_
  - Other expenses \_\_\_\_\_  
(Include down payments, interests, etc.,  
but not food or servants or entertainment)
3. Fair rental value of home, including furniture,  
utilities, garage \_\_\_\_\_

B. PARSONAGE PROVIDED: FAIR RENTAL VALUE \_\_\_\_\_

BASED ON THE ABOVE FIGURES, THE AMOUNT OF YOUR HOUSING ALLOWANCE  
EXCLUDIBLE FROM INCOME TAX LIABILITY IS \_\_\_\_\_.

THE ENTIRE DESIGNATED HOUSING ALLOWANCE IS SUBJECT TO  
SELF-EMPLOYMENT TAX UNLESS YOU HAVE BEEN APPROVED FOR  
EXEMPTION OR ARE RETIRED.

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Exhibit 2

COMPUTATION OF ALLOWABLE EXPENSES  
WHEN TAX-EXEMPT INCOME IS RECEIVED

1. Amount of tax-exempt income (Housing allowance or fair rental value of parsonage provided) \_\_\_\_\_
  
2. Total income from ministry:  
    Salary \_\_\_\_\_  
    Fees \_\_\_\_\_  
    Allowances \_\_\_\_\_  
    Line 1 Amt. \_\_\_\_\_  
                    TOTAL \_\_\_\_\_
  
3. Divide line 1 amount by line 2 amount.  
                    = Nontaxable income % \_\_\_\_\_%
  
4. Total business expenses substantiated:  
    Auto \_\_\_\_\_  
    Travel \_\_\_\_\_  
    M & E \_\_\_\_\_  
    Other \_\_\_\_\_  
                    TOTAL \_\_\_\_\_
  
5. Multiply line 4 total by line 3 percentage. These are nondeductible expenses allowable to tax-exempt income. \_\_\_\_\_
  
6. Subtract line 5 amount from line 4 amount. These are deductible expenses for Federal income tax purposes. \_\_\_\_\_

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Exhibit 3 (1 of 3)

LETTER 2250C

We received your Form 4361, Application for Exemption From Self-Employment Tax for Use by Ministers, Members of Religious Orders and Christian Science Practitioners. We need additional verification before we can continue processing.

Please carefully read and sign the applicable portion of the declaration at the end of this letter and return it to us so that we may continue processing your application. If you do not wish your application to be processed, please sign the applicable portion of the declaration at the end of this letter and return it to us.

We are requesting this verification because we are required by law to make sure you understand the grounds for which we can approve any request for exemption. You must be either (1) conscientiously opposed to; or (2) because of religious principles, opposed to accepting the benefits of public insurance that makes payments toward the cost of, or provides services for, medical care based on services performed as a minister, member, or practitioner. (Public insurance includes insurance systems established by the Social Security Act.) You must also inform the ordaining, commissioning, or licensing body of your church (or order) that you are opposed to such insurance.

If we allow your exemption, it will apply only to earnings from services as a minister, member, or practitioner, under Section 1402(e) of the Internal Revenue Code. You will not be entitled to the Social Security benefits from such services. This election cannot be revoked once it is approved. This letter allows you to verify that you understand the grounds upon which the exemption can be granted and that you still want the exemption or that you wish to withdraw your request.

If a signed copy of this letter requesting exemption is mailed to the Internal Revenue Service Center within 90 days from the date of this letter, the exemption is effective for all tax

years in which you have net self-employment earnings of \$400 or more, if you derive any part of it from ministerial services. If your response is not mailed within the 90-day period, your exemption will not be effective before the date we receive your response to this letter. You will be subject to self-employment taxes for any period during which your exemption is not effective.

If you have any questions about this letter, you may write to us at the address shown above. If you prefer, you may call the IRS telephone number listed in your local telephone directory. An IRS employee there may be able to help you, but the office at the address shown on this letter is most familiar with your case.

When you return the declaration as requested, or if you write to us with questions about this letter, please provide your telephone number and the most convenient time for us to call if we need additional information. Please attach this letter to any correspondence to help us identify your case. Keep the copy for your records.

Thank you for your cooperation.

Sincerely yours,

Chief, Taxpayer Relations Branch

Enclosures:  
Declaration  
Copy of this letter  
Envelope

Applicant's Name  
Social Security Number

Please sign the appropriate signature line. Only one should be signed.

Declaration

I have read this letter and understand the grounds on which I may receive an exemption from self-employment tax. I still wish to proceed with the processing of my application.

\_\_\_\_\_  
Signature

\_\_\_\_\_  
Date

I would like the processing of my application to be discontinued and my application returned to me.

\_\_\_\_\_  
Signature

\_\_\_\_\_  
Date