



10 ESSENTIALS OF **TAXES FOR MINISTERS**

CHURCH

ESSENTIALS
SERIES

Introduction

Introduction

While the intricacies of U.S. tax law may exceed the interest of most ministers and churches who employ them, understanding the basic tax issues represents good stewardship for churches and ministries.

A clear understanding of the 10 Essentials of Taxes for Ministers will provide a working knowledge of the basic concepts of taxation for ministers under U.S. tax laws.

As the Apostle Paul put it, the government authorities are God's servants. We must submit to them. How we follow tax laws reflects the character of our faith to a watching world.

***Therefore, it is necessary to submit to the authorities,
not only because of possible punishment but also as a matter of conscience.
This is also why you pay taxes, for the authorities are God's servants,
who give their full time to governing. Give to everyone what you owe them:
If you owe taxes, pay taxes; if revenue, then revenue; if respect, then respect;
if honor, then honor. Let no debt remain outstanding, except the continuing debt
to love one another, for whoever loves others has fulfilled the law.***

Romans 13:5-8

1

Understand
Ministerial Tax
Qualification

Understand Ministerial Tax Qualification

There is a common myth that all religious leaders qualify for the special treatment afforded to ministers under federal tax law. Meeting the requirement of a “minister” under federal law can be very different from how a church, denomination, or other ministry determines who meets the requirements of a minister. Most ministers serving churches qualify under federal law as ministers, but certainly not all.

In addition to being ordained, commissioned, or licensed, under federal law a minister may include whether or not the individual administers sacraments, conducts worship services, is considered a spiritual leader by the church, and whether or not the minister performs management services in the control, conduct, or maintenance of a religious organization. It may not be necessary for a minister to meet all of these tests to qualify for special tax treatment.

Most ministers serving religious denominations and integral agencies of churches also qualify for ministerial treatment under federal law. However, if ministers are not engaged in service performed in the exercise of the ministry of a local church, are not employed by a religious denomination or an integral agency of a church, or are not assigned by a denomination¹ or a church to their current service, the definition of a qualifying minister narrows. In these situations, Tax Court cases and IRS rulings suggest that an individual will qualify for the special tax treatments of ministers only if the individual’s services for the employer *substantially* involve conducting religious worship or performing sacerdotal functions (for example, performing weddings, funerals, baptisms).

It is important for the *employing organization to decide* whether or not the services of a minister qualify for special tax treatment (ministers are not in a position to decide whether or not they qualify for the special tax treatments). The special tax treatments follow:

- Exclusion for income tax purposes of the housing allowance and the fair rental value of a church-owned parsonage provided rent-free to ministers.
- Exemption of ministers from self-employment tax, *under very limited circumstances*.
- Treatment of ministers as self-employed for Social Security tax purposes (for those who do not elect Social Security exemption) for income from ministerial services.
- Exemption of ministerial compensation from mandatory income tax withholding.

¹“Denominational service” encompasses the administration of religious denominations and their integral agencies, including teaching or administration in religious schools, colleges, or universities that are under the authority of a church or denomination.

- Eligibility for a voluntary income tax withholding arrangement between the minister-employee and a church.
- Potential double benefit of mortgage interest and real estate taxes as itemized deductions and excluded as housing expenses for housing allowance purposes.

Summary. The employing church, denomination, integral agency of a denomination or a church, or other religious organization is responsible to determine whether an individual qualifies as a minister under the federal law definition.

If ministers who qualify under federal law are not afforded these special ministerial tax treatments, this can create a significant financial impairment to ministers.

Conversely, if ministers who do not qualify are provided the special tax treatments, the employing organization may inadvertently assist them in violating the tax law by affording tax-beneficial treatment for otherwise taxable dollars.

2

Understand
Employee
Classification for
Income Taxes

Understand Employee Classification for Income Taxes

Each church (or other employing organization) has the responsibility to determine whether ministers are employees or self-employed under the common law rules. Based on Tax Court cases, the IRS almost always considers ministers as employees for income tax purposes. This is true even though ministers are always self-employed for social security tax purposes.

The income tax filing status of ministers has many ramifications for what and how a church and the minister report to the IRS.

- Employees report compensation from the church on Form 1040, not on Schedule C (used by self-employed individuals). Employees receive Form W-2 each year from the church, not Form 1099-NEC (used to report compensation received by a self-employed individual).
- Employees cannot deduct unreimbursed business expenses or expenses reimbursed under a nonaccountable plan on Form 1040. Expenses related to self-employment income may be deducted on Schedule C.
- Qualified health, accident, and long-term care insurance premiums paid directly by a church for an employee are not reportable as income to ministers (taxable to those who are self-employed).
- Employees may deduct health, accident, and long-term care insurance premiums paid personally on Schedule A as medical and dental expense, subject to a percentage limitation of adjusted gross income.
- Health savings accounts, health reimbursement arrangements, or flexible spending arrangements may be available through a church to employees but are not available to those who are self-employed.
- Group-term life insurance, provided by a church, of \$50,000 or less is tax-free to employees but not available to those who are self-employed.
- A voluntary arrangement to withhold income tax may be used by an employee but is not available to those who are self-employed.

Summary. Ministers are almost always considered employees for income tax purposes (even though they are self-employed for social security tax purposes—see [*Essential 3*](#)).

3

Recognize
Self-Employed
Designation for
Social Security

Recognize Self-Employed Designation for Social Security

Determining the correct social security tax type for ministers is often confusing. Ministers engaged in the exercise of ministry are always treated as self-employed for social security tax purposes. Self-employed ministers pay social security tax under the Self-Employment Contributions Act (SECA), not under the Federal Insurance Contributions Act (FICA).

A church should never deduct FICA-type social security tax from the pay of a qualified minister—only SECA-type social security tax applies. Determining which type of social security tax applies is not a matter for ministers to choose. Rather, it is the responsibility of the church (or other employer) to determine the appropriate type of social security based on whether the individual qualifies as a minister in the eyes of the IRS.

If a church withholds and matches FICA-type social security tax for a qualified minister, the individual is incorrectly being treated as a lay-employee. The FICA matched by the church for social security purposes is improperly treated as tax-free when it is taxable for both income and social security purposes.

Example: Pastor Smith meets the requirements to qualify for ministerial tax status under federal law (see [Essential 1](#)). While the church employing Pastor Smith should treat him as self-employed for social security tax purposes, it instead treats Pastor Smith like an ordinary lay employee and pays 7.65% of Pastor Smith's \$100,000 salary as FICA-type social security.

The church provides Pastor Smith with a \$7,650 ($7.65\% \times \$100,000$) benefit that should be treated as taxable income. If the church wishes to help the pastor offset the financial burden of being considered self-employed for social security tax purposes, it could pay his social security tax obligation while properly treating the amount paid as taxable income.

It is possible for ministers to be exempt from SECA in only a few unusual situations. To claim a SECA exemption, ministers must be conscientiously opposed to public insurance (including an opposition to receiving social security benefits) because of the minister's religious beliefs or because of the position of the minister's religious denomination regarding social security. Claiming a SECA exemption on any other basis violates federal law and demonstrates a significant lack of integrity.

A minister's earnings that are not from the exercise of ministry are generally subject to social security tax under FICA (nonclergy employment) or SECA (independent contractor earnings).

Summary. The key principle is that ministers are not subject to FICA-type social security when serving as an employee and performing ministerial duties for the church.

4

Structure
Ministerial
Compensation
to Maximize
Stewardship

Structure Ministerial Compensation to Maximize Stewardship

Structuring compensation to maximize the stewardship of church funds is often very challenging. It requires a basic understanding of tax law which applies to churches and ministers, determining the needs of the ministers, and identifying church funds available.

Some of the key compensation planning concepts include the following:

- **Consider goals and objectives.** Based on the goals of the church, develop a written compensation policy for ministers.

Example: Based on our goal to launch three campuses in the next five years and expand our international mission strategies, our compensation policy will be designed to attract, retain, reward, and motivate ministers in a fair and equitable manner, when considering the compensation of other ministers (particularly in our community or area), the income level of citizens of our community, and the income level of members of this church.

- **Appoint a compensation committee.** Even though the church in some cases may approve the annual budget and the board may approve the compensation package, one or more board representatives should be designated to meet with the minister, talk about pay expectations, review past pay patterns, discuss the tax consequences of compensation components, and then make recommendations on a compensation plan to the church's board.
- **Document the current compensation elements.** Separately identify and document the current salary, fringe benefits, and professional expense reimbursements.
- **Maximize fringe benefits.** Structure fringe benefits to take advantage of laws which allow tax-free fringe benefits (e.g., qualified health insurance) or tax-deferred benefits (e.g., 403(b) plans).
- **Reimburse expenses on a tax-free basis.** The reimbursement of substantiated expenses under an accountable reimbursement plan and avoiding unsubstantiated expense "allowances" is the best stewardship of the church's and minister's funds.

Example 1: The church provides an expense allowance to the pastor-employee. This type of an arrangement does not comply with the accountable expense plan rules, nor does it represent good stewardship. The amount paid by the church to the minister is fully taxable for income and social security tax purposes and the expenses are not deductible on Form 1040.

Example 2: The church pays business expenses for the pastor-employee, under an accountable expense reimbursement plan, subject to an overall dollar limit for the year. The pastor submits substantiated expense information and is reimbursed. The reimbursements are tax-free for income and social security tax purposes. This arrangement maximizes stewardship in relation to the expenses.

Summary. Stewardship of funds is often maximized for the church and minister by initially focusing on fringe benefits and accountable expense reimbursements, then the housing allowance, and finally cash compensation.

5

Utilize the
Housing Exclusion

Utilize the Housing Exclusion

Ministers are eligible to receive lodging from the church free of income tax liability. Additionally, the housing allowance is an opportunity to exclude dollars from gross income for ministers who provide their own home.

It is important to distinguish between two terms:

- **Housing allowance designation.** The designation of a portion of cash compensation as a housing allowance is done by the church providing the payment to ministers.
- **Housing allowance exclusion.** The mere designation of a housing allowance by a church is only the first step leading to the potential exclusion of dollars from income tax. The second step is the application of the housing allowance limits (as described below) by ministers to determine the exclusion amount.

The housing exclusion is the lowest of these factors:

- Reasonable compensation
- The amount used from current church-provided compensation to provide the home
- The amount prospectively and officially designated by the church
- The fair rental value of the home including utilities and furnishings

Nearly every minister should have a portion of salary designated as a housing allowance. For ministers living in church-provided housing, a housing allowance covering expenses such as furnishings, personal property insurance on contents, and utilities can often save ministers several hundred dollars of income taxes annually. For ministers living in their own homes or rental housing, a properly designated housing allowance may be worth thousands of dollars of income taxes saved.

Ministers who live in church-provided housing have a responsibility to determine and report the fair rental value of the housing for self-employment social security purposes on Schedule SE. The church is not responsible to set the value. The fair rental value should be based on comparable rental values of other similar residences in the immediate neighborhood or community, comparably furnished.

For a more in-depth look at these issues, see the related eBook [**10 Essentials of the Minister's Housing Exclusion**](#).

Summary. Nearly every qualified minister should have a portion of their cash salary designated as a housing allowance. While the most significant income tax savings are available for minister-provided housing, there are also more modest income tax savings for many ministers living in church-provided housing under the housing exclusion rules.

6

Consider Fringe
Benefits

Consider Fringe Benefits

A fringe benefit is any cash, property, or other benefit that minister-employees receive from a church in addition to salary. All fringe benefits are taxable income to employees unless specifically exempted by the Internal Revenue Code.

Many fringe benefits can be provided by a church to ministers without any dollar limitation (qualified health insurance is an example), while other fringe benefits are subject to annual limits (dependent care is an example).

To qualify for exclusion from taxable income, many fringe benefits must be nondiscriminatory. In other words, the benefits must be offered to all employees or employees in certain classes. Certain fringe benefits may be offered to some employees and not to others.

Some of the most important fringe benefits for ministers include:

- **Health insurance.** If the church pays the qualified medical insurance premiums directly to the insurance carrier, the premiums are generally tax-free to ministers.
- **Disability insurance.** If the church pays the disability insurance premiums (and the minister is the beneficiary) as a part of the compensation package, the premiums are excluded from taxable income.
- **Group-term life insurance.** If group life coverage is provided under a nondiscriminatory plan and it does not exceed \$50,000 coverage for ministers, the life insurance premiums are generally tax-free to ministers.
- **Out-of-pocket medical expenses** (all of the following plans are subject to the nondiscriminatory rules):
 - ▶ **Flexible spending account (FSA).** The FSA should generally be the plan of choice for ministers and churches. The FSA is simple to establish and easy to administer by the church.
 - ▶ **Health savings account (HSA).** Within limits, HSA contributions made by churches are excludable from income tax and social security wages. Withdrawals from HSAs to pay medical expenses are tax-free.
 - ▶ **Health reimbursement arrangement (HRA).** If a church offers an HRA, the same HRA benefit must be provided to all employees. This makes this concept very limiting since out-of-pocket costs vary significantly from employee to employee.

- **Cafeteria plan.** Typically, only very large churches can justify establishing and maintaining a cafeteria plan. These plans can cover much more than medical expenses—for example, dependent care, life insurance, and disability insurance.

Consult with a professional tax advisor as to whether some of these benefits may be advantageous for your specific situation.

Summary. Properly focusing on tax-free and tax-deferred fringe benefits can make a significant difference in the stewarding of funds expended by a church on behalf of ministers. Federal tax laws help churches and ministers by subsidizing tax-free fringe benefits and delaying the taxation of tax-deferred benefits.

7

Apply an
Accountable
Reimbursement
Plan

Apply an Accountable Reimbursement Plan

The starting point in considering whether expenses are deductible or reimbursable is to decide whether the expenses are business (ministry) or personal. To be deductible or reimbursable, a business expense must be both “ordinary” and “necessary.” An ordinary expense is one that is common and accepted for ministers. A necessary expense is one that is helpful and appropriate for ministers.

Most ministers spend several thousands of dollars each year on church-related business expenses. For example, the church-related portion of auto expenses is often a major cost. There is only one way for minister-employees to receive a income tax-advantaged treatment of these expenses: have the expenses reimbursed by the church under an accountable expense reimbursement plan. Minister-employees will *always save* tax dollars if the expenses are reimbursed by the church under an accountable plan.

Business and professional expenses of ministers fall into three basic categories:

- expenses reimbursed under an accountable plan,
- expenses paid under a nonaccountable plan, and
- expenses not reimbursed.

Only the first category of expenses provides good stewardship for the church and minister-employees, as expenses can be reimbursed on a tax-free basis. Reimbursements in the second category are treated as taxable income to the minister and expenses cannot be deducted on Form 1040. Expenses in the last category are also not deductible on Form 1040. The first category results in dollar-for-dollar reimbursements, while the last two categories result in absolutely no tax advantage. This is illustrated as follows:

Illustration #1 – Expenses reimbursed under an accountable plan. Church-related business (ministry) expenses properly substantiated on a timely basis are reimbursed dollar-for-dollar on a tax-free basis to ministers. This maximizes stewardship as the expenses paid by ministers are fully returned without any reduction.

Illustration #2 – Expenses paid under a nonaccountable plan. Church-related business (ministry) expenses which are paid by the church in a nonaccountable fashion (inadequate substantiation, not documented on a timely basis, expenses are not business expenses, etc.) must simply be added to income. The business expenses are not deductible on Form 1040.

Illustration #3 – Expenses not reimbursed. Business expenses that ministers incur but are not reimbursed are not deductible on Form 1040.

Out-of-pocket expenses related to Schedule C (C-EZ) income (speaking honoraria and fees) may be deducted on that form.

For a more in-depth look at these issues, see the related eBook, [**5 Essentials of Reimbursing Ministerial Expenses.**](#)

Summary. Most ministers spend several thousands of dollars each year on church-related business expenses. Only when the expenses are fully reimbursed by the church through an accountable plan is there solid stewardship of the funds.

8

Account for Fees and Honoraria

Account for Fees and Honoraria

Fees and honoraria received by ministers are subject to income and self-employment social security taxes (unless a minister has properly opted out of social security related to ministerial income).

Ministerial income may be reported in two ways on Form 1040:

- **Compensation paid by the congregation.** Employee compensation should always be reported on Form W-2.
- **Honoraria, fees, and similar amounts not paid by the congregation.** Ministers may receive a Form 1099-NEC for payments of \$600 or more in a calendar year from various sources, but it is the minister's responsibility for recording and reporting these amounts on Schedule C.

The following are the most common types of income to be reported by ministers on Schedule C:

- **Speaking honoraria.** Ministers often speak at various venues and receive honoraria for these services.
- **Fees.** Ministers may conduct weddings, funerals, and baptisms and receive honoraria for these services.

Even if ministers do not quote an amount for honoraria or fees, payments received by ministers in exchange for services provided in speaking or conducting weddings, funerals, or baptisms represent payment for services rendered and are taxable income. When ministers visit a church other than their employing church, "love offerings" received by ministers in recognition of services rendered should be reported on Schedule C as income.

Expenses to offset related ministerial income are reportable on Schedule C by a minister. Business expenses related to church compensation should not be reported on Schedule C. These expenses are not deductible.

Example: The Form W-2 for a pastor reflects \$100,000 of compensation. Speaking honoraria and marriage, funeral, and baptism fees of \$2,500 were received by the pastor from various sources. Unreimbursed business expenses of \$5,000 relate to the compensation paid by the church. Business expenses of \$800 were incurred in relation to the speaking, marriage, funeral, and baptism services performed.

The \$5,000 is not deductible on Form 1040. The \$2,500 of honoraria and fees should be reported as income on Schedule C, and the \$800 of expenses should be deducted on the same form.

Summary. Distinguishing between church-related income (and related expenses) and non-church related income (and related expenses) is one of the key challenges in the tax life of ministers.

9

Prepare for Retirement

Prepare for Retirement

Being financially prepared for retirement is simply a function of time and money: *the less you have of one, the more you need of the other.*

It is often difficult to save as much as many experts insist is needed for a comfortable retirement based on ministerial compensation levels. But there is one inescapable truth: the sooner you start saving, the better. Saving for retirement isn't like climbing one great peak. It's like climbing several smaller ones.

The best advice for ministers is the simplest—put as much into your 403(b) or 401(k) plan as you can. Whether the payments are church-funded or funded by a salary reduction from your pay, the contributions are tax-deferred for income tax purposes and are not subject to self-employment social security taxes. When you receive benefits from your plan in retirement, the payments are not subject to self-employment social security taxes.

If your plan is sponsored by a denomination, your benefits qualify for housing exclusion treatment, subject to the housing allowance limitations. If you are a good money manager, you may want to arrange your indebtedness so you have mortgage payments until you retire. This will maximize tax-free dollars related to the housing exclusion.

Age 65 was once entrenched as the finish line for our careers. But this false endpoint has disappeared. We are living longer, and the social security retirement age is increasing. This heightens the importance of financial planning for retirement.

When looking towards retirement. It is important for ministers to understand many financial issues, including when to file for social security, working after retirement, and when and how to withdraw money from tax-deferred retirement plans.

10

Plan Ahead for
Ministerial Tax
Payments

Plan Ahead for Ministerial Tax Payments

Lay employees are subject to federal income tax and Federal Insurance Contribution Act (FICA) type social security withholding. However, ministers are not subject to mandatory federal income tax withholding, and ministerial income is subject to Self-Employment Contributions Act (SECA) type social security.

Ministers have several options to pay their federal income tax and SECA-type social security taxes:

- **Voluntary withholding of federal income tax.** Ministers may ask the church to withhold federal income taxes sufficient to cover the federal income tax and self-employment social security tax obligation.
 - ▶ Churches are not required to withhold federal income tax, but the church and minister may agree to federal income tax withholding.
 - ▶ The amount of federal income tax withheld under this agreement may be sufficient to cover the minister's federal income tax and SECA tax obligation.
 - ▶ The withholding agreement may be based on the completion of Form W-4 and submission by the minister to the church, or by a simple written document.
- **Paying estimated taxes using Form 1040-ES.** To avoid underpayment penalties, payments with Form 1040-ES must be filed with the IRS on April 15, June 15, September 15, and January 15 for each tax year. As with a voluntary withholding agreement, the amounts of the estimated payments may be sufficient to cover the minister's federal income tax and SECA tax obligation.
- **Spousal withholding.** A minister's spouse can have sufficient federal income tax withheld to cover the minister's federal income tax withholding and SECA tax obligation.

Summary. The federal income tax is a pay-as-you-go tax. You must pay the tax as you earn or receive income during the year. While churches are not required to withhold income tax from ministerial compensation, ministers and churches may agree on a voluntary withholding arrangement. This is often a wise approach.

Now What?

Action Steps
to Excellence

Now What? Action Steps to Excellence

Action Steps for Churches

- Determine which staff members qualify as “ministers” under the federal tax law requirements.
- Establish which ministers are considered “employees” for income tax purposes (nearly every minister falls into this category).
- Recognize that ministers are always considered “self-employed” for social security purposes, and are therefore subject to SECA-type social security tax, not FICA-type withholding. Review your records to ensure that the church is not withholding FICA-type social security tax when SECA should apply.
- Structure ministerial compensation to maximize stewardship by appointing a compensation committee and considering such issues as the housing allowance (even in the case of church-provided housing), tax-free and tax-deferred fringe benefits, and using an accountable expense reimbursement plan.
- Help ministers in your church differentiate between church-related income (and the related business expenses) and non-church related income (and the related business expenses). These figures must be reported on Forms W-2, Form 2016, Schedule A, and Schedule C respectively.
- Encourage ministers in your church to prepare for retirement by building their 403(b) or 401(k) plans through church-funded and/or salary reduction contributions, as well as by understanding financial issues such as filing for social security, working after retirement, and withdrawing from tax-deferred retirement plans.
- Remind ministers in your church to plan for and pay ministerial tax payments in a timely fashion, possibly through a voluntary withholding agreement between the minister and the church.

Action Steps for Ministers

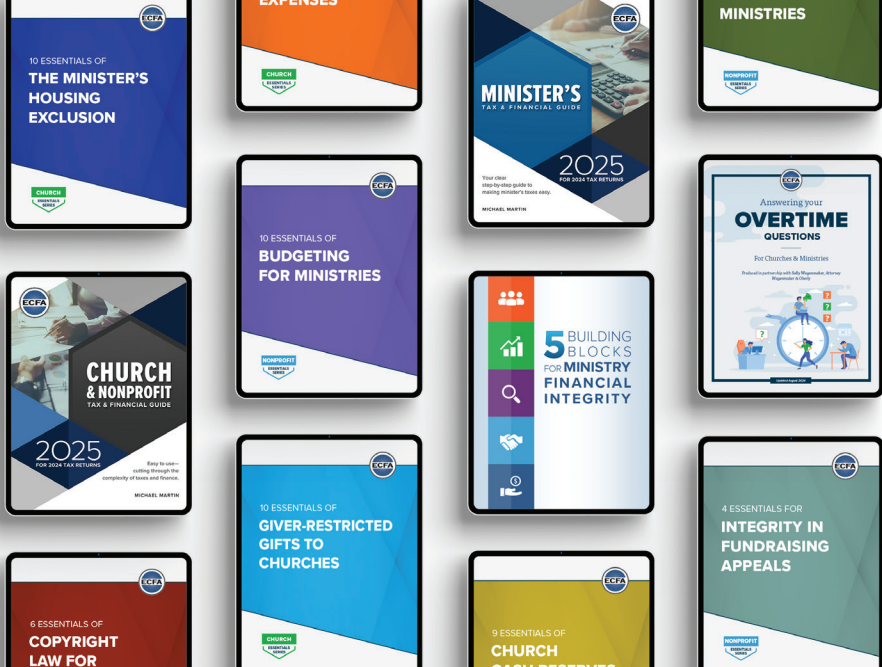
- Communicate with your church governing body to ensure that the church, as the employing organization, has determined that you meet the qualifications as a “minister” under the federal tax law requirements.
- Based on the determination made by the church, establish your status for both income tax purposes and social security purposes. In nearly every case, this will be “employee” for income tax purposes and “self-employed” for social security purposes (and therefore subject to SECA and not FICA).
- Work with your church governing body or compensation committee to structure your ministerial compensation to maximize stewardship by considering such issues as the housing allowance (even in the case of church-provided housing), tax-free and tax-deferred fringe benefits, and using an accountable expense reimbursement plan.
- Differentiate between church-related income (and the related business expenses) and non-church related income (and the related business expenses). These figures must be reported categorically on Forms W-2 and Schedule C respectively.
- Prepare for retirement by building your 403(b) or 401(k) plans through church-funded and/or salary reduction contributions, as well as by understanding financial issues such as filing for social security, working after retirement, and withdrawing from tax-deferred retirement plans.
- Plan for and pay ministerial tax payments in a timely fashion, possibly through a voluntary withholding agreement between you and the church.

Resources

Enjoying this content?

ECFA members can access dozens of eBooks like this one for FREE. Discover vital information for your ministry as you strive to operate with integrity.

[ECFA.org/eBooks](https://ecfa.org/eBooks)



Stay informed.

ECFA Webinars are a free resource for members, keeping you up-to-date on recent developments and best practices for your ministry.

[ECFA.org/Webinars](https://ecfa.org/Webinars)



KNOWLEDGE CENTER

The **Knowledge Center** contains hundreds of documents on ministry finance, governance, stewardship, and more. In addition, check out [ECFA.org/Resources](https://ecfa.org/Resources) for webinar recordings, podcasts, videos, current news, and other practical learning opportunities.



Governance



Financial
Management



Legal
Compliance



Gift
Administration



Leadership

Copyright



[ECFA.org](https://ecfa.org)

Copyright © 2024, ECFA

ISBN: 978-0-9799907-5-5

All rights reserved. No part of this publication may be reproduced, stored in a retrieval system, or transmitted in any form or by any means—electronic, mechanical, photocopy, recording, or any other—except for brief quotations in printed reviews, without the prior permission of the publisher.