

Employment and Tax Status of Clergy

By Richard Hammar,
adapted from
the Church Law Today training program
for pastors

Taxes are a complicated matter. Pastors have it harder than most: their financial well being and local reputation intersect at this confusing juncture. With a little education, however, pastors can understand their tax status and systematize their payments. These handouts provide the foundation for that education. They will explain:

- 1) The importance of the pastor's employment status (employed by the church or self-employed) for tax purposes
- 2) A set of guidelines to determine employment status
- 3) How and why to have income and self-employment taxes withheld
- 4) Several tax rules set up for the benefit of clergy

Use this material in one of your regularly scheduled meetings or as an introduction for someone new to pastoral ministry. Simply select a handout, print and photocopy it—you do not need to ask permission to copy provided you are using the material in a church or educational setting and are not charging for it—and lead a discussion using the discussion questions provided.

We hope this material helps simplify taxes for your church's ministers, so that they can have confidence as they "Give to Caesar what is Caesar's."



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How to use “Employment and Tax Status of Clergy”

You've purchased an innovative resource that will help you develop your pastors in administrative excellence. All of the material is authored by accountant and attorney Richard Hammar, J.D., LL.M., CPA.

Use these handouts at the beginning of a meeting to help launch a discussion, or hand them out as brief primers for new pastors or church treasurers.

Select & Copy

This specific theme is designed to provide clarity for pastors and treasurers with questions about clergy taxes, and to help them decide the best methods for getting their taxes right. Simply print and photocopy the handouts and distribute them as needed. (You do not need to ask for permission as long as you are using the material in a church or educational setting and are not charging for it.)

Prepare & Lead

Allow five minutes for everyone to read through each handout. Then discuss the questions provided, or consider questions such as:

- What does this mean for our pastors? For our treasurer or bookkeeper?
- What one or two practical things could our church or our clergy do to improve in this area?

Pray

Ask God that he would help your church and its ministers be above reproach in regards to financial reporting.

Need more material, or something on a specific topic? See our website at www.BuildingChurchLeaders.com.

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Employment Status 101

What concrete difference does it make if you're an employee or self-employed?

There are two ways for a minister to report federal income taxes: as an employee or self-employed. How should a minister report?

Most clergy should report their federal income taxes as employees, because they will be considered employees under the tests currently used by the IRS and the courts (for more on this, read the article "20 Questions"). Moreover, most clergy will be better off reporting as employees, since they are less likely to be audited and fined, and employer-paid benefits will actually save them money. Here are some of the biggest differences between being self-employed or church-employed.

1. **Reporting compensation.** Self-employed persons report compensation and business expenses on Schedule C of their 1040 form. Employees report their compensation directly on Form 1040.
2. **Adjusted gross income.** Adjusted gross income is usually higher for ministers who report their income taxes as employees. This is because many of their deductions and reimbursements are claimed after adjusted gross income is computed. Self-employed persons deduct business expenses when they compute adjusted gross income.
3. **W-2 or 1099?** Ministers working for a church or church agency should receive a Form W-2 each year if they are employees, and a Form 1099-MISC if they are self-employed (and receive at least \$600 in compensation).
4. **Tax treatment of various fringe benefits.** Certain fringe benefits provided by a church on behalf of a minister are excludable from the minister's income only if he or she is an employee. Examples include medical insurance premiums paid by a church on behalf of its minister; and group term life insurance (up to \$50,000) provided by a church on behalf of a minister.
5. **Audit risk.** Self-employed persons face a much higher risk of having their tax returns audited. Why? IRS data reveals that employees have a much higher rate of voluntarily reporting the correct amount of income.
6. **Consequences of being reclassified as an employee.** Ministers who report their federal income taxes as self-employed face a significant risk of additional taxes and penalties if they are audited by the IRS and reclassified as employees. This is because self-employed ministers deduct their business expenses in a particular manner (Schedule C). If they are reclassified, they are subject to new guidelines (those of Schedule A), and their taxable income can increase.
7. **The down side of employee status.** The primary *disadvantage* of employee status is that most business expenses are deductible only as itemized deductions (on Schedule A). This can be overcome if the church adapts an "accountable reimbursement policy"—under which the church reimburses the pastor for business expenses on an ongoing basis.

Discuss

1. What is our pastor's current employment status? Why did he or she choose that status?
2. How would an IRS audit reflect on our reputation? How can we guard against an audit?
3. What is our church's reimbursement policy? How does this affect our pastor's taxes?

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How to Determine Status

20 guidelines for establishing the right employment status.

Determining a minister's employment status is often difficult. In 1987, the IRS developed a list of twenty criteria to be used as an aid in determining whether an individual is an employee under the common law rules. Although there are some exceptions to this test, its criteria point to the important factors in determining employment status, including whether or not the employee is under another person's control or directions.

1. *Instructions.* A person who is required to comply with instructions about when, where, and how to work is ordinarily an employee.
2. *Training.* Training of a person by an experienced employee or by other means is a factor of control and indicates that the worker is an employee.
3. *Integration.* Integration of a person's services into the business operations generally shows that the person is subject to direction and control and accordingly is an employee.
4. *Services rendered personally.* Self-employed status is indicated when an individual has the right to hire a substitute without the employer's knowledge.
5. *Hiring, supervising, and paying assistants.* Hiring, supervising, and payment of assistants by the employer generally indicates that all workers on the job are employees.
6. *Continuing relationship.* The existence of a continuing relationship between an individual and an organization indicates an employer-employee relationship.
7. *Set hours of work.* The establishment of set hours of work by the employer is a factor indicating control and accordingly the existence of an employer-employee relationship.
8. *Full time required.* If the worker must devote full time to the business of the employer, he or she ordinarily will be an employee.
9. *Doing work on employer's premises.* Doing the work on the employer's premises may indicate that the worker is an employee, especially if the work could be done elsewhere.
10. *Order or sequence of work.* If a worker must perform services in an order or sequence set by the organization, this indicates that the worker is an employee.
11. *Oral or written reports.* A requirement that workers submit regular oral or written reports to the employer is indicative of an employer-employee relationship.
12. *Payment by hour, week, month.* An employee usually is paid by the hour, week, or month, whereas a self-employed person usually is paid by the job.
13. *Payment of business expenses.* Payment by the employer of the worker's business or travel expenses suggests that the worker is an employee.
14. *Furnishing of tools and materials.* The furnishing of tools and materials by the employer indicates an employer-employee relationship.
15. *Significant investment.* The furnishing of all necessary facilities (equipment and premises) by the employer suggests that the worker is an employee.
16. *Realization of profit or loss.* Workers who are in a position to realize a profit or suffer a loss as a result of their services are self-employed and not considered employees.
17. *Working for more than one firm at a time.* A person who works for a number of persons or organizations at the same time is usually self-employed.

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18. *Making services available to the general public.* Workers who make their services available to the general public are usually self-employed.
19. *Right to discharge.* The right to discharge is an important factor in indicating that the person possessing the right is an employer. Self-employed persons ordinarily cannot be fired as long as they produce results which measure up to their contract specifications.
20. *Right to terminate.* An employee ordinarily has the right to end the relationship with the employer at any time he or she wishes without incurring liability. A self-employed person usually agrees to complete a specific job and is responsible for completion.

Discuss

1. Based on the criteria above, is our pastor self-employed or church-employed?
2. Which criteria are exceptions to our pastor's employment status? Do they suggest a change in status?
3. What are some ways we can clarify the church-pastor employment relationship?

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Voluntary Withholding—How Does It Work?

One option that can simplify the pastor's taxes.

The IRS states: “if you perform your services as an employee of the church (under the common law rules), you may be able to enter into a voluntary withholding agreement with your employer, the church, to cover any income and self-employment tax that may be due.” Here’s how voluntary withholding can work for your church’s ministers.

Income Taxes

Most employers are required to withhold federal income taxes from employees’ wages as they are paid. But there are exceptions, including wages paid for “services performed by a duly ordained, commissioned, or licensed minister of a church in the exercise of his ministry.” As a result, a church is not required to withhold income taxes from wages paid to ministers who report and pay their income taxes as employees.

However, ministers who report their income taxes as employees should consider the convenience of voluntary withholding. To do this, a minister would need to file a W-4 form with their church (this form is also known as a “withholding allowance certificate”). On this form they can request that the church withhold federal income taxes from the minister’s wages just as it would for any nonminister employee.

Ministers who are self-employed for income tax purposes normally report and prepay their income taxes and Social Security taxes by means of the estimated tax procedure. But they also are free to enter into an “unofficial” withholding arrangement whereby the church withholds a portion of the minister’s compensation each week and deposits it in a church account. The church would then distribute the balance to the minister in advance of each quarterly estimated tax payment due date. In this circumstance, no W-4 forms should be used—the church simply holds money in a church account for the minister.

Social Security

Ministers are always considered self-employed for the purposes of Social Security regarding services they perform in the exercise of their ministry, and so they pay “self-employment taxes” (Social Security taxes paid by self-employed persons) rather than Social Security and Medicare taxes (taxes that are withheld from an employee’s wages).

Even though they are considered self-employed for Social Security purposes, ministers are eligible for voluntary withholding of the self-employment tax. In this situation, a church whose minister elected voluntary withholding of his income tax simply withholds an additional amount from each paycheck to cover his estimated self-employment tax for the year. The excess income tax withheld is a credit against the tax that the minister claims on his federal income tax return, and is applied to his self-employment tax liability.

Discuss

1. How does our church define “minister”? How does (or could) this affect our pastor’s employment and tax status?
2. Is our church receptive to withholding taxes on behalf of our minister?
3. Is our church receptive to withholding taxes unofficially for self-employed ministers?

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Special Situations

Four tax rules that are available to ministers.

The tax code contains a number of special rules for ministers. Here we will review four:

Rule #1. Parsonages and housing allowances

Ministers who own their home do not pay federal income taxes on the portion of their church compensation that is designated in advance by their church as a housing allowance. However, the allowance must be used to pay for housing related expenses and cannot exceed the annual rental value of the home.

Ministers who live in a church-provided parsonage do not pay income taxes on the annual rental value of the parsonage. However, housing allowances and the rental value of parsonages are fully taxable in computing a minister's self-employment taxes (Social Security and Medicare taxes).

Here are three ways you can get the most out of your housing allowance:

- Have your church designate a portion of your compensation as a housing allowance at the end of each year for the following year.
- Ensure that the allowance is enough to cover your anticipated housing expenses.
- When a church hires you, be sure the church designates a housing allowance prior to the date you begin your duties.

Rule #2. Self-employed status for Social Security

The treatment of ministers as self-employed for Social Security (though they are in most cases employees for income tax purposes) has generated much confusion. Ministers pay the self-employment tax, not "Social Security," "Medicare" or "FICA" taxes. Church treasurers should never treat ministers as employees for Social Security purposes, even if they are employees for income tax reporting purposes.

Rule #3. Exemption from self-employment taxes

Ministers may exempt themselves from self-employment (i.e., Social Security) taxes with respect to services performed in the exercise of ministry. There are several requirements they will need to meet in order to do this. In most cases, they will need to file an exemption on their 1040 federal tax return by April 15 (tax day) of the third year of ministry.

Rule #4. Wages exempt from income tax withholding

Ministers' compensation is exempt from income tax withholding whether a minister reports income taxes as an employee or as self-employed. This means that a church need not withhold income taxes from the salary of a minister who is an employee for income tax reporting purposes. Of course, a church and a minister-employee may agree voluntarily that federal income taxes are withheld from his wages, but this is not required.

Discuss

1. Is our housing allowance system set up in such a way our pastor receives tax benefits? Why or why not?
2. What are the reasons a pastor would want to be exempt from the self-employment tax?
3. Is our treasurer or bookkeeper adequately trained on withholding taxes? How can we support his or her work?

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Books and websites to help with your church and clergy taxes.

- 📖 BuildingChurchLeaders.com: Leadership training resources from Christianity Today International.

 - “Receipts for Donors” Best Church Practices
 - “Finances” Training Theme and PowerPoint
- 📖 ChurchLawToday.com: A resources and training center for pastors, administrators, board members, and other church leaders with a wealth of information on legal, tax, and risk management issues.
- 📖 ChurchLawTodayStore.com: Reference and training material for legal and tax issues as they affect your church.

 - “[Clergy Filing Procedures CD-ROM](#)”—A step-by-step explanation of how to complete tax forms as either an employee or self-employed.
 - “[2007 Church and Clergy Tax Guide](#)”—The comprehensive manual for clergy taxes, with chapters on all major topics. Available in book or CD-ROM format.
 - “[Federal Reporting Requirements for Churches—2007](#)” An audio CD that summarizes the major forms and reporting requirements for church taxes.

Church & Clergy Tax Guide by *Richard Hammar*. A complete and authoritative tax guide for ministers, clergy, and church administrators, published annually, focused on providing relevant information for year-round tax questions. (Church Law & Tax Report, 2005 ISBN 1880562626)

Pastor, Church & Law by *Richard Hammar*. A comprehensive resource for anyone interested in church law and tax issues. (Christian Ministry Resources, 2000; ISBN 1880562421)

Tax Deductions A to Z for Clergy by *Anne Skalka*. An easy-to-use guide for clergy that will help them get the most out the deductions that they are eligible for . (Boxed Books, 2006; 1933672137)

Zondervan 2007 Church and Nonprofit Tax and Financial Guide: For 2006 Returns by *Dan Busby*. Provides advice and examples for filing tax returns. Includes a section on what is different this year from previous years. (Zondervan, 2006; 0310261848)

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