Clergy Status and Its Implication for Payroll and Tax Preparation

by Jerry Stephens, EA

In a Nutshell

In several important respects clergy taxpayers are treated differently than other taxpayers. To qualify for this unique treatment, a person must qualify as a clergy person and must be employed in a clergy capacity. Their unique tax (and, by extension, payroll) treatment can be summarized in four points:

- Federal (and in many jurisdictions, state and municipal) income tax withholding is optional.
- Clergy employees are *always* considered self-employed for social security tax purposes.
- Clergy taxpayers have a limited period during which they can apply to be exempted from paying self-employment social security tax on their clergy earnings.
- Clergy taxpayers may be able to exclude from taxable income a portion of their compensation that is properly designated as housing allowance.

Digging Deeper: *the Clergy-Person*

Clergy taxpayers are treated differently than other taxpayers in several key regards. Their payroll must also be administered differently than for other types of employees. Because of those 'wrinkles' it is critically important that clergy taxpayers fully understand the implications of their clergy status.

To understand the issues involved we must first understand what it means to be a clergy person.

Over the years a wide range of definitions for the titles ‘clergy’, ‘minister’, ‘pastor’, ‘priest’, etc. have been floated in venues both sacred and secular. It is likely that they have distinguishable meanings in other contexts. However, within the context of this article, we will hold them all to be essentially identical.

Actually, two factors must be evaluated to determine if an individual qualifies for clergy status. The individual a) must qualify as a clergy-person and b) must be employed in a clergy capacity by a qualifying organization. We will examine both factors, beginning with the concept of the clergy-person.

Prior to 1989 there was significant confusion in determining who qualified to be considered clergy for payroll and tax purposes. Not only did the meanings of the various appellations differ from denomination to denomination to *non*-denomination but a series of court cases added to the bewilderment by establishing new and sometimes conflicting definitions. In the 1989 tax court case of *Knight v. Commissioner* we were at last given some solid guidance for tax purposes (and, by implication, for payroll purposes). It is precedent upon which both the Congress and the IRS have relied to establish procedures regarding clergy issues.

The court held that five criteria must be examined to determine if an individual qualifies to be considered clergy. Those factors are whether the individual:

- administers sacraments (so-called ‘sacerdotal’ [sas-er-doht-l] functions of ministry include serving preaching and teaching, communion, administering baptism, performing weddings and funerals, pastoral counseling and other similar pastoral activities)
- conducts worship services
- performs services in the ‘control, conduct, or maintenance of a religious organization’

- is 'ordained, commissioned, or licensed'
- is considered to be a spiritual leader by his religious body

The court held that this five-point test "is not an arithmetical test but a balancing test. Failure to meet one or more of these factors must be weighed by the court in each case." In other words, an individual need not satisfy all five criteria to be considered clergy. Indeed, in the *Knight* case, the litigant was considered clergy for tax purposes even though he did not administer sacraments and did not perform services in the control, conduct, or maintenance of a religious organization. It is extremely important to note, however, that the fourth criterion was held to be mandatory: the taxpayer *must* be ordained, commissioned or licensed to be considered clergy.

Most denominations and many local churches have established their own criteria for credentialing clergy. However, several restrictions apply to issuing ministerial credentials that can be recognized by the IRS. For example:

- The credentialing body must generally be recognized by the IRS as an exempt entity (such entities are listed in IRS Publication 78). However, a problem arises in that to be listed in Pub 78 an entity must file and receive IRS approval of Form 1023. Bona fide churches and denominations/associations of churches are statutorily held to be public charities (i.e., tax-exempt) *without* the requirement to file Form 1023. Therefore, most churches and denominations have not filed Form 1023 and are not listed in Pub 78. In such cases the IRS allows the entity to submit a letter affirming that it meets the requirements set forth in §501(c)(3) and §170(b)(1)(A)(i) of the Internal Revenue Code.
- Increasingly, the IRS is *not* recognizing credentials issued by parachurch organizations and other ministries. They will recognize credentials issued by churches, church denominations and other organizations that are directly controlled by a church or denomination. By the way, this is not a result of 'religious persecution,' as many have asserted but rather a matter of 'revenue enhancement' (i.e., asserting the right to collect more tax revenue from people they deem ineligible for the potentially tax preferred clergy status).
- If credentials are issued at multiple levels within a denominational structure the IRS will recognize credentials issued only by the highest level that issues the credentials. In other words, if credentials are issued at both the local church and regional level, the IRS will recognize only those credentials issued at the higher regional level.
- The credentialing body must be self-authorized to issue credentials. Such self-authorization is usually accomplished by establishing a credentialing procedure in its governing documents (constitution or by-laws).
- Clergy candidates must have completed a 'prescribed course of study.' This does not necessarily require a seminary education, but IRS guidance indicates they are looking for a substantial level of preparation for religious service.
- Clergy credentials have limited portability. The IRS (and most state governments) recognizes credentials as valid only if the clergy-person is employed under the umbrella of the issuing organization. Thus, if the credentials are issued by a denominational body, they will be recognized if the clergy-person is employed anywhere within that denominational structure. However, if the credentials are issued at the local church level, those credentials will be recognized only if the clergy person is employed under the umbrella of that issuing church. If the clergy-person leaves that church and is employed by another church that is independent of the original credentialing body, (s)he will be required to be re-credentialed in the new employment context.
- In an earlier tax court case (*Lawrence v. Commissioner)* the court held that issuing ministerial credentials solely for the purpose of qualifying an individual for clergy tax

> status without concurrently conferring any meaningful ecclesiastical role does not qualify the individual for clergy tax status.

In summary, an individual qualifies for clergy tax status if (s)he is duly ordained, licensed or commissioned by a qualifying religious organization and satisfies at least several of the other criteria established in the *Knight* decision.

Digging Deeper Still: *the Clergy-Employee*

As I mentioned earlier, there is a second factor in determining qualification for clergy tax status. In addition to being considered a clergy-person, clergy status applies only with respect to services performed in the exercise of ministry. In other words, in order to qualify an individual must *be* a minister and must be *doing* some form of ministry activity. Determining if the individual is *doing* ministry requires an examination of *what* services are being performed and *for whom*. Let's first examine the services being performed.

IRS regulations state that "service performed by a minister in the exercise of his ministry includes [1] the ministration of sacerdotal functions and [2] the conduct of religious worship, and [3] the 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 church denomination."

Let's consider the question of for whom the services are rendered. Revenue Ruling 78-301 says, "When the individual's regular, full-time duties to the congregation are spiritual or religious in nature, such as leading the worship service, those duties are in the exercise of the ministry." IRS regulations stipulate, "Whether service performed by a minister constitutes the conduct of religious worship or the ministration of sacerdotal functions depends on the tenets and practices of the particular religious body constituting his church or church denomination." Clearly, the leading clergy-person of a church/synagogue/mosque/etc (whether referred to as minister, pastor, parson, elder, priest, rabbi, imam or by any other title) will generally satisfy this requirement, as will many members of the clergy staff.

Internal Revenue Code §1.1402(c)-5.b.2.iii states, "If a minister is performing service in the conduct of religious worship or the ministration of sacerdotal functions, such service is in the exercise of his ministry whether or not it is performed for a religious organization. The application of this rule may be illustrated by the following example:

> "Example. M, a duly ordained minister, is engaged to perform service as chaplain at N University. M devotes his entire time to performing his duties as chaplain which include the conduct of religious worship, offering spiritual counsel to the university students, and teaching a class in religion. M is performing service in the exercise of his ministry."

In summary, clergy taxpayers qualify for clergy treatment only if they are actively engaged in ministry-related activities. Non-ministry activities do not qualify for clergy treatment for payroll or tax purposes. For example, if a clergy person is employed as the church custodian, such service will not qualify. Obviously, secular employment by a clergy-person will not qualify.

The Tax Implications of Clergy Status

So what difference does it make? Why all the fuss? As I said in the beginning, there are several 'wrinkles' in the way clergy payroll and taxes are administered. Failure to know and adhere to these wrinkles can result in significant difficulties (penalties, overpayment/underpayment of taxes, increased audit risk, etc.) for both the clergy taxpayer and his/her employer. Here is an abbreviated look at the four most significant deviations from the norm. Keep in mind that these provisions are with respect to the clergy-person's ministry-related earnings only.

1. Clergy are one of the few exceptions to the rule requiring income tax withholding. The employer and employee *both* have the option of *not* having federal income tax withheld. Stated another way, federal income taxes should be withheld on clergy payrolls only if *both* the employer and clergy employee agree to do so. If both agree to federal income tax withholding, the regular withholding procedures apply.

   It should be noted that many states and municipalities also have this provision. In most such cases, state and municipal withholding follows the federal lead (i.e., if federal income tax is withheld, state and/or municipal taxes must also be withheld).

2. Clergy taxpayers have 'dual tax status', that is, they are *almost always* considered an employee for income tax purposes, but are *always* (without fail!) considered self-employed for social security tax purposes. Because they are self-employed for social security tax purposes they are not subject to the provision of FICA (the social security tax system that applies to employees). Therefore, their employing church/ministry should never withhold FICA tax on clergy employees.

   Self-employment social security taxes are usually paid by making quarterly estimated tax payments. However, (assuming both the employer and clergy employee have agreed to do federal income tax withholding) the IRS not only condones but actually encourages the clergy taxpayer to have extra federal income tax withheld in an amount equal to his/her self-employment tax liability. By doing so the clergy taxpayer may be able to avoid having to make quarterly estimated tax payments.

3. Clergy taxpayers are eligible to receive a housing allowance (sometimes also called a parsonage allowance or manse allowance). However, the employer must designate a specific amount (or a specific percentage of the clergy employee's salary) as housing allowance, and such designation must be done in advance (after the fact designations are not valid).

   It is important to note that the designated amount is not automatically excluded from income. The excludable amount must be determined at the time the clergy taxpayer's tax return is prepared. The excludable amount is limited to the lowest of:

   a) The amount designated by their employer
   b) Their actual, out-of-pocket expenses
   c) The fair rental value of their home

   If either b) or c) is less than the a) (the designated amount), the difference must be added to taxable income by adding it to the amount reported on line 7 of Form 1040. Alas, if the designated amount is the lowest of the three amounts, the tax benefit of the difference is simply lost. For this reason, I recommend to my clergy clients that they estimate their annual housing related expenses and then add a ten percent 'fudge factor' to account for unexpected expenses. If no additional expenses are incurred the excess is simply added back in to taxable income—where it would have been anyway.

   Allowable housing expenses include any that are directly related to providing a home for the clergy taxpayer and his/her family.

   It is important to note that housing allowance is excludable from income tax only; it is *not* excludable from self-employment social security tax.

   If a clergy-person has such excludable housing-related income (s)he is required to reduce any ministry related expenses reported on Schedule C or Form 2106 in an amount equal to the proportion of the excludable income in comparison to total ministry compensation. In other words, if the excludable portion of a clergy-person's income is 25 percent of

his/her total ministry income, his/her ministry-related business expenses must be reduced by twenty-five percent. This is known as the 'Deason Rule', so-called because it results from the 1964 tax-court case *Deason vs Commissioner*.

4. Subject to significant limitations, clergy taxpayers have a limited window of opportunity to 'opt out' of participating in social security taxes and benefits related to their ministry earnings. To qualify, they must have a deeply held religious conviction that it is not appropriate to receive government sponsored public insurance benefits related to their ministry service.

   If a clergy taxpayers chooses opt out (s)he must file Form 4361 not later than the deadline for filing their second tax return on which at least $400 of ministry related earnings is reported. If approved, such clergy taxpayers do not pay social security taxes on their ministry earnings. They also do not accrue social security benefits on those earnings. However, they must still pay social security taxes on all secular earnings and still accrue benefits based on all amounts paid in. In other words, the exemption is only on their ministry earnings; they still pay in and earn benefits on their secular earnings.

For More Information

Ministry Consulting Group LLC has specialized (among other things) in clergy tax preparation since our founding in 1989. Feel free to contact us if you need additional information about clergy tax issues or other non-profit/tax-exempt matters. The easiest way to reach us is via email at info@ministryconsulting.net or at our web site at www.ministryconsulting.net.

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