

**TAX**

**INFORMATION**

**MANUAL**



## 2005 TAX FACTS

1. The maximum taxable FICA wages increased for 2005 to \$90,000 for the social security portion (at 6.2%) and no maximum for the Medicare portion (at 1.45%). The combined FICA withholding rate remains at 7.65% and the SECA (self-employment) tax rate remains at 15.3%.
2. Earnings limits and ages increased for retirees for 2005. Retirees between ages 62-64 may earn up to \$12,000 before social security benefits are reduced. In the year "full retirement age" is reached, a different limit applies to earnings up to the month that full retirement age is reached. The limit for individuals who reach "full retirement age" in 2005 is \$31,800. The Social Security Administration provides a chart to help determine when an individual reaches "full retirement age". See the SSA website at [www.ssa.gov/retirechartred.htm](http://www.ssa.gov/retirechartred.htm).
3. The IRS business travel mileage reimbursement limit is \$.405 per mile for January 1, 2005 to August 31, 2005. Effective September 1, 2005 the limit increased to \$.485 per mile. Any reimbursement over these amounts must be included as taxable income on the worker's Form W-2. A reimbursement at less than the IRS limit is an unreimbursed business expense.

The standard rate for charitable miles for volunteers is at \$.14/mile for 2005, except for charitable miles relating to Hurricane Katrina. For the period August 25 to August 31, 2005, the rate for miles driven for charities providing Hurricane Katrina relief is 29 cents, for deduction purposes, and 40.5 cents, for reimbursement purposes. For the months of September through December 2005, the special Katrina-related rates are 34 cents for deductions and 48.5 cents for reimbursements.

4. The IRA contribution limit is \$4,000 (\$4,500 if age 50 or over) in 2005.
5. The annual contributions limit in 2005 to 403(b) plans is \$14,000. If age 50 or older, the limit is \$18,000 for 2005.

## 2006 TAX FACTS

1. The maximum taxable FICA wages increases for 2006 to \$94,200 for the social security portion (at 6.2%) and no maximum for the Medicare portion (at 1.45%). The combined FICA withholding rate remains at 7.65% and the SECA (self-employment) tax rate remains at 15.3%.
2. Earnings limits and ages increased for retirees for 2006. Retirees between ages 62 and under “full retirement age” (65 and 6 months for retirees born in 1940; 65 and 8 months for those born in 1941) may earn up to \$12,480 before social security benefits are reduced. In the year full retirement age is reached, a different limit applies to earnings up to the month that full retirement age is reached. The limit for individuals who reach “full retirement age” in 2006 is \$33,240 (\$2,770/mo) for months prior to attaining full retirement age. There is no limit on earnings beginning the month an individual attains full retirement age.

The Social Security Administration provides a chart to help determine when an individual reaches “full retirement age.” See the SSA website at [www.ssa.gov/retirechartred.htm](http://www.ssa.gov/retirechartred.htm).

3. The IRS business travel mileage reimbursement limit is \$.445 per mile effective January 1, 2006. Any reimbursement over these amounts must be included taxable income on the worker's Form W-2. A reimbursement at less than the IRS limit is an unreimbursed business expense.

The standard rate for charitable miles for volunteers remains at \$.14/mile for 2006, except for charitable miles relating to Hurricane Katrina. For 2006, these Katrina-related charitable rates will be 32 cents per mile for deduction purposes and 44.5 cents per mile for reimbursement purposes.

Beginning January 1, 2006, 18 cents per mile driven for medical or moving purposes.

4. The IRA contribution limit is \$4,000 (\$5,000 if age 50 or over) in 2006. The annual limit to an IRA takes into account contributions to a 403(b) so as not to exceed the annual limit on an employee's elective deferrals.
5. The annual contributions limit in 2006 to 403(b) plans is \$15,000. If age 50 or older, the limit is \$20,000 for 2006. The annual limit on an employee's elective deferrals generally applies to all of an employee's deferrals under any 403(b), SEP, SIMPLE or 401(k) plan.
6. Based on the increase in the Consumer Price Index (CPI-W), Social Security and Supplemental Security Income (SSI) beneficiaries will receive a 4.1% cost-of-living adjustment for 2006.

## PREFACE

The 1989 WELS Synod convention adopted a resolution instructing the synod's Board of Trustees to issue a tax information manual to each congregation and synodically-affiliated organization (Proceedings, p. 162).

Each WELS congregation and organization is responsible for reproducing and distributing the manual to its workers, treasurers and other interested parties. The manual is designed to be topical so it is important that all congregational workers receive a copy of the entire manual. This distribution will help treasurers understand the nature of called workers' taxes and help called workers understand the complexities of congregational reporting.

Generally, the Internal Revenue Code ("IRC") applies to workers in our churches and related organizations the same as they apply to workers in the secular world. However, four provisions in the IRC are unique to ministers:

1. Section 107 parsonage allowances
2. Ability to be exempted from social security coverage
3. Dual tax status of some ministers-employees for benefit and reporting purposes but self-employed for social security purposes
4. Statutory exemption from income tax withholding

The information contained in this manual is for informational purposes related to federal income taxes and is based only on the resources that the synod has at its disposal. Congregations or individuals using the information contained in this manual should consult a qualified tax consultant to be sure that the information relied upon applies to their particular situation.

For more information on subjects not covered in this manual or for a more in-depth review of subjects contained herein, we suggest the worker, congregation or organization purchase one of the many handbooks available prepared by clergy tax experts. The back page of this manual provides information on where several such sources of tax information may be ordered.

## TABLE OF CONTENTS

<b><u>Subject</u></b>	<b><u>Page</u></b>
Tax Status--Congregations and WELS Organizations.....	1
Tax Status--Ministers of the Gospel .....	3
Employer Identification Number .....	4
Sales Tax Exemption Status.....	4
Federal Unemployment Tax Act (FUTA).....	5
Workers' Compensation Insurance .....	6
Records Retention.....	7
Income .....	8
Unrelated Business Income.....	9
Self-Employment Tax Supplements .....	10
Other Receipts.....	11
Employment Related Forms.....	12
Reporting Wages and Salaries .....	13
Worksheet for Calculating Taxable Income, Box 1 Form W-2 .....	14
Sample W-2, Minister of the Gospel .....	14
Sample W-2, Other Church Employees.....	15
Reporting Other Payments.....	17
Substitute Pastors, Teachers and Independent Contractors.....	19
Fringe Benefits.....	20
Housing.....	21
Parsonage Allowance.....	24
Employment Tax Withholding .....	26
Social Security Taxes.....	28
Charitable Contributions .....	31
Tuition and Scholarships .....	34
Business Expense Reimbursements .....	37
Moving Expenses.....	39
Retirees/Social Security Calls.....	40
Tax Sheltered Annuities and Tax Savings Plans .....	44
Overseas Ministers or Expatriates.....	47
Sources of Tax Information .....	48
Bibliography .....	49

## TAX STATUS - CONGREGATIONS AND WELS ORGANIZATIONS

Certain corporations, such as churches and associations of churches, may qualify as tax-exempt organizations under the Internal Revenue Code (“IRC”) Section 501(c)(3) provided the synod has obtained a group exemption number for all churches and synodical units listed in the synod’s Yearbook. Therefore, it is not necessary for each church and organization to obtain a separate number if they are listed in the Yearbook. However, churches and other organizations are not precluded from obtaining their own 501(c)(3) status.

*WELS churches and other incorporated tax-exempt organizations listed in the synod's Yearbook are covered under IRS Group Exemption Number 1773.*

In a ruling dated August 28, 1944, and confirmed in a communication dated January 25, 1966, the Internal Revenue Service (“IRS”) classified the Wisconsin Evangelical Lutheran Synod (“WELS”), together with all of its districts, congregations, educational, charitable and religious organizations as exempt from federal income tax as organizations described in Section 501(c)(3) of the IRC. The IRS assigned Group Exemption Number 1773 to the synod and its subordinate units. This IRS group ruling determination letter was extended and is continued by an additional group ruling determination letter dated September 21, 2000. Copies of the January 25, 1966 and September 21, 2000 IRS communications are available at the Financial Services Office of the synod. Churches may be required to demonstrate their 501(c)(3) status when seeking a mailing permit from their post office, when opening a bank account, when applying for certain scholarship grants for students, employer matching funds programs, etc.

It is Synodical Council’s policy to update and maintain a current listing of the subordinate units which are included in Group Exemption Number 1773 as 501(c)(3) organizations and to file such updates annually with the IRS. All synodical units included in this group are listed in the synod’s Yearbook, published annually and available through the Northwestern Publishing House in Milwaukee, Wisconsin.

In order to qualify for inclusion as a 501(c)(3) organization in Group Exemption Number 1773, the church/subordinate synodical unit is required to:

1. Qualify as a church or association of churches;
2. Be an integral part of the synodical structure;
3. Submit a request through the respective district president for inclusion in the synod’s Group Exemption Number 1773; and
4. Provide the Employer Identification Number (EIN) of the church or organization.

Some groups/organizations listed in the annual Yearbook are not included under the synod’s tax-exempt umbrella. **The synod’s legal counsel advise that organizations which are associations of individuals or not part of the synodical structure do not qualify for inclusion under the tax-exempt umbrella.** They are required to obtain their own tax-exempt status and number from the IRS.

When a corporation is made up of an association of churches and individuals, it is imperative that the articles of incorporation include a section on dissolution which clearly states that all remaining assets shall become the property of the churches and not of the individuals. Without this provision, the IRS may not recognize the tax-exempt status of an organization. The assets of an exempt organization must be permanently dedicated to an exempt purpose. None of its assets can be used for the benefit of individuals unless those individuals are carrying out the exempt purpose of the organization.

It is the policy of the synod's Synodical Council to communicate annually with the district presidents and request any new or terminated church organizations and/or any name or address changes of churches or organizations in their district. The district presidents are also requested to disseminate copies of synod Form CM-1041, Request for Federal Tax-Exempt Status in Group 1773, to all new units in their district. The completed Form CM-1041 is sent to the Financial Services Office, which annually submits a report listing the changes, deletions and additions in the Group Exemption Roster to the IRS in conformity with Revenue Procedure 68-13.

To request Form CM-1041 or copies of the WELS group tax exemption letters, you may call the Financial Services Office at 414-256-3252 or email [FIN@sab.wels.net](mailto:FIN@sab.wels.net). You may also download Form CM-1041 from our website at [www.wels.net/jumpword/finance](http://www.wels.net/jumpword/finance) – “WELS Financial Services–Public Resources” or “Tax Exemption or IRS Helps” Resource Collection.

### Political and Lobbying Activities

Under the IRC, all section 501(c)(3) organizations are absolutely prohibited from directly or indirectly participating in, or intervening in, any political campaign on behalf of (or in opposition to) any candidate for elective public office. Contributions to political campaign funds or public statements of position (verbal or written) made on behalf of the organization in favor of or in opposition to any candidate for public office clearly violate the prohibition against political campaign activity. Violation of this prohibition may result in denial or revocation of tax-exempt status and the imposition of certain excise tax.

Certain activities or expenditures may not be prohibited depending on the facts and circumstances. For example, certain voter education activities (including the presentation of public forums and the publication of voter education guides) conducted in a non-partisan manner do not constitute prohibited political campaign activity.

In addition, other activities intended to encourage people to participate in the electoral process, such as voter registration and get-out-the-vote drives, would not constitute prohibited political campaign activity if conducted in non-partisan manner. On the other hand, voter education or registration activities with evidence of bias that: (a) would favor one candidate over another; (b) oppose a candidate in some manner; or (c) have the effect of favoring a candidate or group of candidates, will constitute prohibited participation or intervention. For more information, visit the IRS website, [www.irs.gov](http://www.irs.gov) under Charities/Churches and Religious Organizations section. See also IRS Publication 1828, *Tax Guide for Churches and Religious Organizations*.

## TAX STATUS - MINISTERS OF THE GOSPEL

All called pastors, staff ministers, male teachers and male professors of the WELS are considered “Ministers of the Gospel” according to a private letter ruling from the IRS dated March 2, 1955. Ministers of the Gospel are considered employees of their calling bodies according to common law rules. Each is an employee because he performs services subject to the will and control of the calling body as to what will be done and how it will be done. It makes no difference if the congregation or organization (calling body) allows considerable discretion and freedom of action, if it has the legal right to control both the method and result of the services.

In determining whether a worker is a Minister of the Gospel for tax purposes, reference is made to a 1989 tax court case, *Knight v. Commissioner* 92 T.C. 199 (1989). The court ruled that all facts and circumstances must be considered when applying five criteria established by an earlier court ruling.

***Knight v. Commissioner established five criteria to determine who is a 'Minister' for tax purposes. Not all criteria need be met.***

Those criteria include whether an individual 1) is ordained, commissioned or licensed by a church, 2) administers sacraments (sacerdotal functions), 3) conducts worship services, 4) performs services in the control, conduct or maintenance of a religious organization, and 5) is considered to be a spiritual leader by the religious body to which he allies himself. Not all of these factors need be present but circumstances indicate that a **majority** of them must be present in order to be recognized as a Minister of the Gospel for tax purposes. An earlier tax court case, *Wingo v. Commissioner*, 89 T.C. 922 (1987) required that all of these criteria be met. However, recent IRS audit guidelines reference the *Knight* case implying that it is the more reliable of the two cases.

Churches and organizations are encouraged to review the above criteria when considering whether a called worker may be treated as a Minister of the Gospel for tax purposes. Some workers, even though called by the church or organization, may not qualify. A careful assessment of the *Knight* case as it applies to called laymen or seminary students is necessary. For example, the IRS will not consider vicars or seminary students as Ministers of the Gospel according to IRS Publication 525. “You cannot exclude a rental allowance from your income if you are a theological student serving a required internship as an assistant pastor unless you are ordained, commissioned, or licensed as a minister.” Vicars, teacher interns, and staff ministry interns do not appear to normally pass the IRS tests for Minister of the Gospel to exempt them from required federal income tax withholding. Therefore, these three positions are normally considered employees for social security and other purposes.

The IRC treats Ministers of the Gospel as self-employed for purposes of social security (Self-Employment Contributions Act, a.k.a. “SECA”) reporting and specifically exempts them from federal income tax withholding. *Therefore Ministers of the Gospel have a dual tax status under the IRC, they are considered self-employed for social security purposes, and employees for other tax and fringe benefit purposes.*

To obtain copies of the IRS letters regarding tax status of teachers or male teachers as ministers of the gospel, go to our website at [www.wels.net/jumpword/finance](http://www.wels.net/jumpword/finance) – in “Information Only Documents” resource collection – IRS letter 3-2-1955 re male teachers as ministers of the gospel; IRS Technical Advice Memorandum 12-2-1975 re male teachers entitled to Section 107 housing allowance; and IRS letter 5-7-1956 re female teachers not classified as ministers of the gospel. The tax determination letters are password protected. Contact Financial Services for the password.

## EMPLOYER IDENTIFICATION NUMBER

The IRS requires that every incorporated entity, including tax-exempt organizations, obtain a federal Employer Identification Number (“EIN”). This number is used on all correspondence and employment filings with the federal government to identify the entity and also required when opening a bank account, employer matching funds programs, etc.

Exploratory locations are part of the synod’s operation and have no independent legal existence. They may use the synod’s EIN #39-0842084, only if they use the synod’s name, like “WELS Exploratory, d/b/a \_\_\_\_\_ Lutheran Church,” until such time that the congregation organizes and incorporates. As soon as the congregation (or any organization) incorporates, it is required to secure its own EIN by completing IRS Form SS-4, Application for Employer Identification Number, and mailing it to the Regional Service office listed on the back of the form. An original may be obtained from the nearest IRS office or you may obtain the SS-4 form from the IRS website @ [www.irs.ustreas.gov](http://www.irs.ustreas.gov) under Forms.

*WELS exploratories and districts may use the synod's Employer Identification Number 39-0842084, only if they use the WELS name, like “WELS Exploratory, d/b/a \_\_\_\_\_ Lutheran Church.”.*

Every incorporated church and organization within the synodical structure is required to provide the Financial Services Office with its federal EIN. The IRS requires the synod to supply the EINs for all its subordinates under the synod’s tax-exempt Group Exemption Number 1773. They are maintained in the WELS church database.

Non-incorporated entities, which are part of the synod’s operation and have no independent corporate existence (i.e. districts), are entitled to use the synod’s EIN only if they use the WELS name.

To request Form EIN-1, you may call the Financial Services Office at 414-256-3252 or email [FIN@sab.wels.net](mailto:FIN@sab.wels.net). You may also download the EIN-1 form from WELS website at [www.wels.net](http://www.wels.net) – WELS Financial Services – Public Resources.

## SALES TAX EXEMPTION STATUS

States which levy sales taxes on items purchased may exempt church organizations from such tax by issuing the church, school or church-related organization a state sales tax exempt number or certificate of exemption. Forms may be obtained from your state’s government agency on its website. Regulations vary from state to state on sales tax exemption.

Each church or organization must obtain its own specific state tax exempt number or certificate of exemption. Before issuing such exemption, the states usually require that the church, school or church-related organization demonstrate that it also have federal tax exemption status under the 501(c)(3) IRC. Sales Use Tax may be applicable to items sold and may require sales tax reporting to your state.

## FEDERAL UNEMPLOYMENT TAX ACT (FUTA)

Churches and other religious organizations are exempt from unemployment compensation taxes imposed under the Federal Unemployment Tax Act (“FUTA”). Title 26 U.S.C. Art. 3309(b)(1)(A) provides an exemption with respect to “service performed--(1) in the employ of a church or convention or association of churches, or an organization. . . which is operated, supervised, controlled, or principally supported by a church or a convention or association of churches.”

<i>FUTA Title 26 U.S.C. Art. 3309(b)(1)(A) excludes churches and conventions or associations of churches from paying federal unemployment taxes. A U.S. Supreme Court ruling won by the WELS also excluded most church schools.</i>
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In May, 1981 in *St. Martin Evangelical Lutheran Church v. South Dakota*, 451 U.S. 772 (1981), the U.S. Supreme Court determined that personnel working within church schools which have no separate legal existence are “in the employ of a church or convention or association of churches.” The Court thus ruled that church schools are also exempt from unemployment compensation under the umbrella of the church. The only schools that are still subject to the tax are separately incorporated private schools. “WELS Human Resources Office can assist the church or school in responding to any claims filed by a church worker”.

Churches are not required to pay unemployment taxes for **any** of their workers. In addition, no workers are eligible for federal unemployment compensation benefits. Any request for unemployment compensation benefits submitted by any church worker may be sent to the WELS Human Resources Office for disposition.

Most states impose a state unemployment tax on workers similar to the federal unemployment tax. According to FUTA, states may not impose a tax on services performed in the employ of a church, convention or association of churches or certain church-controlled organizations.

## WORKERS' COMPENSATION INSURANCE

Workers' compensation insurance helps insulate employers from lawsuits due to a bodily injury sustained by their employees during the course of employment. The laws in most states require all employers with one or more employees to carry workers' compensation insurance coverage although some states allow optional coverage for religious organizations. The employee generally receives income replacement payments and paid medical expenses related to the injury.

*The WELS VEBA Group Health Plan excludes payment for claims if the injury or illness is work-related. Congregations or organizations must have workers' compensation insurance to properly protect their workers.*

Coverage and rates for such coverage are established by state law and are not negotiable for competitive bidding. However, non-rate factors such as dividends, claims history and other insurance company factors will also be considered by the company when establishing premiums. Premiums generally are based on the payroll of the employer. For workers' compensation insurance purposes, "Ministers of the Gospel" are considered employees. *Most medical insurance programs, including the WELS VEBA Group Health Plan, exclude coverage for work-related injuries.* For example, a pastor injured in an accident on his way to the hospital to make a sick call has insurance coverage under workers' compensation insurance and not under a regular medical insurance plan. The congregation's local insurance agent should be contacted to determine whether it has this coverage and, if not, how to obtain it.

Workers' compensation insurance should not be confused with unemployment compensation or long-term disability insurance coverage. Neither is a substitute for workers' compensation insurance because these coverages generally do not pay medical or hospital expenses but only provide a form of income replacement for the worker.

Amounts received from a workers' compensation insurance policy for lost wages due to a work-related injury or illness are not taxable if they are paid under a state law. If the employer continues to pay a worker's salary during recuperation and the worker returns his workers' compensation benefits to the employer, the employer may reduce the taxable income reported on Form W-2 by the amount returned.

## RECORDS RETENTION

Congregations and organizations should develop **written** record retention guidelines for all important documents. Requirements on different types of records vary so it is difficult to establish a comprehensive guide on how long specific records should be retained. A publication titled “Guide to Record Retention Requirements” is available for a nominal cost from the Superintendent of Documents, U.S. Government Printing Office, Washington, D.C. 20402.

Records and reports on wages and compensation paid to employees should be kept indefinitely, possibly on microfilm or microfiche. Most other tax-related records should be kept at least four years. Publication 1828 provides a list of important records to keep **four** years:

- Amounts and dates of all wage, annuity, and pension payments.
- The fair market value of in-kind wages paid.
- Names, addresses, social security numbers and occupations of employees and recipients.
- Any employee copies of Forms W-2 and W-2c that were returned to you as undeliverable.
- Dates of employment.
- Periods for which employees and recipients were paid while absent due to sickness or injury, and the amount and weekly rate of payments you or third-party payers made to them.
- Copies of employees’ and recipients’ income tax withholding allowance certificates (Forms W-4).
- Dates and amounts of tax deposits made and acknowledgment numbers for deposits made by EFTPS.
- Copies of returns filed.
- Records of fringe benefits provided.

As a guideline, other records which the congregation or organization may consider keeping include:

- Offering envelopes – one year
- Financial secretary offering summaries – indefinitely
- Purchase, construction or major improvements of buildings or residences – indefinitely
- Movable asset purchases – indefinitely, or until asset is disposed of
- Financial asset records such as for stocks, bonds, mutual funds including dividend reinvestment plans – until sold
- Member loan documents – four years after payoff
- Evidence of indebtedness, i.e. mortgage notes – until paid in full and evidence of satisfaction received
- Expense reports and paid invoices – four years
- Canceled checks – four years
- General ledgers, cash receipts journals, cash disbursement journals – indefinitely
- Financial statements – one copy indefinitely
- Minutes of official board, council and voter meetings – indefinitely
- Ministrations, i.e. baptisms, marriages, burials, confirmations – indefinitely
- Articles of Incorporation and Bylaws – indefinitely
- Tax Exemption Certificates and/or IRS Determination Letters – indefinitely
- State Government Reports (Domestication purposes) and Certificate of Authority -- indefinitely.

## INCOME

Certain types of income are treated differently by “Ministers of the Gospel” than by other employees. Thus, it is important to be familiar with the income types and how each is treated for tax purposes. All income that is not specifically exempt is taxable. The taxpayer must keep accurate records of all income that is not subject to income tax. The following listing includes taxable and nontaxable income types according to IRS Publication 525:

Income Item	Subject to Income Tax	Subject to SECA/FICA Tax
Salary	Yes	Yes
Auto allowance	Yes	Yes
Honoraria for marriages, baptisms, etc	Yes	Yes
Cash gifts from employer	Yes	Yes
SECA tax reimbursement	Yes	Yes
Writers fees	Yes	Yes
Cost of living allowance	Yes	Yes
Scholarship for room, board, living	Yes	Yes
Retirement gifts from employer	Yes	Yes
Personal use of church auto	Yes	Yes
Church provided housing		
- Ministers	No	Yes
- Non-ministers	Possible	Possible
Parsonage allowance (Sec 107)	No	Yes
Cash housing allowance		
- Ministers	Yes	Yes
- Non-ministers	Yes	Yes
Medical insurance paid by employer	No	No
Group term life insurance < \$50,000	No	No
Pension premium	No	No
Workers' compensation wage payments	No	No
Direct gifts from relatives, members	No	No
Accountable expense reimbursements	No	No
TSA contributions made by		
- Ministers	No	No
- Non-ministers	No	Yes
Moving expenses, if deductible	No	No
Below fair market value sale of employer property to employee	Yes	Yes
Severance pay	Yes	Yes
Small, non-cash or non-cash equivalent gifts from employer	No	No
Tuition reduction for a school employee or their dependents	No	No
Meals provided by employer	Possible	Possible
Relocation allowance	Yes	Yes
Interest on below-market rate loans from employer	Yes	Yes
Cancellation of loan by employer	Yes	Yes
Free tour for the person guiding the tour	Yes	No
Tuition Refund Plan payments	Yes	No
Utilities allowance		
- Ministers	Yes	Yes
- Non-ministers	Yes	Yes

## UNRELATED BUSINESS INCOME

### Trade or business

The unrelated business income tax (“UBIT”) provisions in IRC Section 512 apply to synod churches or organizations that have income from “operating a trade or business.” Three criteria must exist for a tax-exempt organization to be taxed on unrelated business income:

1. The church or organization must be operating a trade or business;
2. The trade or business must function as an ongoing business; and
3. The conduct of the trade or business must not be substantially related to the church's tax-exempt purpose.

If these three criteria are present, the income generated by the trade or business will be subject to income taxes. The main reason that UBIT is imposed is to put not-for-profit and for-profit organizations on a comparable basis for activities related to carrying on a business. To do otherwise would be to give an advantage to not-for-profit organizations.

Even if the three criteria exist, the income may not be subject to tax if it meets one of the following exceptions:

1. Substantially all of the work operating the trade or business is performed by volunteers;
2. The activity is conducted by the organization primarily for the convenience of its members; or
3. The trade or business involves the selling of merchandise substantially all of which is donated.

Examples of potential “trades or businesses” which may generate unrelated business income are a used clothing store, a day care center, or a lawn service operated by a church with profits going to support the church. The key to determining taxability is that the activity is not substantially related to the tax-exempt purpose. The use of the profits from the trade or business is not a factor in determining taxability.

### Real estate rentals

If a church or organization rents or leases property that it owns to others, the rental income is not subject to UBIT pursuant to IRC Section 512(b). However, it may be subject to UBIT if the property is debt-financed with external debt, i.e. the property is mortgaged by outside parties. Interfund borrowing does not qualify as debt-financed. Limited exceptions exist to exempt property even if it is debt-financed. The congregation or organization is advised to contact a qualified tax advisor if it owns mortgaged real property that it rents out or leases to others.

### Reporting

Unrelated business income is subject to regular federal corporate income tax rates with a \$1,000 deduction from net income before applying the rates. IRS Form 990-T or Form 990-EZ are used to report income, deductions and tax due. In addition, many states have similar reporting and taxpaying requirements.

## SELF-EMPLOYMENT TAX SUPPLEMENTS

Congregations and organizations may choose to reimburse their “Ministers of the Gospel” for a portion of their self-employment (social security) taxes. This is acceptable to the IRS but any such reimbursements must be considered additional compensation (even if the congregation or organization considers this reimbursement a gift) and reported on the worker's Form W-2 along with other forms of compensation.

*Self-employment (social security) tax supplements are taxable income in the year paid for both income and self-employment tax purposes.*

Because a number of factors are relevant to such a reimbursement policy, a uniform policy is virtually impossible to establish. **The key factor is determining what will be considered in the self-employment earnings calculation.** Provided below are a number of considerations that the congregation or organization should keep in mind when deciding how much to reimburse a “Minister of the Gospel”:

- Self-employment tax is paid by a “Minister of the Gospel” on all forms of compensation including the fair rental value of a residence provided and the parsonage allowance.
- A “Minister of the Gospel” can deduct unreimbursed professional expenses when calculating his self-employment earnings.
- Some “Ministers of the Gospel” opt out of social security and therefore pay no self-employment tax.
- A “Minister of the Gospel” must make estimated tax payments on these self-employment supplements during the year and therefore needs the cash reimbursement during the year rather than after the end of the year.
- A “Minister of the Gospel” must pay federal income, state income and self-employment taxes on the reimbursements in the year such reimbursements are paid.
- The effective self-employment tax rate is not necessarily twice the FICA tax rate because of certain deductions that the IRS grants to self-employed individuals (See “Social Security Tax”).
- A “Minister of the Gospel” does not pay self-employment tax on amounts he contributes to his tax-sheltered annuity (403(b) plan).

The congregation or organization should consider documenting such a reimbursement plan through a formal resolution of the congregation. A simple resolution might read as follows:

“Within the provisions of the Internal Revenue Code of 1986, as amended, to assist our “Ministers of the Gospel” with their self-employment tax liability brought on by their dual tax status, the congregation elects to provide additional compensation to its “Ministers of the Gospel” to be calculated as [Form W-2 compensation plus parsonage allowance plus fair rental value of housing provided times the effective self-employment tax rate of 15.3%].”

Note that this resolution would need to be reviewed each year because of the potential that the self-employment tax rate may change.

## OTHER RECEIPTS

### Honoraria, Gifts and Awards

Payments from individuals for performing weddings, baptisms, funerals, etc. are taxable income and reported on Schedule C along with corresponding expenses. All monetary awards paid through the congregation or organization to employees are taxable income reportable by the employer in Box 1, Form W-2 according to IRC Section 102(c). The employer stipulating the award as a gift does not change the taxability to the employee. Taxable cash or cash equivalent (gift certificates, coupons, etc.) gifts include Christmas gifts, service awards, anniversary awards, honoraria and retirement and termination gifts. Hams, turkeys and all such non-cash or non-cash equivalent items of a nominal value given to employees are not taxable income to them.

### Tuition Refund Received

Payments received by pastors and teachers under the Tuition Refund Plan represent taxable income in the year received. Such payments are not subject to social security. Form 1099-MISC is issued from the synod to each recipient of a tuition refund plan payment.

### Pension and Support Payments

Concerning pension and support payments, IRS Publication 525 states:

“A pension or retirement pay for a member of the clergy is usually treated as any other pension or annuity and must be reported on line 16a and lines 16b, Form 1040.”

“Ministers of the Gospel” must include in income offerings and fees received for marriages, baptisms, funerals, etc., in addition to salary. However if the offering is made to the religious institution, it is not taxable to the “Minister of the Gospel”.

Upon retirement, the benefits paid under the synod's or any other qualified pension plan is taxable income on the federal return. State requirements vary so please contact your tax adviser to determine whether pension benefits are taxable in your state. “Ministers of the Gospel” receiving such payments may have a parsonage allowance designated by the synod or other employing body with which he is associated. Thus, the cost of his housing can be treated as a non-taxable pension to the extent used by him for parsonage expenses under regular IRC Section 107 requirements.

### Barter Income

Barter is the exchanging of property or services. For example, a secretary may perform secretarial services for the church in exchange for the church school educating her child. The fair market value of property or services received in bartering must be included in income at the time received. If services are exchanged with another person and both parties have agreed upon the value at that time, that value will be considered the fair market value unless it can be shown to be otherwise. The value must be established objectively without regard to any relationship or partiality between the parties involved. This income should be reported on Schedule C or Schedule C-EZ on Form 1040.

## EMPLOYMENT RELATED FORMS

### Form W-4

When an organization calls or hires an employee, the IRC requires it to obtain and keep a Form W-4 for that employee in a permanent file. This form gives the employee's name, address, social security number, marital status and the number of withholding allowances which the congregation or organization will use to calculate the amount of federal income tax to withhold each pay period. The individual completes Form W-4 and the congregation or organization uses that information to compute withholding amounts.

Although "Ministers of the Gospel" should also complete a Form W-4, they need not complete the allowances portion unless the congregation or organization established a withholding agreement with them. If no withholding agreement exists, the "Minister of the Gospel" simply notes Minister of the Gospel, Exempt from Withholding in the allowances section and the congregation or organization keeps the form in his permanent personnel file.

The IRS requires all employers who receive a Form W-4 with more than 10 allowances to submit a copy of that employee's form to the IRS. In the absence of a Form W-4, the congregation or organization must withhold at the highest possible rate, that is, as if the employee was single with no allowances.

### Form I-9

The Immigration Reform and Control Act of 1986 prohibits employers from hiring aliens who are not authorized to work in the United States. This act was signed into law on November 6, 1986, and enforcement commenced on June 1, 1987. The law attempts to control illegal immigration through a system of sanctions and record keeping requirements imposed upon employers. The law prohibits employers from knowingly hiring illegal aliens and they must verify that all employees hired after November 5, 1986, are eligible to be hired. Employees hired after November 5, 1986, are required to complete Form I-9 Employment Eligibility Verification. The employing body must examine the documentation required by the form within three business days after hiring and the form must also be completed in that time period. The completed form must be retained for three years after hire, or one year after termination of employment, whichever is longer.

The documentation, which has been approved for use by both employers and employees, includes either one original document verifying both identity and work eligibility; or one document establishing identity and a separate document verifying work eligibility. Proper forms of documentation and instructions for completing and maintaining the form are listed on its reverse side.

Form I-9 must be completed for all new workers, called or hired, by all congregations and other religious bodies which call or hire workers. No employers and no employees are exempt under this act. Both the employer and the employee must sign the completed form. The Form I-9 is available by contacting the nearest US Department of Justice, Immigration and Naturalization Services office.

## REPORTING WAGES AND SALARIES

The wages and salaries paid to all employees of the employing body including “*Ministers of the Gospel*” must be reported on Form W-2 at year-end for income tax purposes. IRS Publication 517, Social Security and Other Information for Members of the Clergy and Religious Workers states: “...because of

common law rules...you may be considered an employee for income or retirement plan tax purposes.” The congregation or organization is required to withhold both federal income and social security taxes on all employees other than “Ministers of the Gospel”, which are specifically exempted.

*WELS pastors and teachers are employees and should be issued a Form W-2 for the compensation they receive from their congregation or organization.*

### Form W-2

Form W-2 for a calendar year is issued to each employee by January 31 of the subsequent year. Wages, cash allowances and other amounts listed below paid or given to employees must be included as taxable income in Box 1, Form W-2:

- Wages and salaries to “Ministers of the Gospel” and employees
- Wages paid to Vicars
- Wages paid to Teacher Interns
- Wages paid to Staff Ministry Interns
- Cash housing allowances
- Vacation pay
- Automobile allowance
- Furniture allowance
- Utilities allowance
- Cost of living allowance
- Bonuses and commissions
- Christmas and other gifts paid to employees
- Honoraria (payments for service on which custom forbids a price to be set)
- Social security tax supplements
- Value of an employer provided vehicle (personal use portion)

Areas that deserve special attention are Christmas and other gifts provided to employees. The IRS does not prohibit giving gifts to employees; however, these gifts, as stated in IRC Section 102(c) “...are not excludable from the employee’s income.” They are subject to income and all social security taxes. The only exception would be a non-cash or non-cash equivalent gifts of *de minimis* value, less than \$25.

Please note that the above listing is not all-inclusive. **The general rule is that if the payment is in any way processed through the books of the church or organization or paid out of its funds, then the payment should be reported as taxable compensation and included on the Form W-2.** When preparing the Form W-2, it is helpful to prepare a worksheet for each “Minister of the Gospel” in order to arrive at the total shown in Box 1, Form W-2. The worker may be given a copy of the worksheet so that he/she knows how the taxable income amount was calculated. The worksheet may take on a form similar to the one that follows. The sample worksheet and Form W-2 have been completed for a “Minister of the Gospel”.

**WORKSHEET FOR CALCULATING TAXABLE INCOME, BOX 1 FORM W-2**

Name: Rev John Smith For the year: 20XX

1.	Salary (before deducting parsonage allowance)	\$ <u>37,566</u>
2.	Add: Cash Housing Allowance	<u>0</u>
3.	Automobile Allowance	<u>1,500</u>
4.	Utilities Allowance	<u>900</u>
5.	Social Security Allowance	<u>2,943</u>
6.	Children's Paid Education	<u>0</u>
7.	Relocation Reimbursements	<u>0</u>
	<b>GROSS PAY</b>	<u>42,909</u>
8.	Deduct: Tax Sheltered Annuity (Box 12, Form W-2)	<u>(1,800)</u>
9.	Parsonage Allowance, Sec. 107 (Box 14, Form W-2)	<u>(6,400)</u>
10.	<b>W-2 WAGES, BOX 1</b>	<u>\$ 34,709</u>

Note:

- Salary (#1) is amount approved per the congregation or organization's internal compensation plan.
- Cash Housing Allowance (#2) is cash paid for housing which worker is furnishing.
- Utilities Allowance (#4) is cash paid to worker for utilities. Do not show amounts paid directly to a utility company by church or school.
- Children's Paid Education (#6) are payments to school for called worker's child by church.
- Relocation Reimbursement (#7) are only the amounts paid directly to the called worker for relocation.
- Parsonage Allowance (#9) is the amount that the congregation designates as such by resolution.
- Do not send this form to the IRS.

a Control number		22222		OMB No. 1545-0008				
b Employer identification number (EIN) 99-1234567			1 Wages, tips, other compensation 34,709	2 Federal income tax withheld				
c Employer's name, address, and ZIP code XYZ Lutheran Church 1000 Main Street Anytown USA 00000 (818) 555-1212			3 Social security wages	4 Social security tax withheld				
			5 Medicare wages and tips	6 Medicare tax withheld				
			7 Social security tips	8 Allocated tips				
d Employee's social security number 123-45-6789			9 Advance EIC payment		10 Dependent care benefits			
e Employee's first name and initial		Last name		11 Nonqualified plans		12a		
John C. Smith		Smith		13 Statutory employees <input type="checkbox"/> Retirement plan <input checked="" type="checkbox"/> Third-party sick pay <input type="checkbox"/>		E   1,800		
1002 Main Street		Anytown USA 00000		14 Other PRNG 6,400		12b		
f Employee's address and ZIP code					12c		12d	
15 State	Employer's state ID number	16 State wages, tips, etc.	17 State income tax	18 Local wages, tips, etc.	19 Local income tax	20 Locality name		
USA	12345	34,709						

Form **W-2** Wage and Tax Statement  
Copy 1—For State, City, or Local Tax Department


**2005**

Department of the Treasury—Internal Revenue Service

Form W-2 - Other Church Employees

Called female teachers are considered employees for both federal income tax and social security purposes according to a private letter ruling from the IRS dated May 7, 1956. Compensation paid to female teachers and other full and part-time workers such as organists and janitors must be reported using Form W-2. Wages, allowances and other amounts listed in the previous section must be included as taxable income. Housing provided may or may not have to be included in taxable income and social security wages depending on the circumstances. See "Housing" for additional information.

Federal and state income taxes and social security taxes withheld must be reported on Form W-2. Note that there are two boxes on the Form W-2 (Box 3 and 5) that must be completed. Generally, the amount in Boxes 3 and 5 will be equal. However, only 6.2% of the social security tax withheld is entered in Box 4. The balance of 1.45% is entered in Box 6. Please see 'Employment Tax Withholding' for a further explanation. A sample of a completed Form W-2 is shown below for a called female teacher.

a Control number		OMB No. 1545-0008		Safe, accurate, FAST! Use  Visit the IRS website at <a href="http://www.irs.gov/efile">www.irs.gov/efile</a> .		
b Employer identification number (EIN) 99-1234567		1 Wages, tips, other compensation 26,000	2 Federal income tax withheld 3,900.00			
c Employer's name, address, and ZIP code XYZ Lutheran Church 1000 Main Street Anytown USA 00000 (818) 555-1212		3 Social security wages 26,400	4 Social security tax withheld 1,636.80			
		5 Medicare wages and tips 26,400	6 Medicare tax withheld 382.80			
		7 Social security tips	8 Allocated tips			
d Employee's social security number 123-45-9876		9 Advance EIC payment		10 Dependent care benefits		
e Employee's first name and initial Last name Mary A. Jones 2000 Anytown Avenue Anytown USA 00000		11 Nonqualified plans		12a See instructions for box 12 E 400.00		
		13 Statutory employee <input type="checkbox"/> Retirement plan <input checked="" type="checkbox"/> Third-party sick pay <input type="checkbox"/>	12b			
		14 Other		12c		
				12d		
f Employee's address and ZIP code						
15 State USA	Employer's state ID number 12345	16 State wages, tips, etc. 26,000	17 State income tax 1,820.00	18 Local wages, tips, etc.	19 Local income tax	
				20 Locality name		

Form **W-2** Wage and Tax Statement **2005** Department of the Treasury—Internal Revenue Service  
 Copy B—To Be Filed With Employee's FEDERAL Tax Return.  
 This information is being furnished to the Internal Revenue Service.

Form W-3 is a transmittal form for mailing Copy A of all Forms W-2 prepared for the year. Box 1 wages on Form W-3 should equal the total of Box 1 wages reported on all attached Forms W-2. Additionally, Boxes 2-6 on Form W-3 should equal the total of the corresponding Forms W-2. Form W-3 and all appropriate copies of Forms W-2 are to be sent to the Social Security Administration Data Operations Center by the last day of February of each year for the previous year's information. The address of the Center for the area of the church or organization can be found on the back of Form W-3. The IRS requires certain businesses to file their tax information returns on magnetic media. Please see "Reporting Other Payments."

## Form 941

All employee compensation, which includes wages, gifts, bonuses, etc., must be reported to the IRS annually on Forms W-3 and the employee's Form W-2 as well as on Form 941, Employer's Quarterly Federal Tax Return. Form 941 reports total W-2 wages, social security wages, federal withholding taxes and social security taxes as well as a record of when those taxes should have been remitted to the IRS.

Form W-2 wages should be reported quarterly on Form 941 even if the only employee is a "Minister of the Gospel". In this case, the congregation or organization enters total Box 1, Form W-2 wages on line 2 and submits the form each quarter as long as those wages are paid. At the end of each tax year, the total of line 2 of the four quarterly Form 941's should equal the total Box 1, Form W-2 wages reported to the IRS. In addition, the total of line 3 should equal the total amount of federal income taxes withheld as reported in Box 2 of Forms W-2. Note that the Parsonage allowance is earned proratably during the year. To avoid large negative adjustments in the final quarter, report only the wages that are subject to income taxes on line 2 of Form 941.

Form 941 also details when withheld taxes should have been deposited. The IRS requirements for making tax deposits are found in the Form 941 instructions, the annual Circular E, and in a letter that each employer should receive from the IRS every year. There are severe penalties and interest charges for untimely tax deposits. Therefore the congregation or organization should regularly review how often it needs to remit these taxes, especially if there are substantial personnel changes such as adding or terminating an employee.

The IRS has changed how withheld taxes are to be deposited. Organizations with annual withholding taxes have been making electronic transfers for their tax deposits ("EFTPS") beginning in 1997. Companies with annual deposits in excess of \$200,000 are required to file by EFTPS. If your organization will be required to make electronic deposits, you will receive a notice and application form for your enrollment in this program.

Corrections to prior quarters' filings of Form 941 are made on Form 941c. Form 941c is to be attached to the Form 941 to explain the correction. Contact the IRS for Form 941c and instructions. If the congregation or organization is not filing Form 941 currently, contact the local IRS office to request a blank form. After the first filing of the form, the IRS will automatically send a new form near the end of each quarter.

## New Hire Reporting

The Personal Responsibility and Work Opportunity Reconciliation Act of 1996 (PRWORA) requires employers to notify the government of all new hires. A new hire is defined as either an individual who reports to work with an employer for the first time or one that is rehired after an absence of greater than 90 days. The following information must be forwarded, within 20 days after the date the employee starts work:

Date of employment

Name, address, social security number of employee and date of birth

Name, address and federal ID number of employer

This is a federal law that is also requiring all states to comply. There are no exceptions given for small organizations or not-for-profit organizations. Because states have the option of adopting even stricter requirements than the federal law, we recommend that you contact your State's Department of Revenue regarding forms and information required for compliance.

## REPORTING OTHER PAYMENTS

The federal government requires that certain kinds of non-employee payments be reported if the payment is made to an individual or partnership. Generally, the Form 1099 series is used to report these kinds of payments and common forms that may be applicable to the congregation or organization are Forms 1099-MISC and 1099-INT.

### Miscellaneous Payments

The congregation or organization must issue and file a Form 1099-MISC when it makes payments of \$600 or more in a calendar year to the same individual, partnership or business for 1) rent or 2) any kind of service (such as carpentry, electrical work, roofing, etc.), performed by a non-employee individual during the course of business. There are other less common circumstances when the Form 1099-MISC may need to be filed. 2005 Instructions for Form 1099-MISC gives details on such circumstances. If payments are less than \$600 the organization has the option to issue the Form 1099-Misc.

*Congregations and organizations must issue Form 1099-MISC to individuals and partnerships to whom they pay \$600 or more in a year for performing services.*

### Interest Payments

Congregations and organizations that borrow from their members and pay interest should issue and file Form 1099-INT. This form is filed for each individual to whom the church body pays \$600 or more in interest in a calendar year. If the congregation or organization issues regular statements to the loaning members, it may not have to mail a separate copy of Form 1099-INT to the individual. 2005 Instructions for Form 1099-INT and 1099-OID give filing details on Form 1099-INT.

### Transmitting Forms 1099

Regardless of which Forms 1099 are issued, a Form 1096 transmittal should also be completed and filed with the IRS. This form simply summarizes the statements being transmitted. The original of each Form 1099 is sent with the Form 1096, one copy of the Form 1099 is mailed to the individual and one copy is retained by the filing organization. Forms 1099 for the prior year must be issued by January 31 of each year to the individual who received the interest or payment and filed by February 28 with the IRS. The congregation or organization may have to file on magnetic media or electronically. See the following section for further information.

In order to file these forms, the filing organization will need the taxpayer's social security number. To obtain this number, the individual should complete a Form W-9 Payer's Request for Taxpayer Identification Number. The Form W-9 should be retained by the congregation or organization along with its other tax information as proof of receiving the information from the taxpayer. It is suggested that this form be completed **prior** to the work being done. The congregation or organization may wish to consider finding a new contractor if the original contractor refuses to complete the Form W-9.

Penalties exist for not filing or for late filing of proper information returns. Generally, the penalty is \$50 per return if the organization does not file a timely return, does not furnish a copy of the return to the payee, or does not include a social security number on the information return. 2005 General Instructions for Forms 1099, 1098, 5498 and W-2G gives details on other penalties and how they apply.

### Electronic/Magnetic Media Filing

An organization must report electronically or by magnetic media if they file at least 250 1099-MISC's (payments for services provided by individuals), 1099-INT's (for interest payments), or 1098's (mortgage interest received). Churches or organizations that are required to file should contact the IRS and request Form 4419 Application for Filing Information Returns on Electronic/Magnetic Media.

Media reporting can take a number of forms including electronic, magnetic tape, or 3-1/2 inch diskette. However, the filing organization must receive approval from the IRS before filing any forms on magnetic media. Filing deadlines for electronic and magnetic media are the same as for paper reporting. Publication 3609 may help with information on EFTPS and the options for filing.

Form W-2 goes to the Social Security Administration ("SSA"), therefore, Form 4419 for the IRS is not used. The SSA currently accepts both magnetic media and electronic reporting. Please contact Patricia at [Patricia.A.Hayes@ssa.gov](mailto:Patricia.A.Hayes@ssa.gov) for questions on electronically filing W-2's.

## **SUBSTITUTE PASTORS, TEACHERS AND INDEPENDENT CONTRACTORS**

In determining whether a substitute is an employee or an independent contractor, the congregation or organization must determine whether a significant relationship has formed. Consideration of a significant relationship may include how regularly the substitute is used.

*Paying \$108.28 or more in a calendar year to a substitute pastor, teacher, organist, janitor or other worker requires withholding taxes and, when appropriate, matching FICA.*

When an organization (employer) forms an employment relationship and pays a substitute teacher, substitute “Minister of the Gospel” or organist, it should place such a person on its payroll. The congregation or organization must withhold necessary social security and income taxes from the compensation paid and issue a Form W-2 at year-end to the employee. According to Publication 1828, non-profit organizations that pay an employee less than \$108.28 in a given year need not withhold and match social security taxes. However, federal and state taxes, if any, must be withheld and such wages and withholdings must be reported on Form W-2. If another organization or person is responsible for the costs of the substitute, then that organization or person should reimburse the employing body for salary and any social security taxes paid by the congregation or organization.

In cases in which employers report an employee as an independent contractor, the law dictates that the employer “will be liable for income tax and employee social security tax if the taxes are not deducted and withheld.” (Refer to IRC Section 3509.) Additionally, these taxes will be subject to the payroll tax penalties up to 10% of total tax due with an interest charge retroactive to the date payments were first made.

The associated penalties make it prudent for any congregation or organization to closely scrutinize requests to pay a potential employee as an independent contractor. Several of the characteristics listed in guidelines provided in Revenue Ruling 87-41 indicate an employer/employee relationship exists when a person:

- Is required to comply with instructions about when, where and how work is to be done.
- Is provided an office and materials by the organization.
- Is trained by an experienced employee of the organization.
- Performs services which are integrated with the organization.
- Is hired, supervised and paid by the organization.
- Works hours as set by the organization.
- Submits regular reports to the organization.
- Receives compensation based on hours, days, weeks or months as opposed to a fixed amount per task or project.
- Is provided tools and materials by the organization.
- Is not in position to recognize a profit or loss on duty performed.
- Performs services which can be terminated by the organization at anytime without incurring liability.

The list is not all-inclusive. Please contact your tax advisor as needed.

## FRINGE BENEFITS

For tax purposes, gross income includes all income from whatever source unless specifically excluded under the IRC. As long as the employer follows the strict requirements, submits necessary reports and does not discriminate among its employees, certain fringe benefits excluded by the IRC are “qualified” and, therefore, are not taxable income to the employee. Any non-qualified fringe benefits provided to the employee are considered taxable fringe benefits and are included on the employee’s Form W-2 as compensation in the amount paid or at the fair market value of the benefit provided.

Generally, qualifying non-taxable fringe benefits can be provided to any employee, called or lay. Because “Ministers of the Gospel” are considered “employees” they may also receive fringe benefits tax-free. The following is a list of some of the more common fringe benefits that an employer can provide to employees tax-free:

- Medical and health insurance
- Disability insurance
- Dental Insurance
- Group term life insurance up to \$50,000
- Pension payments on behalf of the employee
- Tuition reduction below graduate level provided the employer is a school
- Scholarships if used for tuition, fees, books, etc., but not for room and board
- Medical expense reimbursements under a proper plan
- Dependent care expense reimbursements under a proper plan
- Continuing education cost reimbursement up to \$5,250 for undergraduate study and graduate level courses (effective January 1, 2002)
- Outsourcing assistance
- Occasional typing of personal letters
- Occasional personal use of church duplicating machine
- Local telephone calls
- Subscriptions to professional publications paid for by the employer on behalf of an employee
- Employer paid moving expenses, if the expenses would have been deductible if you had paid them yourself (See Publication 521, “Moving Expenses” for more detail)
- Employer-provided group legal services
- Employer-provided dependent care
- Employer paid or reimbursed adoption expenses up to \$10,630 (\$10,960 for 2006) per child. (Form 8839 is required)

Other fringe benefits may also be provided on a tax-free basis. Congregations, other organizations, and employees are encouraged to seek advice from their tax advisor when determining the taxability of any fringe benefit.

## HOUSING

### Discrimination

Each congregation and organization is encouraged to consider that discrimination in providing housing, whether in the form of a cash housing allowance or provided housing, may be in violation of federal discrimination laws. Although this does not mean that all housing provided or cash allowances must be equal, there must not be discrimination in the determination of the benefit. If this benefit is provided, congregations and organizations are strongly encouraged to provide it to its workers on an equal basis.

### Fair Rental Value

This designation is given to the “value” of a house or parsonage, including utilities, provided as part of a “Minister of the Gospel’s” compensation. For the “Minister of the Gospel” who has not received an exemption from self-employment tax, this value must be included in net earnings for self-employment (social

*IRC Section 1402(a)(8) requires that “Ministers of the Gospel” add the fair rental value of their **provided** home when calculating social security tax liability.*

security) tax purposes. The “fair rental value” may be based on a professional appraisal of the home or some other reasonable, documentable means of determining the value such as newspapers or realtors considering the location and neighborhood. Realtors use the “rule of thumb” that fair rental value (without furnishings) amounts to 1% of the appraised value per month. For example: a home appraised at \$100,000 could have a fair rental value of \$1,000 per month. However, the facts of each situation must be taken into consideration, including the condition and location of the house, the local market demand and local economic conditions. It is also important that a reasonable method of determining the fair rental value is consistently applied from year to year.

The amount designated as fair rental value of the church-owned home or parsonage is added back when calculating self-employment income. Some “Ministers of the Gospel” have excluded the fair rental value of their home from self-employment income (excluded for social security tax purposes) maintaining that their housing also meets the conditions described in *Rowan Companies, Inc. v. United States, No. 80-780, 101 Sct. 2288, 452 US 247*. In 1982, the U.S. Supreme Court ruled in the “Rowan” case that “where an employer provides housing for an employee for the convenience of the employer, it is not reportable income for any tax, including social security.” This case was based on IRC Section 119 dealing with non-minister housing and not IRC Section 107 allowing ministers to receive tax exempt housing. IRC Section 1402(a)(8) states that a minister’s provided housing must be included for social security tax computations.

Some churches, to assist their “Ministers of the Gospel” in calculating their self-employment taxes, set the ‘fair rental value’ of their workers’ housing. To do this, the amount of rent needs to be the same amount the church would charge an unrelated party.

## Cash Housing Allowance

A cash allowance is paid to a worker who owns or rents his/her own housing. It is treated as salary for tax purposes, included in the calculation of what is reportable on Form W-2, and subject to federal and state income tax as well as self-employment social security taxes for all workers who receive it. (Also see “Parsonage Allowance”.)

## Lodging Furnished Employees

For non-“Ministers of the Gospel”, such as called female teachers and lay employees, the value of employer-furnished lodging is not taxable if all three of the following conditions are met:

1. Lodging is on the employer’s business premises,
2. It is for the employer's convenience, and
3. It is a condition of employment.

The value of living quarters that are provided and do not meet the conditions given above is taxable income and subject to social security taxes. Item one above has been interpreted by the IRS, in Letter Ruling 8213005, and the courts, in *Goldsboro Christian School, Inc. v. Commissioner*, 436 F. Supp. 1314 (D.D.C.1978), as not merely housing owned by the church or organization but at the actual place of business. In one situation, the value of housing provided to hospital employees in an apartment across the street from the hospital was taxable because the apartments were not where the employees conducted their business (IRS Letter Ruling 8938014, June 23, 1989).

## Benefits of Home Ownership

A “Minister of the Gospel” owning his own home has additional tax benefits, a “double deduction” for the mortgage interest and real estate taxes he pays on his home. These items may be included when calculating the non-income taxable parsonage allowance and may also be deductible when itemizing deductions on Schedule A of Form 1040.

In some situations, a congregation provides a home for a “Minister of the Gospel” that is located either on or near the church and/or school property and require that they live in the home provided. The called worker may want to consider purchasing a home for investment purposes and/or to provide a place for retirement. The purchased home could be rented to outside parties, giving him additional income to pay for the home’s expenses. However, if he does not live in the home, he cannot claim the parsonage allowance with respect to that home.

Home ownership provides additional benefits to the minister: he builds equity through the house payments made through time and money spent on improvements; has freedom to make changes without securing congregational approval; and entitles him to the “double deduction” mentioned above. Up to \$500,000 in gain on the sale of a residence may be excluded from taxes for qualified married couples and \$250,000 for single taxpayers. This allows the homeowner to exclude from income the appreciation on his/her residence. To qualify, the owner must have owned the home for five years before the sale and used it as the primary residence during two of those five years. This benefit can be used once every two years, unless the move is a result of a job change. If your current home used the prior law’s two-year rollover to defer any gain, your current home includes the use of the prior law. If you cannot meet the two-year residency test because of unplanned events such as a job change or health problem, you can exclude the portion of profit that is proportional to the time you lived there.

Depending on the situation, it may be less expensive for the congregation to pay a cash housing allowance than to provide housing. The proceeds from the sale or rental of the church-owned home can be invested generating interest income to offset a portion of the cash housing allowance. If the home is sold, related repairs, maintenance and insurance costs disappear and an adequate cash housing allowance can be paid to the “Minister of the Gospel”.

In the synod’s Report to the Ten Districts, May 1982 p. 152ff, the Committee on Cash Housing Allowances issued a detailed report and analysis of housing. It came to no definitive conclusion on whether it is more advantageous to provide housing or a cash allowance.

## PARSONAGE ALLOWANCE

Under IRC Section 107, “Ministers of the Gospel” may have a portion of their compensation designated as a parsonage allowance, also known as a rental allowance. Only workers who are correctly classified as “Ministers of the Gospel” are eligible for the parsonage allowance benefit. See “Tax Status - Ministers of the Gospel” for additional information on this distinction.

For “Ministers of the Gospel” qualifying for a parsonage allowance, the allowance is not income for federal income tax purposes to the extent it is used by the worker in the year received to provide for a home and pay utilities. The congregation or organization receives the request from the pastor and male called workers and passes a resolution officially designating the requested amount as a “parsonage allowance.” This resolution should be entered into the minutes of the congregational or board meeting as official documentation of the amount designated. An amount may be designated for a partial year or may be changed to a new amount, prospectively, for the balance of the calendar year. The resolution may read as follows:

Under provisions of Section 107 of the Internal Revenue Code, the “Ministers of the Gospel” listed below may have a portion of their compensation designated as a parsonage allowance. The amount indicated shall be the designated parsonage allowance for the year 20xx and all future years unless otherwise provided. Should any of the workers listed be provided with a home, he shall have the rent-free use of the home for the year 20xx and all future years unless otherwise provided.

Rev. John J. Doe’s housing allowance designation is \$12,000.

Principal Mr. David D. Davis’s housing allowance designation is \$18,000.

Mid-year changes in personnel, delayed changes, and other unexpected contingencies: “40% (or specific \$ amount) of the salary of every minister and male teacher on staff, regardless of when hired, is hereby designated as a housing allowance for the current and all future years, unless otherwise specifically provided.”

Congregations and called workers should be aware that mid-year changes could result in the loss of favorable tax treatment under Section 107 in the event parsonage allowance not reported upon a mid-year change. The resolution above attempts to cover most situations, however, individual situations should be considered.

The parsonage allowance resolution **cannot be retroactive** to a specific date. It is suggested that the congregation or organization pass the parsonage allowance resolution late in the calendar year to apply to the next calendar year. The recommended resolution provides a “safety net” in the event the congregation or organization fails to record a designation in a particular calendar year. Resolutions for indefinite periods may be used although they become obsolete over time and need to be reviewed periodically. Although not recommended, a separate line item in a budget may also effect a parsonage allowance.

For new employees beginning during the year, the second paragraph of the recommended resolution provides a “safety net”, but should be reviewed with the called worker for any modifications he might need for the balance of the year. The resolution takes effect on the first of the month in which it is approved and entered into the minutes. For this reason, congregations and organizations should pass the parsonage allowance resolution before a new employee commences employment.

*Food and services cannot be claimed under the parsonage allowance. Items that may be claimed (not all inclusive) are:*

*Rent or entire house payment  
Property taxes  
Furniture and appliances  
Utilities  
Water/sewer*

When a “Minister of the Gospel” leaves the congregation or organization, the approved parsonage allowance should be pro-rated on a per payroll or monthly basis from the first of the year. The new congregation or organization should then pro-rate their parsonage allowance from their first payroll to the end of the calendar year.

A “Minister of the Gospel” who rents or is provided a church-owned home may include in the parsonage allowance expenditures for the utilities he pays such as gas, electricity, sewer and water, cable TV and non-business telephone. Other expenses that may be included in computing the amount of parsonage allowance are rent payments, furniture appliances and other expenses directly related to providing a home. Expenses specifically excluded by the regulations under IRC Section 107 are not allowable under the parsonage allowance are costs for food and services.

“Ministers of the Gospel” providing their own homes may consider mortgage interest, property taxes, down payments on a home, homeowner insurance, and insurance premium costs in addition to those listed in the preceding paragraph. Taxes and interest paid on a home mortgage are also deductible as itemized deductions on Schedule A of Form 1040.

According to IRS Publication 517, the maximum amount that a “Minister of the Gospel” may consider a parsonage allowance is the lowest of the following three amounts:

1. The amount actually used to provide a home;
2. The amount officially designated as a rental allowance; or
3. The fair rental value of the home, including furnishings, utilities, garage, etc.

A parsonage allowance can only be claimed on the residence in which a “Minister of the Gospel” lives and not on any other residence owned by him. In addition, a parsonage allowance deduction for mortgage payments will be fully allowed for first mortgages. Parsonage allowance deductions for second mortgages or home equity loans will not be allowed if the proceeds are used for other than home improvements, such as college tuition or auto purchases.

Once the parsonage allowance has been approved, the treasurer deducts that amount from the worker's gross compensation to arrive at the Form W-2 wages. The worker does not have to substantiate his house-related expenses to the congregation or organization unless it requires him to do so, but should maintain adequate records of expenditures. Any excess or unused parsonage allowance should be included on line 7 of IRS Form 1040, and described as “EXCESS PARSONAGE ALLOWANCE.”

## EMPLOYMENT TAX WITHHOLDING

IRS Circular E, Employer's Tax Guide, provides federal income tax and social security tax withholding tables for employers to use when calculating payroll tax withholding. The employer must remit all employment taxes to the federal government within the time periods detailed in Circular E or as required by the IRS in their annual letter to the employer. All employers receive a copy of Circular E and the previously mentioned letter automatically from the IRS each year as it is updated. State tax withholding regulations and deposits may differ from federal regulations. Contact the appropriate state authorities for current information.

Generally, all compensation including taxable fringe benefits paid to employees is subject to withholding unless specifically exempted by the IRC. The congregation or organization should contact their tax advisor if it is unsure whether an item of compensation is subject to withholding.

### Ministers of the Gospel

The congregation or calling body is not required to withhold any taxes from compensation paid to "Ministers of the Gospel". However, if the employer agrees, a "Minister of the Gospel" may establish a withholding agreement to have income taxes withheld from his paycheck based on a fully completed Form W-4. **Social Security taxes may not be withheld.** However, a voluntary increase in the Federal taxes withheld is acceptable and may be used to cover estimated self-employment tax liability. Sufficient federal tax withholding would mean the "Minister of the Gospel" would not need to make estimated Federal tax payments (social security) each quarter. No social security taxes or social security wages are reported on Form W-2. Any withholding agreement between the congregation or calling body should be written and must contain:

1. the name and address of the church or organization,
2. the name of the "Minister of the Gospel", address and social security number, and
3. a statement that the "Minister of the Gospel" agrees to have taxes withheld.

The withholding agreement may be terminated at any time in writing by either the congregation or calling body or the "Minister of the Gospel" himself.

### Vicars, Teacher Interns, and Staff Minister Interns

According to the IRS, students serving in the role of vicar and intern have an employee relationship with the church or school. Since they do not qualify as "Ministers of the Gospel", they are not exempt from employment taxes. The employer is required to withhold all taxes, including social security and Medicare from the students' wages.

### Other Employees

Effective January 1, 1984, social security coverage is mandatory and therefore social security tax must also be paid by all non-profit organizations on all salaries and wages paid to female called and all lay employees. The social security tax is separated into two parts--social security (old age, survivors, and disability insurance) and

*2005 social security rates are 7.65% for the employee and 7.65% for the employer. Ministers of the Gospel pay 15.3% self-employment tax.*

Medicare (hospital insurance). The employee's and employer's shares are 6.2% for social security and 1.45% for Medicare. The combined rate remains at 7.65% for 2005. The congregation or organization must pay a tax of 7.65% for 2005 and must also withhold Social Security tax at the combined rate of 7.65% on compensation paid to its employees. The IRS may update this rate on January 1 of each year. In addition, the maximum wage on which congregations or organizations must withhold and match Social Security tax can also change each year. The maximum for 2005 is \$90,000 for the social security portion (\$94,200 for 2006). There is no maximum for the Medicare portion.

The congregation or organization is also required to withhold and remit federal income taxes and, if applicable, state income taxes. Information on Form W-4 determines the amount to withhold. Based on Form W-4, the congregation or organization withholds federal income taxes according to the tables listed in the current year's Circular E.

The employer must report and remit all taxes withheld in a given pay period to the individual when the salary is paid. At year-end, the total withheld for social security, federal income and state income taxes is reported to the employee and the government on Form W-2.

Congregations and organizations created after September 30, 1984, may elect to be exempt from withholding and matching social security taxes. To elect exemption, the congregation or organization files IRS Form 8274 prior to the date on which the first quarterly Form 941, Employer's Quarterly Federal Tax Return, is due. **A congregation or organization that exempts itself makes its called female and lay workers liable for paying self-employment taxes on their personal tax returns. If it elects exemption, the congregation or organization should notify any prospective employees of this requirement.**

## SOCIAL SECURITY TAXES

The social security and Medicare taxes are collected under two acts: Federal Insurance Contributions Act (“FICA”) that requires both the employer and employee pay the taxes, and the Self-Employment Contributions Act (“SECA”) which requires a person who is self-employed to pay all of the taxes. No earnings are subject to both of these systems. Therefore, a worker either pays FICA tax or SECA tax on earnings from a particular occupation. The SECA tax rate for 2005 and 2006 remains at 15.3%. Self-employed workers, including Ministers of the Gospel, may deduct one-half of their self-employment taxes as an adjustment to gross income on page one of their Form 1040.

### Self-Employment (SECA) Taxes

A “Minister of the Gospel” has dual tax status. He is considered both an employee and a self-employed person for tax reporting purposes. IRS Publication 517 states:

“...you are considered a self-employed individual in performing your ministerial services for social security tax purposes. However...you may be considered an employee for income or retirement plan tax purposes.”

Earnings from self-employment include the gross income earned minus the expenses related to the gross income. Honoraria and offerings for marriages, baptisms, funerals, etc., minus the deductions reported on Schedule C that are related to the income are considered when figuring net earnings from self-employment. Payments made to “Ministers of the Gospel” to pay half or some other portion of the SECA tax is taxable income and treated as compensation. All unreimbursed ministerial business expenses may be deducted to arrive at the self-employment tax. However, unreimbursed meal and entertainment expenses are deductible only up to 50% of the otherwise deductible amount.

Not taxed for federal income tax purposes, but added back for earnings from self-employment are:

- The fair rental value of the home provided, and
- The parsonage allowance

Self-employed individuals may be able to deduct the amount paid for medical and dental insurance and qualified long-term care insurance for themselves and their spouse, and their dependents. See Chapter 7 in Publication 535 for more information about the self-employed health insurance deduction.

Expatriate ministers determine net earnings from self-employment without regard to foreign earned income exclusion or the foreign housing exclusion or deduction. “Ministers of the Gospel” living abroad should consult either IRS Publication 593, Tax Guide for U.S. Citizens and Resident Aliens Abroad, or IRS Publication 570, Tax Guide for Individuals in U.S. Possessions.

### Estimated Tax, Form 1040ES

All taxpayers must pay their federal income and social security taxes as earned. The employer withholds and makes payment to state and federal tax collection agencies for his employees. The only exception is for Ministers of the Gospel unless the congregation or organization has entered into a withholding agreement with the “Minister of the Gospel”. Therefore, the “Minister of the Gospel” is generally required to pay an estimate of his taxes on a quarterly basis. For 2005, at least 90% of 2005

taxes or 100% of 2004 taxes must be paid through quarterly payments or the IRS may impose a penalty. 110% of 2004 taxes must be paid if adjusted gross income exceeds \$150,000. One-fourth of the estimate for a calendar year is due on April 15<sup>th</sup>. The remaining due dates are June 15, September 15 and January 15. The January 15 payment may be made with the filing of the tax return if filing is done by January 31 and the entire balance is paid with the file returned. State estimated payments may also be required. You should seek advice of a tax advisor.

Schedule SE (Form 1040)

All “Ministers of the Gospel” participating in the social security program are subject to the SECA tax and must calculate their net profit or loss from services as a minister on Line 2, Part I of Schedule SE. This schedule is a part of Form 1040.

The computation of earnings from self-employment is based on the data shown on the Form W-2 worksheet prepared by the treasurer and delivered with the Form W-2. However, there are some differences reflected in the computation format shown below:

<u>WORKSHEET FOR CALCULATING NET EARNINGS FROM SELF-EMPLOYMENT</u>	
Net Compensation (Box 1, Form W-2)	\$ 34,709
<u>Add:</u>	
Parsonage provided - Fair Rental Value	9,200
Section 107 Parsonage Allowance, (Box 14 PRSNG, Form W-2)	6,400
Honoraria and other income not included in Form W-2 (from Schedule C)	
Subtotal of Additions	15,600
<u>Deduct:</u>	
Auto and Other Expenses (Form 2106)	
Other Business Expenses (Schedule A)	
Other Business Expenses (Schedule C)	
Moving Expenses (if included on W-2 Worksheet, lines 5 and 6)	
Subtotal of Deductions	0
Net earnings from self-employment	\$ 50,309

No deductions may be claimed for SECA tax purposes for the actual expenses in providing or renting a home (IRC Section 1402(a)). However, a “Minister of the Gospel” is allowed to reduce his net earnings from self-employment by the amount of his tax sheltered annuity contributions made during the year (Rev. Rul. 68-395). Since Form W-2 does not include the amount contributed to the TSA, no adjustment need be made on the above worksheet.

**This form should be replicated, completed, and a copy given to the person who does your payroll.**

The fair rental value of the parsonage provided should include such items as utilities, maintenance, furnishings, etc. if these items were paid by the congregation or calling body and not by the minister.

Social Security Exemption - Filing Form 4361

“Ministers of the Gospel” have a choice, in the beginning of their ministry, to exempt themselves from social security coverage. However, any service not performed in the exercise of one’s ministry is subject to either FICA or SECA tax. Obtaining exemption by filing Form 4361 Application for Exemption from Self-Employment Tax for Use by Ministers, does not cause one to waive his right to receive social security benefits from earnings other than as a minister. IRS Publication 517, Social Security for Members of the Clergy and Religious Workers, states that Form 4361:

“ . . . includes a statement certifying that you are conscientiously opposed to, or because of your religious principles you are opposed to, accepting, for services performed as a member of the clergy, any public (governmental) insurance that makes payments in the event of death, disability, old age, or retirement. This includes public insurance that makes payments toward the cost of, or provides services for, medical care, including the benefits of any insurance system established by the social security Act. You do not have to be opposed to accepting public insurance for services you perform in a capacity other than as a minister . . . .”

Form 4361 must be filed by April 15<sup>th</sup> of the second tax year in which the minister has net earnings from self-employment of \$400 or more. The two tax years do not need to be consecutive. Ministers opting out of social security are required, by law, to notify the ordaining body, i.e. the Wisconsin Evangelical Lutheran Synod, for synod pastors, staff ministers, male teachers and male professors. The federal employer identification number (EIN) that needs to be filled in is the congregation’s or the organization which you are employed, not the synod’s EIN (part of box #4), because the congregation/organization pays the salaries. A copy of your completed Form 4361 must be sent to WELS Financial Services, Attention: Nancy Gittel, which are kept on file.

## CHARITABLE CONTRIBUTIONS

In the 501(c)(3) tax exemption letters dated January 25, 1966, as extended and continued by an additional group ruling determination letter dated September 21, 2000, referred to in "Tax Status - Congregations and WELS Organizations," the IRS states "Contributions made to you and your listed districts, congregations, educational charitable and religious organizations are deductible by donors as provided by section 170 of the Code. Bequests, legacies, devises, transfers, or gifts to or for the use of your listed districts, are deductible for Federal estate and gift tax purposes ..."

The church or organization should arrange its financial affairs in such a way as to only accept contributions and gifts that will further its ministry. A church or organization may lose its tax-exempt status from income tax if it accepts gifts that are given only to provide direct financial benefits to its members (except as allowed by law such as an itemized charitable contribution deduction).

Congregations and organizations that qualify as charitable organizations can accept gifts in good faith from any donor and acknowledge receipt of the gift from the donor. It is not responsible for deciding whether a donor can or cannot take a tax deduction for a charitable contribution. In addition, the congregation or organization should not indicate the value of contributed non-cash gifts without a written appraisal from a qualified appraiser. Either the donor or the charitable organization, by agreement, may arrange and pay for the cost to appraise non-cash gifts.

Cash or physical property may be donated to a charitable organization. **The value of time or services is not a charitable contribution** for tax purposes and should not be acknowledged in such a way as to lead the volunteer to believe that they are. However, some unreimbursed out-of-pocket expenses may be deductible by the volunteer. The standard mileage allowance rate for volunteers is \$.14/mile for 2006, other than activities related to Hurricane Katrina relief. See IRS Publication 526, Charitable Contributions, for more detail.

Special Rates for Katrina-Related Charitable Miles: For the period August 25 to August 31, 2005, the rate for miles driven for charities providing Hurricane Katrina relief is 29 cents, for deduction purposes, and 40.5 cents, for reimbursement purposes. For the months of September through December 2005, the special Katrina-related rates are 34 cents for deductions and 48.5 cents for reimbursements. For 2006, these Katrina-related charitable rates will be 32 cents per mile for deduction purposes and 44.5 cents per mile for reimbursement purposes. Revenue Procedure 2005-78 contains additional information and limitations on the use of the standard mileage rates.

### Voluntary Payroll Deductions

Withholding of monies from an employee's net pay which are then passed on to a charitable organization is an allowable form of making a charitable contribution. However, a reduction in an employee's salary in lieu of making a charitable contribution, which is not reported on Form W-2, is not allowed. Congregations and organizations should not consider a reduction in salary as an acceptable charitable contribution by one of its employees. To do so is to consider the contribution as a professional expense and IRC Section 162(b) states: "No deductions shall be allowed under subsection 162(a) for any contribution or gift which would be allowable as a deduction under section 170 (Schedule A) were it not for the percentage limitations, the dollar limitations or the requirements as to the time of payment, set forth in such section." The only place that charitable deductions are allowed is on Form Schedule A.

## Substantiation and Disclosure Requirements for Charitable Contributions

Donors **must have a receipt** from the charitable organization to claim an income tax deduction on single payments or gifts worth \$250 or more. **A canceled check is not sufficient for federal tax purposes.** Individual gifts, even though totaling greater than \$250, are not aggregated together. Thus a person who donates \$100 each week does not require a receipt; however, the individual who makes one \$275 donation does. The IRS does not specify any format for these receipts but each receipt must state the amount donated and estimated value of any goods or services received by the donor. A proper year-end statement provided to each donor will suffice in place of individual receipts if it contains the appropriate disclosures and is received by the donor before filing their tax return. If the sole service exchanged is an “intangible religious benefit” or small goods given to members (e.g. a bookmark or inexpensive cross to new members) without regard to their contributions, no value need be assigned and the receipt should state that the only benefits are intangible religious benefits. The statement may read as follows:

*WELS churches or organizations should issue receipts or proper statements for every contribution of \$250 or more. Donors cannot take a tax deduction without a proper receipt.*

The donor received no good or services, other than intangible religious and spiritual benefits, in exchange for the gifts listed on this receipt.

For non-cash donations which a donor claims is worth greater than \$250, the receipt only needs to contain a description of the property with no estimate of value. For non-cash gifts over \$500, the donor needs to complete Form 8283 to receive the tax deduction on his tax return. This form describes the item, how it was valued, the signature of the certified appraiser, if needed, and, the signature organization acknowledging receipt of the items. The organization receiving the goods does not give a monetary value to any non-cash good received. Additionally, if any assets received on Form 8283 are sold within two years of the donation, the donee is required to file Form 8282 with the IRS. Form 8282 lists the item and the amount for which the item was sold.

If you contribute property to a qualified organization, the amount of your charitable contribution is generally the fair market value of the property at the time of your contribution. Reference Publication 561 for general guidelines for determining the fair market value of various types of donated property.

Charitable organizations **must** give notification of *quid pro quo* contributions. These are a combination of contributions and payments for goods or services furnished by the charity to the donor. Thus, if a donor receives some economic or financial benefit from making the donation, their only charitable contribution is the amount over the benefit they received. If the congregation or organization receives \$75 or more and the donor receives economic or financial benefit as a direct result of the contribution, the congregation or organization is required to provide the donor a receipt advising them of the estimated value or the benefit and the amount that is deductible. In contrast to the substantiation requirement which has no penalties, congregations or organizations that fail to meet these disclosure requirements are subject to a penalty of \$10 per contribution to a maximum of \$5,000 per particular fund raising event.

### Tuition and Scholarships

Tuition and payments for scholarships may or may not be considered a contribution. Please refer to “Tuition and Scholarships” in this manual for additional information.

## Special Offerings

The most common special offerings are for employees in honor of either their retirement or anniversary at the church or organization. If members give a gift **directly** to the employee, the employee probably has no taxable income and the member has no charitable contribution. Special offerings given through the church or organization may be deductible by the member and are generally additional compensation when given to the employee. This issue has been the subject of several cases and IRS interpretations. As a result of these complexities, the congregation or organization is advised to contact a tax advisor **before** any such offering is implemented.

Other common special offerings may be for occurrences such as serious illness, accident, severe weather damage, etc. to the recipients. Separate funds for these one-time occurrences, which benefit one individual, may have adverse tax consequences for an employee at a church or organization. As mentioned in the "Reporting Wages and Salaries," any gift given to the employee by his/her employer must be added to their Form W-2 and have all taxes withheld, if applicable. These additional taxes may place additional hardship on the employee. In order to avoid the adverse tax consequences, members should contribute through a general collection or send their gifts directly to the worker affected.

## TUITION AND SCHOLARSHIPS

### Tuition

Contributions made by parents of students to churches or organizations operating schools may be allowable as charitable contributions so long as they are true contributions and not tuition. The major factor is the degree of compulsion and/or lack of compulsion under which the payments are made. Note that merely making a payment to a church with instructions to forward all or a portion of the payment does not change the reason payment is made, the compulsion is the major factor. A church or organization that imposes a charge or so called “minimum contribution” on parents and if not met denies continued enrollment in the school is in fact imposing tuition. On the other hand, a church that suggests a minimum but does not deny continued enrollment if not met is merely guiding its parents on grounds of good Christian stewardship and the financial needs of the church. If the payment must be made in order for the child to continue to receive the benefit of the school’s education, no charitable contribution exists and the church or organization should not acknowledge receipt of a contribution to the extent of the required amount.

In IRS Revenue Ruling 83-104, the IRS held that whether an undesignated payment is a charitable contribution depends on:

whether a reasonable person, taking all the facts and circumstances of the case in due account, would conclude that enrollment in the school was in no manner contingent upon making the payment, that the payment was not made pursuant to a plan (whether express or implied) to convert nondeductible tuition into charitable contributions, and that receipt of the tuition into charitable contributions, and that receipt of the benefit was not otherwise dependent upon the making of the payment.

The revenue ruling goes on to state that if one or more of the following factors is present, the payment will be **presumed to not** be a charitable contribution:

- the existence of a contract under which a taxpayer agrees to make a “contribution” and which contains provisions ensuring the admission of the taxpayer's child.
- a plan allowing taxpayers either to pay tuition or to make “contributions” in exchange for schooling.
- the earmarking of a contribution for the direct benefit of a particular individual.
- the otherwise-unexplained denial of admission or readmission to a school of children of taxpayers who are financially able, but who do not contribute.

Churches or organizations that pay tuition for their employees’ children to attend a school must include those payments as taxable compensation on the Form W-2 (Private Letter Ruling 9226008).

### Scholarships and Tuition Reductions

A church or organization may set up a scholarship fund to provide educational grants to members or others. This scholarship fund should be controlled by the church or organization and administered under written guidelines. Contributions made to this fund should be considered charitable contributions providing that the donor does not specify the student/family to receive the grant. Additionally, the IRS may question a scholarship fund that benefits a specific donor. IRS Publication

526, Charitable Contributions, states “Direct contributions to needy or worthy individuals are not deductible. The contributions must be made to or for the use of a qualified organization and not be earmarked by you for the use of a specific person.”

Treasury Regulation 1.117-(3)(a) states that the term “scholarship” cannot include “any amount provided by an individual to aid a relative, friend, or other individual in pursuing his studies where the grantor is motivated by family or philanthropic considerations.” As was stated earlier and is restated here, a church or organization may lose its tax-exempt status if it accepts gifts that are given only to provide direct financial benefits to its members.

Scholarships granted to students are not taxable income to them unless the scholarship is used for living expenses or travel. If the scholarship is used for living expenses or travel, it must be added to the individual’s Form 1040A or Form 1040 on the wages line and identified with “SCH” in the margin (IRS Publication 520).

A tuition **reduction** (up to 100%) may be granted, tax free, to employees of a school, their spouses or dependent children if it is granted equally to all employees. The congregation or organization should formally adopt such a policy, if it chooses to provide this benefit to its workers.

### Education Tax Credits

Several education tax credits are available and, in order to take advantage of these, timing is important. The Hope Scholarship Credit and the Lifetime Learning Credit are available for qualified tuition and related expenses for post secondary education. The Hope Scholarship Credit is intended to defray expenses for the first two years of college and equals 100 percent of each qualified student’s first \$1,000 (\$1,100 for 2006) of tuition expenses plus 50 percent of the next \$1,000 for a maximum benefit of \$1,500 per student. You may prepay these expenses prior to year-end for academic periods beginning January through March of 2006, if necessary, to get the benefit for 2005.

In years that the Hope Scholarship Credit is not available, the Lifetime Learning Credit may be an attractive alternative, especially since the credit is available for an unlimited number of years. It is available for undergraduate and graduate tuition. You may also prepay these expenses prior to year-end for academic periods beginning January through March of 2006 to get the benefit for 2005. The credit equals 20 percent of qualifying annual tuition costs up to \$10,000 for a maximum benefit of \$2,000 per year. A student’s tuition costs cannot be used to claim both the Hope Scholarship Credit and Lifetime Learning Credit in the same year.

If you claim your child as a dependent on your 2005 income tax return, only you can take the Hope Scholarship Credit or Lifetime Learning Credit for his or her tuition expenses. On the other hand, if your child is *not* a dependent, only he or she can claim these credits. Note that these credits are phased out for married taxpayers filing a joint return as modified AGI rises from \$87,000 to \$107,000 (to increase to \$90,000 to \$110,000 in 2006) and for single taxpayers as modified AGI rises from \$43,000 to \$53,000 (to increase to \$55,000 in 2006). If you will not be eligible for one of these credits due to modified AGI in excess of these limits and your non-dependent child would be eligible based on his or her modified AGI, it may be beneficial for the child to pay his or her tuition. This can be accomplished by making a gift to your child of the funds necessary to pay his or her tuition. Again, you should consider the effect of these gifts on your children’s eligibility for financial aid as well as consider any gift tax implications.

The provisions in the 2001 Tax Act pertaining to education incentives may provide useful benefits not only for your children but for you as well. For example, the Act extends the exclusion for

employer-provided education assistance paid pursuant to a qualified education assistance program to graduate education expenses. In addition, you may deduct up to \$2,500 of interest on education loans, subject to certain increased income phase-out ranges. The Act also repeals the 60-month limit on the deductibility of education loan interest, and provides for an above-the-line deduction for qualified higher education expenses.

## BUSINESS EXPENSE REIMBURSEMENTS

A congregation or organization should consider establishing a business expense reimbursement policy in which the employee submits an expense report along with receipts documenting the business expenses and is reimbursed dollar for dollar or cents-per-mile based on that report. If the expense is incurred on behalf of the congregation or organization, the employee would be reimbursed for that expense. In this situation, where the business expense has been properly accounted for and reimbursed, no taxable income is created. **The employer need not report these “accountable” expense reimbursements on the employee’s Form W-2.** Reimbursed personal expenses, however, are generally considered taxable income and should be reported as such on the employee’s Form W-2. No deduction is allowed for non-employee spouse or dependent’s travels even if they accompanied for a business purpose. Any reimbursement for spouse/dependent must be included as taxable income in Box 1, Form W-2. Spouses or dependents who are also employees of the congregation or organization may be reimbursed if they accompanied for a true business purpose. In situations where the spouse/dependent is also an employee of the congregation or organization, it is suggested that requests for reimbursement be separately submitted by the employee and spouse/dependent.

*Allowances are taxable in full without an `accountable' reimbursement policy. Accountable reimbursement plans are tax-free.*

**When an employer pays an allowance to an employee, the IRS considers the entire allowance additional compensation unless the employee is required to:**

1. Substantiate the expenses to the employer within a reasonable time, and
2. Return any excess amount not used for business expenses within a reasonable time.

The IRS allows two ways to satisfy the reasonable time requirements:

1. The employer may issue a statement at least quarterly indicating the excess reimbursement and asking for substantiation or its return within 120 days, or,
2. The expenses may be substantiated within 60 days after they are incurred and the excess returned within 120 days after the expenses are incurred.

By not meeting these two requirements, the IRS views the allowance as additional compensation rather than an expense reimbursement and the entire allowance must be added to Form W-2 wages. The employee then may deduct the expenses on his or her personal income taxes on Schedule A as miscellaneous itemized deductions that are detailed on Form 2106, Employee Business Expenses. If the employee itemizes deductions, these “unreimbursed employee business expenses” will be limited to the amount greater than 2% of the adjusted gross income.

Any business expense reimbursement policy that a congregation or organization may establish should require adequate documentation. Adequate documentation includes receipts and, in the case of travel, a statement indicating the time and place, business purpose and business relationship for which the expense was incurred. A photocopy of an expense or mileage log with this information clearly indicated, and supporting receipts may serve as adequate, low-effort documentation for the employee. Currently the IRS requires that a receipt support all lodging expenses, regardless of amount, and all other expenses greater than \$75. Employers are strongly encouraged to have expense substantiation requirements at least equal to those of the IRS.

IRC Section 265 has important implications in relation to the tax-free parsonage allowance. Under

the provisions of Section 265, Ministers of the Gospel who claim a parsonage allowance **must reduce their unreimbursed employee business expenses** by the percentage that their parsonage allowance is of their total income. In the 1988 case of *Dalan v. Commissioner (TC Memo 1988-106)*, a minister could not deduct all of his business expenses because he had a parsonage allowance. The Tax Court did not allow a percentage of his business expenses because of the provisions in Section 265. Since a portion of the minister's income is not taxable (the parsonage allowance portion), a portion of his expenses is also disallowed as a deduction. Without applying Section 265, there would be a double deduction, the income would not be taxable and the expenses attributable to earning the exempt income would be deductible against taxable income.

Example of how the pro-ration works:

Reverend Jones had parsonage allowance deductions of \$4,985. His salary was \$20,000 and he received a \$1,500 auto allowance. He incurred \$3,000 in business expenses. Rev. Jones can only deduct \$2,304 on his Schedule A calculated as follows:

$$\frac{4,985}{20,000 + 1,500} = 23.19\% \times \$3,000 = \$696 \text{ and } \$3,000 - \$696 = \$2,304$$

A letter from the IRS to one tax editor, Richard Hammar, indicates that the pro-ration calculation should be attached to the Form 1040 as a separate schedule (Church Law & Tax Report, March/April 1990).

The IRS has issued a Market Segment Specialization Program (MSSP) for Ministers wherein they have provided a variety of guidelines and information for the public and for their auditors. Two important areas addressed in this MSSP are:

1. Salary reduction reimbursement programs for business expenses do not meet the requirements of Treasury Regulation 1.62-2(d). Thus, any congregation or organization that reduces reported taxable income by a worker's business expenses must be aware that they have not established a tax-free reimbursement plan. Any reduction of W-2 income from such a program will be disallowed and the employee will face an increase in his taxable income.
2. The deduction for an office in the home will be questioned closely as it will generally be deemed to be unnecessary. When space is available for working at the church, the school, or elsewhere, the IRS will usually not consider the accessibility or convenience of that space when they consider whether to allow a deduction for an office in the home. The fact that the space exists will usually be the determining factor when disallowing a home office deduction.

## MOVING EXPENSES

Moving expenses of employees, whether pastors, teachers, or lay people, may be paid by the congregation or organization. Certain moving expenses need not be added to other reported taxable income on Form W-2 if they meet the following tests:

Distance Test: The new church or place of work must be at least 50 miles farther from the worker's former residence than was the former church or place at which he served.

Time Test: The worker must work full time for at least 39 weeks (not necessarily consecutively) during the first 12 months after he arrives in the general area of the new job location. He/she does not have to work for the same employer but his/her full-time work must be in the same general commuting area.

In addition to these two tests, the move must be closely related, both in time and place, to the start of work at the new congregation or organization. Nondeductible expenses are included in income. They include meals, house hunting trips and selling or purchasing costs for residences.

Because deductible moving expenses are a reduction of income on the front of the taxpayer's Form 1040, the congregation or organization should not add moving expense reimbursements to the employee's Form W-2 if it reasonably believes the employee may deduct them (meet the distance and time tests referred to above). Box 12 of Form W-2 must be completed and only include the total of qualified moving expenses reimbursed to the employee. Moving expenses an employer pays to a third party on behalf of the employee (such as to the moving company) will not be reported on Form W-2. If the employing church or other calling organization provides moving expense reimbursement or direct third-party payments for expenses that would otherwise not be deductible, such amounts must be reported in Box 1 of Form W-2. This is the only reporting to the government by the employer of these expenses. These amounts are included in income and are subject to employment taxes and income tax withholding.

IRS Publication 521, Moving Expenses, gives details on the moving expense deduction for both United States and foreign moves. It lists items that may and may not be deducted as moving expenses, shows dollar limits on various types of moving expenses, and explains how to report the deductions for both United States and foreign moves.

Form 3903, Moving Expense Adjustment, must be filed with the employee's tax return to deduct moving expenses from income if the move is within or to the United States. Form 3903F, Foreign Moving Expense Adjustment, is to be used if the move was to a foreign location.

Beginning January 1, 2006, the standard mileage rate for moving purposes is 18 cents per mile driven.

## RETIREES/“SOCIAL SECURITY” CALLS

### Social Security Earnings Limitation

Virtually all earnings from employment or self-employment are taxable for social security purposes even if earned during retirement. Earnings received beyond the limits shown below will affect the amount of social security the retiree can draw.

As of January 2000, the Retirement Earning Test has been eliminated for individuals between the ages of 65 through 69. It remains in effect for those ages 62 and up to “full retirement age”. A modified test applies for the year an individual reaches full retirement age (65 and 6 months for retirees born in 1940; 65 and 8 months for those born in 1941. This change was signed into law in April 2000. Retirees may earn up to the following amounts without sacrificing a portion of social security benefits:

	<u>2006</u>
Under full retirement age	\$12,480
The year an individual reaches full retirement age	\$33,240
After an individual reaches full retirement age	Unlimited

Benefits are reduced \$1 for every \$2 earned over the limitation for ages 62 through 64. The reduction in benefits is \$1 for every \$3 of excess earnings for ages 65 up to full retirement age. Retirees receiving social security benefits must submit an ‘Annual Report of Earnings’ to the social security office if they earn more than the earnings limitation. There is a special rule for those workers who retire during a year and receive social security benefits for the remainder of the year. This rule says “you can receive a full benefit for any month of entitlement in which your wages do not exceed the monthly exempt amount and you do not perform substantial service in self-employment.” The monthly exempt amount is calculated as the annual earnings limitation for the appropriate age divided by twelve.

The fair rental value of the parsonage (or cash housing allowance paid to the worker) is counted as income in arriving at the earnings limitation amount. Pension and retirement payments (Revenue Ruling 58-359), interest and dividends, rental income, and sales of property are not counted as earnings. Also, reimbursements for business and professional expenses are not counted toward the earnings limitation if the individual accounts for the expenses and returns any overpayments.

### Benefits in Retirement

If an individual works beyond “full retirement age” and does not begin receiving social security benefits, the benefits will be increased by a percentage factor. For those born during the years 1917-1924, the increase is 3% for each year worked prior to receiving the benefit, up to age 70. For those born after 1924, the percentage increase is higher, rising gradually to 8% per year of delay for those born after 1942 up to age 70.

Retired pastors and teachers of the synod are included in the synod's Pension Plan and may be enrolled in the WELS VEBA Group Health Plan. Workers approaching retirement should review these plans to familiarize themselves with the benefits of each. Questions relating to either plan should be directed to the WELS Benefit Plans Office.

The Personal Earnings and Benefit Estimate Statement provide the individual with the estimated amount of benefit they may expect to receive upon retirement. This statement can be requested at any time during your working years. You can request it by either contacting your local SSA office or by contacting their web site at address [www.ssa.gov](http://www.ssa.gov).

Benefits under the Social Security program must be applied for to the Social Security Administration and it is suggested that workers get in touch with Social Security if:

- They are unable to work because of an illness or injury that is expected to last a year or longer.
- They are 62 or older and plan to retire.
- They are within 3 months of their “full retirement age”, even if they do not plan to retire.
- Someone in their family dies.
- They, their spouse, or young children suffer permanent kidney failure.
- They are 65 or older, blind, or disabled with limited income and resources (to apply for supplemental security income (SSI)).

It is important to call, visit, or write any Social Security Administration office before reaching 65, not only about retirement checks, but also about Medicare insurance.

Retirees must not only consider the reduction of benefits but also the taxation of social security benefits. The earnings limitation discussed above states that benefits will be reduced if the limitation is exceeded. A two-tier, progressive system adds taxation of some social security benefits. In the worst case scenario, 85% of social security benefits may be taxed for "provisional income" in excess of \$34,000 for single persons and \$44,000 for married persons. “Provisional income” is generally calculated as adjusted gross income (all forms of taxable income before deductions) **plus** tax exempt interest **and** one half of the social security benefits received during the year. The following example illustrates the tax rules:

A married couple filing a joint federal tax return receives \$14,000 of social security benefits and has other taxable income of \$36,000. They also received \$2,000 in tax-free municipal bond interest. The amount of their social security benefits that is taxable is calculated as:

Taxable income	\$36,000
Tax free municipal bond interest	2,000
One half of benefits	<u>7,000</u>
“Provisional income”	\$45,000
Less: threshold amount	<u>&lt;44,000&gt;</u>
Excess	\$ 1,000

Include the lower of the two following amounts in income:

85% of social security benefits	\$11,900
50% of (44,000 - 32,000) + 85% of \$1,000	\$ 6,850

The base amount is \$32,000 in the case of a joint return and \$25,000 for single persons.

## “Social Security” Calls

A few congregations and organizations within the synod issue a semi-retirement type of call because the nature of the work is less than full time. Generally, social security calls are issued to “Ministers of the Gospel” who have retired from active work in the church and are drawing social security and other retirement benefits. Occasionally an active minister who is about to retire may be extended this type of call. When issuing or considering a social security call the congregation or minister should take into account the possible reduction in retirement benefits and the tax consequences of issuing or accepting such a call.

Both WELS VEBA Group Health Care and Pension Plans consider a person an ‘active’ employee if he works 20 or more hours a week. This is the threshold that has been established for distinguishing between a retiree and an active employee. If the call is for less than 20 hours per week, the worker continues receiving Medicare Supplement health care benefits and pension benefits. If the worker is compensated for 20 hours per week or more, the pension is discontinued and the worker is then covered under the active WELS VEBA Group Health Plan.

Additional factors which must be reviewed by the congregation or organization and the minister when considering a social security call include: 1) All earnings will be taxable for self-employment tax purposes if the services performed are ministerial services and, 2) tax-sheltered annuities are allowable up to the standard 403(b) amounts. However, salary reduction agreements for TSA’s are not considered when calculating the earnings limitation.

## Retired Minister’s Parsonage Allowance

Synod pension benefits received are included as income for income tax purposes, but excluded for social security purposes. A retiree may have the WELS Pension Commission designate all or part of their pension benefit as a Section 107 parsonage allowance.

In addition to designating his pension, a retired “Minister of the Gospel” may request the former calling body to designate a portion of his part-time earnings as a parsonage allowance. In any case, the parsonage allowance is limited to the least of the fair rental value of the house provided including utilities; the amount designated; or the amount actually spent.

The Church Retirement Benefits Simplification Act clarified that a retired minister’s parsonage allowance designated by a denominational Pension Board is exempt from social security taxes. Ministers may also be eligible for a refund of taxes paid previously. Contact a tax professional for more information.

## Retirement Gifts

The IRS applies IRC Section 102(c) to retirees as well as employees. *Commissioner v. Duberstein*, 363 U.S. 278, 285 (1960), indicated that the most important issue surrounding a payment was the transferor's intention. The IRS has indicated that its position is not consistent with that ruling and that **retirement gifts generally will be considered compensation for past services**, thus making the amount taxable income to the recipient and not a gift.

If congregations or organizations still wish to provide a form of retirement gift to their workers, it is

recommended that the payments be made directly to the worker from its members and that no charitable contribution receipt be issued for those contributing to the gift. It is likely that such payments will be considered tax-free gifts from one individual to another with no tax consequences to the retiree.

## TAX SHELTERED ANNUITIES AND TAX SAVINGS PLANS

Pursuant to IRC Section 403(b), certain qualified employers (public schools and some tax-exempt organizations) may establish tax-sheltered annuity (“TSA”) plans on behalf of their employees. A tax-sheltered annuity plan generally will reduce the employee's federal income tax liability because it reduces taxable compensation. Any employee of a qualified employer may benefit from reduced federal income taxes under a TSA. IRS Publication 571 states: “Full or part-time employment is not a factor in determining whether you are an employee [for TSA eligibility purposes].” “Ministers of the Gospel” may also benefit from reduced self-employment taxes by establishing a TSA since contributions to a TSA are not included in self-employment earnings. However, the congregation or organization must withhold and match social security taxes for called female teachers and lay employees on the total amount of compensation including any TSA contributions.

*Contributions to a TSA by Ministers of the Gospel are not subject to social security tax.*

A qualified employer for these purposes includes any “organization that is tax exempt because it is organized and operated exclusively for religious, charitable, scientific, public safety testing, literary, or educational purposes...” (IRS Publication 571). In addition, only qualified employees may receive a tax-sheltered annuity plan from their employer. The employees must be subject to the will and control of the employer regarding what work they do and how they do it. Independent contractors are not qualified employees.

A tax-sheltered annuity plan requires a written agreement between the employee and employer to have the employee's annual compensation reduced by a specified amount or percentage and to contribute that amount into a tax-sheltered plan. The tax-sheltered plan can invest in annuity contracts, custodial accounts that hold mutual fund shares, or in retirement income accounts. The custodian of the plan may be a life insurance company, bank, or mutual fund company, or the congregation or organization itself, provided that the IRS has approved its written plan. IRC Section 403(b) allows employees to make several reduction agreements with an employer during the taxable year.

Tax-sheltered annuity contributions can be handled in one of two ways, through a salary reduction agreement or through employer contributions to a “defined contribution plan.”

1. The congregation or organization can first establish the annual salary of the employee and then establish a salary reduction agreement with the employee on how much will be contributed. The employee's gross and net pay is reduced each month by an equal portion of the agreed-upon amount and the congregation or organization remits the same amount each month to the custodian of the tax-sheltered plan. At year-end, the employee's Form W-2 will show the agreed upon salary less the amount contributed to the tax-sheltered plan.
2. The congregation or organization can establish the annual salary and contribute an agreed upon amount into a tax-sheltered, defined contribution plan in addition to the annual salary. No monthly reduction of the employee's established salary occurs but the congregation or organization still makes monthly contributions to the tax-sheltered plan. At year-end, the employee's Form W-2 will show only the annual salary and not the contributions to the tax-sheltered account. Since this is, in effect, a pension plan, additional governmental reporting may be necessary under this option.

The maximum annual non-taxable contribution amount to a 403(b) plan for any employee is \$14,000 for 2005 (\$15,000 for 2006), but catch-up provisions exist for higher annual contributions. Catch up provisions include an extra \$4,000 (\$5,000 for 2006) for employees over age 50. These catch-up calculations can become quite involved, a qualified sales agent or financial planner and IRS Publication 571, Tax Sheltered Annuity Programs for Employees of Public Schools and Certain Tax-Exempt Organizations, should be consulted for further details.

If you have at least 15 years of service with a church, the limit on elective deferrals is increased by the least of the following amounts:

1. \$3,000
2. \$15,000, reduced by increases to the overall limit that you were allowed in earlier years because of this year's of-service rule; or
3. \$5,000 times your number of years of service for the organization, minus the total elective deferrals under the plan for earlier years.

A self-employed person may also make contributions to a KEOGH or similar type retirement plan up to the annual contribution limit of \$42,000 (increased to \$44,000 in 2006).

Payments made to a TSA are not shown as income on the workers Form W-2. Total annual contributions are reported in Box 13, and checked as 'Deferred Compensation' in Box 15, Form W-2. Note that a worker cannot transfer 403(b) amounts into any other pension plan.

### Individual Retirement Accounts – IRAs

Contributions to an Individual Retirement Account (IRA) may be made by "Ministers of the Gospel", female called workers, and lay employees. However, they may not be deductible on Form 1040 if the worker is eligible for participation in the employer's retirement plan (Note that this includes the Synod's pension plan.) or if the worker participates in a TSA plan. Contributions to an IRA, whether tax deductible or not, are subject to social security taxes. A tax, legal, or other consultant should be contacted for specific questions about IRAs. The "spousal IRA" allows for a non-compensated spouse to deduct up to \$3,000 (\$3,500 if 50 and over). However, the compensated spouse's income must be greater than the total of both spouses' IRA deposits. The IRA contribution limits are still \$4,000 in 2005 (\$4,500 if 50 and over). For 2006, the limit is \$4,000 (\$5,000 if over age 50).

Contributions to a Roth IRA are not deductible, but distributions may not be taxable. With many called workers in lower tax brackets the benefit of the conventional IRA's deductibility are limited. The Roth IRA may provide much greater tax relief in later years. As with any type of tax and retirement planning, many variables must be weighed as it applies to a workers' unique situation. For traditional and Roth IRA's, the maximum catch-up contribution is \$500 for 2005 (\$1,000 for 2006).

### Flexible Spending Arrangements

Internal Revenue Code Section 125 allows organizations to set up Flexible Spending Arrangements (FSA). The FSA is a calendar year program that allows employees to designate a certain amount of money each year to be withheld for specified purposes (medical and/or dependent care expenses). This money is then used to reimburse the employee for out-of-pocket expenses as detailed in the program. Any money not used before year-end cannot be used or carried over to a subsequent year by the employee and becomes general funds of the congregation or organization. Many individuals do not have enough expenses to itemize on Form 1040 Schedule A, and may not have enough medical expenses to meet the required minimum. These plans allow amounts designated to be used for specified purpose without paying income or social security taxes.

The congregation or organization must approve an FSA before it is implemented.

### Archer MSA Contributions and Health Flexible Spending Arrangements

Recently laws were enacted providing Medical Savings Accounts (MSA's") and Health Flexible Spending Arrangements ("Health FSA's"). Funds transferred to your MSA and Health FSA are not included in your income. Please consult your tax advisor for details.

Because the qualification and reporting requirements for this type of program can be involved, the congregation is advised to contact a local legal or tax professional for assistance.

## OVERSEAS MINISTERS OR EXPATRIATES

The expatriate or WELS worker going abroad is directed to the following IRS publications for detailed discussions on the treatment of foreign income and general tax questions:

*Foreign earned income may qualify for a \$80,000 exclusion allowance from income tax if the worker meets **either one of two tests.***

- Publication 54 Tax Guide for U.S. Citizens and Resident Aliens Abroad
- Publication 514 Foreign Tax Credit for Individuals
- Publication 570 Tax Guide for Individuals with Income from U.S. Possessions
- Publication 593 Tax Highlights for U.S. Citizens and Residents Going Abroad
- Publication 901 U.S. Tax Treaties

IRS Publication 593 states:

“As a U.S. citizen or resident alien, your worldwide income generally is subject to U.S. income tax regardless of where you are living. Also, you are subject to the same income tax return filing requirements that apply to U.S. citizens or residents living in the United States. However, several income tax benefits might apply if you meet certain requirements while living abroad. You may be able to exclude from your income a limited amount of your foreign earned income. You also may be able either to exclude or deduct your housing amount from gross income. To claim these benefits you must file a tax return and attach Form 2555 Foreign Earned Income.”

The expatriate worker may be able to claim a credit against U.S. income tax liability, or take an itemized deduction, for the foreign income taxes paid. The taxpayer must be familiar with possible tax treaties or conventions the United States may have with the country in which he is resident, as well as foreign country tax laws and filing requirements.

If the expatriate worker's tax home (the place of business or employment where the worker is permanently or indefinitely engaged to work as an employee or self-employed individual) is in a foreign country and the bona fide residence test (must be a resident for one full tax year) or the physical presence test (must be physically present in a foreign country or countries 330 full days during a period of 12 consecutive months) is met, up to \$80,000 of foreign earned income may be excluded from taxable income during the year. Beginning in 2008, the \$80,000 amount will be adjusted for inflation. Foreign housing amounts may also be excluded.

Workers that meet the requirement for, and take the \$80,000 exclusion and have a TSA may not claim both the TSA exclusion explained in “Tax Sheltered Annuities and Tax Savings Plans,” and the foreign earned income exclusion. The IRS considers this to be taking the exclusion twice on the same dollars of income.

Form 2555 Foreign Earned Income or Form 2555-EZ Foreign Earned Income Exclusion must be filed with Form 1040 to claim the foreign earned income exclusion. Only Form 2555 can be used to claim the foreign housing exclusion or deduction.

As the US and foreign country tax laws for expatriates and overseas workers contain complex provisions, overseas workers are encouraged to contact a tax advisor familiar with these issues regarding their specific situation.

# SOURCES OF TAX INFORMATION

## Income Tax Law for Ministers and Religious Workers by B.J. Worth

Order from: Worth Tax & Financial Service (574) 267-4687  
3201 E Center St  
Warsaw, IN 46582

## Church & Clergy Tax Guide by Richard R. Hammar, J.D., LL.M., CPA

Order from: Christian Ministry Resources (800) 222-1840  
PO Box 2301  
Matthews, NC 28106

## IRS Publications

Order from: IRS (800) 829-1040 [www.irs.ustreas.gov](http://www.irs.ustreas.gov)

15 (Circular E) Employer's Tax Guide  
15A Employer's Supplemental Tax Guide  
17 Your Federal Income Tax  
54 Tax Guide for US Citizens and Resident Aliens Abroad  
463 Travel, Entertainment and Gift Expenses  
505 Tax Withholding and Estimated Tax  
508 Tax Benefits for Work-Related Education  
514 Foreign Tax Credit for Individuals  
517 Social security and Other Information for Members of the Clergy and Religious Workers  
520 Scholarships and Fellowships  
521 Moving Expenses  
524 Credit for the Elderly or the Disabled  
525 Taxable and Nontaxable Income  
526 Charitable Contributions  
529 Miscellaneous Deductions  
533 Self-Employment Tax  
535 Business Expenses  
552 Recordkeeping for Individuals  
553 Highlights of Tax Changes  
554 Older Americans Tax Guide  
557 Tax Exempt Status for Your Organization  
560 Retirement Plans for Small Business (Self-Employed)  
561 Determining the Value of Donated Property  
570 Tax Guide for Individuals in U.S. Possessions  
571 Tax-Sheltered Annuity Programs for Employees of Public Schools and Certain Tax Exempt Organizations  
575 Pension and Annuity Income  
587 Business Use of Your Home  
593 Tax Highlights for U.S. Citizens and Residents Going Abroad  
596 Earned Income Credit  
598 Tax on Unrelated Business Income  
901 U.S. Tax Treatises  
915 Social Security and Equivalent Railroad Retirement Benefits  
929 Tax Rules for Children and Dependents  
1220 Specifications for filing Form 1098, 1099, 5498, and W-2G Electronically or Magnetically  
1546 The Taxpayer Advocate Service of the IRS  
1828 Tax Guide for Churches and Religious Organizations

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- 525 Taxable and Nontaxable Income
- 526 Charitable Contributions
- 571 Tax-Sheltered Annuity Programs for Employees of Public Schools and Certain Tax Exempt Organizations
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