

Tax and Legal Guide for Elders: *Tax Law for Church Leaders*

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I. Complying with the tax laws

(Rom. 13:1-7) “*Everyone must submit himself to the governing authorities, for there is no authority except that which God has established. The authorities that exist have been established by God. ... 5 Therefore, it is necessary to submit to the authorities, not only because of possible punishment but also because of conscience. 6 This is also why you pay taxes, for the authorities are God's servants, who give their full time to governing. 7 Give everyone what you owe him: If you owe taxes, pay taxes; if revenue, then revenue; if respect, then respect; if honor, then honor.*”

A. *Being associated with a church is no excuse for violating the tax laws.*

B. *Withholding for preachers:* Almost everyone gets this wrong because the rules don't make good sense.

1. Ministers are self-employed for Social Security withholding purposes. Therefore, they are obligated to file quarterly estimates, except as described below.

2. Ministers are NOT self-employed for any other purposes. NOT for income tax, SUI, retirement plans, W-2, or otherwise. However, churches are *exempt* from FUTA.

a) Ministers are *not* independent contractors for other purposes except—

(1) Missionaries

(2) Some part-time ministers

b) This is inconsistent and foolish.

c) It makes no sense.

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- d) It's the law.
 - e) The church and minister cannot elect for the minister to be an employee for Self-Employment Contributions Act (SECA) purposes. SECA is the self-employment equivalent of FICA.
3. Who is a "minister"?
- a) Same principles apply as for a housing allowance. See below.
4. Is income tax withholding mandatory? It's optional for federal purposes but generally mandatory under state law.
- a) Minister elects withholding by completing a Form W-4.
 - b) The wise eldership *insists* that the preacher elect withholding. Withholding keeps the ministers from overspending their money or having to borrow when taxes come due
 - c) Ignore financial planners who say otherwise. They are wrong.
5. Is Social Security withholding mandatory?
- a) It's not technically even possible
 - b) But the preacher can over-withhold income taxes and take a credit against SECA, thereby avoiding the need to file quarterly returns
 - c) This is *highly* recommended. This practice eliminates quarterly returns and cash flow problems created by having to pay estimates. It makes preachers much less likely to suffer penalties or not have the cash when taxes are due.
6. What if the church fails to withhold as required?
- a) Church owes the taxes if the preacher or other employee doesn't pay them.
 - b) On audit, the church owes the taxes unless it can prove the preacher or other employee paid them — this is often not possible.
 - c) Elders are *personally* responsible to assure that taxes that have been withheld are paid to the government. *Check.*
 - d) If your deacon steals from the church, you have personally guaranteed payment to the government.

- e) Use an insured payroll service or bonded employee to handle payroll.
- f) Don't let payroll be handled by a volunteer.
- g) *But* be sure the payroll service understands the peculiarities of church payrolls.

C. *Opting out of Social Security*: Is it smart to opt out? Is it right?

1. Preacher must swear that as a matter of church doctrine or personal conscience, participating in public insurance *of any kind* is immoral.
2. That's rarely true in the Churches of Christ.
3. IRS Publication 517 summarizes the law. You may file a Form 4361 to opt out only if—
 - You are conscientiously opposed to public insurance because of your individual religious considerations (not because of your general conscience), or you are opposed because of the principles of your religious denomination; and
 - You file for other than economic reasons.
4. Most Church of Christ preachers cannot take this oath.
5. It also leaves many preachers penniless at retirement or in the event of disability—or a burden on their last congregation.
6. And it may disqualify him from Medicare in his retirement years (of course, if they retire poor enough, they can qualify for Medicaid, but this requires near-total indigence).
7. From the Medicare website:

You will be eligible to apply for Medicare if you have paid into Social Security for at least 10 years or you are eligible to receive Social Security benefits on your spouse's earnings. If you do not meet these requirements, you can still get Medicare hospital insurance (Part A) by paying a monthly premium if you are a citizen or a lawfully admitted alien who has lived in the U.S. for at least five years.
8. Medicare Part A premium is \$375/month: \$4,500 a year in after-tax lost benefits

9. If a preacher has opted out, make sure he is setting aside 15.3% of his gross wages (on wages up to approximately \$90,000) for retirement and disability insurance.
10. Saving is not a better deal than Social Security if you don't save!
11. Saving is not a better deal than Social Security if you don't have portable disability and health insurance.
12. Opting out is normally *irrevocable*, but Congress sometimes enacts an amnesty to opt back in without penalty.
13. No amnesty is presently in effect.
14. In the absence of amnesty, the minister can turn himself in, admit making a false oath, and pay three years back taxes and so get on the system.
15. This must be handled by a skilled professional.

D. *Tax planning for missionaries in foreign countries*: Avoiding domestic and foreign tax problems—

1. The law is less than clear.
 - a) Some churches rely on Rev. Rul. 62-113, which treats housing, travel, and food costs as tax free to the missionary if he is otherwise working for free.
 - b) He likely can draw a salary while in the United States but not while acting as a missionary.
2. Otherwise, the missionary remains a U.S. citizen and must pay U.S. taxes.
3. He may be able to deduct travel, housing, and meals, subject to AGI limitations, *if* his tax residence is in the U.S.
4. The missionary may also owe income taxes in the country in which he lives, especially if his tax residence shifts to the foreign land.
5. Under many tax treaties, 183 residence in a foreign country makes the missionary a tax resident of the foreign country, subjecting him to the tax jurisdiction of that country.
6. U.S. tax treaty or credit for foreign taxes may avoid double taxation by allowing a credit for taxes paid in the foreign country.

7. Law is a mess. Fact situation should be carefully reviewed by a highly qualified tax adviser.
8. A close decision is whether to treat the missionary as an employee, and so qualify him for a housing allowance, or as an independent contractor, and thereby move the tax issues to the missionary
9. Recently, a group of European missionaries found themselves in serious trouble with local authorities for failure to pay European taxes.
10. Generally, US gives a credit for foreign taxes paid, but this may be inadequate and it may be too late to seek a refund of US-paid taxes.

E. *Housing allowances*: The tax advantages and how to survive an audit

1. Advantages: a double tax benefit—
 - a) Tax exemption from income taxes for the portion of salary that is a housing allowance
 - b) Deduction of property taxes and interest, even though paid with tax-exempt dollars
2. The allowance is the lesser of—
 - a) fair rental value plus furnishings, utilities, garage, etc.,
 - b) amount declared, and
 - c) amount spent
 - d) NOT for domestic help, food, etc.
 - e) NOT if a parsonage is actually provided as well (this eliminates the “fair rental value” portion of the allowance)
3. Housing allowance must be declared in writing by a qualified church committee or official (not the minister) *before* the tax year begins.
4. Declaring the allowance after the fact is illegal.
5. Who is a “minister”?
 - a) Generally, the rulings speak in terms of having authority to administer sacraments, but in the Churches of Christ, any male member can oversee the Lord’s Supper and any member can baptize.

b) There is little definite authority, but I think the following guidelines are likely right:

(1) Among Churches of Christ, the preaching minister, campus minister, teen minister, and involvement minister would almost certainly qualify, due to their “pastoral duties.”

(2) A woman children’s minister would qualify if the church grants her pastoral responsibilities, that is, if she has essentially the same relationship with the elders, job duties, and rights as the teen minister.

(3) Minister of music, education director, or preschool director likely don’t qualify, but it depends on their total job obligations.

(4) In the Churches of Christ, it is nearly essential that title “minister” or “preacher” be used and the minister be treated much the same as the preacher.

(5) Thus, “director of children’s programs” would likely not qualify, while a “children’s minister” likely would.

(6) The job must be *sui generis* (of the same type) with the preacher.

c) Housing allowances are OK for *retired* clergy.

d) BUT not for surviving spouses.

6. What if you declare too little? The savings is the lesser of the amount declared or the amount spent on eligible expenses

7. What if you declare too much? The declaration has to be in good faith.

8. The housing allowance is *not* exempt from SECA.

9. The minister is far better off to own his own home than to be provided a “parsonage.” Owning his own home —

a) Allows him to build equity toward retirement.

b) Some preachers have been evicted by their churches from their homes on retirement!

c) Allows a double tax benefit, interest and property tax deductions as well as the housing allowance exclusion.

10. See IRS Publication 517

11. *Deason v. Commissioner*, 41 T.C. 465 (1964), requires that ministers lose a portion of their business expenses proportional to their housing allowance.

a) The Tax Court has followed this more than once, but it seems logically flawed.

b) As the housing allowance is limited to particular expenses—house payments, maintenance, and such—how can the court allocate other expenses to it?

F. *Prohibition from income tax & political activities*: Political activities may cost you your tax exemption and obligate you to pay excise taxes.

1. Despite rightwing complaints about anti-religious discrimination, the real reason churches can't lobby or support candidates is that funds donated for political purposes are supposed to be nondeductible.

2. It's really all about protecting federal revenues.

3. The issues are being audited by the IRS, and leftwing organizations are reporting churches that violate the rules to the IRS. *Be careful*.

4. Several nonprofits are under audit due to partisan activity in the Bush/Kerry campaign, including the NAACP.

5. In general, no church may be tax exempt if a "substantial part" of its activities is attempting to influence legislation. "Substantial part" is not defined.

6. Churches are *absolutely* prohibited from directly or indirectly participating in or intervening in any political campaign on behalf of or in opposition to any political candidate for public elective office.

7. Many Christian writers believe these restrictions reflect God's will or prudent practice anyway. David Lipscomb, *Civil Government* (1913); Charles Colson, *Kingdoms in Conflict* (1989).

8. Permitted activities—

a) Non-partisan voter education, public forums, voter guides;

b) Voter registration and get-out-the-vote efforts.

9. Solution is to work through a PAC or other political organization. See Internal Revenue Code 527 for tax rules. In other words, be sure the

church is paid the fair rental value of its space and doesn't use paid-for staff time. So long as tax-deductible money is not used directly or indirectly to subsidize political speech, the restriction doesn't apply.

10. State and federal law strictly regulate 527 organizations—with severe penalties for mistakes.

- a) A church could form a PAC, collect contributions, support candidates, and run ads for or against legislation, so long as the PAC takes no advantage of the church's tax exempt status.
- b) Preacher cannot work for the PAC except on his own time as a volunteer or while being paid by the PAC, not the church.
- c) No partisan comments may be made in church publications or at church functions
- d) Church building may be used by PAC on same terms as other civic organizations.
- e) Comments by church leaders should expressly disclaim any intention to speak on behalf of the congregation.

11. Real-life examples—

- a) A church's exemption was revoked because the church took out full-page advertisements urging people to vote against Bill Clinton.
- b) An organization that sponsored religious radio and television broadcasts was denied exemption where it advocated for the election of conservative, Christian candidates.
- c) A charity (widely believed to be the Christian Coalition) received a ruling that it had violated the law because of fundraising solicitations naming specified races and candidates.

12. See IRS Publication 1828

G. *Charitable donations*

1. Church must give receipts for donations of more than \$250. This includes multiple donations that add up to more than \$250 if somehow connected, such as due to an annual pledge card

- a) May be wise to set up tracking system for individual donations, to prevent loss of donation.

- b) Such a system also allows you to remind people to catch up missed donations!
2. New tax law just passed denies any deduction for cash contributions with no receipt or canceled check—*regardless of size*.
 3. It is improper to deduct or give a receipt for the value of services
 4. It is improper to deduct or give a receipt for the purchase price of goods or services—the value of the goods or services bought must be subtracted from the amount of the deduction unless “incidental.”
 - a) Hence, it is wrong to sell a book for a \$7.00 “donation.”
 - b) On the other hand, if you really do give the books away for free, then donations to support the book program is perfectly fine. Just tell the truth and don’t rationalize.
 - c) On the other hand, if a \$1,000 donation buys a \$7 book, the donation is likely fully deductible because the book is incidental.
 5. Receipts must state the value of what is sold for the “donation” as an offset.
 6. The church engages in tax fraud if it gives a receipt for more than the fair market value of the goods contributed or if the goods are described as better than they are.
 7. New law prohibits a deduction for clothing that’s not in “good, new” condition. Give NO receipt for shabby clothes.
 8. Tell the owner the IRS prohibits you from giving such a receipt. It does.
 9. Never place a value on a receipt for goods (just money). That’s the taxpayer’s burden.

H. *Gambling* is illegal in most states.

1. Lotteries, raffles, and such are typically illegal gambling unless there is no prize of any value.
2. Purchase of lottery tickets is not generally deductible because you are buying a chance rather than making a donation.
3. Penalty for illegal gambling activity is generally *criminal*.
4. Check with a good lawyer before any bingo, cow drops, or the like.

5. Some states allow nonprofits to have lotteries, but it's still gambling.
6. If you're going to do this, you can't preach against gambling anymore.

I. *Retirement planning*

1. A church may adopt same retirement plans as a private employer, but a church is exempt from many of the rules that private employers must cope with.
2. A church may also adopt a 403(b) plan, but these may be impractical on a small scale.
3. Qualified plans include a 401(k), profit sharing, or a defined benefit plan. 401(k) is most popular.
4. But these are expensive to administer and involve lots of paperwork.
5. An IRA-SIMPLE is inflexible but very low cost and very simple to administer.
 - a) The only documentation needed is IRS Form 5304-SIMPLE or 5305-SIMPLE.
 - b) Each employee opens an IRA and church contributes salary reduction contributions as well as its own contributions, which may be matching contributions.
 - c) Have an outside professional train the staff on investing. No church official should even give investment advice.
 - d) But do make sure advice is given.
 - e) Congress has just issued rules on how to do this.

J. *Cafeteria plans*

1. Also known as 125 plans.
2. May allow employees to deduct health insurance, child care, and uninsured medical expenses (but child care credit is better for lower income employees).
3. It's one way of getting employees to think of health insurance as salary.
4. Saves church FICA match.

K. *How Alabama churches may become exempt from sales taxes*

1. In Alabama, churches are normally subject to sales and use taxes.
2. Churches may become exempt, however, through a restructuring.
3. Savings for a construction project can be over 5% or more of the total building cost (\$50,000 on a \$1 million project).
4. Cannot be done retroactively.