



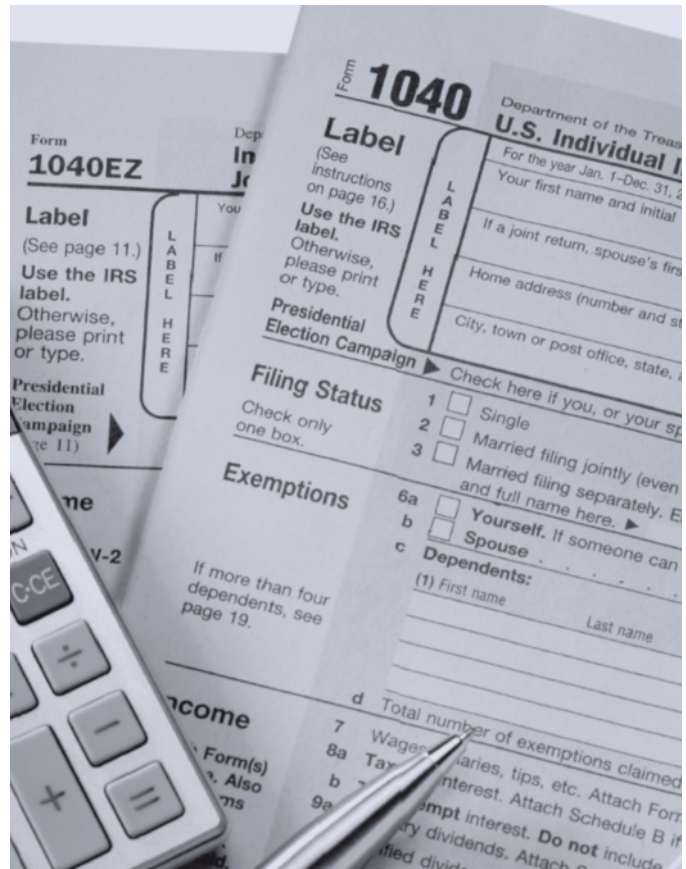
The Board of Pensions
of the Presbyterian Church (U.S.A.)

Tax Guide for Ministers for 2010 Returns



Richard R. Hammar, J.D., LL.M., CPA
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Published by The Board of Pensions of the Presbyterian Church (U.S.A.)
2000 Market Street, Philadelphia, PA 19103-3298
800-773-7752 (800-PRESPLAN)

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This publication is intended to provide a timely, accurate, and authoritative discussion of tax reporting compliance, and the impact of recent changes in the tax laws. It is not intended as a substitute for legal, accounting, or other professional advice. If legal, tax, or other expert assistance is required, the services of a competent professional should be sought. Although we believe this book provides accurate information, there may be changes resulting from IRS or judicial interpretations of the Tax Code, new tax regulations, or technical corrections that occurred after the printing of this edition that are not reflected in the text.



The Board of Pensions
of the Presbyterian Church (U.S.A.)

2000 Market Street
Philadelphia, PA 19103-3298

January 2011

Dear Minister Member,

The Board of Pensions is pleased to again publish the *Tax Guide for Ministers* to help you prepare your federal income tax return.

In light of the complexity of changing tax laws and regulations relating to ministers, we believe it's important to offer you this valuable resource. To assure the reliability of the information provided, we work with Richard R. Hammar, noted church and clergy tax expert, to develop this publication. The guide includes step-by-step instructions, examples, and information about situations specific to your tax return.

As we did last year, we have updated *Federal Reporting Requirements for Churches* for church treasurers. You can find this document, as well as the *Tax Guide*, online in the Treasurers & Administrators section of Pensions.org. Or you can call the Board at 800-773-7752 (800-PRESPLAN) to request a printed copy.

We're very pleased that we can make this resource available to you during the tax season, and we hope you find it especially useful. If there is anything else we can do for you, please give us a call.

Sincerely,

Robert W. Maggs, Jr.
President and Chief Executive

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January 2011

Dear Minister,

All or part of your Benefits Plan pension, disability, or retirement savings benefits may be excludable as housing allowance from gross income for Federal income tax purposes, subject to certain provisions established by Federal tax laws.

For retired or disabled ministers who own or rent their home, the tax laws limit the exclusion to the smallest of:

- a) the amount designated in advance by the Board as a housing allowance,
- b) the actual amount spent by the minister for housing-related expenses (housing, utilities, maintenance, repairs), or
- c) the fair rental value of the home, including furnishings and utilities.

For ministers living rent-free in a church-owned manse, the IRS regulations limit the exclusion to the smallest of a) or b), above.

You should maintain records of these expenses to support the housing allowance exclusion.

The housing allowance exclusion is not available to surviving spouses or retired lay employees.

To satisfy the requirement that the housing allowance be designated in advance, the Executive Committee of the Board of Directors, acting "ad interim" for the Board of Pensions, at its October 2, 2009 meeting designated for the calendar year 2010 that 100% of Pension, Disability and Retirement Savings Plan benefits distributed by The Board of Pensions of the Presbyterian Church (U.S.A.) to eligible ordained ministers and commissioned lay pastor members shall constitute a housing allowance, provided, however, that such housing allowance is not to exceed the fair rental value of the home, including furnishings and appurtenances, such as a garage, plus the cost of utilities and any other applicable tax law limits.

For further information on housing allowance provisions, refer to the *Tax Guide for Ministers* published by the Board of Pensions, talk with your tax adviser, or refer to IRS Publication 517, *Social Security and Other Information for Members of the Clergy and Other Religious Workers*.

The IRS does not require that you file this letter with your return. We recommend that you keep this letter with your tax papers in the event the IRS selects your return for audit and requires that you substantiate your exclusion.

Sincerely,

A handwritten signature in blue ink that reads "Michael F. Fallon, Jr." in a cursive, flowing script.

Michael F. Fallon, Jr.
Vice President, Finance

Part 1. Introduction

How to use this guide

This book contains the basic information you need to complete your 2010 federal income tax return. It gives special attention to several forms and schedules and the sections of each form most relevant to ministers.

A supplement to help churches comply with their federal tax reporting requirements is available to church treasurers and others at Pensions.org.

Key Point. Congress, the courts, or the IRS may cause tax changes at any time, in some cases retroactively. This guide includes only the law in effect at the time of its preparation. Be certain to refer to the final instructions for Form 1040 when completing your tax return.

This guide is divided into the following sections:

Part 1: Introduction – This section reviews tax highlights for 2010 and presents several preliminary questions you should consider before preparing your tax return.

Part 2: Special Rules for Ministers – In this section, you learn whether or not you are a minister for tax purposes, whether you are an employee or self-employed for both income tax and Social Security purposes, and how you pay your taxes.

Part 3: Step-by-Step Tax Return Preparation – This section explains how to complete the most common tax forms and schedules for ministers.

Part 4: Comprehensive Examples and Sample Forms – This section shows a sample tax return prepared for an ordained minister and spouse and for a retired minister and spouse.

Federal Reporting Requirements for Churches: 2010 Tax Year – This resource provides assistance to churches in filing federal reporting tax forms. It is available to church treasurers and others at Pensions.org.

Tax highlights for 2010

Several tax provisions expired at the end of 2009, and several more were due to expire at the end of 2010. With the passage of the Tax Relief, Unemployment Insurance Reauthorization and Jobs Creation Act (the “2010 Tax Relief Act” or “The Act”) late in 2010, many of these tax provisions were extended through 2012. Here is a summary of the extended provisions of most relevance to clergy and church staff:

- **Income tax brackets.** The lower income tax rates enacted by Congress in 2001 and 2003 were to expire at the end of 2010. They were extended for two years (through 2012) for all taxpayers by the 2010 Tax Relief Act.

- **Marriage penalty relief.** For many years, married couples filing a joint tax return paid more taxes than if they were unmarried filing individual returns. In 2001 Congress ended this so-called “marriage penalty” by (1) increasing the basic standard deduction for a married couple filing a joint return to twice the basic standard deduction for an unmarried individual filing a single return, and (2) increasing the 15 percent income tax rate bracket for a married couple filing a joint return to twice the size of the corresponding rate bracket for an unmarried individual filing a single return. These provisions were to have expired at the end of 2010, but both were extended by the 2010 Tax Relief Act for two years (through 2012).
- **Payroll tax “holiday.”** For employees subject to FICA taxes, the 2010 Tax Relief Act reduces the employee’s withholding for Social Security from 6.2 percent to 4.2 percent of wages up to \$106,800. There is no reduction in the Medicare tax portion of 1.45 percent withheld on all employee wages (no cap). For ministers subject to SECA taxes, the 2010 Tax Relief Act reduces the overall Social Security portion of the tax from 12.4 percent to 10.4 percent on income up to \$106,800. The Act does not reduce the Medicare portion of the tax, which remains at 2.9 percent. Accordingly, the total SECA tax for ministers for 2011 will be 13.3 percent (10.4 percent plus 2.9 percent) of wages up to \$106,800, plus 2.9 percent of any wages in excess of \$106,800. Please reference Notice 1036 on the IRS Web site for the percentage method income tax withholding tables and the lower Social Security withholding rate.
- **For pensioners.** The Board of Pensions has implemented the new tax withholding tables for 2011. January’s pension payments and all subsequent 2011 pension payments reflect the new tax tables. To review the 2011 federal income tax withholding tables, please reference Notice 1036 on the IRS Web site.
- **Making Work Pay Credit.** In the past, eligible individuals could claim a refundable income tax credit for two years (2009 and 2010). The credit was the lesser of (1) 6.2 percent of an individual’s earned income, or (2) \$400 (\$800 in the case of a joint return). Taxpayers could elect to receive this benefit through a reduction in the amount of income tax withheld from their paychecks or through claiming the credit on their tax returns. The credit expired at the end of 2010 and was not renewed. The withholding tables for 2011 are no longer adjusted for this credit. Because the tax tables used for withholding purposes included this tax credit in 2010, your federal tax withholding may increase in 2011.

- **Capital gains and dividends.** Under prior law, the capital gains and dividend rates for taxpayers below the 25 percent income tax bracket was equal to zero percent. For those in the 25 percent tax bracket and above, the capital gains and dividend rates were 15 percent. These rates were to expire at the end of 2010, and higher rates (10 percent and 20 percent) were to apply. The 2010 Tax Relief Act extends the lower capital gains and dividends rates for all taxpayers for an additional two years, through 2012.
- **Child tax credit.** Generally, taxpayers with income below certain threshold amounts may claim the child tax credit to reduce federal income tax for each qualifying child under the age of 17. In 2001, Congress increased the credit from \$500 to \$1,000 and made it refundable up to 15 percent of earnings above \$10,000. In 2009, Congress amended the law to allow earnings above \$3,000 to count towards refundability for 2009 and 2010. The 2010 Tax Relief Act extends these changes (which were scheduled to expire at the end of 2010) for an additional two years, through 2012.
- **Dependent care credit.** The dependent care credit allows taxpayers a credit for a percentage of child care expenses for children under age 13 and disabled dependents. In 2001, Congress increased the amount of eligible expenses from \$2,400 for one child and \$4,800 for two or more children to \$3,000 and \$6,000, respectively, and increased the applicable percentage from 30 percent to 35 percent. The 2010 Tax Relief Act extends these changes (which were scheduled to expire at the end of 2010) for an additional two years, through 2012.
- **Earned income tax credit.** Under prior law, working families with two or more children qualified for an earned income tax credit equal to 40 percent of the family's first \$12,570 of earned income. In 2009, Congress increased the earned income tax credit to 45 percent of the family's first \$12,570 of earned income for families with three or more children and increased the beginning point of the phase-out range for all married couples filing a joint return (regardless of the number of children). The 2010 Tax Relief Act extends for an additional two years, through 2012, the increased credit for families with three or more children and the higher phase-out ranges for all married couples filing a joint return.
- **Coverdell Education Savings Accounts.** Coverdell Education Savings Accounts are tax-exempt savings accounts used to pay the higher education expenses of a designated beneficiary. In 2001, Congress increased the annual contribution amount from \$500 to \$2,000 and expanded the definition of education expenses to include elementary and secondary school expenses.

These changes, which were to have expired at the end of 2010, were extended by the 2010 Tax Relief Act, through 2012.
- **Employer-provided educational assistance.** An employee may exclude from taxable income up to \$5,250 per year of employer-provided education assistance. Prior to 2001, this incentive was temporary and only applied to undergraduate courses. Congress enacted legislation in 2001 that expanded this provision to graduate education and extended it to the end of 2010. The 2010 Tax Relief Act extends the changes to this provision for an additional two years, through 2012.
- **American Opportunity Tax Credit.** The American Opportunity Tax Credit is available for up to \$2,500 of the cost of tuition and related expenses paid during the taxable year. Under this tax credit, taxpayers receive a tax credit based on 100 percent of the first \$2,000 of tuition and related expenses (including course materials) paid during the taxable year and 25 percent of the next \$2,000 of tuition and related expenses paid during the taxable year. Forty percent of the credit is refundable (i.e., payable to individuals with no income tax liability). This tax credit is subject to a phase-out for taxpayers with adjusted gross income in excess of \$80,000 (\$160,000 for married couples filing jointly). The 2010 Tax Relief Act extends this credit, which was scheduled to expire at the end of 2010, for an additional two years, through 2012.
- **Alternative minimum tax.** The Act allows an individual to offset the entire regular tax liability and alternative minimum tax ("AMT") liability by nonrefundable personal credits for 2010 and 2011. The provision provides that the individual AMT exemption amount for taxable years beginning in 2010 is (1) \$72,450 for married individuals filing a joint return and surviving spouses, (2) \$47,450 for other unmarried individuals, and (3) \$36,225 for married individuals filing separate returns. The provision provides that the individual AMT exemption amount for taxable years beginning in 2011 is (1) \$74,450 in the case of married individuals filing a joint return and surviving spouses, (2) \$48,450 in the case of other unmarried individuals, and (3) \$37,225 in the case of married individuals filing separate returns. Without these changes, the AMT exemption amounts would have plummeted in 2010 and beyond, exposing tens of millions of Americans to the AMT.
- **Energy-efficient new homes credit.** The 2010 Tax Relief Act extends through 2011 the credit for manufacturers of energy-efficient residential homes.
- **Energy-efficient appliances.** The Act extends through 2011 the credit for U.S.-based manufacture of energy-efficient clothes washers, dishwashers, and refrigerators.

- **Energy-efficient existing homes credit.** The Act extends through 2011 the credit for energy-efficient improvements to existing homes. Standards for eligible improvements are updated to reflect advances in energy efficiency.
- **Above-the-line deduction for certain expenses of elementary and secondary school teachers.** The Act extends through 2011 the \$250 above-the-line tax deduction for teachers and other school professionals for expenses paid or incurred for books, supplies (other than non-athletic supplies for courses of instruction in health or physical education), computer equipment (including related software and service), other equipment, and supplementary materials used by the educator in the classroom.
- **Deduction of state and local general sales taxes.** Congress enacted legislation in 2004 that provided an itemized deduction for state and local general sales taxes in lieu of the itemized deduction for state and local income taxes. Taxpayers could deduct the total amount of general state and local sales taxes they paid by accumulating receipts showing general sales taxes paid, or they could use tables created by the IRS. This provision was adopted to address the unequal treatment of taxpayers in the nine states that have no income tax. Taxpayers in these states cannot take advantage of the itemized deduction for state income taxes. Allowing them to deduct sales taxes helps offset this disadvantage. This deduction, which was scheduled to expire at the end of 2009, was extended by the 2010 Tax Relief Act, through 2011.
- **Above-the-line deduction for qualified tuition and related expenses.** Under prior law, an above-the-line deduction of up to \$4,000 was available for qualified education expenses incurred by a taxpayer or a taxpayer's spouse or dependent. Qualified education expenses included tuition and certain related expenses required for enrollment or attendance at an eligible educational institution (any college, university, vocational school, or other post-secondary educational institution eligible to participate in a student aid program administered by the Department of Education). Student activity fees and expenses for course-related books, supplies, and equipment were included in qualified education expenses only if the fees and expenses had to be paid to the institution as a condition of enrollment or attendance. This deduction, which was scheduled to expire at the end of 2009, was extended through 2011 by the 2010 Tax Relief Act.
- **Extension of tax-free distributions from individual retirement plans ("IRAs") for charitable purposes.** The Act extends through 2011 a provision that permits tax-free distributions to charity from an IRA of up to \$100,000 per taxpayer, per taxable year. Distributions are eligible for the exclusion only if made on or after the date the IRA owner attains age 70½ and only to the extent the distribution would be includible in gross income (without regard to this provision). The Act allows individuals to make charitable transfers during January of 2011 and treat them as if made during 2010.
- **Parity for mass transit benefits.** The Act extends through 2011 the increase in the monthly exclusion for employer-provided transit and vanpool benefits to equal that of the exclusion for employer-provided parking benefits.
- **Refund and tax credit disregard for means-tested benefit programs.** Prior law ensured that the refundable components of the earned income tax credit and child tax credit did not make households ineligible for means-tested benefit programs, and did not count as income in determining eligibility (and benefit levels) in such programs. Without these provisions, the receipt of a tax credit could put a substantial number of families over the income limits for these programs in the month that the tax refund was received. The 2010 Tax Relief Act disregards all refundable tax credits and refunds as income for means-tested benefit programs. The proposal is effective for amounts received after December 31, 2009, and does not apply to amounts received after December 31, 2012.
- **Extension of enhanced charitable deduction for contributions of food inventory.** The Act extends through 2011 a provision allowing businesses to claim an enhanced deduction for the contribution of food inventory.
- **Personal exemption phase-out.** Personal exemptions allow a certain amount per person to be exempt from tax (currently \$3,650). Due to the Personal Exemption Phase-out ("PEP"), the exemptions are phased out for taxpayers with income above a certain level. The PEP was repealed in 2010. This repeal was extended by the 2010 Tax Relief Act, through 2012.
- **Itemized deduction limitation.** Generally, taxpayers itemize deductions if their total deductions are more than the standard deduction amount. Since 1991, the amount of itemized deductions is reduced for taxpayers with income above a certain amount. This limitation is generally known as the "Pease limitation." It was repealed for 2010. The 2010 Tax Relief Act extends the repeal of the Pease limitation for an additional two years, though 2012.
- **Estate tax relief.** Beginning in 2001, Congress began phasing out the estate tax. It was fully repealed in 2010. The 2010 Tax Relief Act revives the estate tax,

but establishes an exemption of \$5 million per person and \$10 million per couple and a top tax rate of 35 percent for two years, through 2012. The exemption amount is indexed beginning in 2012. The proposal is effective January 1, 2010, but allows an election to choose no estate tax and modified carryover basis for estates arising on or after January 1, 2010, and before January 1, 2011. Under prior law, couples had to do complicated estate planning to claim their entire exemption. The 2010 Tax Relief Act allows the executor of a deceased spouse's estate to transfer any unused exemption to the surviving spouse without such planning. This provision is effective for estates of decedents dying after December 31, 2010.

Some expired tax provisions were not extended by the 2010 Tax Relief Act. These include:

- **Making Work Pay Credit.** See additional information in the tax highlights section on page 1.
- **Additional standard deduction for state and local property taxes.** Congress enacted legislation in 2008 that provided a limited tax deduction for state and local property taxes to nonitemizers by increasing their standard deduction by the lesser of (1) the amount allowable to the taxpayer as a deduction for state and local taxes, or (2) \$500 (\$1,000 in the case of a married individual filing jointly). The increased standard deduction was determined by taking into account real estate taxes for which a deduction was allowable to the taxpayer.
- **Deduction of state and local tax on the purchase of qualified motor vehicles.** In the past, taxpayers could claim an above-the-line deduction for qualified motor vehicle taxes. Qualified motor vehicle taxes included any state or local sales or excise tax imposed on the purchase of a qualified motor vehicle. A qualified motor vehicle was a passenger automobile, light truck, or motorcycle which had a gross vehicle weight of not more than 8,500 pounds that was acquired for use by the taxpayer after February 17, 2009, and before January 1, 2010, the original use of which began with the taxpayer. The deduction was limited to the tax on up to \$49,500 of the purchase price of a qualified motor vehicle. Congress has not extended this deduction.
- **Waiver of minimum required distribution rules for IRAs and defined contribution plans.** In general, persons participating in IRAs and defined benefit plans must begin receiving "required minimum distributions" by a certain age in order to avoid penalties. Congress suspended this rule for 2009, but has not done so for any subsequent year.

There were several tax developments in 2010 that will affect tax reporting by both ministers and churches for 2010 and future years. Here is a rundown of some of the key provisions:

1. You may be able to claim the earned income credit for 2010 if (1) you do not have a qualifying child and you earned less than \$13,460 (\$18,470 if married filing jointly), (2) a qualifying child lived with you and you earned less than \$35,535 (\$40,545 if married filing jointly), (3) two qualifying children lived with you and you earned less than \$40,363 (\$45,373 if married filing jointly), or (4) three or more qualifying children lived with you and you earned less than \$43,352 (\$48,362 if married filing jointly). The maximum earned income credit for 2010 is (1) \$457 with no qualifying child, (2) \$3,050 with one qualifying child, (3) \$5,036 with two qualifying children, and (4) \$5,666 with three or more qualifying children.
2. If you are covered by a retirement plan at work, your deduction for contributions to a traditional IRA is reduced (phased out) if your modified adjusted gross income (AGI) is more than \$89,000 but less than \$109,000 for a married couple filing a joint return or a qualifying widow(er), or more than \$56,000 but less than \$66,000 for a single individual. If you file a joint return and your spouse is covered by a retirement plan at work but you are not, your deduction is phased out if your modified AGI is more than \$167,000 but less than \$177,000. If your modified AGI is \$177,000 or more, you cannot take a deduction for contributions to a traditional IRA.
3. The dollar limit on annual elective deferrals an individual may make to a 403(b)(9) retirement plan increased to \$16,500 in 2010. It remains at \$16,500 for 2011.
4. The catch-up contribution limit on elective deferrals to a 403(b)(9) retirement plan for individuals who had attained age 50 by the end of the year was \$5,500 in 2010. It remains at \$5,500 for 2011.
5. The IRS has announced that it will not issue private letter rulings addressing the question of "whether an individual is a minister of the gospel for federal tax purposes." This means taxpayers will not be able to obtain clarification from the IRS in a letter ruling on their status as a minister for any one or more of the following matters: (1) eligibility for a parsonage exclusion or housing allowance, (2) eligibility for exemption from self-employment taxes, (3) self-employed status for Social Security, or (4) exemption of wages from income tax withholding. The IRS also has

announced that it will not address “whether amounts distributed to a retired minister from a pension or annuity plan should be excludible from the minister’s gross income as a parsonage allowance.”

6. The standard business mileage rate was 50 cents per mile for business miles driven during 2010. The standard business mileage rate for 2011 is 51 cents per mile.
 7. The IRS maintains that a minister’s housing allowance is “earned income” in determining eligibility for the earned income credit for ministers who have not opted out of Social Security by filing a timely Form 4361. For ministers who have opted out of Social Security, the law is less clear and the IRS has not provided guidance.
 8. Recent tax law changes will result in lower taxes for 2011, and lower estimated tax payments for many taxpayers. Be sure your estimated tax calculations or withholdings take into account the most recent tax law changes.
 9. Late in 2010, Congress enacted the Creating Small Business Jobs Act. The Act removes cell phones from the definition of listed property. As a result, the heightened substantiation requirements and special depreciation rules that apply to listed property do not apply to cell phones. This provision is effective for taxable years ending after December 31, 2009. This legislation allows employers and employees to come up with reasonable estimates of the personal use of employer-provided phones. It also allows employees to claim a depreciation deduction for cell phones that they purchase for business use without having to establish that the phones meet the “condition of employment” and “convenience of the employer” requirements. The IRS is taking additional steps to address the cell phone problem. In 2009, it announced that it is considering four alternative methods to comply with the substantiation requirements that govern employee use of employer-provided cell phones:
 - Under the first option, an employer could treat all of an employee’s use of an employer-provided cell phone as business use to the extent employees establish that they use a non-employer-provided cell phone for personal use during working hours.
 - Under the second option, the IRS would specify an amount of “minimal” personal use that would be disregarded in determining the amount of personal use of an employer-provided cell phone.
 - Under the third option, an employer would treat 75 percent of each employee’s use of an employer-provided cell phone as business use and the remaining 25 percent as personal use.
 - Under the fourth option, an employer could use statistical sampling to measure an employee’s personal use of an employer-provided cell phone. The remaining use would be deemed to be for business purposes.
- These four options are only proposals at this time. None of them has been adopted. Further, the IRS has said that use of any of these four options will require an employer to implement a written policy that (a) requires employees to carry and use the employer-provided cell phone in connection with the employer’s business, and (b) prohibits personal use of the phone other than for minimal personal use. It is also anticipated that the employer will be required to reasonably believe that the cell phone is not used for other-than-minimal personal use. In the event that an employee’s use of an employer-provided cell phone is for personal use or is not properly substantiated, the fair market value of using the phone would be includible in the employee’s income as a taxable fringe benefit.
10. Many churches employ retired persons who are receiving Social Security benefits. Persons younger than full retirement age may have their Social Security retirement benefits cut if they earn more than a specified amount. Full retirement age (the age at which you are entitled to full retirement benefits) for persons born between 1943-1954 is 66 years. In the year you reach full retirement age, your monthly Social Security retirement benefits are reduced by \$1 for every \$3 you earn above a specified amount (\$3,140 per month for 2011). No reduction in Social Security benefits occurs for income earned in the month full retirement age is attained (and all future months). Persons who begin receiving Social Security retirement benefits prior to the year in which they reach full retirement age will have their benefits reduced by \$1 for every \$2 of earned income in excess of a specified amount. For 2011, this annual amount is \$14,160.
 11. For 2010, the following three inflation adjustments took effect:
 - The amounts of income you need to earn to boost you to a higher tax rate were adjusted for inflation.
 - The value of each personal and dependency exemption, available to most taxpayers, remains unchanged at \$3,650.

- The standard deduction is \$11,400 for married couples filing a joint return, and \$5,700 for singles and married individuals filing separately (both unchanged). Nearly two out of three taxpayers take the standard deduction rather than itemizing deductions, such as mortgage interest, charitable contributions, and state and local taxes.
12. Will Congress give ministers another opportunity to revoke an exemption from Social Security? It does not look likely, at least for now. No legislation is pending that would provide ministers with this option.
 13. The Patient Protection and Affordable Care Act (the “Healthcare Reform Law”) was enacted on March 23, 2010. Here are a couple of the tax provisions that take effect this year and during the next several years.
 - **Small Business Health Care Tax Credit.** The credit is designed to encourage small employers, including small church employers, to offer health insurance coverage for the first time or maintain coverage they already have. In general, the credit is available to small employers that pay at least half the cost of single coverage for their employees. The Board of Pensions has posted more information for churches about this credit, which is available for tax year 2010, on its Web site. It is also addressed in the *Federal Reporting Requirements for Churches*.
 - **Adoption Credit.** The Healthcare Reform Law raises the maximum adoption credit to \$13,170 per child, up from \$12,150 in 2009. It also makes the credit refundable, meaning that eligible taxpayers can get it even if they owe no tax for that year. In general, the credit is based on the reasonable and necessary expenses related to a legal adoption, including adoption fees, court costs, attorney’s fees, and travel expenses. Income limits and other special rules apply. In addition to filling out Form 8839 (Qualified Adoption Expenses), eligible taxpayers must include with their 2010 tax returns one or more adoption-related documents.
 14. The amount of taxable investment income a child can have without it being subject to tax at the parent’s rate for 2010 remains the same (\$1,900) as 2009.
 15. **New Rules for Children of Divorced or Separated Parents.** For tax years beginning after July 2, 2008, (the 2009 calendar year for most taxpayers), new rules apply to allow the custodial parent to revoke a release of claim to exemption that was previously released to the noncustodial parent on Form 8332 or similar form.
 16. **COBRA Premium Assistance.** There are changes to the COBRA premium assistance provisions. To be eligible for COBRA premium assistance, you must be a qualified beneficiary as a result of an involuntary termination that occurred during the period beginning on September 1, 2008, and ending on May 31, 2010 (a five-month extension of the original period). In addition, you are eligible for the premium assistance for a maximum period of 15 months (increased from nine months) after the first month for which the premium assistance applies to you. There are also special rules for individuals who lost their health coverage because of a reduction in work hours. Church plans are not subject to COBRA and employees participating in church plans are not eligible for the COBRA premium assistance benefits. For more information on COBRA premium assistance, see IRS Publication 502.
 17. **Economic Recovery Payment.** Any economic recovery payment you received during 2010 is not taxable. These \$250 payments were made in 2010 to people who:
 - received Social Security benefits, Supplemental Security Income (SSI), railroad retirement benefits, or veterans disability compensation or pension benefits in November 2008, December 2008, or January 2009,
 - live in a U.S. state, the District of Columbia, Puerto Rico, Guam, the U.S. Virgin Islands, American Samoa, or the Northern Mariana Islands, and
 - did not receive an economic recovery payment in 2009.

If you are married and you and your spouse meet these requirements, each of you may get a \$250 payment.

If you are entitled to a payment, you will get it automatically. You do not need to apply for it. However, any payment you receive will reduce your Making Work Pay Credit on Schedule M (Form 1040A or 1040).
 18. For 2010, the maximum amount of qualified long-term care premiums you can include as medical expenses has increased. You can include qualified long-term care premiums, up to the amounts shown below, as medical expenses on Schedule A (Form 1040).
 - Age 40 or under - \$330
 - Age 41 to 50 - \$620
 - Age 51 to 60 - \$1,230
 - Age 61 to 70 - \$3,290
 - Age 71 or over - \$4,110

19. Residential Energy Credits.

- **Nonbusiness energy property credit.** This credit, which expired after 2007, has been reinstated. You may be able to claim a nonbusiness energy property credit of 30 percent of the cost of certain energy-efficient property or improvements you placed in service in 2010. This property can include high-efficiency heat pumps, air conditioners, and water heaters. It also may include energy-efficient windows, doors, insulation materials, and certain roofs. The credit has been expanded to include certain asphalt roofs and stoves that burn biomass fuel.

The total amount of credit you can claim in 2010 is limited to \$1,500.

- **Residential energy efficient property credit.** Beginning in 2009, there is no limitation on the credit amount for qualified solar electric property costs, qualified solar water heating property costs, qualified small wind energy property costs, and qualified geothermal heat pump property costs. The limitation on the credit amount for qualified fuel cell property costs remains the same.

Preliminary questions

Below are several questions you should consider before preparing your 2010 federal tax return.

Q. Must ministers pay federal income taxes?

A. Yes. Ministers are not exempt from paying federal income taxes.

Q. How much income must I earn to be required to file a tax return?

A. Generally, ministers are required to file a federal income tax return if they have earnings of \$400 or more. Different rules apply to some ministers who are exempt from self-employment taxes.

Q. Can I use the simpler Forms 1040A or 1040EZ rather than the standard Form 1040?

A. Most ministers must use the standard Form 1040.

Q. What records should I keep?

A. You should keep all receipts, canceled checks, and other evidence to prove amounts you claim as deductions, exclusions, or credits.

Q. What is the deadline for filing my federal income tax return?

A. April 18, 2011. The due date is April 18, 2011, instead of April 15, because of the Emancipation Day holiday in the District of Columbia (even if you do not live in the District of Columbia.)

Q. What if I am unable to file my tax return by the deadline?

A. You can obtain an automatic six-month extension (from April 18 to October 17, 2011) to file your 2010 Form 1040 if you file Form 4868 by April 18, 2011, with the IRS service center for your area. Your Form 1040 can be filed at any time during the six-month extension period. An extension only relieves you from the obligation to file your return; it is not an extension of the obligation to pay your taxes. Therefore, you must make an estimate of your tax for 2010 and pay the estimated tax with your Form 4868.

Q. Should I prepare my own tax return?

A. The answer depends on your ability and experience in working with financial information and in preparing tax returns. Keep in mind: Ministers' taxes present a number of unique rules, but these rules are not complex. Many ministers will be able to prepare their own tax returns if they understand the unique rules that apply. This is not hard. These rules are summarized below. If you decide to prepare your own, there are many excellent software programs available. The more sophisticated programs include clergy tax information. On the other hand, if you experienced unusual events in 2010, such as the sale or purchase of a home or the sale of other capital assets, it may be prudent to obtain professional tax assistance. The IRS provides a service called Taxpayer Assistance, but it is not liable in any way if its agents provide you with incorrect answers to your questions. Free taxpayer publications are available from the IRS and many of these are helpful to ministers.

Recommendation. If you need professional assistance, here are some tips that may help you find a competent tax professional:

- Ask other ministers in your community for their recommendations.
- If possible, use a CPA who specializes in tax law and who is familiar with the rules that apply to ministers. A CPA has completed a rigorous educational program and is subject to strict ethical requirements.
- Ask local tax professionals if they work with ministers and, if so, with how many.
- Ask local tax professionals a few questions to test their familiarity with ministers' tax issues. For example, ask whether ministers are employees or self-employed for Social Security. Anyone familiar with ministers' taxes will know that ministers always are self-employed for Social Security with respect to their ministerial duties. Or ask a tax professional if a minister's church salary is subject to income tax withholding. The answer is no, and anyone familiar with ministers' taxes should be able to answer this question.

- Enhanced Financial Services is a benefit offered through the Board of Pensions' Employee Assistance Program. By contacting our third-party provider, CIGNA Behavioral Health (CBH), at 866-640-2772, active plan members, spouses, and their eligible dependents have free telephonic access to a team of financial experts to discuss a variety of financial matters. Certified Financial Planners, certified tax preparers, enrolled agents, Certified Public Accountants, and professionals from the banking and insurance industries are available to discuss a variety of topics. (The complete list can be found on the CBH Web site.)
- To have your tax returns prepared telephonically for a fee typically discounted over retail rates, call the Enhanced Financial Services component of CBH at 866-640-2772. A tax professional can thoroughly explain the process to you and answer your questions.

Part 2. Special Rules for Ministers

Who is a minister for federal tax purposes?

Key Point. The IRS has its own criteria for determining who is a minister for tax purposes.

The criteria the IRS uses to determine who is a minister are not necessarily the same as those used by the Presbyterian Church (U.S.A.). Whether or not you qualify as a minister for tax purposes is a very important question since special tax and reporting rules apply to ministers under federal tax law. These rules include:

- eligibility for housing allowances,
- self-employed status for Social Security purposes,
- exemption of wages from income tax withholding (ministers use the quarterly estimated tax procedure to pay their taxes unless they elect voluntary withholding), and
- eligibility under very limited circumstances to exempt themselves from self-employment taxes.

These special rules apply only with respect to services performed in the exercise of ministry.

Example. Pastor J is an ordained minister at his church. In addition, he works a second job for a secular employer. Assume that Pastor J qualifies as a minister for federal tax purposes. Since his church duties constitute services performed in the exercise of ministry, the church can designate a housing allowance for him. However, the secular employer cannot designate any portion of Pastor J's compensation as a housing allowance, since this work would not be service in the exercise of ministry.

To determine if a person is a minister for federal tax purposes, the following five factors must be considered: (1) is the person ordained, licensed, or commissioned; (2) does the person administer sacerdotal functions; (3) does the person conduct religious worship; (4) does the person have management responsibilities in the church; and (5) is the person considered to be a religious leader by the church? The first of these factors is required, and the others are then evaluated on a case-by-case basis.

Key Point. The IRS has issued audit guidelines for its agents to follow when auditing ministers. The guidelines reject the narrow view that a minister must satisfy all five of the factors listed above. In general, to be considered a "minister" for federal tax purposes, you must be ordained, licensed, or commissioned and meet a majority of the remaining four factors.

Consult IRS Publication 517 for more specific information.

Presbyterian Commissioned Lay Pastors may be able to qualify for some of the special tax rules that apply to ministers under federal tax law if their qualifications and service meet the criteria established by the IRS for ministers. If you are in such service, you should review this issue carefully with a tax adviser or consultant when preparing your tax return.

Are ministers employees or self-employed for federal tax purposes?

Key Point. Most Presbyterian ministers are considered employees for federal income tax purposes under the tests currently used by the IRS and the courts and should receive IRS Form W-2 from their church or employer reporting their taxable income. However, ministers are self-employed for Social Security purposes (with respect to services they perform in the exercise of their ministry).

Ministers have a *dual* tax status. For federal income taxes they ordinarily are employees, but for Social Security purposes, they are self-employed with regard to services performed in the exercise of ministry. These two rules are summarized as follows:

1. Income taxes. For federal income tax reporting, most Presbyterian ministers are employees under the test currently used by the IRS. This means that they should receive a Form W-2 from their church at the end of each year (rather than a Form 1099). It also means that they report their business expenses on Schedule A rather than on Schedule C. A few ministers are self-employed, such as some traveling evangelists and some interim pastors. Also, many ministers who are employees of a local church are self-employed for other purposes.

For example, the minister of a local church almost always will be an employee, but will be self-employed with regard to guest speaking appearances in other churches and services performed directly for individual members (such as weddings and funerals).

Example. Pastor B is a minister at First Presbyterian Church. She is an employee for federal income tax reporting purposes with respect to her church salary. However, she is self-employed with respect to honoraria she receives for speaking in other churches and for compensation church members give her for performing personal services such as weddings and funerals. The church issues Pastor B a Form W-2 reporting her church salary. Pastor B reports this amount as wages on line 7 of Form 1040. She reports her compensation from self-employment activities on Schedule C.

Key Point. Most ministers will be better off being treated as employees since the value of various fringe benefits will be tax free; the risk of an IRS audit is substantially lower; and reporting as an employee avoids the additional taxes and penalties that often apply to self-employed ministers who are audited by the IRS and reclassified as employees.

Tax savings tip. Ministers and other church staff members should carefully review their Form W-2 to be sure that it does not report more income than was actually received. If an error was made, the church should issue a corrected tax form (Form W-2c). See the *Federal Reporting Requirements for Churches: 2010 Tax Year*, published by the Board of Pensions, for details.

The Tax Court Test. The United States Tax Court has created a seven-factor test for determining whether a minister is an employee or self-employed for federal income tax reporting purposes. The test requires consideration of the following seven factors: (1) the degree of control exercised by the employer over the details of the work; (2) which party invests in the facilities used in the work; (3) the opportunity of the individual for profit or loss; (4) whether the employer has the right to discharge the individual; (5) whether the work is part of the employer's regular business; (6) the permanency of the relationship; and (7) the relationship the parties believe they are creating. Most ministers will be employees under this test.

2. Social Security. The tax code treats ministers as self-employed for Social Security purposes with respect to services performed in the exercise of their ministry, even if they report their income taxes as an employee. This means that ministers must pay self-employment taxes (Social Security taxes for the self-employed) unless they have timely filed an exemption application that has been approved by the IRS. As noted next, few ministers qualify for this exemption.

Key Point. Unless approved for exemption, ministers must pay Social Security and Medicare taxes on their ministerial income at the self-employment — or SECA — rate. (SECA, short for Self-Employment Contributions Act, refers to the law under which self-employed people pay for Social Security and Medicare.) They are not subject to FICA even though they report their income taxes as employees and receive a Form W-2 from their church. (FICA, short for Federal Insurance Contribution Act, refers to the law under which employees and employers contribute to Social Security and Medicare.) No earnings are subject to both SECA and FICA.

Exemption from Social Security (self-employment) taxes

Key Point. The Presbyterian Church (U.S.A.) 198th General Assembly (1986) approved a Pastoral Letter to Candidates Regarding Social Security that strongly supports participation in the Social Security program. Further, the Benefits Plan assumes participation in Social Security, and the plan's benefits may not be adequate for a secure retirement or disability without Social Security benefits.

If ministers meet several requirements, they may exempt themselves from self-employment taxes with respect to their ministerial earnings. Among other things, the exemption application (Form 4361) must be submitted to the IRS within a limited time period. The deadline is the due date of the federal tax return for the second year in which a minister has net earnings from self-employment of \$400 or more, any part of which comes from ministerial services. Further, the exemption is available only to ministers who are opposed on the basis of religious considerations to the acceptance of benefits under the Social Security program (or any other public insurance system that provides retirement or medical benefits). As a result, a minister who files the exemption application may still purchase life insurance or participate in retirement programs administered by nongovernmental institutions (such as a life insurance company or the Board of Pensions).

A minister's opposition must be to accepting benefits under Social Security (or any other public insurance program). Economic or any other nonreligious considerations are not a valid basis for the exemption, nor is opposition to paying the self-employment tax.

The exemption is effective only when it is approved by the IRS. Few ministers qualify for exemption. Many younger ministers opt out of Social Security without realizing that they do not qualify for the exemption. A decision to opt out of Social Security is irrevocable.

An exemption from self-employment taxes applies only to ministerial services. Ministers who have exempted themselves from self-employment taxes must pay Social Security taxes on any non-ministerial compensation they receive. They remain eligible for Social Security benefits based on their non-ministerial employment assuming that they have worked enough credits. Generally, 40 credits are required. If you were born in 1929 or later, you need 40 credits (10 years of work). People born before 1929 need fewer than 40 credits. Also, the Social Security Administration has stated that ministers who exempt themselves from self-employment taxes may qualify for Social Security benefits (including retirement and Medicare) on the basis of their spouse's coverage if the spouse has enough credits. However, the amount of these benefits will be reduced by the so-called "windfall elimination provision." Contact a Social Security Administration office for details.

Key Point. The amount of earnings required for a quarter of coverage (enough to earn one credit) in 2011 is \$1,120. Credits are used to determine if you have the minimum amount of work covered to qualify for Social Security benefits. A quarter of coverage is the basic unit for determining whether a worker is insured under the Social Security program. You can earn up to four credits within one year.

Key Point. Ministers who work after they retire must pay Social Security tax on their wages (unless they exempted themselves from Social Security as a minister and they are employed in a ministerial capacity).

How do ministers pay their taxes?

Key Point. Ministers must prepay their income taxes and self-employment taxes using the estimated tax procedure unless they have entered into a voluntary withholding arrangement with their church with respect to federal income tax only.

As noted above, ministers' wages are exempt from federal income tax withholding. This means that a church does not have to withhold income taxes from a minister's paycheck. And, since ministers are always self-employed for Social Security with respect to their ministerial services, a church does not withhold the employee's share of Social Security and Medicare taxes. Ministers must prepay their income taxes and self-employment taxes by using the estimated tax procedure unless they have entered into a voluntary withholding arrangement with their church. Estimated taxes must be paid in quarterly installments. If your estimated taxes for the current year are less than your actual taxes, you may have to pay an underpayment penalty. You can amend your estimated tax payments during the year if your circumstances change. For example, if your

income or deductions increase unexpectedly, you should refigure your estimated tax liability for the year and amend your remaining quarterly payments accordingly.

You will need to make estimated tax payments for 2011 if you expect to owe at least \$1,000 in tax for 2011 after subtracting your withholding and credits and if you expect your withholding and credits to be less than the smaller of (1) 90 percent of the tax to be shown on your 2011 tax return or (2) 100 percent of the tax shown on your 2010 tax return (110 percent if adjusted gross income exceeds \$150,000). Your 2010 tax return must cover all 12 months.

The four-step procedure for reporting and prepaying estimated taxes for 2011 is summarized below.

Step 1. Obtain a copy of IRS Form 1040ES before April 15, 2011. You can obtain forms by calling the IRS toll-free forms hotline at 800-TAX-FORM (800-829-3676) or from the IRS Web site (IRS.gov).

Step 2. Compute estimated taxes for 2011. Compute your estimated tax for 2011 using the Form 1040-ES worksheet.

Step 3. Pay one-fourth of your total estimated taxes for 2011 in each of four quarterly installments as follows:

For the Period	Due Date
January 1 - March 31	April 18, 2011
April 1 - May 31	June 15, 2011
June 1 - August 31	September 15, 2011
September 1 - December 31	January 15, 2012

If the due date for making an estimated tax payment falls on a Saturday, Sunday, or legal holiday, the payment will be on time if you make it on the next day that is not a Saturday, Sunday, or legal holiday. You must send each payment to the IRS, accompanied by one of the four payment vouchers contained in Form 1040-ES.

Step 4. Compute actual taxes at the end of the year. After the close of 2011, compute your actual tax liability on Form 1040. Only then will you know your actual income, deductions, exclusions, and credits. If you overpaid your estimated taxes (that is, actual taxes computed on Form 1040 are less than all of your estimated tax payments plus any withholding), you can elect to have the overpayment credited against your first 2012 quarterly estimated tax payment or spread it out in any way you choose among any or all of your next four quarterly installments. Alternatively, you can request a refund of the overpayment. If you underpaid your estimated taxes (that is, your actual tax liability exceeds the total of your estimated tax payments plus any withholding), you may have to pay a penalty.

Key Point. Ministers who report their income taxes as employees can request that their employing church *voluntarily* withhold income taxes from their wages. Simply furnish the church with a completed W-4 (withholding allowance certificate). Since ministers are not employees for Social Security purposes, the church must not withhold the employee's share of Social Security and Medicare taxes. However, ministers can request on Form W-4 (line 6) that an additional amount of income tax be withheld to cover their estimated self-employment tax liability for the year. The excess income tax withheld is a credit that can be applied against the minister's self-employment tax liability.

Part 3. Step-by-Step Tax Return Preparation

Tax forms and schedules

This step-by-step analysis covers these forms and schedules:

Form 1040 is the basic document you will use. It summarizes all of your tax information. Details are reported on supplementary schedules and forms.

Schedule A is for itemized deductions for medical and dental expenses, taxes, interest, contributions, casualty and theft losses, and miscellaneous items. Some expenses related to ministerial income may also be deducted on Schedule A.

Schedule B is for reporting dividend and interest income.

Schedule C is for reporting your income and expenses from business activities you conduct other than in your capacity as an employee. Examples would be fees received for guest speaking appearances in other churches or fees received directly from members for performing personal services, such as weddings and funerals.

Schedule SE is for Social Security taxes due on your self-employment income and on your salary and housing allowance as an employee of the church if you are an ordained minister.

Form 2106 is used to report expenses you incur in your capacity as an employee of the church.

These forms and schedules, along with others, are included in the illustrated example in Part 4 of this guide. These forms and schedules are the ones most commonly used by ministers, but you may have a need for others. These forms may be obtained at your local post office or IRS office. Or, you can obtain them by calling the IRS toll-free forms hotline at 800-TAX-FORM (800-829-3676). They also are available on the IRS Web site (IRS.gov).

Form 1040

Step 1: Name and address

Print or type the information in the spaces provided. If you are married but filing a separate return, enter your spouse's name on line 3 instead of below your name. If you filed a joint return for 2009 and you are filing a joint return for 2010 with the same spouse, be sure to enter your names and Social Security numbers in the same order as on your 2009 return.

If you plan to move after filing your return, use Form 8822 to notify the IRS of your new address.

If you changed your name because of marriage, divorce, etc., be sure to report the change to the Social Security Administration (SSA) before filing your return. This prevents delays in processing your return and issuing refunds. It also safeguards your future Social Security benefits.

Enter your P.O. box number only if your post office does not deliver mail to your home.

If you want \$3 to go to the presidential election campaign fund, check the box labeled "yes." If you are filing a joint return, your spouse can also have \$3 go to the fund. If you check a box, your tax or refund will not change.

Step 2: Filing status

Select the appropriate filing status from the five options listed in this section of Form 1040.

Step 3: Exemptions

To claim a dependency exemption for a *qualifying child*, the child must be a United States citizen or resident, and meet the following five tests:

1. *Relationship test.* The child must be your child (including an adopted child, stepchild, or eligible foster child), brother, sister, stepbrother, stepsister, or a descendant of any of them.

2. *Residency test.* The child must live with you for more than half of the year. Temporary absences for special circumstances, such as school, vacation, medical care, military service, or detention in a juvenile facility, count as time lived at home. A child who was born or died during the year is considered to have lived with you for the entire year if your home was the child's home for the entire time he or she was alive during the year. An exception applies, in certain cases, for children of divorced or separated parents.

3. *Age test.* At the end of 2010, the child must be under age 19 and younger than you, or under age 24, a student and younger than you, or any age and permanently and totally disabled.

4. *Support test.* The child must not have provided over half of his or her own support in 2010.

5. *Special test for child of more than one person.* In some cases, a child will meet the other four tests and be a qualifying child of more than one person. Only one of these persons can claim the child as a qualifying child. If both persons cannot agree on who will treat the child as a qualifying child, the IRS applies a “tie-breaker” rule to determine which person can claim the child.

To claim a dependency exemption for a *qualifying relative*, the person must be a relative and must meet all of the following conditions:

- The person must be either your relative or any other person (other than your spouse) who lived in your home all year as a member of your household. If the person is not your relative, your relationship must not violate local law.
- The person cannot be your qualifying child (see previous five tests) or the qualifying child of another person in 2010.
- The person must have gross income of less than \$3,650. If the person is permanently and totally disabled, certain income from a sheltered workshop may be excluded for this purpose.
- You must have provided over half of the person’s support in 2010. Exceptions apply, in certain cases, for children of divorced or separated parents, for a person supported by two or more taxpayers, and kidnapped children.

For more information on dependents, see IRS Publication 501.

Step 4: Income

Several items of income are reported on lines 7 through 22. The most important of these (for ministers) are discussed below.

Key Point. Some items, such as the housing allowance, are not reported as income. They are called exclusions and are explained next.

Line 7. Wages, salaries, tips, etc.

Key Point. The amount reported on line 7 ordinarily will be the same as reported by the church as wages in box 1 of the minister’s Form W-2.

As an employee, you should receive a Form W-2 from your church reporting your wages at the end of each year. Report this amount on line 7. Then determine if this amount reflects all of your church income. If it does not, report the remaining income on line 21 as other income.

Determining church wages or salary. Besides a salary, ministers’ wages may include several other items. Some items are:

- bonuses
- excess housing allowance (the amount by which a housing allowance exceeds the lesser of a minister’s actual housing expenses or the fair rental value of the minister’s home)
- the cost of sending a minister to the Holy Land (if paid by the church)
- Christmas and special occasion offerings
- retirement gifts paid by a church
- the portion of a minister’s Social Security tax paid by a church to the minister
- personal use of a church-provided car
- purchases of church property for less than fair market value
- business expense reimbursements under a non-accountable plan.
- reimbursements the church made for the minister’s moving expenses (but not if the minister substantiated the reimbursed expenses under an accountable arrangement)
- imputed cost of group term life insurance coverage (including death benefits under the Benefits Plan) exceeding \$50,000 and the entire cost of coverage of spouse and dependents if the coverage exceeds \$2,000 and is paid by the church
- church reimbursements of a spouse’s travel expenses incurred while accompanying a minister on a business trip (represents income to the minister unless the spouse’s presence serves a legitimate business purpose and the spouse’s expenses are reimbursed under an accountable arrangement)
- “discretionary funds” established by a church for a minister to spend on current needs if the minister is allowed to distribute funds for his or her personal benefit
- “below-market interest loans” of at least \$10,000 made by a church to a minister
- cancellation of a minister’s debt to a church
- severance pay
- payment of a minister’s personal expenses by the church

Key Point. The IRS can assess intermediate sanctions in the form of substantial excise taxes against a minister who is an officer or director of his or her employing church and, in some cases, against church board members if the minister is paid an excess benefit. Excess benefits may occur if a church pays a minister an excessive salary, makes a large retirement or other special

occasion “gift” to a minister, gives church property (such as a parsonage) to the minister, or sells church property to the minister at an unreasonably low price. A rebuttable presumption arises that compensation is reasonable if it is approved by an independent board on the basis of “comparable data” or independent compensation surveys and the basis for the board’s decision is documented.

Key Point. The IRS has ruled that “disqualified persons” receive “automatic” excess benefits resulting in intermediate sanctions, regardless of amount, if they use church assets (vehicles, homes, credit cards, computers, cell phones, etc.) for personal purposes, or receive nonaccountable expense reimbursements (not supported by adequate documentation of business purpose), *unless* such benefits are reported as taxable income by the church on the disqualified person’s W-2 or by the disqualified person on his or her Form 1040 for the year in which the benefits are provided. A disqualified person is an officer or director of the employer or a relative of such a person. The concept of automatic excess benefits will directly affect the compensation practices of most churches and expose some ministers and church board members to intermediate sanctions.

If some of these items were not reported on your Form W-2, they still must be reported as income. Either have your church issue a “corrected” Form W-2 (Form W-2c) or report the items as other income on line 21. If this is the case, be sure this is addressed and corrected for future years.

Items not reported on line 7. Some kinds of income are not taxable. These items are called *exclusions*. Most exclusions apply in computing both income taxes and self-employment taxes. The housing allowance is an example of an exclusion that applies only to income taxes and not to self-employment taxes. Some of the more common exclusions for ministers include:

- Gifts are excludable from taxable income, so long as they are not compensation for services performed. However, employers generally are not permitted to give tax-free gifts to employees.
- Life insurance proceeds and inheritances are excludable from taxable income.
- Medical insurance premiums paid by an employer for employees (and their spouses and dependents up to age 26) are excludable from taxable income. This exclusion is not available to self-employed individuals.
- The value of accident or health benefits that are provided to an employee (with the exception of some long-term care benefits) are excludable in most cases.

See IRS Publication 17, Chapter 5, *Wages, Salaries and Other Earnings* and Publication 969, *Health Savings Accounts and Other Tax-Favored Health Plans*, for additional information.

- Employees may exclude the cost of employer-provided group term life insurance as long as the amount of coverage does not exceed \$50,000.

Key Point. The death benefits under the Benefits Plan generally exceed the \$50,000 limit. Your W-2 should include imputed income reporting the taxable cost of these benefits. See the *Federal Reporting Requirements for Churches: 2010 Tax Year*, published by the Board of Pensions, or visit the Board of Pensions Web site (Pensions.org) for the Taxation of Death Benefit Dues calculator to compute the imputed income amount.

- Employees may exclude from their taxable income qualified tuition reductions provided by their employer. A qualified tuition reduction is a reduction in tuition provided to employees or their spouses or dependent children by an employer that is an educational institution.
- The value of free childcare services provided by a church to its employees is excluded from employees’ income so long as the benefit is based on a written plan that does not discriminate in favor of highly compensated employees. (Other conditions apply.)

There are five other exclusions that will be discussed separately—the housing allowance, tax-sheltered annuities, qualified scholarships, Assistance Program grants, and sale of one’s home.

Housing allowance

Ministers who own or rent a home

The most important tax benefit available to ministers who own or rent their homes is the housing allowance exclusion. Ministers who own their home do not pay federal income taxes on the amount of their compensation that their employing church designates in advance as a housing allowance to the extent that (1) the allowance represents compensation for ministerial services, (2) it is used to pay housing expenses, and (3) it does not exceed the annual fair rental value of the home (furnished, plus utilities). Housing-related expenses include mortgage payments, rent, utilities, repairs, furnishings, insurance, property taxes, additions, and maintenance. Ministers who rent a home or apartment do not pay federal income taxes on the amount of their compensation that their employing church designates in advance as a housing allowance to the extent that the allowance represents compensation for ministerial services and is used to pay rental expenses such as rent, furnishings, utilities, and insurance. Please note that the expenses listed above are not an all-inclusive list.

Ministers who live in a church-owned manse

Ministers who live rent-free in a church-owned manse may exclude the lesser of the following amounts provided the exclusion is not greater than reasonable pay for your services:

1. The housing allowance designated by the church in advance of the payment of the compensation; or
2. Actual housing expenses not paid by the church (including utilities, furnishings, repairs, and improvements). Ministers who live rent-free in church manses should not include the fair rental value of the parsonage as income for federal income taxes. If these ministers incur any out-of-pocket expenses in maintaining the manse (such as utilities, property taxes, insurance, furnishings, or lawn care), they should be sure that their employing church designates in advance a portion of their annual compensation as a manse allowance. The amount so designated is not reported as wages on the minister's Form W-2 at the end of the year. (If the allowance exceeds the actual expenses, the difference must be reported as income by the minister.) This is a very important tax benefit for ministers living in church-provided manses. Unfortunately, many of these ministers are not aware of this benefit or are not taking advantage of it.

Retired ministers

Retired ministers can exclude from gross income the rental value of a home (plus utilities) furnished to you by your church as part of your pay for past services, or the part of your pension that was designated as a rental allowance. The Board of Pensions designates 100 percent of your pension as a housing (rental) allowance. The self-employment tax does not apply to the rental value of a manse provided after a minister retires or to pension designated as a housing allowance that is received by a minister from a church plan after retirement.

Retirement home fees

Many ministers move into a retirement home following their retirement from ministry. There often are two costs associated with such living arrangements: (1) a lump sum entrance fee, and (2) monthly or annual maintenance fees. The IRS has ruled that a lump sum entrance fee paid by a retired minister to gain admission to a retirement community cannot be prorated over several years and claimed as a housing expense in those years. It can only be treated as a housing expense in the year that it is actually paid [IRS Letter Ruling 8348018 (1983)].

What about monthly or annual maintenance fees? Can a retired minister's housing allowance (designated by the Board) be applied to these fees?

That depends. Section 107 of the tax code allows ministers to exclude from gross income the portion of their compensation designated in advance as a housing allowance to the extent that the allowance is used to "rent or provide a home." The regulations define this language as follows:

"Circumstances under which a rental allowance will be deemed to have been used to rent or provide a home will include cases in which the allowance is expended (1) for rent of a home, (2) for purchase of a home, and (3) for expenses directly related to providing a home. Expenses for food and servants are not considered for this purpose to be directly related to providing a home."

As a result, a retired minister's housing allowance can be applied to any portion of a monthly maintenance fee charged by a retirement home that is "an expense directly related to providing a home." The regulations prohibit housing allowances from being applied to the costs of "food and servants," and, therefore, a housing allowance could not be applied to any portion of a maintenance fee that goes to food or housekeeping expenses.

How much should a church designate as a housing allowance?

Many churches base the allowance on their minister's estimate of actual housing expenses for the new year. The church provides the minister with a form on which anticipated housing expenses for the new year are reported. For ministers who own their homes, the form asks for projected expenses in the following categories: down payment, mortgage payments, property taxes, property insurance, utilities, furnishings and appliances, repairs and improvements, maintenance, and miscellaneous. Many churches designate an allowance in excess of the anticipated expenses itemized by the minister. Basing the allowance solely on a minister's actual expenses penalizes the minister if actual housing expenses turn out to be higher than expected. In other words, the allowance should take into account unexpected housing costs or inaccurate projections of expenses. Commissioned Lay Pastors ("CLP") may be able to exclude income designated as a housing allowance if they meet the IRS requirements for ministers (summarized above); the employing church designates a portion of the CLP's salary as housing allowance, in advance of payment; and the CLP complies with the requirements for documentation of the housing expenses outlined above.

Housing expenses to include in computing your housing allowance exclusion

Ministers who own or rent their home should take the following expenses into account in computing their housing allowance exclusion:

- down payment on a home (but remember, a housing allowance is nontaxable only to the extent that it does not exceed the lesser of actual housing expenses or the annual fair rental value of a minister's home)
- mortgage payments on a loan to purchase or improve your home (include both principal and interest)
- rent
- real estate taxes
- property insurance
- utilities (electricity, gas, water, trash pickup, local telephone charges)
- furnishings and appliances (purchase and repair)
- structural repairs and remodeling
- yard maintenance and improvements
- maintenance items (pest control, etc.)
- homeowners association dues

Note that these exclusions are for federal income tax purposes only. Ministers cannot exclude the annual rental value of a manse or a housing allowance when computing their Social Security taxes.

The housing allowance is available to ministers whether they report their income taxes as employees or as self-employed (whether the church issues them a W-2 or a 1099).

Example. A church designated \$12,000 of Reverend D's 2010 compensation as a housing allowance. Reverend D's housing expenses for 2010 were utilities of \$2,000, mortgage payments of \$6,000, property taxes of \$2,000, insurance payments of \$1,000, repairs of \$1,000, and furnishings of \$1,000. The annual fair rental value of the home (furnished, plus utilities) is \$10,000. Reverend D's housing allowance is nontaxable in computing his income taxes only to the extent that it is used to pay housing expenses and does not exceed the annual fair rental value of his home (furnished, plus utilities). Stated differently, the nontaxable portion of a housing allowance is the least of the following three amounts: (1) the housing allowance designated by the church; (2) actual housing expenses; (3) the annual fair rental value of the home (furnished, plus utilities). In this case, the lowest of these three amounts is the annual fair rental value of the home (\$10,000), and so this represents the nontaxable portion of Reverend D's housing allowance. Reverend D must report the difference between this amount and the housing allowance designated by his church (\$2,000) on line 7 of Form 1040.

Example. Same facts as the previous example, except that the church designated \$9,000 of Reverend D's salary as a housing allowance. The lowest of the three amounts in this case would be \$9,000, the church-designated housing allowance, so this represents the nontaxable amount. Note that Reverend D's actual housing expenses were more than the allowance, so he was "penalized" because of the low allowance designated by his church.

Example. Reverend Y owns a home and incurs housing expenses of \$12,000 in 2010. These expenses include mortgage principal and interest, property taxes, utilities, insurance, and repairs. The church designated (in advance) \$12,000 of Reverend Y's 2010 compensation as a housing allowance. Reverend Y is able to itemize expenses on Schedule A (Form 1040). He is able to claim itemized deductions on Schedule A for both his mortgage interest and his property taxes even though his taxable income was already reduced by these items because of their inclusion in the housing allowance. This is often referred to as the "double deduction." In reality, it represents an exclusion and a deduction.

Example. In preparing her income tax return for 2010, Reverend H discovers that her church failed to designate a housing allowance for her for 2010. She asks her church to pass a resolution retroactively granting the allowance for 2010. Such a resolution is ineffective, and Reverend H will not be eligible for any housing allowance exclusion in 2010.

Please note the following manse/housing allowance tips:

- Under no circumstances can a church designate a housing allowance retroactively. Unfortunately, many churches fail to designate housing allowances and thereby deprive ministers of an important tax benefit.
- Ministers who own their homes lose the largest component of their housing allowance exclusion when they pay off their home mortgage loan. Many ministers in this position have obtained home equity loans or a conventional loan secured by a mortgage on their otherwise debt-free home and have claimed their payments under these kinds of loans as a housing expense in computing their housing allowance exclusion. The Tax Court has ruled that this is permissible only if the loan was obtained for housing-related expenses.
- Ministers should be sure that the designation of a housing or parsonage allowance for the next year is on the agenda of the church (or session) for one of its final meetings during the current year. The designation should be an official action, and it should be duly recorded in the minutes of the meeting. The IRS also recognizes designations included in employment contracts and budget line items assuming that in

each case the designation was appropriately adopted in advance by the church and supported by underlying documentation as to each minister's anticipated housing expenses.

- A housing allowance can be amended during the year if a minister's housing expenses are more than expected. However, an amendment is only effective prospectively. Ministers should notify their church if their actual housing expenses are significantly more than the housing allowance designated by their church. Remember, however, that it serves no purpose to designate a housing allowance greater than the fair rental value of a minister's home (furnished, plus utilities).
- The housing allowance designated by the church is not necessarily nontaxable. It is nontaxable (for income tax reporting purposes) only to the extent that it is used to pay for housing expenses and, for ministers who own their home, does not exceed the fair rental value of their home (furnished, plus utilities). The housing allowance exclusion is an exclusion for federal income taxes only. Ministers must add the housing allowance as income in reporting self-employment taxes on Schedule SE (unless they are exempt from self-employment taxes).
- If the housing allowance designated by the church exceeds the amount that can be claimed, the excess housing allowance should be reported on line 7 of Form 1040.
- The Sarbanes-Oxley Act makes it a crime to knowingly falsify any document with the intent to influence

“the investigation or proper administration of any matter within the jurisdiction of any department or agency of the United States ... or in relation to or contemplation of any such matter or case,” and this provision contains no exemption for churches or pastors. It is possible that a pastor's backdating of a board resolution to qualify for a housing allowance for the entire year violates this provision in the Sarbanes-Oxley Act, exposing the pastor to a fine or imprisonment. Even if the pastor's action does not violate the Sarbanes-Oxley Act, it may result in civil or criminal penalties under the tax code.

- The rental value of a parsonage and a housing allowance are exclusions only for federal income tax reporting purposes. Ministers cannot exclude a housing allowance or the fair rental value of a parsonage when computing self-employment (Social Security) taxes unless they are retired. The tax code specifies that the self-employment tax does not apply to “the rental value of any parsonage or any parsonage allowance provided after the [minister] retires.”
- A lawsuit was filed in October 2009 by the Freedom from Religion Foundation, Inc., challenging the constitutionality of tax benefits associated with the housing allowances that churches provide to pastors. On May 21, 2010, the court ruled the case will be allowed to go to trial, likely in the fall of 2011. If the court rules that the housing allowance is unconstitutional, the matter would likely end up before the U.S. Supreme Court a year or two later.

Housing allowance expense worksheet for ordained ministers who own their home

Ordained ministers are permitted to exclude from their church income (for federal income tax purposes) a housing allowance designated in advance by their employing church, to the extent that the allowance is used to pay housing expenses. To assist the church in designating an appropriate amount, the minister can use this form to estimate 2011 housing expenses. It is designed for ministers who own or rent their home.

Category	Estimated Expense Amount for 2011
Down payment on a home	\$
Mortgage payments on a loan to purchase or improve your home (include both principal and interest), rental payments	\$
Real estate taxes	\$
Property insurance	\$
Utilities (electricity, gas, water, trash pickup, local telephone charges)	\$
Furnishings and appliances (purchase and repair)	\$
Structural repairs and remodeling	\$
Yard maintenance and improvements	\$
Maintenance items (pest control, etc.)	\$
Homeowners association dues	\$
Miscellaneous	\$
Total estimated expenses for 2011	\$

Tax-sheltered annuities/section 403(b)(9) plans

For 2010, payments made by your church and your salary reduction contributions to a 403(b)(9) plan are not subject to federal income tax as long as the total annual addition to your retirement account does not exceed 100 percent of your compensation (not including housing allowance) or \$49,000 (limit remains at \$49,000 in 2011).

Employee contribution limits. The employee elective contribution limit is \$16,500 in 2010 and 2011. An additional “catch-up” contribution, which is available to those over 50 years old, is limited to \$5,500 in 2010 and 2011. For purposes of these limits, “compensation” does not include housing allowance excluded from reportable income under Sections 415(c) and 402(g) of the tax code.

Key Point. One of the most popular supplemental retirement programs for ordained ministers is the Retirement Savings Plan, administered by the Board of Pensions. The Retirement Savings Plan offers 11 investment options through Fidelity Investments. Ministers can contact Fidelity Investments at 800-343-0860 for more details regarding changes in 403(b)(9) plans.

For more information, refer to IRS Publication 571, “Tax-Sheltered Annuity Plans,” available at IRS.gov.

15-year catch-up provision. Under certain circumstances, employees with 15 years of church service may make additional contributions (not to exceed \$3,000 per year and accumulatively not more than \$15,000 over the lifetime of a participant). If you are interested in determining whether you can make such an additional contribution, contact Fidelity Investments at 800-343-0860 for more information.

Qualified scholarships

Key Point. Qualified scholarships are excludable from taxable income.

Only amounts received as a qualified scholarship by a candidate for a degree may be excluded from gross income. A qualified scholarship is any grant amount that, in accordance with the conditions of the grant, is used for tuition and course-related expenses. Qualified tuition and related expenses are those used for (1) tuition and fees required for the enrollment or attendance at an educational institution, or (2) fees, books, supplies, and equipment required for courses of instruction at the educational institution. The scholarship need not specify that it is to be used only for qualified tuition and related expenses. All that is required is that the recipient uses the scholarship for such expenses and that the scholarship does not specify that it is to be used for nonqualified expenses (such as room and board).

Any amount received in excess of the qualified tuition and related expenses (such as amounts received for room and board) is not eligible for this exclusion.

Any amount received that represents payment for teaching, research, or other services required as a condition for receiving a qualified scholarship cannot be excluded from gross income. In addition, amounts paid by a church for the education of a pastor or other church employee cannot be treated as a nontaxable scholarship if paid “as compensation for services.”

Example. First Presbyterian Church establishes a scholarship fund for seminary students. Robert is a church member who is pursuing a master’s degree at a seminary. The church votes to award him a scholarship of \$1,500 for 2011. As long as Robert uses the scholarship award for tuition or other course-related expenses, he need not report it as income on his federal tax return, and the church need not issue him a 1099-MISC. The better practice would be for the church to stipulate that the scholarship is to be used for tuition or other course-related expenses (for example, fees, books, supplies), or for the church to pay the expenses directly to the educational institution. This will ensure that the scholarship does not inadvertently become taxable income because its specific use was not designated and the recipient used it for nonqualified expenses.

Assistance Program grants

Grants and stipends received by Benefits Plan members from the Assistance Program are needs-based gifts from the Board of Pensions that are excluded from taxes, unless you are an employee of the Board of Pensions. Any portion of a grant paid by your employer would be reportable and taxable.

Sale or exchange of your principal residence

For sales of principal residences, the following rules apply:

A married couple (who file a joint return) can exclude up to \$500,000 of gain from the sale or exchange of a principal residence. Single taxpayers can exclude up to \$250,000.

Holding period. To qualify for the full exclusion, a taxpayer must have owned and occupied the residence as a principal residence for at least two of the five years before the date of sale or exchange. But the tax benefit may not be lost completely if this “holding period” is not satisfied. Taxpayers who sell a home without meeting this requirement get a partial benefit if they had to sell their home because of a change in place of employment, health, or other unforeseen circumstances. The partial benefit is the fraction of \$500,000 (or \$250,000 for single taxpayers) equal to the fraction of two years that the home was owned and occupied as a principal

residence. To illustrate, assume that Minister B and his wife purchased a home on July 1, 2009, for \$150,000, and sold it on July 1, 2010, for \$200,000 because of a change in place of employment. Since they owned and occupied the home for only half of the minimum requirement of two years, they can exclude up to half of \$500,000. This means that their entire gain is nontaxable.

Key Point. In 2008, Congress enacted legislation specifying that gain from the sale or exchange of a principal residence allocated to periods of nonqualified use is not excluded from gross income. The amount of gain allocated to periods of nonqualified use is the amount of gain multiplied by a fraction, the numerator of which is the aggregate periods of nonqualified use during the period the property was owned by the taxpayer and the denominator of which is the period the taxpayer owned the property.

A period of nonqualified use means any period (not including any period before January 1, 2009) during which the property is not used by the taxpayer or the taxpayer's spouse or former spouse as a principal residence. For purposes of determining periods of nonqualified use, the following are not taken into account: (a) any period after the last date the property is used as the principal residence of the taxpayer or spouse (regardless of use during that period) and (b) any period (not to exceed two years) that the taxpayer is temporarily absent by reason of a change in place of employment, health, or certain unforeseen circumstances.

This provision is effective for sales and exchanges after December 31, 2008.

Multiple sales allowed. Taxpayers can claim the \$500,000 exclusion every two years, and there is no minimum age requirement.

Remarriages. Assume that John is a single taxpayer who has never excluded gain from the sale of a home under the new rules. He marries Jane, who has used the exclusion within two years before their marriage. John can still claim up to a \$250,000 exclusion of gain from the sale of residence. Once two years have passed since the last exclusion was allowed to either of them, they can exclude up to \$500,000 of gain on a joint return.

Example. Pastor T is 60-years old, married, and considering moving into a smaller and less expensive home. She has owned her present home for several years and is concerned that she may have to pay taxes on the gain she would realize from selling her home and buying a less expensive home. She need not be concerned. Any gain she realizes from selling her current home and buying a less expensive home will be nontaxable gain, assuming that she lived in the previous home for

at least two years and the gain is less than \$500,000. And, if she later decides to relocate to another home, she again can exclude the gain from tax.

Key Point. Current law does not force taxpayers to replace a current residence with a residence of equal or greater cost to avoid capital gains tax.

Line 8a. Interest income: attach Schedule B if over \$1,500

Complete this line only if you had taxable interest income. If you had taxable interest income of more than \$1,500, complete parts I and III of Schedule B. Report tax-exempt interest income on line 8b.

Line 9. Dividend income: attach schedule B if over \$1,500

Enter your total ordinary dividends on line 9a. If you had dividend income of more than \$1,500, complete parts II and III of Schedule B. Dividends on insurance policies are a partial return of the premiums you paid. Do not report them as dividends. Include them in income on line 21 only if they exceed the total of all net premiums you paid for the contract.

Enter your total qualified dividends on line 9b. Qualified dividends are eligible for a lower tax rate than other ordinary dividends. Generally, these dividends are shown in Form(s) 1099-DIV, box 1b. If you have questions, please refer to the IRS Publication 550 for the definition of qualified dividends if you received dividends not reported on Form 1099-DIV.

Line 12. Business income (or loss): attach schedule C or C-EZ

Complete this line only if you have any net earnings from self-employment activities. These include:

- compensation reported to you on a Form 1099-MISC
- fees received directly from church members for performing personal services (such as marriages and funerals)
- honoraria you received for guest speaking appearances in other churches

If you received income from any of these kinds of activities, compute your net earnings on Schedule C and transfer this amount to line 12. Schedule C is discussed more fully on pages 33-34 of this book. You may be able to use the simpler Schedule C-EZ if several conditions are met. See the instructions to Schedule C-EZ for details.

Line 13. Capital gain (or loss): attach schedule D

Complete this line only if you have any gains or losses from the sale of capital assets. These include stocks, bonds, and property. Gain or loss is reported on Schedule D.

Line 16a. Total pensions and annuities

The retirement benefits you receive from the Benefits Plan and other deferred compensation (such as Retirement Savings Plan distributions) are taxable under federal and some state income tax laws. Unless you direct otherwise, the Board will deduct federal tax withholdings from your pension benefits. The 1099R form you receive from the Board reports to the IRS the gross amount of the pension benefits (that is, the amount before any deductions for Medicare Supplement or Supplemental Death Benefit subscription charges) and any amount withheld for income taxes.

The Board of Pensions annually designates 100 percent of the pension and disability benefits for retired ministers as a housing allowance. Consistent with that designation, if you are an ordained minister, the 1099R will show that the taxable amount of the pension income is “not determinable.” If you are a retired or disabled minister, you may exclude all or a portion of your pension or disability income from your gross income reported on line 16a of Form 1040 if (1) you can document that the monies were actually spent on housing-related expenses during the tax year, and (2) the amount excluded does not exceed the fair rental value of the home (furnished, including utilities). A copy of the letter can be found at the beginning of this Tax Guide.

Key Point. Do not report the amount of pension income excluded as housing allowance as earned income in computing self-employment taxes.

Key Point. Lay retirees and surviving spouses are not entitled to exclude any portion of their benefits as housing allowance.

Some portion of your pension may be attributable to dues you were personally responsible for paying (“personally remitted dues”). If your 1099 reports an amount of employee-paid dues or if you personally paid some of the Benefits Plan pension dues with after tax funds, you may be entitled to an exclusion of part of the pension benefits as your investment in the pension contract. See IRS Publication 571 for further information on this subject.

Taxation of distributions from a 403(b)(9) plan

Amounts you contribute through salary reduction and the earnings attributable to these contributions generally cannot be withdrawn before you reach age 59½, separate from service, die, or become disabled. In some cases of financial hardship, you may withdraw your own salary reduction contributions (but not the earnings on these) prior to the occurrence of any of the above events.

Once amounts are distributed, they are generally taxable as ordinary income unless properly designated as a minister’s housing allowance. In addition, if amounts are distributed prior to you reaching age 59½, you will be assessed an additional tax of 10 percent of the amount which is includable in income unless one of the following exceptions applies:

1. The distributions are part of a series of substantially equal periodic payments made over your life or the lives of your beneficiaries and after you separate from service.
2. The distributions are made after you separate from service on or after age 55.
3. The distributions do not exceed the amount of medical expenses that you could deduct for the current year.
4. The distributions are made after your death or after you become disabled.
5. The distributions are made to an alternate payee pursuant to a qualified domestic relations order.

The additional tax is computed on Form 5329.

Line 20a. Social Security benefits

Key Point. Individuals who receive Social Security, retirement, disability, or survivor benefits may have to pay taxes on a portion of their benefits.

If you received Social Security benefits in 2010, you need to know whether or not these benefits are taxable. Here are seven rules the IRS formulated to assist Social Security beneficiaries with knowing if their benefits are taxable:

1. How much, if any, of your Social Security benefits are taxable depends on your total income and marital status.
2. Generally, if Social Security benefits were your only income for 2010, your benefits are not taxable and you probably do not need to file a federal income tax return.
3. If you received income from other sources, your benefits will not be taxed unless your modified adjusted gross income is more than the base amount for your filing status.
4. Your taxable benefits and modified adjusted gross income are figured on a worksheet in the Form 1040A or Form 1040 instruction booklet.
5. You can do the following quick computation to determine whether some of your benefits may be taxable:
 - First, add one-half of the total Social Security benefits you received to all your other income, including any tax-exempt interest and other exclusions from income.

- Then, compare this total to the base amount for your filing status. If the total is more than your base amount, some of your benefits may be taxable.
6. The 2010 base amounts are:
- \$32,000 for married couples filing jointly
 - \$25,000 for single, head of household, qualifying widow/widower with a dependent child, or married individuals filing separately who did not live with their spouses at any time during the year
 - \$0 for married persons filing separately who lived together during the year
7. For additional information on the taxability of Social Security benefits, see IRS Publication 915 (Social Security and Equivalent Railroad Retirement Benefits), available at IRS.gov.

Working after you retire. Many churches employ retired persons who are receiving Social Security benefits. Persons younger than full retirement age may have their Social Security retirement benefits cut if they earn more than a specified amount. Full retirement age (the age at which you are entitled to full retirement benefits) for persons born between 1943-1954 is 66 years. In the year you reach full retirement age, your monthly Social Security retirement benefits are reduced by \$1 for every \$3 you earn above a specified amount for 2010 and 2011, this annual amount is \$37,680. No reduction in Social Security benefits occurs for income earned in the month full retirement age is attained (and all future months).

Persons who begin receiving Social Security retirement benefits before the year in which they reach full retirement age will have their benefits reduced by \$1 for every \$2 of earned income in excess of a specified amount. For 2010 and 2011, this annual amount is \$14,160.

While the Social Security Administration has never officially addressed the issue, it is likely that a minister's housing allowance counts as earnings for purposes of the annual earnings test.

Line 21. Other income: list the type and amount.

Recommendation. If you have other income to report on line 21, consider enclosing an explanation of your other income with your Form 1040 or write a brief explanation in the space provided next to line 21. This will help to avoid confusion.

Complete this line only if you have other income. This includes the following items:

- a canceled debt or a debt paid for you by another person (unless the person who canceled or paid your debt intended it to be a gift)

- the fair market value of a free tour you receive from a travel agency for organizing a group of tourists (in some cases this may be reported on Schedule C)
- most prizes and awards

Step 5: Adjustments to income

You may deduct certain adjustments from gross income in computing your adjusted gross income. Report the adjustments on lines 23 through 37 of Form 1040. The most relevant adjustments to ministers are summarized on the following pages.

Line 26. Moving expenses

If your "allowable moving expenses" are not reimbursed by your employer, or they are reimbursed under a nonaccountable plan, you compute your moving expense deduction on Form 3903 and report your deduction on line 26. If your employer reimburses your allowable moving expenses under an accountable plan, the reimbursements are not reported by the employer as taxable income, and you have no deduction to report on line 26. To be an accountable plan, your employer's reimbursement arrangement must require you to meet all three of the following rules: (1) your expenses would have been deductible had you paid them yourself; (2) you must adequately account to your employer for these expenses within a reasonable period of time; and (3) you must return any excess reimbursement or allowance within a reasonable period of time.

Allowable moving expenses are expenses you incurred because of a change of jobs or your acceptance of a new job if you satisfy the following conditions:

- Your new job location is at least 50 miles farther from your former home than your previous job location was. For example, if your previous job was three miles from your former home, your new job must be at least 53 miles from that home (measured according to the shortest of the more commonly traveled routes between those points).
- If you report your income taxes as an employee, you must work full-time for at least 39 weeks during the first 12 months after you arrive in the general area of your new job location. You do not have to work for one employer for the 39 weeks. However, you must work full-time within the same general commuting area. If you are married and file a joint return and both you and your spouse work full-time, either of you may satisfy the full-time work test. However, you may not combine your weeks of work.
- Your move must be closely related, both in time and place, to the start of work at your new job location. In general, moving expenses incurred within one year from the date you first reported to work are considered closely related in time to the start of work

at the new location. It is not necessary that you make arrangements to work before moving to a new location, as long as you actually do go to work. If you do not move within one year, you ordinarily may not deduct the expenses unless you can show that circumstances existed that prevented the move within that time. A move is generally not closely related in place to the start of work if the distance from your new home to the new job location is greater than the distance from your former home to the new job location.

Deductible moving expenses include the following:

Moving your household goods and personal effects. You may deduct the cost of packing, crating, and transporting your household goods and personal effects from your former home to your new one. You may also deduct the cost of storing and insuring household goods and personal effects within any consecutive 30-day period after the day your things are moved from your former home and before they are delivered to your new home.

Travel expenses. You may deduct the cost of transportation and lodging (but not meals) for yourself and members of your household while traveling from your former home to your new home. You may deduct expenses of only one trip to your new home. However, all of the members of your household do not need to travel together.

You may not deduct any of the following expenses as moving expenses: pre-move house-hunting expenses, temporary living expenses, the expenses of disposing of your former home and obtaining your new home, home improvements to help you sell your former home, loss on the sale of your former home, mortgage penalties, any part of the purchase price of your new home, meal expenses incurred while moving to your new home, and real estate taxes. Use Form 3903 to compute the deduction.

As noted above, if your employer reimburses your allowable moving expenses under an accountable arrangement, the reimbursements are not reportable as taxable income to you and there are no deductions to report.

Line 27. One-half of self-employment tax

Key Point. Every minister who pays Social Security taxes on ministerial income qualifies for this deduction. Some are not claiming it.

All ministers are self-employed for Social Security purposes with respect to their ministerial income. They can deduct half of their actual self-employment taxes as an adjustment on line 27 of Form 1040, whether or not they are able to itemize deductions on Schedule A.

Line 32. Payments to an individual retirement account (IRA)

An individual retirement account is a savings plan that lets you set aside money for your retirement. Contributions to an IRA may be tax deductible, and earnings are not taxed until they are distributed to you. Anyone who has compensation is eligible to set up or contribute to an IRA. Compensation includes an employee's salary, a self-employed person's earnings, or any other amounts you receive for performing personal services. Compensation does not include rental income, interest income, dividend income, or any amount received as a pension, annuity, or deferred compensation. Further, compensation does not include a minister's housing allowance or the fair rental value of a church-provided manse.

For 2010, the contribution ceiling for an IRA is the lesser of \$5,000 or 100 percent of your annual compensation. All IRA contributions must be made by the due date of your tax return, not including extensions. This means that your 2010 IRA contribution must be made by April 15, 2011, even if you obtain an extension for filing this return.

Married persons who receive no compensation can contribute up to \$5,000 annually to an IRA if the compensation of their spouse is at least as much as the combined amount of their IRA contributions. A joint return must be filed, however, in order to deduct contributions to your spouse's IRA.

For 2010, if you file a joint return and your taxable compensation is less than that of your spouse, the most that can be contributed for the year to your IRA is the smaller of the following two amounts: (1) \$5,000 (\$6,000 if you are age 50 or older), or (2) the total compensation includible in the gross income of both you and your spouse for the year, reduced by your spouse's IRA contribution for the year to a traditional IRA and any contributions for the year to a Roth IRA on behalf of your spouse.

If you or your spouse were covered by an employer retirement plan at any time during 2010 and you made IRA contributions, your allowable IRA deduction may be less than your contributions. Your allowable deduction may be reduced or eliminated, depending on your filing status and the amount of your income. The deduction begins to decrease (phase out) when your income rises above a certain amount and is eliminated altogether when it reaches a higher amount. (See IRS Publication 590.) The amounts vary depending on your filing status. The W-2 form you receive from your church or other employer has a box used to show whether you were covered for the year. The "Pension Plan" box should have a mark in it if you were covered. Employer retirement plans include 403(b)(9) tax-sheltered annuities.

Even if your spouse is covered by an employer-sponsored retirement plan, you may be able to deduct your contributions to an IRA for 2010 if you were not covered by an employer plan and your adjusted gross income was less than \$177,000 (\$179,000 for 2011).

Individuals who cannot claim a deduction for an IRA contribution still can make nondeductible IRA contributions, subject to the lesser of \$5,000 or earned income limits. Earnings on these amounts continue to accumulate on a tax-deferred basis. When distributions are made from the IRA, special rules apply in figuring the tax on the distributions when both deductible and nondeductible contributions were made to the IRA. Form 8606 is used to designate a contribution as nondeductible and must be filed or the full amount of future withdrawals may be taxed. Withdrawals before age 59½ are subject to a 10 percent penalty tax that also applies to deductible IRA contributions.

No further contributions to an IRA are permissible once you reach age 70½, and distributions from an IRA must begin no later than the end of the year in which you reach that age. The IRS has interpreted this rule to mean that distributions must begin by April 1 of the year following the year you reach age 70½. If this rule applies to you, you should consult your tax adviser.

Summarized below are a few important rules that pertain to IRAs.

1. Taxpayers can make early withdrawals from an IRA to pay for qualified higher education expenses of the taxpayer or the taxpayer's spouse, child, or grandchild without triggering the 10 percent penalty that applies to early distributions from an IRA.
2. The deductible IRA "phase-out" ranges are increased if either you or your spouse is an active participant in an employer-sponsored retirement plan.
3. Subject to income limitations, taxpayers can make annual nondeductible contributions of up to \$5,000 to a Roth IRA, and distributions from such an IRA are not taxed if they are made after a five-year holding period and are made as a result of the account holder's attaining age 59½ or older, death, disability, or purchase of a first home. Earnings on Roth IRAs accumulate tax-free.
4. Taxpayers can withdraw up to \$10,000 from their IRA prior to age 59½ for first-time homebuyer expenses without triggering the 10 percent penalty that applies to "premature distributions."
5. Qualified charitable distributions of up to \$100,000 may be made from an IRA to a church or other charity. A qualified charitable distribution is any distribution from an IRA directly by the IRA

trustee to a charitable organization, including a church, that is made on or after the date the IRA owner attains age 70½. This provision is effective for distributions made in 2008, 2009, and 2010.

Example. A church has a senior pastor who is 52-years old, and a youth pastor who is 30-years old. The church does not participate in a retirement program for its staff. In 2010, the senior pastor could contribute \$6,000 to an IRA (maximum annual contribution of \$5,000 plus a "catch-up" contribution of \$1,000), and the youth pastor could contribute \$5,000.

Step 6: Adjusted gross income

Line 37. Compute adjusted gross income

Subtract your total adjustments (line 36) from your total income (line 22) to compute your adjusted gross income (line 37). Carry this amount to line 38 at the top of page 2 of your Form 1040.

Step 7: Tax computation

Line 40. Itemized deductions or standard deduction

Key Point. Itemize your deductions on Schedule A only if they exceed the standard deduction for your filing status.

On line 40, you enter either your itemized deductions from Schedule A or a standard deduction amount. Itemized deductions are discussed under Schedule A, beginning on page 24 of this guide. For 2010, the standard deduction amounts are as follows:

Filing Status	Standard Deduction Amount
Single	\$5,700
Married filing jointly or qualifying widow(er)	\$11,400
Married filing separately	\$5,700
Head of household	\$8,400

In some cases, your standard deduction may be higher than these amounts. Use Schedule L (Form 1040) to figure your standard deduction if:

- you paid state or local sales or excise taxes in 2010 on the purchase of a new motor vehicle after February 16, 2009, and before January 1, 2010
- you have a net disaster loss on Form 4684, line 17

Line 42. Personal exemptions

For 2010, the personal exemption amount is \$3,650. Multiply this amount times the number of exemptions claimed on line 6d and enter the total on line 42. Personal exemptions are phased out for certain high-income ministers. The instructions to Form 1040 contain a worksheet that should be used to compute this reduced exemption amount.

Line 44. Compute tax

Most ministers can use the tax tables to determine their income taxes. Some higher income ministers must use the tax rate schedules. (A spouse's income is considered in deciding whether or not to use the tax rate schedules.)

Step 8: Credits

Line 48. Credit for child and dependent care expenses: attach Form 2441

Complete this line if you are eligible for a credit for child or dependent care expenses. This credit is computed on Form 2441, as illustrated at the end of this guide.

Line 51. Child tax credit

An individual may claim a tax credit for each qualifying child. A qualifying child is a child who is (1) under 17 years of age at the end of 2010; (2) your child, decedent, stepson or stepdaughter, or foster child; (3) claimed by you as a dependent on your tax return; and (4) a citizen, national, or resident of the United States. The amount of credit per child is \$1,000 through 2010 and \$500 thereafter.

The credit is phased out for individuals with income over certain threshold amounts. Specifically, the otherwise allowable child tax credit is reduced by \$50 for each \$1,000 (or fraction thereof) of modified adjusted gross income over \$75,000 for single individuals or heads of households, \$110,000 for married individuals filing joint returns, and \$55,000 for married individuals filing separate returns. For purposes of this limitation, modified adjusted gross income includes certain otherwise excludable income.

To the extent the child credit exceeds the taxpayer's tax liability, the taxpayer is eligible for a refundable credit (the additional child tax credit) equal to 15 percent of earned income in excess of a threshold dollar amount (the "earned income" formula). It is reported on Form 8812 and line 65 (Form 1040).

Families with three or more children may determine the additional child tax credit using an "alternative formula" if this results in a larger credit than determined under the earned income formula. Under the alternative formula, the additional child tax credit equals the amount by which the taxpayer's Social Security taxes exceed the taxpayer's earned income credit (EIC). The American Recovery and Reinvestment Act of 2009 modified the earned income formula to apply to 15 percent of earned income in excess of \$3,000 for taxable years beginning in 2009 and 2010.

Earned income is defined as the sum of wages, salaries, and other taxable employee compensation plus net self-employment earnings. Unlike the EIC, which also includes the preceding items in its definition of earned

income, the additional child tax credit is based only on earned income to the extent it is included in computing taxable income.

The child tax credit is in addition to the dependent care credit you can claim if you pay someone to care for your dependent child who is under age 13 (or a disabled dependent) so you can work.

Step 9: Other taxes

Now that you have subtracted credits from your federal income tax, you report other taxes you may owe.

Line 56. Self-employment tax: attach Schedule SE (also see line 27)

Key Point. All ordained ministers must pay self-employment taxes on compensation received from the exercise of their ministry unless they have received IRS recognition of exempt status.

All ordained ministers are self-employed for Social Security purposes with respect to their ministerial income. They compute their self-employment taxes on Schedule SE and report the total tax on line 56 of Form 1040.

Step 10: Payments

Line 61. Federal income tax withheld

Ordained ministers' wages are exempt from federal income tax withholding. As a result, only those ministers who have entered into a voluntary withholding arrangement with their church will have income taxes withheld and reported on line 61. The church should report the amount of voluntarily withheld taxes on the minister's Form W-2.

Key Point. Ministers who enter into voluntary withholding arrangements will have federal income taxes withheld from their wages. Under no circumstances should a church withhold the employee's share of Social Security and Medicare taxes from the wages of such a minister since ministers are self-employed for Social Security purposes with respect to their ministerial duties. Ministers can request (on Form W-4) that their church withhold an additional amount of income taxes to cover their expected self-employment tax liability. These additional withholdings must be treated as income taxes withheld (on Form W-2 and 941 forms) rather than the employee's share of Social Security and Medicare taxes. These ministers must still complete Schedule SE.

Line 62. 2010 estimated tax payments

Compensation paid to ministers for ministerial duties is not subject to tax withholding. As a result, ministers must prepay their income tax and Social Security (self-employment) taxes by using the quarterly estimated tax procedure unless they have entered into a voluntary

withholding agreement with their employing church. The estimated tax procedure is summarized in Part 2 of this guide in the section “How do ministers pay their taxes?” The total amount of estimated tax payments made to the IRS is reported as a payment of taxes on line 62.

Line 64. Earned income credit

New in 2010. The maximum earned income credit for 2010 is (1) \$457 with no qualifying child; (2) \$3,050 with one qualifying child; (3) \$5,036 with two qualifying children; and (4) \$5,666 with three or more qualifying children.

The earned income credit reduces tax you owe and may give you a refund even if you do not owe any tax. A number of technical requirements must be met in order to qualify for this credit. Unfortunately, many taxpayers who qualify for the earned income credit do not claim it because it is so difficult to compute. In most cases, the amount of your earned income credit depends on: (1) whether you have no qualifying child, one qualifying child, or two or more qualifying children; and (2) the amount of your earned income and modified adjusted gross income. For 2010, the credit can be as much as: \$457 if you do not have a qualifying child; \$3,050 if you have one qualifying child; \$5,036 if you have two qualifying children; or \$5,666 if you have more than two qualifying children. A qualifying child is a child who: (1) is your son, daughter, brother, sister, stepbrother, stepsister, adopted child, grandchild, stepchild, or foster child; (2) was (at the end of 2010) under age 19, under age 24 and a student, or any age and permanently and totally disabled; and (3) lived with you in the United States for more than half of 2010.

You are not eligible for the credit if your earned income is more than:

- \$13,460 (\$18,470 if married filing jointly) if you do not have a qualifying child,
- \$35,535 (\$40,545 if married filing jointly) if you have one qualifying child,
- \$40,363 (\$45,373 if married filing jointly) if you have two qualifying children, or
- \$43,352 (\$48,362 if married filing jointly) if you have more than two qualifying children.

You can compute the credit yourself or the IRS will compute it for you. To figure the amount of your earned income credit, you must use the EIC Worksheet and EIC Table in the instructions for Form 1040, line 64a and 64b. Ministers may want to consider having the IRS compute the credit for them, especially due to confusion about how the housing allowance affects the credit.

Key Point. Publication 596 clearly states that a housing allowance, or fair rental value of a parsonage, is included in the definition of earned income when computing the earned income credit for ministers who have not exempted themselves from self-employment taxes. Unfortunately, the instructions are less clear for ministers who have exempted themselves from self-employment taxes, but the instructions suggest that these ministers do not include a housing allowance or the fair rental value of a parsonage in computing their earned income for purposes of the credit. The author has confirmed with the IRS national office that this is not the intent of the law, but the IRS has failed to clarify this issue. Ministers who are affected by this issue should consult their own tax adviser for help.

Step 11: Refund or amount you owe

After totaling your payments, you can calculate whether you owe the government or a refund is due you. If you owe a tax, be certain to enclose with your return a check in the amount you owe payable to the “United States Treasury.” Do not attach the check to your return. Include your daytime phone number, your Social Security number, and write Form 1040 for 2010 on the check. You also may have to pay an underpayment penalty (refer to line 76 of Form 1040).

If you have overpaid your taxes, you have two options: (1) request a full refund, or (2) apply the overpayment to your 2011 estimated tax.

Step 12: Sign here

You must sign and date the return at the bottom of page 2. If you are filing a joint return, your spouse must also sign the return. In the “your occupation” space, enter your occupation — *Minister*.

Other forms and schedules

Schedule A

Key Point. If your itemized deductions exceed your standard deduction, you should report your itemized deductions on Schedule A (Form 1040). This section will summarize the itemized deductions.

Step 1: Medical and dental expenses (lines 1-4)

You may deduct certain medical and dental expenses (for yourself, your spouse, and your dependents) if you itemize your deductions on Schedule A, but only to the extent that your expenses exceed 7.5 percent of your adjusted gross income. You must reduce your medical expenses by the amounts of any reimbursements you receive for those expenses before applying the 7.5 percent test. Reimbursements include amounts you receive from insurance or other sources for your medical expenses (including Medicare). It does not matter if the reimbursement is paid to the patient, the doctor, or the hospital.

The following expenses ARE deductible as medical expenses:

- fees for medical services
- fees for hospital services
- meals and lodging provided by a hospital during medical treatment (subject to some limits)
- medical and hospital insurance premiums that you pay
- special equipment
- Medicare A premiums you pay if you are exempt from Social Security and voluntarily elect to pay Medicare A premiums
- Medicare B premiums you pay
- Medicare D premiums you pay
- Medicare Supplement premiums you pay (or are deducted from your pension)
- long-term care insurance premiums, subject to certain limitations on the amount that may be deducted.
- special items (false teeth, artificial limbs, eyeglasses, hearing aids, crutches, etc.)
- transportation for necessary medical care. For 2010, the standard mileage rate for medical travel was 16.5 cents per mile
- medicines and drugs requiring a prescription.
- the portion of a life-care fee or founder's fee paid either monthly or in a lump sum under an agreement with a retirement home that is allocable to medical care
- wages of an attendant who provides medical care
- the cost of home improvements if the main reason is for medical care
- the cost of a program to stop smoking and for prescription medicine to alleviate nicotine withdrawal
- exercise expenses (including the cost of equipment to use in the home) if required to treat an illness (including obesity) diagnosed by a physician, and the purpose of the expense is to treat a disease rather than to promote general health and the taxpayer would not have paid the expense but for this purpose
- surgery to improve defective vision, such as laser eye surgery or radial keratotomy
- diagnostic tests, such as a full body scan, pregnancy test, or blood sugar test kit
- medical treatment at a center for drug or alcohol addiction

The following items are NOT deductible as medical expenses:

- funeral services
- health club dues (except as noted above)
- household help
- life insurance
- maternity clothes
- nonprescription medicines and drugs
- nursing care for a healthy baby
- toothpaste, cosmetics, toiletries
- trip for general improvement of health

Step 2: Taxes you paid (lines 5-9)

Generally, real estate, state and local income, and personal property taxes actually paid during 2010 are deductible. Ministers who own their homes and pay real estate property taxes can include the full amount of such taxes in computing their housing allowance exclusion. They may also fully deduct the amount of the taxes as an itemized deduction on Schedule A. Federal income tax and gasoline taxes are not deductible for federal income tax purposes.

Key Point. You can elect to deduct state and local general sales taxes instead of state and local income taxes as an itemized deduction on Schedule A (Form 1040), line 5b. Generally, you can use either your actual expenses or the state and local sales tax tables to figure your sales tax deduction. The deduction is available through 2011.

In states without a sales tax, you may be able to deduct certain other taxes or fees instead. Take the deduction on Schedule A if you are itemizing deductions and are not electing to deduct state and local general sales taxes. If you are not itemizing deductions, these taxes may increase your standard deduction and are claimed on Schedule L.

If the amount of your income on Form 1040, line 38, is equal to or greater than \$135,000 (\$260,000 if married filing jointly), you cannot deduct these taxes.

Taxpayers can claim an above-the-line deduction for qualified motor vehicle taxes. Qualified motor vehicle taxes included any state or local sales or excise tax imposed on the purchase of a qualified motor vehicle. A qualified motor vehicle was a passenger automobile, light truck, or motorcycle which has a gross vehicle weight of not more than 8,500 pounds that was acquired for use by the taxpayer after February 17, 2009, and before January 1, 2010, the original use of which begins with the taxpayer. The deduction was limited to the tax on up to \$49,500 of the purchase price of a qualified motor vehicle.

Step 3: Interest you paid (lines 10-15)

Interest is an amount paid for the use of borrowed money. Interest that you pay for personal reasons (that is, interest on a car loan, credit card, or a personal loan) is not deductible as an itemized deduction on Schedule A. In most cases, you will be able to deduct all of your mortgage interest on any loans secured by your main home, including first and second mortgages, home equity loans, and refinanced mortgages. Whether your home mortgage interest is deductible under these rules depends on the date you took out the mortgage, the amount of the mortgage, and your use of the proceeds. If all of your mortgages fit into one of the following categories, you can deduct all of your interest and report it on Schedule A (Form 1040):

- mortgages you took out on your main home on or before October 13, 1987
- mortgages you took out on your main home after October 13, 1987, to buy, build or improve your home, but only if these mortgages (plus any mortgages in the preceding category) totaled over \$1 million at any time throughout 2010 (\$500,000 if married filing separately)
- mortgages you took out after October 13, 1987, on your main home, other than to buy, build or improve your home, but only if these mortgages totaled over \$100,000 at any time throughout 2010 (\$50,000 if married filing separately)

If you had a main home and a second home, the dollar limits explained in the second and third categories described above apply to the total mortgage on both homes.

Key Point. Ministers who own their homes can deduct mortgage interest payments as an itemized deduction even though such payments were included in computing the housing allowance exclusion (the so-called double deduction). However, ministers are subject to the limitations on mortgage loans discussed in this section.

The term “points” is sometimes used to describe certain charges paid by a borrower. They are also called loan origination fees, maximum loan charges, or premium charges. If the payment of any of these charges is *only* for the use of money, it ordinarily is interest paid in advance and must be deducted in installments over the life of the mortgage (not deducted in full in the year of payment). However, points are deductible in the year paid if the following requirements are satisfied: (1) your loan is secured by your main home; (2) paying points is an established business practice in your area; (3) the points you paid were not more than the points generally charged in your area; (4) you use the cash method of accounting; (5) the points were not paid in the place of amounts that ordinarily are stated separately on the

settlement statement, such as appraisal fees, attorney fees, and property taxes; (6) you use your loan to buy or build your main home; (7) the points were computed as a percentage of the principal amount of the mortgage; (8) the amount is clearly shown on the settlement statement; (9) the funds you provided at or before closing, plus any points the seller paid, were at least as much as the points charged.

Step 4: Gifts to charity (lines 16-19)

Cash contributions to churches, schools, and most other public charities are deductible up to 50 percent of adjusted gross income. Contributions of property are subject to different limitations. See IRS Publication 526. Contributions of cash or checks are reported on line 16, while contributions of noncash property are reported on line 17. If you do not itemize deductions, you cannot deduct any of your charitable contributions.

The value of personal services is never deductible as a charitable contribution, but unreimbursed expenses incurred in performing services on behalf of a church or other charity may be. For example, if you drive to and from volunteer work on behalf of a charity, you may deduct the actual cost of gas and oil or you may claim the standard charitable mileage rate of 14 cents for each substantiated mile (for 2010 and 2011). Unreimbursed travel expenses incurred while away from home (whether within the United States or abroad) in the course of donated services to a tax-exempt religious or charitable organization are deductible as a charitable contribution. There are two ways to do this.

Individuals performing the charitable travel can keep track of their own travel expenses and then claim a charitable contribution for the total on Schedule A. Or, these individuals could provide their church or charity with a travel report substantiating all travel expenses. In such a case, the church or charity could issue the individual a charitable contribution receipt for the total amount of the substantiated travel expenses. Travel expenses that can be receipted include airfare, lodging, meals, and incidental expenses.

No charitable deduction is allowed for travel expenses incurred while away from home in performing services for a religious or charitable organization unless there is no significant element of personal pleasure, recreation, or vacation involved in the travel.

Example. Pastor J goes on a trip to Europe. He is in Europe for 10 days and conducts one-hour services on two of those days. Pastor J will not be able to claim a charitable contribution deduction for the travel expenses that he incurs in making this trip. The same rule would apply if Pastor J's spouse or children go along on the trip.

Charitable contributions must be claimed in the year they are delivered. One exception is a check that is mailed to a charity—it is deductible in the year the check is mailed (and postmarked), even if it is received early in the next year.

Charitable contributions generally are deductible only to the extent they exceed the value of any premium or benefit received by the donor in return for the contribution.

There are limits on the amount of a contribution that can be deducted. Generally, cash contributions to churches, schools, and other public charities are deductible up to a maximum of 50 percent of adjusted gross income. In some cases, contributions that exceed these limits can be carried over and claimed in future years. Some charitable contributions are limited to 20 percent or 30 percent of adjusted gross income, depending on the recipient and the form of the contribution.

Designated contributions are those that are made to a church with the stipulation that they be used for a specified purpose. If the purpose is an approved project or program of the church, the designation will not affect the deductibility of the contribution. An example is a contribution to a church building fund. However, if a donor stipulates that a contribution be spent on a designated individual, no deduction is allowed unless the church exercises full administrative control over the donated funds to ensure that they are being spent in furtherance of the church's exempt purposes. Designated contributions that ordinarily are not deductible include contributions to church benevolence or scholarship funds that designate a specific recipient. Contributions to benevolence or scholarship funds ordinarily are deductible if the donor does not earmark a specific recipient.

Contributions to a church or missions board that specify a particular missionary may be tax-deductible if the church or missions board exercises full administrative and accounting control over the contributions and ensures that they are spent in furtherance of the church's mission. Direct contributions to missionaries or any other individual are not tax-deductible, even if they are used for religious or charitable purposes.

Charitable contributions must be properly substantiated. Individual cash contributions of less than \$250 may be substantiated by a canceled check or a receipt from the charity. Current rules govern the substantiation of individual contributions of cash or property of \$250 or more. These rules are explained in the supplement to this guide entitled *Federal Reporting Requirements for Churches: 2010 Tax Year*.

If you contribute property that you value at \$500 or more, you must include a completed Form 8283 with your Form 1040. Complete only section A if the value

claimed is \$500 or more but less than \$5,000. If you claim a deduction of more than \$5,000 for a contribution of noncash property (other than publicly traded securities), then you must obtain a qualified appraisal of the property and include a qualified appraisal summary (Section B of Form 8283) with your Form 1040.

Special rules apply to donations of cars, boats, and planes. See the instructions to IRS Form 1098-C for details.

Key Point. The Tax Court ruled that a donor who contributed property worth more than \$10,000 to a church was not eligible for a charitable contribution deduction even though there was no dispute as to the value of the property because he failed to attach a qualified appraisal summary (Form 8283) to the tax return on which the contribution was claimed.

Step 5: Casualty and theft losses (line 20)

Most taxpayers have at some time suffered damage to their property as a result of hurricanes, earthquakes, tornadoes, fires, vandalism, car accidents, floods, or similar events. When property is damaged or destroyed by such events, it is called a casualty. If your property is stolen, you may also have a deductible theft loss. You must itemize your deductions on Schedule A to be able to claim a casualty or theft loss to nonbusiness property. To determine your deduction, you must reduce the amount of your casualty and theft losses by any insurance or reimbursement you receive. No deduction is allowed for a casualty or theft loss that is covered by insurance unless a timely insurance claim for reimbursement has been filed.

You can deduct personal casualty or theft losses only to the extent that:

1. The amount of each separate casualty or theft loss is more than \$100, and
2. The total amount of all losses during the year (reduced by the \$100 limit) is more than 10 percent of the amount on Form 1040, line 38.

The 10 percent of AGI limitation does not apply to a casualty loss that occurred in an area determined by the President of the United States to warrant federal disaster assistance. For information on disaster losses, see IRS Publication 547.

To claim a casualty or theft loss, you must be able to show that the loss, in fact, occurred. In addition, the loss generally is defined as the lesser of (1) the decrease in fair market value of the property as a result of the casualty or theft, or (2) your adjusted basis in the property before the casualty or theft.

Calculate non-business casualty and theft losses on Form 4684 and report them on Schedule A as an itemized deduction.

Step 6: Job expenses and most other miscellaneous deductions (lines 21-27)

You may deduct certain miscellaneous expenses on Schedule A. These deductions are in addition to the itemized deductions for medical expenses, taxes, interest, charitable contributions, and casualty and theft losses. Most miscellaneous itemized expenses are deductible only to the extent that they exceed two percent of adjusted gross income. Miscellaneous expenses subject to the two percent floor include:

- unreimbursed and nonaccountable reimbursed employee business expenses (discussed more fully below)
- professional society dues
- safety deposit box rental
- employee educational expenses
- tax counsel and assistance
- home office
- home expenses-work
- related supplies
- expenses of looking for a new job
- investment counsel fees
- professional books and periodicals
- investment expenses
- 50 percent of unreimbursed business meals and entertainment
- IRA custodial fees

Certain miscellaneous expenses are not subject to the two percent floor. However, these expenses ordinarily are not available to ministers.

Employee business expenses

Key Point. Most ministers incur business expenses. How these expenses are handled, by both the minister and the church, significantly impacts whether (and to what extent) they are deductible.

The more common examples of ministerial business expenses are summarized below.

Local transportation expenses

Expenses incurred in driving your car for business purposes within your community represent one of the most important business expenses for ministers. A common example would be driving your car from your church to a hospital to visit members. Commuting to and from work is never a business expense. However, if you drive to a hospital (or some other business location) on the way home from church, the expenses incurred in driving from the church to the second business location are business expenses even though you are on the way home. The remaining miles between the second business location and your home are nondeductible commuting expenses.

These expenses can be deducted using either a standard mileage rate or the actual costs of operating the car for business miles. Most ministers choose the standard mileage rate because of its simplicity. However, use of the standard mileage rate is available only if that method is selected for the first year a car is used in your trade or business. The actual expense method is very complex and is explained fully in IRS Publication 463.

The standard business mileage rate for 2010 was 50 cents per mile.

Key Point. The standard business mileage rate for 2011 is 51 cents per mile.

Ministers should consider the advantages of using a church-owned car for their business travel. This will eliminate most recordkeeping and reporting requirements. Some conditions apply. See the illustration at the end of this guide for a summary of the various tax options pertaining to business use of a car.

Travel expenses

Travel expenses are the expenses that you incur while traveling away from home overnight for your work or business. A common example would be automobile, lodging, and meal expenses you incur in traveling to a convention meeting. You can deduct these expenses if you can substantiate them, as explained below.

Deductible travel expenses include:

- air, rail, and bus fares
- operating and maintaining your car
- taxi fares or other costs of transportation between the airport or station and your hotel, or from one work site to another
- meals and lodging while you are away from home on business
- cleaning and laundry expenses
- telephone and fax machine expenses
- tips

IRS regulations clarify that while a non-employee spouse's travel expenses incurred while accompanying a minister on a business trip are not deductible as a business expense, the reimbursement of those expenses by the church will not represent taxable income so long as the spouse's presence on the trip serves a legitimate business purpose and the spouse's expenses are reimbursed under an accountable arrangement.

One way for the *unreimbursed* travel expenses of a non-employee spouse to be deductible would be if the spouse performed substantial church-related activities during the trip. Under these circumstances, the spouse's unreimbursed travel expenses could be claimed as a charitable contribution deduction.

Entertainment expenses

You may be able to deduct entertainment expenses you incur for your ministry. You may take the deduction only if you can demonstrate that the amounts spent are either (1) directly related to the active conduct of your ministry, or (2) associated with the active conduct of your ministry, and the entertainment occurred directly before or after a substantial business discussion. These two tests are summarized below:

- *Directly related test.* To show that entertainment was directly related to the active conduct of your business, you ordinarily must be able to demonstrate that (1) you had more than a general expectation of deriving income or some other specific business benefit at some indefinite future time; (2) you did engage in business during the entertainment period; and (3) the main purpose of the entertainment was the transaction of business.
- *Associated entertainment.* To show that entertainment was associated with the active conduct of your ministry, you must be able to demonstrate that you had a clear business purpose in incurring the expense, and that the meal or entertainment directly preceded or followed a substantial business discussion.

Entertainment includes any activity generally considered to provide entertainment, amusement, or recreation. This covers entertaining guests at restaurants, social or athletic facilities, sporting events, or on hunting, fishing, vacation, or similar trips. Expenses are not deductible when business acquaintances take turns picking up each other's entertainment checks without regard to whether any business purposes are served. Ministers incur entertainment expenses in a variety of situations. Common examples include entertaining denominational leaders, guest speakers, church groups (youth, choir, deacons, etc.), or meeting with members at a restaurant for counseling purposes.

Key Point. You may deduct only 50 percent of your business-related entertainment expenses, including meals. This 50 percent limitation is incorporated directly into the tax returns (see Form 2106). This rule does not apply to expenses you incur that are reimbursed by your employer under an "accountable reimbursement plan" (described elsewhere in this guide).

Entertainment expenses incurred in your home are especially scrutinized by the IRS. You must be able to demonstrate that your expenses were not purely social but rather had a primary business purpose.

Entertainment expenses of spouses may also be deductible if their presence serves a legitimate business purpose or if it would be impractical under the circumstances to entertain the business associate without including his or her spouse.

If a spouse's entertainment expenses are deductible because it is impractical to entertain his or her spouse without the spouse being included, your spouse's entertainment expenses incurred on the same occasion will also be deductible. For example, your spouse joins you because your business associate's spouse will be present.

The IRS frequently challenges entertainment expenses, and so you should be prepared to fully substantiate such expenses as described below.

Example. Pastor R invites the members of the church board to his home for dinner and a meeting. The expenses incurred by Pastor R and his guests for food and beverages ordinarily will constitute entertainment expenses.

Example. Pastor S invites a friend and fellow minister to her home for dinner. The friend resides in another state and is visiting Pastor S for the day. Ordinarily, such a visit will be a social visit and the expenses associated with it will not be deductible.

Example. Pastor K is the head of staff of his church. He takes a prospect for a ministerial staff position out to dinner, where they discuss the person's background and suitability for the position. The person's spouse comes along because it would be impractical to discuss the position solely with the prospect. Further, Pastor K's spouse accompanies her husband because the other spouse is present. Pastor K pays everyone's meal expense. The cost of the meals of all four people, subject to the 50 percent limitation, is a deductible entertainment expense.

Educational expenses

Certain educational expenses are deductible by ministers. You may deduct expenses you have for education, such as tuition, books, supplies, correspondence courses, and certain travel and transportation expenses, even though the education may lead to a degree, if the education satisfies one or both of the following conditions:

- the education is required by your employer, or by law or regulation, to keep your salary, status, or job; or
- the education maintains or improves skills required in your present work.

However, you may not deduct expenses incurred for education, even if one or both of the requirements mentioned above are met, if the education is required to meet the minimum educational requirements to qualify you in your trade or business or is part of a program of study that will lead to qualifying you in a new trade or business, even if you did not intend to enter that trade or business.

Example. The minister at First Presbyterian Church takes a counseling course at a local university. Expenses associated with the course are deductible educational expenses if the course maintains or improves job skills and is not a part of a program of study that will qualify the minister for a new trade or business.

Subscriptions and books

Ministers often subscribe to a number of periodicals and purchase books that are directly relevant to the performance of their professional duties. The cost of a subscription is a legitimate business expense if it is related to the minister's duties at the church. Minister's journals and specialized periodicals clearly satisfy this test. News magazines may also qualify if a minister can demonstrate that the information contained in such periodicals is related to his or her ministry (for example, sources of illustrations for sermons). The cost of a general circulation daily newspaper is not deductible.

The unreimbursed cost of books that are related to your ministry is a professional business expense and accordingly is deductible.

Personal computers

Many ministers have purchased personal computers that they use at home. Since computers lend themselves to personal as well as business use, they are singled out for special treatment. If you report your income taxes as an employee (or you report as self-employed but are reclassified as an employee by the IRS in an audit) and you purchase a home computer that you use in connection with your work, you must meet the following tests to claim any depreciation of section 179 deduction:

- your use of the computer in your home must be *for the convenience of your employer*; and
- your use of the computer in your home is *required as a condition of your employment*.

What do these terms mean? *For the convenience of your employer* means that you can clearly demonstrate that you cannot perform your job without the home computer. The fact that the computer enables you to perform your work more easily and efficiently is not enough. Further, you must prove that the computers available at your place of employment are insufficient to enable you to properly perform your job. Obviously, this is a difficult test to satisfy. *Required as a condition of your employment* means that you must not be able to properly perform your duties without the computer. It is not necessary that your employer explicitly requires you to use the computer. On the other hand, it is not enough that your employer merely states that your use of the home computer is a condition of your employment.

If you are an employee and these tests are not met, you cannot deduct any of the cost of your home computer.

If you are an employee and you meet both tests described above, you can claim a business deduction if you use your home computer more than 50 percent of the time during the year in your work. You can claim a deduction for the entire purchase price in the year of purchase (you do not need to depreciate the computer). Of course, the price must be reduced by the percentage of use that is personal as opposed to business related.

Cell phones

In 2010, Congress removed cell phones from the definition of listed property. As a result, the heightened substantiation requirements and special depreciation rules that apply to listed property no longer apply to phones. This provision is effective for taxable years ending after December 31, 2009. See "Tax Highlights for 2010" in Part 1 of this guide for additional information.

Office in the home

Most ministers have an office in their home. For the costs of such an office to be deductible as a business expense, several conditions must be satisfied. These include:

- The costs must not have been excluded as the minister's housing allowance.
- The home office must be your principal place of business.
- The home office must be exclusively used in your trade or business. This means that the home office must not be used by other family members (for example, to watch television or do homework). The use of a part of your home for both personal and business purposes does not meet the exclusive use test.
- The home office must be used on a regular basis in your trade or business. This means that you must use the home office on a continuous basis for professional purposes (for example, preparing sermons, conducting counseling, doing research, contacting members, writing correspondence, preparing for church meetings). Occasional or incidental use of the office for such purposes is not enough, even if the office is used for no other purposes.
- If you are an employee, the home office must be for the convenience of the employer. This means that the home office must do more than make the employee's job easier or efficient—it must be essential to the performance of your job.

Very few ministers will satisfy all of these conditions, which means that a home office deduction generally is not available.

Key Point. The IRS audit guidelines for ministers instruct IRS agents to take the position that a minister who excludes all of his housing expenses as a housing allowance exclusion has in effect already “deducted” all of the expenses associated with an office in the home and accordingly should not be able to claim any additional deduction of such expenses as an itemized (home office) deduction on Schedule A.

How to report employee business expenses

The deductibility of your business expenses depends on whether you are an employee or self-employed, whether the expenses are reimbursed by the church, and whether any reimbursed expenses are paid under an accountable or a nonaccountable reimbursement plan. This section addresses the tax treatment of business expenses for ministers who report their income taxes as employees. The tax treatment of business expenses for ministers with self-employment income is discussed below (under the section on Schedule C).

The business expenses of ministers who are employees for federal income tax reporting purposes (this includes most Presbyterian ministers as explained earlier) can be handled in any of the following three ways:

Method 1: Unreimbursed expenses

Key Point. Unreimbursed expenses are expenses that are not reimbursed by the church. They may be deducted only as a miscellaneous itemized deduction on Schedule A to the extent they exceed two percent of a minister’s adjusted gross income.

Many ministers incur unreimbursed business expenses. These are expenses that are not reimbursed by the church. Ministers who are employees for income tax reporting purposes claim their unreimbursed business expenses on Schedule A—if they are able to itemize, and only to the extent that such expenses exceed two percent of adjusted gross income.

Key Point. Ministers who are employees for income tax reporting purposes cannot claim any deduction for *unreimbursed* employee business expenses for which an employer reimbursement was available.

Method 2: Nonaccountable reimbursed expenses

Key Point. Ministers who are employees for income tax reporting purposes deduct any business expenses reimbursed by their church under a nonaccountable reimbursement plan on Schedule A if they are able to itemize and only to the extent that such expenses exceed two percent of adjusted gross income. The full amount of the church’s reimbursements must be included in the minister’s income whether or not the expenses are deductible. A church has a nonaccountable plan if it reimburses ministers (or other employees) for business

expenses without requiring adequate substantiation of the amount, date, place, and business purpose of the expenses, or not requiring excess reimbursements to be returned to the church.

It is very common for churches to reimburse a minister’s business expenses without requiring any substantiation of actual expenses or a return of reimbursements in excess of substantiated expenses (for example, excess reimbursements). The most common example is the monthly car allowance. Many churches pay their minister a monthly allowance to cover business use of an automobile, without requiring any substantiation of actual expenses or a return of the amount by which the allowances exceed actual expenses. Such a reimbursement arrangement is called a nonaccountable reimbursement arrangement, since the minister is not required to account for (substantiate) the actual amount, date, place, and business purpose of each reimbursed expense. Another common example would be a church that reimburses expenses that are claimed by a minister without adequate substantiation.

For ministers who are employees, the full amount of the church’s reimbursements or allowances must be reported as income on the minister’s Form W-2 (and 1040). The minister can deduct actual expenses only as a miscellaneous itemized deduction on Schedule A to the extent these expenses exceed two percent of adjusted gross income. These rules are especially harsh, since the church’s reimbursements are fully reported as income to the minister who in many cases is unable to claim any deduction because of insufficient itemized expenses to use Schedule A.

Caution. Nonaccountable expense reimbursements that are not reported as taxable income on a minister’s W-2 or Form 1040 are classified as an “automatic excess benefit” by the IRS, meaning that the minister and church board members are exposed to substantial excise taxes (called “intermediate sanctions”). Only officers and directors (and their relatives) are subject to this rule.

The IRS has advised ministers to comply with the so-called *Deason* allocation rule when computing deductions for unreimbursed business expenses as well as business expenses reimbursed by a church under a nonaccountable arrangement. This rule requires ministers to reduce their business expense deduction by the percentage of their total compensation that consists of a tax-exempt housing allowance. This rule does not apply to the computation of self-employment taxes since the housing allowance is not deductible in computing these taxes. *The Deason rule can be avoided if a church adopts an accountable business expense reimbursement arrangement.*

Key Point. The IRS audit guidelines for ministers instruct agents to apply the so-called *Deason* allocation rule when auditing ministers.

Method 3: Accountable reimbursed expenses

Key Point. The limitations on the deductibility of unreimbursed and nonaccountable reimbursed employee business expenses can be avoided if the church adopts an accountable reimbursement plan. Reimbursements paid by the church under an accountable arrangement are not reported as income to the minister, and the minister need not claim any deductions.

The best way for ministers to handle business expenses is to have their employing church adopt an accountable business expense reimbursement arrangement. Under such an arrangement, (1) a church agrees to reimburse ministers (and other church workers, if desired) for those business expenses that are properly substantiated as to date, amount, place, and business purpose, and (2) ministers are required to return any excess reimbursements (in excess of substantiated expenses) to the church. Reimbursements of business expenses under such an arrangement are not reported as taxable income on the minister's Form W-2 or Form 1040, and there are no deductions to claim. In effect, the minister is reporting to the church rather than to the IRS.

An accountable business expense reimbursement arrangement should be established by the church in an appropriate resolution. In adopting a resolution, pay special attention to the following rules:

- Condition the reimbursement of any expense on adequate substantiation. This will include written evidence for all expenses and receipts for expenses of \$75 or more. The evidence must substantiate the amount, date, place, and business nature of each expense. The key point is this: A church must require the same degree of substantiation as would be required for a deduction on the minister's income tax return.
- Expenses must be substantiated and excess reimbursements returned to the church within a reasonable time. Expenses will be deemed substantiated within a reasonable period of time if they are substantiated within 60 days. Excess reimbursements will be deemed to be returned to the employer within a reasonable period of time if they are returned within 120 days.
- Business expense reimbursements cannot be funded under an accountable plan out of a minister's own salary (for example, through salary reductions).

Example. Pastor R is senior minister at First Presbyterian Church. He reports his federal income taxes as an employee, and the church reimburses him for all of his business and professional expenses (by means of a credit card or cash reimbursements). However, Pastor R is not required to account for such expenses by providing the church treasurer with receipts documenting the amount, time and place, business purpose, and business relationship of each expense. Pastor R simply informs the treasurer at the end of each month of the total expenses incurred during that month. Assume further that Pastor R cannot itemize deductions on Schedule A (he does not have sufficient deductions). If Pastor R received reimbursements of \$4,000 in 2010: (1) the church would report the entire reimbursements (\$4,000) as income on Pastor R's W-2, and Pastor R would report them as income (salary) on his Form 1040; and (2) Pastor R cannot deduct the reimbursed expenses as a miscellaneous itemized deduction on Schedule A since he does not have sufficient expenses to itemize. In other words, all of Pastor R's business expense reimbursements are includable in his income for tax purposes, but he cannot offset any of this income by deducting any portion of his business expenses. Even if Pastor R could itemize deductions, his nonaccountable reimbursed expenses would be treated just like unreimbursed expenses—they are deductible only as miscellaneous itemized deductions, and then only to the extent that they (along with most other miscellaneous expenses) exceed two percent of his adjusted gross income. Clearly, the tax impact of these rules can be costly for ministers who do not account to their employing church for their business expenses. Further, if the church and Pastor R neglect to report the reimbursements as taxable income, the reimbursements become an "automatic excess benefit" triggering intermediate sanctions against (1) Pastor R (assuming he is an officer or director, or the relative of one) of up to 225 percent of the excess benefit (\$9,000), and (2) the board, of up to a maximum penalty of \$20,000.

Example. Same facts as the previous example, except that the church adopts an accountable reimbursement plan, and Pastor R is reimbursed for \$4,000 of substantiated expenses. Under these facts, the church would not report the \$4,000 of reimbursements as income on Pastor R's Form W-2, and Pastor R would not have to report the reimbursements or claim the expenses on his Form 1040.

Churches occasionally reimburse ministers for nonbusiness expenses. Such reimbursements, though they require an accounting, ordinarily must be included in the minister's wages for income tax reporting purposes, and they are not deductible by the minister. Such personal, living, or family expenses are not deductible, and

the entire amount of a church's reimbursement must be included on the minister's Form W-2 and Form 1040.

Business expenses must be substantiated by adequate evidence to support an income tax deduction or an expense reimbursement under an accountable reimbursement plan of an employer. Stricter substantiation rules apply to transportation, travel, and entertainment expenses.

Schedule B

Schedule B is used to report taxable interest income and dividend income of more than \$1,500.

Step 1: Interest income (lines 1-4)

List (on line 1) the name of each institution or individual that paid you taxable interest if you received more than \$1,500 of taxable interest in 2010. Be sure the interest you report on line 1 corresponds to any 1099-INT forms you received from such institutions. Do not include tax-exempt interest.

Step 2: Dividend income (lines 5-6)

List (on line 5) the name of each institution that paid you dividends if you received more than \$1,500 in dividends in 2010. Be sure the dividends you report on line 5 correspond to any 1099-DIV forms you received from such institutions.

Step 3: Foreign accounts and foreign trusts (lines 7-8)

Be sure to complete this part of the schedule if you had more than \$1,500 of either taxable interest or dividends.

Schedule C

Key Point. Most ministers who serve local churches or church agencies are employees for federal income tax purposes with respect to their church salary. They report their church salary on line 7 of Form 1040 and receive a Form W-2 from the church. They do not report their salary as self-employment earnings on Schedule C.

Key Point. Use Schedule C to report income and expenses from ministerial activities you conduct other than in your capacity as a church employee. Examples would be fees received for guest speaking appearances in other churches, and fees received directly from church members for performing personal services, such as weddings and funerals.

Recommendation. Some ministers are eligible to use the simpler Schedule C-EZ.

Step 1: Introduction

Complete the first several questions on Schedule C. Ministers should list code 813000 on line B since this is the code that refers to ministers and chaplains.

Some ministers who report their church compensation as self-employed point to this code as proof that ministers serving local churches can report as self-employed. This is not so. This code applies to the incidental self-employment activities of ministers who report their church salaries as employees. It also applies to those few ministers who are self-employed, such as traveling evangelists.

Step 2: Income (lines 1-7)

Report on line 1 your gross income from your self-employment activity.

Step 3: Expenses (lines 8-27)

Warning. Many ministers continue to report their income taxes as self-employed. One so-called advantage to this arrangement is the ability of the minister to fully deduct business expenses on Schedule C whether or not the minister can itemize deductions on Schedule A. This advantage is illusory. Most ministers, if audited by the IRS, would be reclassified as employees and their Schedule C deductions disallowed. This could result in substantial additional taxes, penalties, and interest, particularly if the minister is not able to use Schedule A. The best way for all ministers to handle their business expenses is through an accountable expense reimbursement arrangement.

Report any business expenses associated with your self-employment earnings on lines 8 through 27. For example, if you incur transportation, travel, or entertainment expenses in the course of performing self-employment activities, you deduct these expenses on lines 8 through 27 of Schedule C.

Since self-employed ministers list only their net self-employment earnings (that is, after deducting all business and professional expenses) as a component of gross income on line 12 of Form 1040, they in effect are able to deduct 100 percent of their business and professional expenses even if they do not have enough itemized deductions to use Schedule A.

Self-employed individuals, including ministers, can deduct only 50 percent of business meals and entertainment. Further, self-employed individuals who use Schedule C to report their business deductions are not subject to the two percent floor that applies to the deduction of employee business and professional expenses that are either unreimbursed or reimbursed under a nonaccountable reimbursement plan. Some ministers point to these as advantages of reporting church income as self-employed rather than as employees. Nothing could be further from the truth. The IRS considers most ministers serving local churches and church agencies to be employees rather than self-employed for federal income tax reporting purposes.

The so-called advantage of being able to deduct all of one's business expenses on Schedule C is of little value in the event of an IRS audit and reclassification as an employee. In addition, a minister who reports his church income as self-employed is taxed on the value of certain fringe benefits (including Benefits Plan dues or other employer-paid medical insurance).

Key Point. One of the reasons the audit rate is much higher for self-employed taxpayers is that only 30 percent of all taxpayers have sufficient itemized expenses to use Schedule A. If the IRS can reclassify taxpayers from self-employed to employee status, it will generate far more tax dollars since only 30 percent of taxpayers can itemize deductions on Schedule A. Expenses that could have been claimed by a self-employed taxpayer on Schedule C are lost if that taxpayer is reclassified as an employee and has insufficient expenses to itemize on Schedule A.

Example. Pastor M reports his income taxes as a self-employed person. He has \$4,000 of business expenses in 2010 that were not reimbursed by his church. He deducted all of them on Schedule C. He did not have enough expenses to itemize deductions on Schedule A. Pastor M is later audited by the IRS, and he is reclassified as an employee. He will not be able to deduct any of the \$4,000 of business expenses since they are deductible by an employee only as an itemized deduction on Schedule A. Further, Pastor M will have to pay interest and possibly penalties in addition to the additional taxes.

Schedule C-EZ

The IRS has released a simpler form of Schedule C that can be used by some people with self-employment earnings. The new Schedule C-EZ can be used instead of Schedule C if you meet all of these requirements:

- You had business expenses associated with your trade or business of \$5,000 or less in 2010.
- You use the cash rather than the accrual method of accounting.
- You did not have an inventory at any time during the year.
- You did not have a net loss from your trade or business.
- You had only one business as a sole proprietor.
- You had no employees.
- You do not use Form 4562 to compute a depreciation deduction with regard to your trade or business.
- You do not claim a deduction for the business use of your home.

Many ministers who report their church compensation as employees will be able to use this form to report

small amounts of self-employment earnings they receive during the course of a year as honoraria for occasional guest speaking appearances or as fees received directly from church members for services rendered on their behalf (for example, marriages and funerals).

Schedule SE

Key Point. Use Schedule SE to report Social Security taxes on any income you earned as a minister if you have not applied for and received IRS approval of an exemption application (Form 4361). Remember, ministers always are self-employed for Social Security purposes with respect to their ministerial services. They pay self-employment taxes, and never FICA taxes, with respect to such services.

Key Point. Ministers who have received IRS approval of an application for exemption from self-employment taxes (Form 4361) do not pay any Social Security taxes on compensation received for their ministerial services. They do not use Schedule SE.

Step 1: Section A (line 2)

Most ministers use the short Schedule SE rather than the long Schedule SE. This means that they complete section A on page 1 of the schedule rather than Section B on page 2.

Ministers report their net self-employment earnings on line 2 of Section A. This amount is computed as follows:

1. Add the following to the church salary:
 - other items of church income (including taxable fringe benefits)
 - self-employment earnings from outside businesses
 - annual rental value of manse or nontaxable portion of housing allowance
 - business expense reimbursements made under a nonaccountable plan
2. Next, subtract the following from the above total:
 - unreimbursed business expenses (disregard the *Deason* reduction rule);
 - business expenses reimbursed under a nonaccountable plan (disregard the *Deason* reduction rule);
 - most income tax exclusions other than the housing allowance, the fair rental value of a manse, and the foreign-earned income exclusion

Step 2: Section A (line 4)

Ministers (and other taxpayers who are considered self-employed for Social Security purposes) can reduce their taxable earnings by 7.65 percent, which is half the Social Security and Medicare tax paid by employers

and employees. To do this, multiply net earnings from self-employment by 0.9235 on line 4. Self-employment taxes are paid on the reduced amount.

Step 3: Section A (line 5)

The self-employment tax for 2010 is computed on this line. The self-employment tax rate for 2010 is 15.3 percent, which consists of the following two components: (1) a Medicare hospital insurance tax of 2.9 percent, and (2) an old-age, survivor, and disability (Social Security) tax of 12.4 percent. For 2010, the 2.9 percent Medicare tax applies to all net earnings from self-employment regardless of amount. The 12.4 percent Social Security tax applies to only the first \$106,800 of net self-employment earnings (in 2010).

New in 2011. The 2010 Tax Relief Act provides a Social Security tax holiday for 2011. Under current law, self-employed individuals pay a 12.4 percent Social Security self-employment tax (SECA tax) on all wages earned up to \$106,800. The 2010 Tax Relief Act provides a SECA tax reduction for 2011 of two percentage points. This means self-employment individuals will pay only 10.4 percent on their SECA tax wages up to \$106,800. The tax reduction will not reduce your future Social Security benefits. Ministers should adjust their estimated SECA tax payments to reflect the two percent tax reduction in 2011.

Form 2106

Key Point. Use Form 2106 to compute your employee business expenses claimed on Schedule A.

Step 1: Enter your expenses

On lines 1 through 6, you report your employee business expenses. For most ministers, the most significant employee business expense is the business use of a car. This expense is computed on Part II (side 2) of Form 2106 and then reported on line 1 of Part I. Ministers may use the actual expense method of computing their car expenses, or the standard mileage rate. Most ministers elect the standard mileage rate. Under this method, substantiated business miles are multiplied by the current standard mileage rate (50 cents per mile for business miles driven during 2010). You compute your vehicle expenses using the standard mileage rate in Section B of Part II (line 22).

Key Point. The business standard mileage rate for 2011 is 51 cents per mile.

Those ministers using the actual expense method compute their car expenses in Section C of Part II. Some restrictions apply to use of the standard mileage rate. First, you must maintain adequate records to substantiate your business miles, and second, you must use the standard mileage rate for the first year you

began using your car for business purposes in order to use that method in subsequent years.

On line 3, you report your travel expenses incurred while away from home overnight on business. This would include travel to other cities to perform weddings or funerals, or trips to denominational meetings. Do not include meals and entertainment on line 3 (these items are reported separately on line 5). On line 4, report business expenses other than local transportation, overnight travel, and meals and entertainment. This would include education, publications, and the other kinds of business expenses discussed previously in this guide.

Step 2: Enter amounts your employer gave you for expenses listed in Step 1

If your employer (church) reimbursed some or all of your business expenses and does not report them as income in box 1 of your Form W-2, report the amount of these reimbursements on line 7. This would include any amount reported under code L in box 12 of your Form W-2 (substantiated car expense reimbursements up to the standard business mileage rate), and reimbursements of business expenses under an accountable arrangement.

Step 3: Figure expenses to deduct on Schedule A (Form 1040)

On lines 8 through 10, you compute the amount of your business expense deduction to be claimed on Schedule A. The deduction will be limited to the amount that exceeds two percent of your adjusted gross income.

Form 2106-EZ

Employees can use a simplified Form 2106-EZ to compute their business expense deduction for 2010 if their employer did not reimburse business expenses and they use the standard mileage rate for computing automobile expenses.



IRS Resources

- Publication 1** Your Rights as a Taxpayer
- Publication 15** Circular E, Employer's Tax Guide
- Publication 15-A** Employer's Supplemental Tax Guide
- Publication 334** Tax Guide for Small Business (For Individuals Who Use Schedule C or C-EZ)
- Publication 463** Travel, Entertainment, Gift, and Car Expenses
- Publication 517** Social Security and Other Information for Members of the Clergy and Religious Workers
- Publication 521** Moving Expenses
- Publication 525** Taxable and Nontaxable Income
- Publication 526** Charitable Contributions
- Publication 550** Investment Income and Expenses
- Publication 553** Highlights of Tax Changes
- Publication 557** Tax-Exempt Status for Your Organization
- Publication 561** Determining the Value of Donated Property
- Publication 571** Tax-Sheltered Annuity Plans (403(b) Plans)
- Publication 598** Tax on Unrelated Business Income of Exempt Organizations
- Publication 600** State and Local General Sales Taxes
- Publication 910** Guide to Free Tax Services
- Publication 1771** Charitable Contributions: Substantiation and Disclosure Requirements
- Publication 1828** Tax Guide for Churches and Religious Organizations
- Publication 3079** Gaming Publication for Tax-Exempt Organizations

Visit IRS.gov or call 800-829-1040 for forms or information.

These and many other publications can be downloaded from the Board's Web site, Pensions.org, or call 800-773-7752 (800-PRESPLAN) for a copy.

The Board of Pensions Resources

Dues & Invoices

- Understanding Effective Salary
- 2011 Dues Schedule
- Worksheet for Full-Time Equivalent Salary Basis for Healthcare Dues
- BoardLink (online billing service)
- Benefits Administration Handbook for Churches and Employing Organizations
- Church Treasurer & Business Administrator News, Fall 2010

Special Circumstances

- Your Benefits as a Member Couple

Taxation of Death Benefits

- Taxation of Death Benefit Dues Calculator
- USERRA Q & A

Flexible Spending Accounts – Sample Forms and Plan

- Sample Guide for Employers Considering Health Flexible Spending Accounts
- Sample Session Resolution
- Sample Health Flexible Spending Plan Employee Summary
- Sample Health Flexible Spending Account Plan
- Sample Health Flexible Spending Account Enrollment
- Sample Health Flexible Spending Account Worksheet
- Sample Reimbursement Claim Form for Health Flexible Spending Account

Calculators

- Total Effective Salary Calculator
- Dues Calculator
- Supplemental Death Benefit Rate Calculator
- Optional Dental Benefit Rate Calculator