Annual Information Return) solely to meet the reporting requirements of section 6039D of the tax code ("fringe benefit plans") should file neither Form 5500 nor Schedule F. In fact, Schedule F has been eliminated, and Form 5500 has been modified so fringe benefit plan information cannot be reported.

Fringe benefit plans are often associated with ERISA group health plans and other welfare benefit plans. The exemption of pure fringe benefit plans from the Form 5500 filing requirement does not cover these associated welfare plans. But, in many cases, a Form 5500 was not required for the welfare plan because it was exempt from filing a Form 5500 report under Department of Labor regulations. For example, fully insured or unfunded welfare plans covering fewer than 100 participants at the beginning of the plan year are eligible for a filing exemption, as are church plans. Unless exempt, however, ERISA welfare plans must still file in accordance with the Form 5500 instructions on welfare plan filing requirements.

Form 5500 must be filed annually by every pension benefit plan. However, church plans are exempt from this requirement so long as they have not elected to be covered by ERISA. See Chapter 10 for more information about church retirement plans.

Chapter 6 PARSONAGES AND HOUSING ALLOWANCES

Joseph established it as a law concerning land in Egypt—still in force today—that a fifth of the produce belongs to Pharaoh. It was only the land of the priests that did not become Pharaoh's.

Genesis 47:26

CHAPTER HIGHLIGHTS

- **PARSONAGES** Ministers who live in a church-owned parsonage that is provided rent-free as compensation for ministerial services do not include the annual fair rental value of the parsonage as income in computing their federal income taxes. The annual fair rental value is not deducted from the minister's income. Rather, it is not reported as additional income anywhere on Form 1040 (as it generally would be by nonclergy workers).

- **PARSONAGE ALLOWANCES** Ministers who live in a church-provided parsonage do not pay federal income taxes on the amount of their compensation that their employing church designates in advance as a parsonage allowance, to the extent that the allowance represents compensation for ministerial services and is used to pay parsonage-related expenses such as utilities, repairs, and furnishings.

- **HOUSING ALLOWANCES** 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 the allowance represents compensation for ministerial services, is used to pay housing expenses, and does not exceed the fair rental value of the home (furnished, plus utilities). Housing-related expenses include mortgage payments, 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 and does not exceed the fair rental value of the home (furnished, plus utilities).

- **DESIGNATING AN ALLOWANCE** Parsonage and housing allowances should be (1) adopted by the church board or congregation, (2) in writing, and (3) in advance of the calendar year. However, churches that fail to designate an allowance in advance of a calendar year should do so as soon as possible in the new year (though the allowance will only operate prospectively). In designating housing allowances, churches should keep in mind that the nontaxable portion of a housing allowance cannot exceed the fair rental value of a minister's home (furnished, plus utilities). Therefore, nothing will be accomplished by designating allowances significantly above this limit.

- **SAFETY NET HOUSING ALLOWANCES** Churches should consider adopting a "safety net" allowance to protect against the loss of this significant tax benefit due to the inadvertent failure by the church to designate an allowance.

- **EQUITY ALLOWANCES** Churches should consider adopting an appropriate "equity allowance" for ministers who live in church-owned parsonages.

- **AMENDING THE ALLOWANCE** Churches can amend an allowance during the year if the original allowance proves to be too low. But the amended allowance will only operate prospectively.

- **NO RETROACTIVE APPLICATION** Under no circumstances can a minister exclude any portion of an allowance retroactively designated by a church.

- **SOCIAL SECURITY** A housing allowance and the annual rental value of a parsonage are exclusions only for federal income tax reporting. Ministers cannot exclude a housing allowance (or the annual fair rental value of a parsonage) when computing their self-employment (Social Security) taxes unless they are actually 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." *IRC 1402(a)(8).*

- **PENSION FUNDS** In some cases a church pension plan may designate a housing allowance for retired ministers.

- **REPORTING** Housing allowances are not required to be reported on a minister's Form W-2, but many churches do so by reporting the allowance (or the annual rental value of a parsonage) in box 14. The instructions to Form W-2 say this regarding box 14: "You may use this box for any information that you want to give to your employee. Label each item. Examples include . . . a minister's parsonage allowance and utilities."

Box 14 is used by employers to communicate information to their employees and is ignored by the IRS. This is one way for a church to remind a minister of the amount of the church-designated housing allowance. IRS Publication 517 contains a comprehensive clergy tax filing illustration that includes a minister's housing allowance in box 14. So, while some churches use box 14 to report a minister's housing allowance, this is optional and not required. Further, a church does not need to issue two checks—one for salary and one for housing allowance.

■ **SETTING THE ALLOWANCE** There is no limit on the amount of a minister's compensation that can be designated by a church as a housing allowance (assuming that the minister's compensation is reasonable in amount). However, for ministers who own their home, a church ordinarily should not designate a housing allowance significantly above the fair rental value of the minister's home, since the nontaxable portion of a housing allowance cannot exceed this amount.

IMPORTANT NOTICE: CURRENT STATUS OF PARSONAGE AND HOUSING ALLOWANCE EXCLUSIONS

In March 2019, a three-judge panel of a federal appeals court (the Seventh Circuit Court of Appeals) unanimously affirmed the constitutionality of the housing allowance. *Gaylor v. Mnuchin, 919 F.3d 420 (7th Cir. 2019).* It based its ruling on two grounds:

(1) The Lemon test

First, it applied the so-called *Lemon* test, which dates back to a 1971 Supreme Court ruling in *Lemon v. Kurtzman*, 403 U.S. 602 (1971), in which the Court announced a three-part test for evaluating claims that a state or federal law, such as the housing allowance, constitutes an impermissible establishment of religion under the First Amendment's nonestablishment of religion clause. Under the *Lemon* test, a law challenged on establishment clause grounds is valid if it meets three conditions: first, it has a clearly secular purpose; second, it has a primary effect that neither advances nor inhibits religion; and third, the law does not foster an excessive entanglement between church and state. The court concluded that all three elements were met, and so the housing allowance did not violate the First Amendment's ban on an establishment of religion.

The court concluded that there was not one but three legitimate secular purposes underlying the housing allowance:

(1) The elimination of discrimination against ministers in the tax code in several provisions granting housing benefits to secular workers. The housing allowance simply treats ministers like secular workers.

(2) The elimination of discrimination between ministers. The point here is that for many years, the only tax benefit for ministerial housing was the exclusion of the fair rental value of a church-provided parsonage from taxation. Ministers who did not live in a parsonage, but instead owned or rented a home, received no tax benefit. The housing allowance was enacted by Congress in 1954 to address this discrepancy and provide parity between ministers who lived in parsonages and those who did not.

(3) The avoidance of excessive entanglement between church and state.

(2) Historical significance

The court based its decision on a second ground that it called the "historical significance test." According to several rulings by the United States Supreme Court, the establishment clause must be interpreted with reference to historical practices. In other words, the longer a practice has gone unchallenged, the more likely it will survive a challenge under the establishment clause. A perfect example of this is a 1983 Supreme Court decision upholding the constitutionality of legislative chaplains. The Court pointed out that the very first session of Congress, in which the First Amendment's establishment clause was drafted, also provided funds for congressional chaplains. That's pretty strong evidence that congressional chaplains do not constitute an unconstitutional establishment of religion. The appeals court noted that there are over 2,500 state and federal laws providing tax exemptions of various sorts to religion, and this practice, dating back to the founding of the nation, reinforced the constitutionality of the housing allowance.

The FFRF chose not to appeal the decision by the Seventh Circuit Court of Appeals. It is possible that it, or another hostile organization, will sue in another court. Predicting the future status of a tax benefit such as the housing allowance is a difficult task, but I believe a solid case can be made for the continuation of this benefit for years to come based on the compelling logic of the appeals court's decision (which was based squarely on rulings by the Supreme Court). Any developments will be addressed in future editions of this tax guide.

How should churches and pastors respond to this ruling? Consider the following:

- Continue designating housing allowances for ministers. The housing allowance remains valid and active for all churches and qualifying clergy across the country.
- Monitor developments.
- In the event that another court invalidates the housing allowance in a final decision, note the following:
  - Many ministers will experience an immediate increase in income taxes. As a result, they should be prepared to increase their quarterly estimated tax payments to reflect the increase in income taxes in order to avoid an underpayment penalty. Note that there will be no effect on self-employment taxes for which the housing allowance is not tax-exempt.
  - Ministers who are considering the purchase of a new home should not base the amount and affordability of a home mortgage loan on the availability of a housing allowance exclusion unless and until the courts conclusively uphold the constitutionality of the allowance.
  - Many churches will want to increase ministers' compensation to offset the adverse financial impact. Thousands of ministers have purchased a home and obtained a mortgage loan on the assumption that the housing allowance would continue to be available as it has for more than a half century. The sudden elimination of this tax benefit will immediately thrust many clergy into a dire financial position with a mortgage loan based on a tax benefit that no longer is available. Many church leaders will want to reduce the impact of such a predicament by increasing compensation. Such an increase could be phased out over a period of years to minimize the impact on the church.
  - The fair rental value of church-provided parsonages remains a nontaxable benefit.

TABLE 6-1

TAX CONSEQUENCES OF VARIOUS CLERGY HOUSING ARRANGEMENTS

RULE	EXPLANATION
Parsonage	Annual fair rental value of a church-owned parsonage provided rent-free to a minister as compensation for ministerial services is excluded from income in computing federal income taxes.
Parsonage allowance	Ministers who live in a church-provided parsonage do not pay federal income taxes on the amount of their compensation that their employing church designates in advance as a parsonage allowance, to the extent the allowance represents compensation for ministerial services; is used to pay parsonage-related expenses such as utilities, repairs, and furnishings; and does not exceed the fair rental value of the parsonage (furnished, plus utilities).
Rental allowance	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 the allowance represents compensation for ministerial services; is used to pay rental expenses; and does not exceed the fair rental value of the home (furnished, plus utilities).
Housing allowance	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 the allowance is used to pay housing expenses and does not exceed the fair rental value of the home.

INTRODUCTION

The three most common housing arrangements for ministers are (1) living in a church-provided parsonage, (2) renting a home or apartment, or (3) owning a home. The tax code contains a significant benefit for each housing arrangement. The rules are summarized below:

- **Parsonages.** Ministers who live in a church-provided parsonage that is provided as compensation for ministerial services do not include the annual rental value of the parsonage as income in computing their federal income taxes.
- **Parsonage allowances.** Ministers who live in a church-provided parsonage do not pay federal income taxes on the amount of their compensation that their employing church designates in advance as a parsonage allowance, to the extent that the allowance represents compensation for ministerial services; is used to pay parsonage-related expenses such as utilities, repairs, and furnishings; and does not exceed the fair rental value of the parsonage (furnished, plus utilities).
- **Housing allowances (minister rents a home or apartment).** 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, is used to pay rental expenses, and does not exceed the fair rental value of the home (furnished, plus utilities).
- **Housing allowances (minister owns a home).** 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 the allowance represents compensation for ministerial services, is used to pay housing expenses, and does not exceed the fair rental value of the home (furnished, plus utilities). Housing-related expenses include mortgage payments, utilities, repairs, furnishings, insurance, property taxes, additions, and maintenance.

These rules (summarized in Table 6-1) represent the most significant tax benefits enjoyed by ministers. Yet many ministers either fail to claim them or do not claim enough. In some cases this results from tax advisers who are unfamiliar with ministers' taxes.

Because the rules for ministers living in church-owned parsonages differ from the rules that apply to ministers who own or rent their home, this chapter will be divided into two sections. See "Parsonages" on page 244 for a summary of the requirements for obtaining the full benefit available to ministers who live in a church-owned parsonage. The rules that apply to ministers who rent or own their homes are considered under "Owning or Renting Your Home" on page 251.

A. PARSONAGES

★ **KEY POINT** Ministers who live in a church-owned parsonage that is provided as compensation for ministerial services do not include the fair rental value of the parsonage as income in computing their federal income taxes. The fair rental value is not deducted from the minister's income. Rather, it is not reported as additional income anywhere on Form 1040 (as it generally would be by nonclergy workers).

★ **KEY POINT** Ministers who live in a church-provided parsonage do not pay federal income taxes on the amount of compensation their employing church designates in advance as a parsonage allowance, to the extent that the allowance represents compensation for ministerial services and is used to pay parsonage-related expenses such as utilities, repairs, and furnishings.

1. OVERVIEW

Since 1921 ministers have been permitted to exclude from their gross income for income tax purposes the annual fair rental value of a church-owned parsonage provided to them rent-free as part of their compensation for services rendered to the church. Congress has never explained the justification for this rule. Presumably, it is based on the principle that the rental value of lodging furnished rent-free to an employee on an employer's business premises should be excluded from gross income if it is furnished "for the convenience of the employer" and the employee must accept such lodging in order to adequately perform his or her duties. *IRC 119.*

Section 107 of the tax code says simply that "in the case of a minister of the gospel, gross income does not include—(1) the rental value of a home furnished to him as part of his compensation; or (2) the rental allowance paid to him as part of his compensation, to the extent used by him to rent or provide a home and to the extent such allowance does not exceed the fair rental value of the home, including furnishings and appurtenances such as a garage, plus the cost of utilities."

Note the following four considerations.

Minister of the gospel

The rental value of a parsonage and a parsonage allowance are nontaxable fringe benefits for ministers. The definition of *minister* for federal tax purposes is addressed in Chapter 3.

Compensation for the exercise of ministry

The annual rental value of a parsonage and the portion of a minister's compensation designated in advance by his or her employing church as a parsonage allowance are excluded from income in computing federal income taxes only if they represent compensation for services performed in the exercise of ministry. The income tax regulations specify that the parsonage or parsonage allowance must be "provided as remuneration for services which are ordinarily the duties of a minister of the gospel." In other words, the parsonage and "parsonage allowance" exclusions are available only if

- the recipient is a minister of the gospel, and
- the benefit is made available to the minister as compensation for services which are ordinarily the duties of a minister of the gospel.

These eligibility requirements are addressed in Chapter 3.

An exclusion

A parsonage allowance and the annual rental value of a church-provided parsonage are exclusions from gross income rather than deductions in computing or reducing adjusted gross income. As a result, they are not reported on Form 1040. Many ministers find this confusing and think they are not receiving a tax benefit unless they can deduct something on their tax return. In fact, some ministers erroneously deduct the annual rental value of a parsonage. This practice clearly violates federal tax law.

Keep in mind that virtually any other worker who receives rent-free use of an employer-provided home must include the annual rental value of the home in his or her gross income in computing both income taxes and Social Security taxes. Ministers, however, do not. This is a significant benefit. As noted below, the annual rental value of a parsonage (and any additional parsonage allowance designated by a church) must be included in self-employment earnings on Schedule SE (Form 1040) in computing a minister's Social Security tax liability.

EXAMPLE Frank lives in Chicago and works for a large company. His employer wants to transfer Frank to a Los Angeles office for two years and then return him to Chicago. The company allows Frank to live in a home it owns in Los Angeles for the two-year term. The annual rental value of the home provided to Frank rent-free is income to him in computing both income tax and Social Security tax. So if Frank's annual salary is $50,000 and the annual rental value of the Los Angeles home is $15,000, Frank's employer must report compensation of $65,000 on Frank's Form W-2.

EXAMPLE Same facts as the preceding example except that Frank is a minister who leaves a church in Chicago to accept a pastoral position in Los Angeles and that the Los Angeles church provides him with rent-free use of a church-owned parsonage. Frank's W-2 income would be only $50,000 (not $65,000). The annual rental value of the home is not reported as taxable income. This is a significant benefit compared to the previous example involving an employee who was not a minister, and it will result in a tax savings of several thousand dollars. Some ministers erroneously deduct the rental value of their parsonage from their taxable income. For example, assume that Frank instructs his church treasurer to reduce his W-2 income by $15,000 so that only $35,000 is reported. This practice clearly violates federal law and should be avoided. The tax benefit is that Frank does not have to report the annual rental value of the home ($15,000) as income in addition to his $50,000 salary. Note that Frank would have to pay Social Security taxes on the rental value of the parsonage (assuming that he is not exempt from Social Security coverage).

Valuing the exclusion

Section 107 excludes the annual rental value of a parsonage provided rent-free to a minister as compensation for ministerial services as well as an allowance paid to a minister that is used to pay expenses incurred in maintaining the parsonage (e.g., utilities, repairs, furnishings). Ministers who live in a church-owned parsonage do not report the annual rental value of the parsonage as income, and the church is not required to declare an allowance in the amount of the annual rental value of the parsonage. The exclusion is automatic. However, if the minister incurs any expenses in living in the parsonage, he or she may exclude them only to the extent that they do not exceed a parsonage allowance declared in writing and in advance by the church board. See Illustration 6-1 for an example of a parsonage allowance designation.

EXAMPLE Pastor W lives rent-free in a church-owned parsonage having an annual rental value of $12,000 in 2021. The church expects Pastor W to incur some expenses in living in the parsonage, so it provides him with an allowance of $300 each month. His salary (not including the monthly allowance) was $45,000 in 2021. On his 2021 federal income tax return, Pastor W would not report the annual rental value of the parsonage ($12,000) as income, even though the church never designated that amount as a parsonage allowance. However, he would have to report the total monthly allowances ($3,600) as income unless the church board declared a parsonage allowance in writing and in advance of at least $3,600. The rental value of the parsonage and parsonage allowance are taxable in computing self-employment taxes. *Eden v. Commissioner, 41 T.C. 605 (1961). See also Revenue Ruling 59-350.*

EXAMPLE Pastor R lives rent-free in a church-owned parsonage having an annual rental value of $12,000 in 2021. The church pays the utilities charged to the parsonage, which amount to $3,000 for 2021. The IRS *Tax Guide for Churches and Religious Organizations* specifies that "a minister who is furnished a parsonage may exclude from income the fair rental value of the parsonage, including utilities." In effect, the church is designating this amount as a parsonage allowance each month by paying it. While the $3,000 does not represent taxable income to Pastor R for income tax reporting, it does for self-employment (Social Security) tax reporting; so Pastor R must add the $3,000 to self-employment earnings in computing the self-employment tax. The annual rental value of the parsonage ($12,000) is also subject to the self-employment tax.

EXAMPLE IRS Publication 517 contains the following example: Pastor Roger Adams receives an annual salary of $39,000 as a full-time minister. The $39,000 includes $5,000 that is designated as a rental allowance to pay utilities. His church owns a parsonage that has a fair rental value of $12,000 per year. The church gives Pastor Adams the use of the parsonage. He isn't exempt from SE tax. He must include $51,000 ($39,000 plus $12,000) when figuring his net earnings for SE tax purposes. The results would be the same if, instead of the use of the parsonage and receipt of the rental allowance for utilities, Pastor Adams had received an annual salary of $51,000 of which $17,000 ($5,000 plus $12,000) per year was designated as a rental allowance.

➡ **TIP** Churches should declare a parsonage allowance in advance of each calendar year for any minister who lives in a parsonage to cover any miscellaneous expenses the minister may incur while living in the parsonage. The allowance should be declared in writing and be incorporated into the minutes of the board or other group that designates it. Churches failing to declare a parsonage allowance before January 1 need not wait until the following year to act. The declaration is effective from the date of its enactment. Therefore, a church failing to declare a parsonage allowance until

March of 2021 (for 2021) can still provide its minister with an important tax benefit for the remainder of the year.

2. DESIGNATING A PARSONAGE ALLOWANCE

Ministers who live in a church-provided parsonage often incur expenses in maintaining the parsonage. Common examples include utilities, repairs, insurance, and furnishings. The portion of a minister's compensation that is designated in advance by the church as a parsonage allowance is not subject to federal income taxes, to the extent the allowance represents compensation for ministerial services; is used to pay parsonage-related expenses such as utilities, repairs, and furnishings; and does not exceed the fair rental value of the parsonage (furnished, plus utilities).

The income tax regulations specify that the designation of the allowance may be contained in "an employment contract, in minutes of or in a resolution by a church or other qualified organization or in its budget, or in any other appropriate instrument evidencing such official action." The regulations further provide that "the designation . . . is a sufficient designation if it permits a payment or a part thereof to be identified as a payment of rental allowance as distinguished from salary or other remuneration." *Treas. Reg. 1.107-1(b).*

In other words, the designation must simply distinguish a part of the minister's compensation as a parsonage allowance. This can be done by giving a minister two separate checks—one designated as salary and the other as the parsonage allowance. This approach is not necessary, since a church that has designated a portion of a minister's compensation as a parsonage allowance has thereby made the required identification, and it is free to issue a minister one check per pay period that combines both salary and the parsonage allowance.

The church's designation should be in writing, although if a board orally agrees to a specific allowance and neglects to make a written record of its action, it could draft an appropriate record of its action at a later time, dated as of the earlier meeting. *Kizer v. Commissioner, T.C. Memo. 1992-584.*

★ **KEY POINT** Section 35 of *Robert's Rules of Order Newly Revised* (11th ed., 2011) recognizes a motion to "amend something previously adopted" as an incidental main motion by which a deliberative body can change an action previously taken or ordered. This would include amending the minutes of a church board meeting to reflect a parsonage allowance *that in fact was adopted* but that was not reflected in the original minutes.

ILLUSTRATION 6-1

PARSONAGE ALLOWANCE DESIGNATION FOR MINISTERS WHO LIVE IN A CHURCH-OWNED PARSONAGE

The following resolution was duly adopted by the board of directors of First Church at a regularly scheduled meeting held on December 15, 2020, a quorum being present:

Whereas, section 107 of the Internal Revenue Code permits a minister of the gospel to exclude from gross income the rental value of a parsonage furnished to him as part of his compensation, and a church-designated parsonage allowance paid to him as part of his compensation, to the extent the allowance represents compensation for ministerial services; is used to pay parsonage-related expenses such as utilities, repairs, and furnishings; and does not exceed the fair rental value of the parsonage (furnished, plus utilities); and

Whereas, Pastor John Smith is compensated by First Church exclusively for services as a minister of the gospel; and

Whereas First Church provides Pastor Smith with rent-free use of a church-owned parsonage as compensation for services that he renders to the church in the exercise of his ministry; and

Whereas, as additional compensation to Pastor Smith for services that he renders to the church in the exercise of his ministry, First Church also desires to pay Pastor Smith an amount to cover expenses he incurs in maintaining the parsonage; therefore, it is hereby

Resolved, that the annual compensation paid to Pastor Smith for calendar year 2021 shall be $50,000, of which $5,000 is hereby designated as a parsonage allowance pursuant to section 107 of the Internal Revenue Code; and it is further

Resolved, that the designation of $5,000 as a parsonage allowance shall apply to calendar year 2021 and all future years unless otherwise provided by this board; and it is further

Resolved, that as additional compensation to Pastor Smith for calendar year 2021 and for all future years unless otherwise provided by this board, Pastor Smith shall be permitted to live in the church-owned parsonage located at 123 Main Street, and that no rent or other fee shall be payable by Pastor Smith for such occupancy and use.

The Tax Court has ruled that an oral designation is sufficient, since "there is no requirement that the designation be in writing." *Libman v. Commissioner, 44 T.C.M. 370 (1982).* This practice should be avoided, however, since it will always create problems of proof.

A parsonage allowance should be designated by the same body (a board or the membership) that approves compensation. A parsonage allowance must be designated in advance, since it is nontaxable only to the extent it is used to pay parsonage-related expenses. Ideally, a parsonage allowance should be designated in advance of each new year. A sample resolution that accomplishes this is set forth in Illustration 6-6 on page 279. If a church fails to designate a parsonage allowance before the start of a new year, it is not lost for the entire new year. Rather, the church can designate a parsonage allowance at any time during the year for the remainder of that year. To illustrate, if a church discovers on March 10, 2021, that it has not yet designated a parsonage allowance for its pastor for that year, it can do so on that date for the remainder of the year.

➔ **TIP** Many ministers who live in a parsonage are unaware that they do not pay tax on that portion of their salary that is designated in advance by their church as a parsonage allowance (to the extent it is used to pay parsonage-related expenses). Such an allowance costs the church nothing, but it provides a minister with a significant tax benefit.

EXAMPLE A minister reduced his taxable income by the amount of a parsonage allowance. The IRS audited the minister and determined that he was not eligible for a parsonage allowance, since no evidence existed that the church had ever designated one. The Tax Court agreed. It noted that the minister had the "burden of proving that the amount at issue was properly designated as a rental allowance by official church action before payment" and concluded that "the record is devoid of any such evidence." *Logie v. Commissioner, T.C. Memo. 1998-387.*

3. REASONABLE IN AMOUNT

An additional requirement, not mentioned in section 107, is that the annual rental value of a parsonage (or a parsonage allowance declared by a church) must be reasonable in amount. *IRC 501(c)(3).* Providing a minister with a parsonage (or parsonage allowance) that is excessive in amount may constitute unreasonable compensation. Such a finding could jeopardize the tax-exempt status of the church. It also could trigger intermediate sanctions against the minister and the church board members who approved the transaction. Intermediate sanctions are excise taxes the IRS can assess as a result of an "excess benefit transaction" favoring a director or officer. See "General Considerations" on page 126 for a discussion of unreasonable compensation and intermediate sanctions.

The IRS *Tax Guide for Churches and Religious Organizations* states that "a minister who is furnished a parsonage may exclude from income the fair rental value of the parsonage, including utilities. However, the amount excluded cannot be more than the reasonable pay for the minister's services."

EXAMPLE A federal court noted that a prominent televangelist lived in a parsonage and also received a housekeeping and maintenance allowance and a housing allowance, despite the fact that his ministry paid all of his utilities and other housing expenses. Such payments clearly were above any reasonable parsonage-related expenses, in the court's judgment. This case illustrates that ministers who live in a parsonage and who pay none of the expenses of maintaining the parsonage are not eligible for a parsonage allowance exclusion. *Heritage Village Church and Missionary Fellowship, Inc., 92 B.R. 1000 (D.S.C. 1988).*

4. ELIGIBILITY FOR BOTH THE PARSONAGE EXCLUSION AND PARSONAGE ALLOWANCE

A reasonable basis exists for the conclusion that ministers who live in a church-owned parsonage can exclude from gross income not only the annual rental value of the parsonage but also a parsonage allowance designated by the church, to the extent the allowance represents compensation for ministerial services; is used to pay parsonage-related expenses such as utilities, repairs, and furnishings; and does not exceed the fair rental value of the parsonage (furnished, plus utilities). This conclusion is supported by the following precedent:

IRS Publication 517

The current edition of IRS Publication 517 (Social Security and Other Information for Members of the Clergy and Religious Workers) clearly recognizes that ministers who live in a church-provided parsonage may have some of their compensation designated in advance by their employing church as a parsonage allowance: "You can exclude from gross income the fair rental value of a house or parsonage, including utilities, furnished to you as part of your earnings. However, the exclusion cannot be more than the reasonable pay for your services. *If you pay for the utilities, you can exclude any allowance designated for utility costs, up to your actual cost*" (emphasis added). IRS Publication 517 includes the following example.

EXAMPLE Rev. Joanna Baker is a full-time minister. The church allows her to use a parsonage that has an annual fair rental value of $24,000. The church pays her an annual salary of $67,000, of which $7,500 is designated for utility costs. Her

actual utility costs during the year were $7,000. For income tax purposes, Rev. Baker excludes $31,000 from gross income ($24,000 fair rental value of the parsonage plus $7,000 from the allowance for utility costs). She will report $60,000 ($59,500 salary plus $500 of unused utility allowance). Her income for SE tax purposes, however, is $91,000 ($67,000 salary + $24,000 fair rental value of the parsonage).

Revenue Ruling 59-350

In Revenue Ruling 59-350 the IRS ruled that a minister who lived in a church-owned parsonage could exclude from gross income that portion of his salary that was designated in advance by his employing church as a parsonage allowance. The IRS observed:

> *[A] minister of the gospel who is furnished a parsonage rent-free may exclude a rental allowance to the extent used by him to pay for utilities so long as the employing church or church organization designates a part of his remuneration as a rental allowance. . . .*
>
> *Therefore, a minister of the gospel is permitted to exclude from his gross income, under section 107(1) of the Code, the rental value of a home furnished him as part of his compensation and, in addition, may exclude from his gross income, under section 107(2) of the Code, the "designated" rental allowance, to the extent expended for utilities.*
>
> *Accordingly, [if] a minister of the gospel who is provided a home rent-free by a church or other qualified organization as part of his compensation . . . pays for his utilities, [and] an amount of his compensation is designated as a "rental allowance" to cover the cost of his utilities, he may exclude from his gross income not only the rental value of the home but also the amount of the "rental allowance" to the extent used by him to pay for his utilities.*

Revenue Ruling 63-156

In Revenue Ruling 63-156 the IRS stated:

> *A retired minister of the gospel is furnished rent-free use of a home pursuant to official action taken by the employing qualified organization in recognition of his past services which were the duties of a minister of the gospel in churches of his denomination. In addition, he is paid a rental allowance, within the meaning of section 107(2) of the Internal Revenue Code of 1954, for utilities, maintenance, repairs and other similar expenses directly related to providing a home.*
>
> *The rental value of the home furnished to the retired minister as part of his compensation for past services is excludable from his gross income under section 107(1) of the Code. Also, the rental allowance paid to him as part of his compensation for past services is excludable under section 107(2) of the Code, to the extent used by him for expenses directly related to providing a home.*

These precedents clearly support the view that ministers who live in church-owned parsonages can exclude from gross income not only the annual rental value of the parsonage but also a parsonage allowance designated by the church, to the extent it is used to pay for parsonage expenses.

5. SOCIAL SECURITY

Ministers cannot exclude a housing allowance (or the annual fair rental value of a parsonage) when computing their 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." *IRC 1402(a)(8).*

Therefore, in computing the Social Security tax on Schedule SE of Form 1040, nonretired ministers who live in a church-owned parsonage must *include* the annual rental value of the parsonage as income on line 2 (of either the short or long Schedule SE, whichever applies). A minister also must include as income any parsonage allowance paid by the church to cover miscellaneous expenses in maintaining the parsonage.

6. RENTAL VALUE OF A PARSONAGE

Ministers who have not exempted themselves from paying self-employment (Social Security) tax on their ministerial income must report any parsonage allowance and the annual rental value of a parsonage as income when reporting self-employment taxes on Schedule SE (Form 1040).

The rental value of a parsonage is a question to be determined in each case on the basis of the evidence. Some have suggested that a fair approximation of the monthly rental value of a home can be computed simply by taking 1 percent of the home's fair market value. For example, if a home has a fair market value of $200,000, its monthly rental value would be $2,000 ($200,000 × 1 percent) and its annual rental value would be $24,000. This method may yield accurate results in some cases, but it will yield inaccurate results in others. Generally, it yields excessive rental values. This approach has never been endorsed by the IRS or any court.

★ **KEY POINT** The IRS audit guidelines for ministers instruct agents that "determining the fair rental value [of a parsonage] is a question of all facts and circumstances based on the local market, but the church and minister have often already agreed on a figure and can provide documentary evidence."

★ **KEY POINT** The IRS provided some indication of how it will determine a home's fair rental value in a series of four letter rulings issued in 2004. The IRS observed, "In the agent's report, she determined an annual amount of $X as rental value for the property. . . . She stated: 'Calling a property management company and asking about the house determined this rental value, I did not identify the address; rather I used the information about the house, how many acres, square footage and area, etc.' The rental value was $X per month. This appears correct as the other houses owned and operated by Pastor B and the church were consistent with this value. The other rentals were not as spacious, nor did they have the amenities consistent with this property. In addition, the other rentals were in [an adjacent county] as opposed to [this county], which has a higher rental value. Those houses were being rented for approximately $Y/month." *IRS Private Letter Rulings 200435019, 200435020, 200435021, 200435022.*

EXAMPLE Pastor T lives in a church-owned parsonage. He is not exempt from Social Security coverage. In an effort to avoid any increase in Pastor T's Social Security tax liability, the church agrees to "rent" the parsonage to Pastor T for $1 each year. Pastor T then lists only $1 as the parsonage's rental value on his Schedule SE in computing his Social Security tax liability. This practice will not achieve its desired savings in Social Security taxes, since a minister must include the annual rental value of a church-provided parsonage as income on Schedule SE. The annual rental value of the parsonage is not $1. Rather, it is what houses of comparable size and quality in the same vicinity would rent for in an arm's-length transaction.

EXAMPLE A minister was provided with a parsonage, and in addition, a portion of his annual compensation was designated a parsonage allowance to assist him in paying utilities, furnishings, and other miscellaneous expenses. The annual rental value of a parsonage is taxable in computing a minister's self-employment (Social Security) tax. The minister claimed that this amount includes any parsonage allowance designated by the church. As a result, he reduced his parsonage's annual rental value by the parsonage allowance designated by his church in computing his self-employment tax. The Tax Court ruled that this was improper, noting that the minister had "not proven that the stipulated annual rental value of the parsonages already includes amounts designated or received in cash relating to the utility and other household expenses of the parsonages." *Radde v. Commissioner, T.C. Memo. 1997-490 (1997).*

Some churches in high-cost areas purchase a parsonage in order to make housing available to their minister. However, the rental value of such parsonages often is very high, resulting in large increases in the minister's self-employment taxes. For example, assume that a church purchased a parsonage several years ago that currently is worth several hundred thousand dollars and that has an annual rental value of $25,000. A minister who lives in such a parsonage would need to add the full $25,000 annual rental value in computing his or her earnings subject to the self-employment tax. This will result in an increase in self-employment taxes of nearly $4,000 (without taking into account any available deductions).

While this is a significant tax increase, keep in mind the following considerations:

- The minister is still receiving a significant income tax benefit (the $25,000 is not taxable for income tax purposes).
- The minister occupies a home of substantial value.
- Lower-cost accommodations may be much farther away from the church.
- Ministers pay the full 15.3-percent self-employment rate only on earnings up to a specified amount ($142,800 for 2021), and they pay only the 2.9-percent Medicare component of self-employment taxes on all net earnings from self-employment in excess of this amount. So, to the extent that the annual rental value of the parsonage boosts the minister's earnings above $142,800 for 2021, the excess is only subject to the 2.9-percent Medicare tax.

EXAMPLE Pastor H excluded a parsonage allowance from his reportable income though his employing church had never designated a portion of his compensation as a parsonage allowance. The Tax Court ruled that Pastor H was not entitled to exclude the allowance, since it had not been designated by his church prior to the time of its payment. *Horlz v. Commissioner, 42 T.C.M. 1037 (1981).*

7. EQUITY ALLOWANCES

Ministers who live in church-owned parsonages experience a significant disadvantage—they do not acquire equity in a home. To illustrate, assume that Pastor E lives in church-owned parsonages throughout his 35-year career as a minister. When Pastor E retires, he must vacate the parsonage he is occupying, and he has no equity interest in any of the parsonages he has occupied that can be used to acquire a retirement home. If Pastor E had owned homes throughout his career, he would have accumulated equity in the amount of his combined principal mortgage payments plus any appreciation in the value of the homes he owned. At retirement, not only would Pastor E have a home in which he could remain, but he also would have accumulated a significant equity interest.

Some churches have helped ministers who live in parsonages avoid or at least reduce the adverse economic impact of this housing arrangement by providing them with an equity allowance over and above their stated compensation. This allowance is designed to partially or wholly compensate the minister for the lost opportunity of accumulating equity in a home.

Since the purpose of such an allowance is to assist the minister in obtaining suitable housing at retirement, it is important that

IRS TAX GUIDE FOR CHURCHES

The current edition of the IRS *Tax Guide for Churches and Religious Organizations* contains summaries of several rules that pertain to churches and ministers. The guide contains the following statements regarding parsonages and parsonage allowances:

- A minister's gross income does not include the rental value of a home (a parsonage) provided, or the rental allowance paid, as part of his or her compensation for services performed that are ordinarily the duties of a minister.
- A minister who is furnished a parsonage may exclude from income the fair rental value of the parsonage, including utilities. However, the amount excluded cannot be more than the reasonable pay for the minister's services.
- A minister who receives a parsonage or rental allowance excludes that amount from his income. The portion of expenses allocable to the excludable amount is not deductible. This limitation, however, does not apply to interest on a home mortgage or real estate taxes, nor to the calculation of net earnings from self-employment for SECA tax purposes.
- The fair rental value of a parsonage or housing allowance is excludable from income only for income tax purposes. These amounts are not excluded in determining the minister's net earnings from self-employment for Self-employment Contributions Act (SECA) tax purposes. Retired ministers who receive either a parsonage or housing allowance are not required to include such amounts for SECA tax purposes.

the allowance not be available to the minister until retirement. One way churches can accomplish this is to deposit the annual equity allowance in a tax-favored retirement program not currently accessible to the minister. Such an arrangement can mitigate the economic hardship faced by many ministers who reside in a church-owned parsonage. However, since an equity allowance ordinarily does not compensate a minister for actual costs incurred in living in a parsonage, it is not excludable from income as a parsonage allowance.

➧ **TIP** Churches should consider adopting an appropriate equity allowance for ministers who live in church-owned parsonages.

▲ **CAUTION** Section 409A of the tax code imposes strict new requirements on most nonqualified deferred compensation plans (NQDPs). IRS regulations define an NQDP broadly, to include any plan that provides for the deferral of compensation. This definition is broad enough to cover some forms of equity allowances, depending on how they are structured by a church. As a result, any church that is considering an equity allowance should contact a tax professional to have the arrangement reviewed to ensure compliance with both section 409A and the regulations. Such a review will protect against the substantial penalties the IRS can assess for noncompliance. It also will help clarify whether a deferred compensation arrangement is a viable option in light of the limitations imposed by section 409A and the final regulations. See "Section 409A" on page 502 for more information.

8. IRS AUDIT GUIDELINES FOR MINISTERS

The IRS has issued audit guidelines for its agents to follow when auditing ministers. The guidelines provide agents with the following information regarding parsonages and parsonage allowances:

> *Internal Revenue Code section 107 provides an exclusion from gross income for a "parsonage allowance" . . . . The term "parsonage allowance" includes church provided parsonages, rental allowances with which the minister may rent a home and housing allowances with which the minister may purchase a home. A minister can receive a parsonage allowance for only one home. . . .*
>
> *The value of the "allowed" parsonage allowance is not included in computing the minister's income subject to income tax and should not be included in W-2 wages. However, the parsonage allowance is subject to self-employment tax along with other earnings. If a church-owned parsonage is provided to the minister, instead of a housing allowance, the fair rental value of the housing must be determined. Determining the fair rental value is a question of all facts and circumstances based on the local market, but the church and minister have often already agreed on a figure and can provide documentary evidence.*
>
> *The [parsonage allowance] exclusion only applies if the employing church designates the amount of the parsonage allowance in advance of the tax year. The designation may appear in the minister's employment contract, the church minutes, the church budget, or any other document indicating official action. An additional requirement . . . is that the fair rental value of the parsonage or parsonage allowance is not more than reasonable pay for the ministerial services performed.*

The audit guidelines contain the following example:

EXAMPLE A is an ordained minister. She receives an annual salary of $36,000 and use of a parsonage which has an annual rental value of $800 a month, including utilities. She has an accountable plan for other business expenses such as travel. A's gross income for arriving at taxable income for federal income tax purposes is $36,000, but for self-employment tax purposes it is $45,600 ($36,000 salary + $9,600 annual rental value of parsonage).

★ **KEY POINT** The audit guidelines assist IRS agents in the examination of ministers' tax returns. They alert agents to the key questions to ask and provide background information along with the IRS position on a number of issues. It is of utmost importance that ministers be familiar with these guidelines.

★ **KEY POINT** It is unfortunate that the guidelines state that the housing allowance "only applies if the employing church designates the amount of the allowance in advance of the tax year," since this statement is not true. The tax code does not impose such a requirement. It is true that a church's housing allowance designation cannot be made retroactively. But this does not mean it has to be made in advance of a tax year. To illustrate, many churches fail to designate a housing allowance by the end of a calendar year and discover the omission a few months into the new year. The church can still designate a housing allowance for the minister for the remainder of the new year. Unfortunately, unless the guidelines are amended, IRS agents may unnecessarily disallow housing allowance exclusions under these facts. A strict interpretation of the audit guidelines would preclude ministers who are called to a church in midyear from receiving a housing allowance, since the allowance would not be designated "in advance of the tax year." This is clearly an incorrect result.

9. PARSONAGES PROVIDED TO RETIRED MINISTERS

The tax status of parsonages and parsonage allowances provided to retired ministers is addressed under "Housing Allowances" on page 515.

B. OWNING OR RENTING YOUR HOME

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 the allowance represents compensation for ministerial services, is used to pay housing expenses, and does not exceed the fair rental value of the home (furnished, plus utilities). Housing-related expenses include mortgage payments, 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.

1. OVERVIEW

The previous section addressed parsonages and parsonage allowances. Most ministers, however, do not live in a parsonage. Instead, they either own or rent a home. This section will address the tax rules that apply to these ministers. The tax code uses the term *rental allowance* for allowances paid to ministers who either rent or own their home. This terminology is confusing, so this text uses the term *housing allowance* for ministers who either rent or own their home.

★ **KEY POINT** The IRS audit guidelines for ministers state that the term *parsonage allowance* includes "church provided parsonages, rental allowances with which the minister may rent a home and housing allowances with which the minister may purchase a home."

Section 107 of the tax code specifies that "in the case of a minister of the gospel, gross income does not include—(1) the rental value of a home furnished to him as part of his compensation; or (2) the rental allowance paid to him as part of his compensation, to the extent used by him to rent or provide a home and to the extent such allowance does not exceed the fair rental value of the home, including furnishings and appurtenances such as a garage, plus the cost of utilities."

Following are four important considerations to note:

- The housing allowance is available only to a *minister of the gospel*. This term is defined in Chapter 3.
- A housing allowance must represent compensation for *services performed in the exercise of ministry*. This term is defined in Chapter 3.
- The housing allowance is an *exclusion* from gross income rather than a deduction in computing or reducing adjusted gross income. As a result, it is not reported on Form 1040. In effect, the housing allowance is claimed by not reporting it as income. As will be explained later, if the actual housing allowance exclusion is less than the church-designated allowance, the minister will need to report the difference as additional income on his or her federal tax return. This assumes that the church reduced the minister's Form W-2 or 1099-NEC income by the amount of the allowance. Note further that the actual housing allowance exclusion must be reported as self-employment earnings on a nonretired minister's Schedule SE (Form 1040) in computing Social Security taxes, assuming