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Minister Housing Allowance Presents New Challenges

By Paul G. Schloemer and Ryan Wilson

DECEMBER 2005 - For over 50 years, ministers have enjoyed the benefits of tax-free housing. IRC section 107 permits qualified ministers to exclude housing-related compensation from gross income to the extent it relates to service performed in their ministry.

[The term “minister” as used herein refers to people holding various titles in a variety of religious organizations. A “minister of the gospel” as defined below, meets specific criteria defined in Treasury Regulations sections 1.107-1(a) and 1.1402(c)-5.] This benefit has recently come under scrutiny due to heightened concern about the separation of religious organizations and government, and because of perceived abuses of this privilege.

Changes in the operation of religious organizations have meant that more ministers are serving in nontraditional roles, including situations where they have both ministry and nonministry responsibilities. This results in situations where an employee’s right to a housing allowance is less clear. A careful application of IRC section 107 is necessary to ensure that the minister has a valid claim to a housing allowance and that the claim will withstand IRS examination.

Tax preparers can provide assistance by verifying that an individual meets the definition of a minister under IRC section 107 and by maintaining adequate documentation to ensure that valid housing-allowance claims are upheld. This information can also aid those serving on church boards or as advisors to churches. These preparers can enhance tax-law compliance by educating church leaders and employees on the requirements of IRC section 107 and by providing advice in cases where an employee’s right to a housing allowance is less clear.

Application of IRC Section 107

IRC section 107 allows a tax-free housing benefit for a “minister of the gospel” in two situations. First, the employer can allow the minister to live rent-free in a home (parsonage) owned by the church. The minister can exclude this benefit from gross income up to the home’s fair rental value. The value of the parsonage must be clearly distinguished from other compensation, and includes items such as furniture, insurance, utilities, and taxes.

If a parsonage is not provided to the minister, a nontaxable housing allowance can be provided so that the minister can rent or buy a home. This is the option used most frequently. It provides ministers with the freedom to choose their preferred type of housing. The allowance covers items such as mortgage payments (principal and interest), insurance, repairs, utilities, and other expenses to keep the home in working order.

The value of a home or a housing allowance provided to a minister is nontaxable for federal income tax purposes and typically nontaxable under state income tax laws. To exclude this compensation, the amount should be designated prior to the year in which it is paid, and documented in an employment contract, church budget, or the minutes from church meetings or church board meetings [Treasury Regulations section 1.107-1(b)].

Although the term “minister” is not defined in the IRC, the IRS and courts have helped clarify the definition. Per Treasury Regulations section 1.107-1(a), the housing allowance must be provided in exchange “for services which are ordinarily the duties of a minister of the gospel.” The regulations under section 107 reference the regulations under section 1402 for a definition of the duties of a minister. Under Treasury Regulations section

1.1402(c)-5, these duties include: 1) the ministration of sacerdotal functions, 2) the conduct of religious worship, and 3) the direction of organizations within the church. In addition to performing these duties, the individual must be ordained, commissioned, or licensed as a minister of the church.

Court Interpretations

Over the past 40 years, the Tax Court has decided several key cases that help define a minister for the purposes of IRC section 107. The IRS has enlisted these rulings to clarify the government position on this issue. In defining a minister, the focal point is on the duties carried out by the individual, rather than her education or position in the organization.

In *Salkov v. Comm'r* [(1966) 46 TC 190], at issue was whether a Jewish cantor met the definition of a minister. The court found that Salkov had a position of authority similar to that of a rabbi and, with one exception (addressing issues of Jewish law), performed the same duties. Therefore, the cantor was “the equivalent of a minister of the gospel within the intendment of section 107.” The court found in Salkov’s favor because he essentially performed all the duties of a religious leader in the Jewish faith.

In *Lawrence v. Comm'r* [(1968) 50 TC 494], a “minister of education” at a Baptist church did not qualify as a minister. Bob Lawrence was “commissioned” by his church, but not ordained. He supervised several church programs, trained workers and teachers, sought new church members, visited the sick, provided counseling, and assisted during worship services. Occasionally, he even preached at worship services, a task typically reserved for the senior pastor. In spite of Lawrence’s extensive involvement in church activities, the court held that he was not a minister within the definition of IRC section 107.

The court identified two “ordinances” in Lawrence’s church that resembled sacraments: baptism, and the Lord’s Supper or communion. His failure to officiate at these ordinances was a determining factor in the court’s decision to disallow the housing allowance. The fact that *Lawrence* was not ordained by the church also hurt his assertion that he qualified as a minister. His “commissioning” by his church was discounted by the court as a mere formality, initiated merely to take advantage of the benefits of IRC section 107. The *Lawrence* case emphasized the importance of performing the key duties of a minister. All ministry duties are not equal in determining who qualifies for a housing allowance.

In *Wingo v. Comm'r* [(1987) 89 TC 911], the Tax Court specified five factors (three activities and two attributes) used to identify a minister as defined under IRC section 107. An individual possessing these factors would presumably qualify as a minister:

- Performing sacerdotal functions;
- Conducting worship services;
- Controlling or maintaining the organization;
- Considered a spiritual leader; and
- Ordained, licensed, or commissioned.

In addition to the three activities of a minister listed in the regulations under section 1402, the court affirmed that the minister must be commissioned, ordained, or licensed, and considered a spiritual leader. The court concluded that to qualify as a minister under IRC section 107, all five requirements must be fulfilled. The Tax Court and the IRS have frequently referred back to the five factors specified in *Wingo*.

In *Knight v. Comm'r* [(1989) 92 TC 199], the Tax Court took a less restrictive approach to defining a minister than it had two years earlier in *Wingo*. *Knight* was not ordained by his church, could not administer the sacraments, and could not participate in church government. The court, however, held that he was a minister because he was licensed by the church, conducted worship services, and was considered a spiritual leader, thus meeting three out of the five factors. The opinion stated that meeting the definition of a minister is not simply an arithmetical test; having a majority of the factors in the taxpayer’s favor may not be sufficient. Instead, failure to meet one or more of the factors must be weighed by the court in each case. At a minimum, the minister must be licensed, commissioned, or ordained.

Oscar Haimowitz had worked for Temple Adath Israel for 30 years. He was hired as executive director, performing mainly administrative tasks. Over time, he became more involved in religious tasks, assisting (but never officiating) in various ceremonies. He was never ordained as a rabbi or commissioned as a cantor, but he was recognized as a “fellow” by the Synagogue Administrators Association.

The Tax Court held [*Haimowitz v. Comm’r* (1997) T.C. Memo. 1997-40] that Haimowitz was not a minister because his duties “were mostly secular in nature.” He never performed the role of a rabbi or a cantor. In addition, Haimowitz’s designation as a “religious functionary” did not meet the requirements of being ordained, commissioned, or licensed. Thus, Haimowitz did not meet any of the five factors specified in *Wingo*.

Haimowitz illustrates the danger of granting a housing allowance to employees with mainly secular duties. Unless a substantial portion of the employee’s duties fit within the realm of those listed in Treasury Regulations section 1402(c)-5(b)(2), the definition of a minister is not met and the benefits of IRC section 107 are not available. This position was affirmed in a recent IRS Technical Advice Memorandum (IRS Letter Ruling 200318002).

The Impact of Changes in Church Operations

Recent changes in the way churches operate have raised new issues in compensating ministers through the use of a housing allowance. An employee may have the credentials of a minister (e.g., a seminary degree) but not fill a traditional ministerial role. In the following situations, compensation through use of a housing allowance is more tenuous:

- Ministers performing extensive counseling or administrative duties;
- Children’s ministry workers, and education directors;
- Music ministers, and worship leaders; and
- Employees in dual roles (e.g., administrators with ministry duties).

Treasury Regulations section 1.107-1 requires that the housing allowance be provided for performing the duties of a minister. These duties vary among denominations. Duties that exemplify a minister in one denomination may not be appropriate in identifying a minister in another. For example, the sacerdotal functions identified in *Lawrence* (baptism and the Lord’s Supper) were not applicable to the Jewish cantor in *Salkov*.

Ministers claiming a housing allowance have the burden of proving that their duties exemplify those of a minister in their faith. Those with extensive counseling or administrative responsibilities would not qualify as ministers under the Tax Court’s ruling in *Haimowitz*. Their duties would typically not include sacerdotal functions or leading worship. Exclusion from these roles would probably also prevent them from being recognized as spiritual leaders. Thus, administrators and counselors would typically fail to meet at least three of the five factors specified in *Wingo*. These employees would not qualify as ministers under IRC section 107 without a preponderance of other duties that exemplify those of a minister.

Children’s ministry workers and those supervising Christian education (e.g., Sunday school classes or small groups) may be recognized as spiritual leaders in a church, but may be excluded from leading worship and performing sacerdotal functions. Worship leaders would appear to be in position where they can claim at least some role in conducting worship services, but in many churches they would not be recognized as spiritual leaders unless they perform sacerdotal functions or preaching duties. Thus, it is more difficult for those involved in these areas of ministry to claim the housing allowance exclusion.

These employees can take the position that they qualify as ministers if their duties include key ministerial functions. Regular involvement (at least quarterly) in preaching and sacerdotal functions substantiates a position as a spiritual leader. Assuming the employee is ordained, commissioned, or licensed, involvement in these key duties can provide evidence that they meet four of the five factors described in *Wingo*. Church management should assist in this area by specifying the required ministerial duties prior to the year that an employee is granted a housing allowance. In addition, it is important to produce job descriptions and schedules

documenting that those individuals leading children's and music ministries and supervising education are regularly performing the duties of a minister.

In some cases, employees have been assigned a dual role. An individual's employment may specifically allocate time between ministry and nonministry duties. This approach allows churches to control payroll costs while assuring that necessary functions are carried out. For example, employees with expertise in nonministry areas, such as marketing or computers, may be assigned these secular duties along with ministry responsibilities.

If more than 50% of an employee's time is devoted to nonministry duties, granting a housing allowance is a tenuous position. At the same time, it seems unfair to exclude employees from the benefits of a housing allowance if part of their job involves performing the typical duties of a minister. In the eyes of a court, it appears that all employees are measured under the same standard; if most of their duties are secular, they probably fail to meet the definition of a minister. This assignment of employees to dual roles is becoming more common. Future legislation should consider whether employees in this situation should be granted a limited housing allowance for the ministry portion of their jobs.

Other Issues Unique to Ministers

For qualified ministers, other issues make compliance with tax law complex and cumbersome. Because these issues are unique, ministers and even practitioners may be unfamiliar with them. Two key issues encountered by ministers are the documentation of housing expenses and the impact of self-employment tax.

Documenting housing expenses. IRC section 265(a)(6) provides that mortgage interest and real estate taxes qualify as itemized deductions even though these expenses are paid out of funds from the minister's housing allowance. Thus, ministers derive a double benefit by excluding housing allowance income under IRC section 107 while receiving a deduction for interest and taxes paid with funds from the allowance.

Like other taxpayers, ministers that itemize deductions must maintain documentation to support them. Ministers must also maintain documentation showing that the housing allowance claimed was actually used to maintain a home. In addition to statements supporting property tax and mortgage-interest payments, ministers must track mortgage principal payments, the cost of maintenance and repairs, utilities, insurance, furnishings, cleaning supplies, and amounts spent on home improvements. Thus, the recordkeeping burden required to support the housing allowance exclusion is beyond that required of the typical homeowner.

Ministers are well advised to take advantage of electronic recordkeeping programs to aid in documenting itemized deductions and housing allowance expenses on a contemporaneous basis. Because expenses related to home maintenance are incurred frequently, meticulous recordkeeping is necessary. Records should contain the amount, date, location, and purpose of the expense. The benefits of maintaining timely and detailed records are time saved when filing tax returns, assurance that all material expenses have been included, and avoidance of IRS adjustments if returns are subject to audit.

Self-employment tax. Perhaps the most confusing aspect of tax law for ministers is that most qualify as employees for federal income tax purposes while being classified as independent contractors for self-employment tax purposes. A minister meets the definition of an employee when the employer has the right to direct and control how the work is performed (e.g., setting work hours and location), not just the end result. Under common law, an employer typically exercises enough control over a minister to classify him as an employee for federal income tax purposes. Thus, withholding on taxable compensation is required, and the minister receives Form W-2 for tax-return filing purposes.

As an independent contractor, a minister's housing allowance and other compensation for ministry duties are subject to self-employment taxes at a 15.3% rate. This represents a substantial increase in payroll taxes for those entering the ministry. Planning is required so that the minister's tax withholding is increased or quarterly estimated payments are established to meet the higher employment-tax liability.

Another employment-tax issue is the option for ministers to request exemption from self-employment tax under Treasury Regulations section 1.1402(e)-2A(a)(1). By requesting exemption, the minister asserts opposition to the acceptance of public insurance payments for retirement, disability, death, or medical care. Form 4361 must be filed before the due date (including extensions) of the tax return for the second year in which the minister has at least \$400 of net self-employment earnings. If the exemption is granted, all compensation for ministry is excluded from self-employment tax.

Meeting the Challenge

In the current legal climate, any hint of government endorsement of religion is viewed suspiciously. The removal of the Ten Commandments from courthouses, the elimination of prayer at school events, and challenges to the mention of “God” on currency and in the Pledge of Allegiance reflect an environment that seeks to sever all ties between government and religion. The question of whether providing tax benefits to ministers is an unconstitutional subsidization of religion is a contentious issue.

Litigation attacking the constitutionality of IRC section 107 may well be forthcoming. Strong opinions against providing benefits to ministers have been voiced in the past [see Taft, “Tax Benefits for the Clergy: The Unconstitutionality of Section 107,” *Georgia Law Journal* 1261 (1974)]. Recently, the Ninth Circuit Court questioned the constitutionality of the housing allowance (*Richard D. Warren*, 282 F3d 1119). The court appointed law professor Erwin Chemerinsky to serve as amicus curiae. His brief argued that the housing allowance violated the Constitution’s establishment clause. Congress responded quickly to this challenge, endorsing the constitutionality of the housing allowance in the Clergy Housing Allowance Clarification Act of 2002. Future legislators and presidential administrations may be less willing to take such a strong stand on this issue.

Those involved in granting and claiming housing allowances should be aware of increased risk in this area and take steps to “audit-proof” this benefit. Parties that can assist in this process include church administrators and leadership boards, and those serving as advisors to churches and ministers.

Recommendations for Church Administrators and Church Boards

Church administrators and leadership boards should be aware that this benefit may be subject to closer examination in the future and that the IRS may attack cases where individuals have been more aggressive in claiming the housing allowance without facts that are convincingly in their favor. In the past, ministers in the areas of education and music have been prime targets, because their duties place them outside traditional minister roles. This trend toward nontraditional roles will continue as churches seek innovative approaches to ministry.

Administrators can preserve this benefit for qualified employees by educating staff on the requirements for claiming a housing allowance. Strict adherence to guidelines, such as documenting the amount of the allowance and approving the allowance prior to the year in which it is paid, is crucial. Ensuring that ministers continue to perform ministerial duties, and documenting this, would be ideal.

A closely related issue for church leadership is determining the appropriate amount of compensation. The total compensation amount is usually set first, followed by designating a portion of the total as housing allowance. Underpaying staff can undermine employees’ personal finances and cause morale problems. Paying excessive compensation to a minister can threaten the church’s tax-exempt status. Loss of tax-exempt status has onerous consequences. The church’s net income is subject to income taxes, and donors’ contributions are no longer deductible. In addition, the church could lose benefits such as preferential postage rates, exemption from sales and property taxes, and housing allowance exclusions for ministers.

In determining compensation, church leaders should take advantage of surveys that provide compensation levels paid by other churches (e.g., 2005 *Compensation Handbook for Church Staff*, Christian Ministry Resources, July 2005). These surveys provide compensation ranges based on minister qualifications such as experience, education, and tenure, as well as church characteristics such as revenues and number of members.

This information can be used to develop objective benchmarks for compensation, so that employees are treated equitably. In addition, the use of survey data protects against the accusation of excessive compensation.

Recommendations for Tax Preparers

It is important for tax preparers to ascertain whether individuals that claim the benefits of a housing allowance are qualified to do so, because disallowance of the benefit in an IRS audit can result in substantial tax liabilities at both the federal and state level, along with interest and potential negligence penalties. At a minimum, ministers should be commissioned, ordained, or licensed. Ministers should be made aware that their housing allowance is dependent on regular performance of duties as defined in IRC section 1402. If the minister does not have the strongest evidence in support of her claim to the housing allowance, the performance of ministerial activities during the year should be documented. Documentation may be the one factor preventing adjustments in an IRS audit that occurs years later.

Church finances are frequently as complex as those of for-profit entities. Churches are now more likely to have a person with accounting expertise as a board member or an outside consultant. Addressing the housing allowance and other compensation issues is an opportunity to provide valuable advice that can protect the church and its employees from IRS examinations, and may present opportunities to generate consulting revenues. Church administrators may be open to enlisting an outside advisor's expertise to address housing-allowance issues in instances where employees perform duties outside the traditional minister role.

Even though the benefits of tax-free housing provided under IRC section 107 have been a fixture of the tax law for over 50 years, the changes in church operations that have placed ministers in nontraditional roles make complying with the provisions of this tax law more challenging. Church administrators and leadership boards should be aware of key issues that determine which employees should be granted a housing allowance. Accounting professionals and tax advisors have an opportunity to use their expertise in this area to enhance tax-law compliance and to ensure that valid housing-allowance claims withstand IRS challenges.

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