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**The Tax Adviser****Clergy Tax Rules Extend Beyond Churches**

By Paul Schloemer, Ph.D., CPA

July 1, 2009

**EXECUTIVE SUMMARY**

- Whether an individual qualifies as a minister for tax purposes is determined based on who employs the individual and the duties the individual performs. An individual does not have to work for a church or denomination to be considered a minister but must perform the duties of a minister as specified in the regulations to be treated as a minister.
- Ministers are subject to special tax rules, including eligibility for a tax-free parsonage or housing allowance, being treated as self-employed for Social Security tax purposes, and being exempt from federal income tax withholding.
- If an employer provides the minister a housing allowance, the exclusion is limited to the lesser of the amount designated in advance by the employer as a housing allowance, the fair rental value of the residence, or the actual expenses incurred.

Changes in society have prompted significant changes in the way religious and charitable organizations carry out their missions. As a result, ministers now work in a variety of organizations, and their duties extend beyond those associated with traditional church pastors. These changes have made determining who meets the definition of a "minister of the gospel" a complex decision.<sup>1</sup>

Those who qualify as ministers are subject to a unique set of tax rules. These rules include the benefit of a tax-free housing allowance and the detriment of being self-employed for Social Security tax purposes. Thus, clarity on the definition of minister is an important issue for these taxpayers and their advisers. The first part of this article provides guidelines to help determine who qualifies as a minister subject to these rules.

The second part summarizes tax rules applicable to ministers. Failure to comply with these rules can result in significant additional taxes and penalties for the minister and the employer. Anyone employing ministers should have an internal specialist address compliance in this area or solicit assistance from a tax adviser who is well versed in the rules. Those advising ministers should also be familiar with these rules to ensure compliance and to help their clients take full advantage of the available tax benefits.

**Definition of Minister Under the Regulations**

The regulations under Secs. 107 and 1402 provide guidelines for determining who qualifies as a minister. Both sections state that a minister is distinguished by the duties he or she performs. The regulations state that the duties of a minister include

the ministrations of sacerdotal functions and the conduct of religious worship, and the control, conduct, and maintenance of religious organizations (including the religious boards, societies, and other integral agencies of such organizations), under the authority of a religious body constituting a church or church denomination.<sup>2</sup>

Regs. Sec. 1.107-1(a) provides a similar definition. The duties of a minister

include the performance of sacerdotal functions, the conduct of religious worship, the administration and maintenance of religious organizations and their integral agencies, and the performance of teaching and administrative duties at theological seminaries.

The definitions above identify the following categories of people who qualify as ministers:

- Those in traditional clergy roles (e.g., priests, pastors, rabbis) who typically perform sacerdotal functions and conduct worship;
- Those who work for secular organizations to the extent they perform sacerdotal functions and conduct worship;
- Those who control and maintain religious organizations at the local church or denomination level; and
- Teachers and administrators at seminaries.

Two key issues arise in defining those who qualify as ministers: whether their service is conducted under the authority of a church or denomination and whether their duties are encompassed by the regulations above. Those under the control of a church or denomination whose predominant duties are specified in the regulations have the strongest positions.

The more crucial of the two issues is the duties performed by the minister. Individuals performing minister duties outside the auspices of a church or denomination can qualify as ministers based on duties performed. For example, chaplains employed by secular organizations have successfully qualified as ministers because they conducted worship and administered sacraments.<sup>3</sup>

Regs. Sec. 1.1402(c)-5 provides the following examples that help identify those outside traditional minister roles who qualify as ministers. In these examples, either the specific duties of the minister or the assignment of duties by the religious organization determine whether the person qualifies as a minister.

- An ordained chaplain at a university who teaches a religion class, provides spiritual counseling, and conducts worship services is considered a minister.<sup>4</sup> In this example, the duties of the chaplain qualify him or her as a minister even though he or she is not working at a religious organization.
- A person performs the duties of a minister while conducting religious worship and performing sacerdotal functions even if other employment is not ministry related.<sup>5</sup> In effect, a person can have two careers simultaneously, one as a minister and another in a secular position.
- An ordained minister directing an agency of the denomination qualifies as a minister.<sup>6</sup>
- An ordained minister assigned by his or her denomination to advise a company in the publication of a book about the denomination is considered a minister.<sup>7</sup>

In the last two examples, the taxpayers are ministers based mainly on their conduct and maintenance of a denomination, not because their daily tasks are those of a typical minister.

## IRS and Judicial Determinations

The above examples from the regulations notwithstanding, those performing tasks outside traditional ministry roles have a more difficult time qualifying as ministers. This issue has come up in court cases and IRS rulings involving employees in religious and secular organizations. This section summarizes how the Tax Court has interpreted the definition of a minister.

### Employees of Churches

A plethora of court cases has applied the regulations to various situations to determine who meets the definition of a minister. Most of these cases address whether those employed by local churches are ministers.

The Tax Court provided what is probably the most widely cited and useful analysis of the law in *Knight*.<sup>8</sup> Knight was not ordained and could not administer the sacraments. However, he conducted worship, was licensed, and was considered a spiritual leader in his church. The court held that Knight qualified as a minister, applying a five-factor test initially established in *Wingo*.<sup>9</sup> In that case, the Tax Court set forth the following attributes and duties of a minister:

- Is ordained, commissioned, or licensed;
- Is recognized by the religious body as a spiritual leader;
- Conducts religious worship;
- Administers sacraments; and
- Is involved in the control, conduct, or maintenance of a religious organization.

In *Knight*, the court stated that the first factor must be met and the other factors should be weighed against the facts and circumstances of each taxpayer to make a determination. The *Knight* decision is particularly influential because it is the most recent case on this issue decided by the full Tax Court. In addition, IRS audit guidelines cite this decision, referring those auditing ministers back to these five factors.<sup>10</sup>

The guidance provided in *Knight* is even more important given two recent moves by the IRS. First, the IRS no longer provides a definition of minister in the latest edition of its *Tax Guide for Churches and Religious Organizations*.<sup>11</sup> Second, the IRS has stated that it will no longer issue private letter rulings addressing the issue of whether a taxpayer meets the definition of a minister.<sup>12</sup> Lacking IRS guidance, ministers and their employers must rely on judicial interpretations to determine those who qualify as ministers.

Subsequent Tax Court decisions measured the facts of each case against the five factors from *Wingo*. For example, in *Haimowitz*,<sup>13</sup> the taxpayer did not meet the definition of a minister because he was not ordained, commissioned, or licensed in the Jewish faith, and his duties were mainly administrative. Haimowitz failed to meet any of the five factors. In *Brannon*,<sup>14</sup> the Tax Court ruled that the taxpayer satisfied the definition of a minister because he met four of the five factors specified in *Wingo*. He was licensed, conducted worship, presided over the sacerdotal functions of baptism, communion, and marriage, and was assigned to control and maintain the Trinity-Weoka Church.

Most ministers work for local churches, and many court decisions address whether church employees qualify as ministers. There are fewer decisions providing guidance on whether those employed by church-affiliated organizations qualify as ministers. The next section draws heavily on IRS guidance to provide parameters that determine how those employed by these organizations can qualify as ministers.

### Employees of Church-Affiliated Organizations

Under Regs. Sec. 1.107-1(a), ordained administrators and teachers at seminaries qualify as ministers. The IRS has taken a narrow interpretation of this regulation. The educational institution must be an integral part of a church or denomination. Thus, faculty and administrators at interdenominational seminaries are not ministers because the seminaries are not controlled by a specific church or denomination.<sup>15</sup>

Control by a church or denomination must be evident. In *Colbert*,<sup>16</sup> a religion professor at a church-affiliated college was denied a housing allowance because there was no evidence that a church exercised control over the school. Church control was also a key issue in Letter Ruling 9144047.<sup>17</sup> In this ruling, four ordained religion professors at a Christian college qualified as ministers and were eligible for a housing allowance. The IRS ruled that the church controlled the college because it was founded and partially funded by the church and controlled by a board of trustees, the majority of whom the church selected.

Teachers and administrators at elementary and secondary schools have also attempted to qualify as ministers. Lack of control by a church or denomination prevents these individuals from qualifying even if the school has a religious purpose.<sup>18</sup> Even those employed by church-controlled schools cannot qualify as ministers if they are not ordained or commissioned and their duties are indistinguishable from those of employees at secular schools.<sup>19</sup>

Given the IRS interpretation of Regs. Sec. 1.107-1(a), seminaries and religious colleges should carefully examine their circumstances to ensure that employees meet IRS parameters before treating them as ministers. Teachers in elementary and secondary schools would qualify as ministers only in unusual circumstances. For example, an ordained rabbi at a school controlled by a local synagogue who teaches religion classes, conducts worship services, and prepares students for adult Jewish life could qualify as a minister.<sup>20</sup>

#### Employees of Nonchurch Organizations

Those employed outside churches have a more difficult time qualifying as ministers. Nevertheless, the regulations provide leeway for some individuals to qualify. The determination depends on duties performed and affiliation with a religious organization, with duties performed being the most important factor. Individuals in this category include chaplains in prisons and hospitals and those employed by parachurch organizations.<sup>21</sup>

Chaplains working for nonchurch organizations who conduct worship and perform sacerdotal functions have successfully qualified as ministers. Performance of these two functions is the key factor in the following cases and rulings.

In *Boyd*,<sup>22</sup> the taxpayer was a chaplain employed by the Indianapolis Police Department. The IRS conceded that he performed the duties of a minister. However, it took issue with his employment outside a religious organization. The court ruled in favor of Boyd because he performed the duties of a minister under the close supervision of a federation of churches, providing a connection to a religious organization.

IRS rulings that address whether chaplains qualify as ministers are relatively old. This limits their value, since it is likely that IRS perspective has changed. Rev. Rul. 71-258<sup>23</sup> held that chaplains in government-owned hospitals and private nonprofit hospitals were ministers because they conducted worship and performed sacraments (baptisms, marriages, funerals, and prayers for the sick).

Three IRS letter rulings also held that chaplains were ministers. Only the taxpayers who requested these rulings can rely on them, but they reveal IRS reasoning. A negative aspect of these rulings is that they were issued more than 20 years ago.

A chaplain for a state Department of Human Services was held to be a minister based on duties performed.<sup>24</sup> A chaplain for a nonprofit, nonchurch-related hospital was a minister because he conducted worship, performed sacraments, and provided counseling to patients, their relatives, and hospital staff.<sup>25</sup>

Letter Ruling 8519004<sup>26</sup> is the most recent of the three rulings and provides an even stronger set of facts for the taxpayer. The chaplain performed sacerdotal functions and worked for an organization founded and funded by local churches for the purpose of supplying chaplains to local hospitals. Thus, the chaplain performed minister duties and was under the control of local churches.

Those employed by parachurch organizations face the challenge of qualifying as ministers under the same rules as those employed by churches. Ministers receiving favorable rulings have succeeded by producing evidence of their connection to local churches.

A 1994 Tax Court decision considered the situation of two Baptist ministers who established an organization to promote world missions.<sup>27</sup> The organization carried out its mission by producing videotapes for local churches, and the taxpayers were the key people in the production process. The court held that this production and distribution of videos supported the cause of foreign missions, a sacerdotal function within the Baptist faith. Although the taxpayers were not affiliated with any local church, the tapes they produced were used by over 30,000 churches. This was evidence of a connection to local churches.

In a more recent decision, an ordained minister working for an evangelical organization qualified as a minister. The organization produced religious literature and television programs and conducted crusades. The IRS disallowed the minister's housing allowance because he did not work for a church or denomination. In siding with the taxpayer, the Tax Court saw the followers of the organization as a "body of believers" similar to a church. They were loyal to the organization and consistently attended its worship services and crusades.<sup>28</sup>

Regardless of their place of employment, taxpayers seeking to qualify as ministers must establish that they perform the duties of a minister as described in the regulations. They have a stronger position if they can show that they perform their duties in association with a denomination or a local church. Employees of churches, church-affiliated organizations, and secular organizations who qualify as ministers are subject to the benefits and requirements described in the next section.

### Tax Rules Unique to Ministers

Those meeting the definition of minister face a unique set of tax rules in three areas. Ministers are:

- Eligible for the housing allowance and parsonage exclusion;
- Considered self-employed for Social Security tax purposes; and
- Exempt from federal income tax withholding.

Those advising ministers should be familiar with the application of tax law in these areas.

#### Housing Allowance/Parsonage

Sec. 107 provides an exclusion from gross income to the extent that a minister's employer pays his or her housing costs. The employer can provide housing by paying housing costs (parsonage) or providing cash that the minister uses to pay these costs (housing allowance). Housing costs include rent, mortgage payments (principal and interest), utilities, maintenance, insurance, and furnishings.

This exclusion is the most attractive benefit available to ministers because housing costs represent a high percentage of income. Most state income tax laws also permit an exclusion, increasing the tax savings. Most rulings and case law related to ministers concern the claiming of this exclusion.

The employer must designate the amount of the housing allowance in advance. It is limited to the lesser of:

- The amount designated by the employer;

- The fair rental value of the residence; or
- The actual expenses incurred.

The employer's governing body should approve the amount of the housing allowance prior to when the minister earns it. To ensure compliance with this deadline, a discussion with the minister and the organization's administrators should begin by October of each year so that the organization can designate an appropriate estimate of the allowance. The minister should take the initiative, using actual expenses through September 30 of the current year to project expenses for the following year. Using this evidence, the governing body can designate an allowance that approximates the minister's actual expenses without exceeding the fair rental value limit.

In 2002, Congress amended Sec. 107 to state explicitly that the amount excluded as housing allowance cannot exceed the fair rental value of the residence plus the cost of utilities.<sup>29</sup> This upper limit on the amount of the housing allowance can be estimated using internet or print sources that document local rental values. The minister's tax adviser should retain this documentation if the claimed housing allowance approaches this limit.

#### Self-Employed Status

Ministers are self-employed for Social Security tax purposes with respect to their ministerial services, even though most are treated as employees for federal income tax purposes. Self-employment tax is assessed on taxable compensation and nontaxable housing allowance/parsonage. The 15.3% self-employment tax rate presents a challenge to new ministers who are used to paying half this rate in secular jobs. Quarterly estimated tax payments are typically necessary to ensure that the minister has paid an adequate amount of tax throughout the year. The minister can also increase his or her withholding on taxable compensation to meet estimated tax payment requirements.

Ministers can claim exemption from self-employment taxes by electing to be excluded from the Social Security system.<sup>30</sup> In claiming exemption, the minister is stating his or her opposition to accepting public insurance payments for disability, death, retirement, or medical care based on religious convictions. Note that the minister is objecting to receipt of benefits from a public insurance system, not payment of self-employment taxes. Many might object to the funding and administration of the Social Security system, but the minister's request for exemption is not based on these issues. Once the IRS approves the exemption, it is irrevocable. This requires the minister to consider seriously his or her belief about government assistance.

To claim exemption, the minister must file Form 4361, Application for Exemption from Self-Employment Tax for Use by Minister, Members of Religious Orders and Christian Science Practitioners, with the IRS and receive IRS approval.<sup>31</sup> The deadline for claiming exemption is the due date (including extensions) of the tax return for the second year in which the minister reports at least \$400 in net selfemployment earnings. Detailed requirements for claiming this exemption can be found in Regs. Sec. 1.1402(e) and the instructions to Form 4361.

#### Classification as Employees or Independent Contractors

Most ministers are classified as employees for federal income tax reporting based on tests established by the IRS and the courts. The extent of control by the employer determines the minister's classification. Because most employers have the right to designate how the minister performs his or her job, including when and where the work is performed, ministers are most likely to be classified as employees.

These ministers receive Form W-2 and report their taxable gross income as employees. However, the minister's status as self-employed for Social Security tax purposes comes into play here. Since they are considered self-employed, ministers are exempt from federal income tax withholding.<sup>32</sup> However, ministers can request that their employers withhold taxes.<sup>33</sup> This approach may be easier than making quarterly estimated payments. Ministers can withhold at a higher rate to cover both income and self-employment taxes.

## Conclusion

The tax rules applicable to ministers provide a challenge to employers trying to comply with the tax law in this area. The first challenge is determining those who meet the definition of a minister under Sec. 107. The second is applying a unique set of rules to those who qualify as ministers. Addressing these issues before year end is the best way to avoid the potential pitfalls.

Those serving as personal tax advisers to ministers should also be aware of the unique tax issues. These advisers have the opportunity to improve compliance and to help their clients take advantage of tax benefits afforded to ministers. There is also the opportunity for tax advisers who are familiar with these rules to expand their practice, assisting employers who lack expertise in this area.

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#### Editor Notes

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#### Notes

<sup>1</sup> The term "minister" will be used in this article to refer to those who qualify as "ministers of the gospel" under Sec. 107.

<sup>2</sup> Regs. Sec. 1.1402(c)-5(b)(2).

<sup>3</sup> For example, see IRS Letter Rulings 8004046 (10/30/79) and 8138184 (6/29/81).

<sup>4</sup> Regs. Sec. 1.1402(c)-5(b)(2)(iii).

<sup>5</sup> Regs. Sec. 1.1402(c)-5(c)(2).

<sup>6</sup> Regs. Sec. 1.1402(c)-5(b)(2)(iv).

<sup>7</sup> Regs. Sec. 1.1402(c)-5(b)(2)(v).

<sup>8</sup> Knight, 92 T.C. 199 (1989).

<sup>9</sup> Wingo, 89 T.C. 911 (1987).

<sup>10</sup> IRS, Market Segment Specialization Program: Ministers (April 1995).

<sup>11</sup> IRS Publication 1828, Tax Guide for Churches and Religious Organizations (2008). The publication's glossary merely says, "As used in this booklet, the term minister denotes members of clergy of all religions and denominations. . . ."

<sup>12</sup> Rev. Proc. 2006-3, 2006-1 I.R.B. 122.

<sup>13</sup> Haimowitz, T.C. Memo. 1997-40.

<sup>14</sup> Brannon, T.C. Memo. 1999-370.

<sup>15</sup> Rev. Rul. 63-90, 1963-1 C.B. 27, and IRS Letter Ruling 7833017 (5/16/78).

<sup>16</sup> Colbert, 61 T.C. 449 (1974).

<sup>17</sup> IRS Letter Ruling 9144047 (6/3/91).

<sup>18</sup> IRS Letter Ruling 8646018 (8/14/86).

<sup>19</sup> IRS Letter Ruling 200318002 (1/7/03).

<sup>20</sup> IRS Letter Ruling 9126048 (4/2/91).

<sup>21</sup> Parachurch organizations are religious organizations that operate outside of a particular denomination.

<sup>22</sup> Boyd, T.C. Memo. 1981-528.

<sup>23</sup> Rev. Rul. 71-258, 1971-1 C.B. 283.

<sup>24</sup> IRS Letter Ruling 8004046 (10/30/79).

<sup>25</sup> IRS Letter Ruling 8138184 (6/29/81).

<sup>26</sup> IRS Letter Ruling 8519004 (1/28/85).

<sup>27</sup> Mosley, T.C. Memo. 1994-457.

<sup>28</sup> Whittington, T.C. Memo. 2000-296.

<sup>29</sup> Clergy Housing Allowance Clarification Act of 2002, P.L. 107-181, §2(a).

<sup>30</sup> Sec. 1402(e). Note that the exemption from self-employment tax applies only to earnings from ministerial services (Regs. Sec. 1.1402(e)-2A(a)).

<sup>31</sup> Members of religious orders who have taken a vow of poverty are automatically exempt and do not have to file Form 4361.

<sup>32</sup> Sec. 3401(a)(9).

<sup>33</sup> Sec. 3402(p)(3).



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