

MEMO #13

Pensions and Benefits USA

The Minister's Housing Allowance



Remember! The minister's housing, whether parsonage or housing allowance, is not part of the minister's gross income.

Introduction

A substantial tax benefit is provided to qualifying ministers based on Section 107 of the Internal Revenue Code (IRC). It consists of only one sentence which currently states 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 a 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.”

The basis of this exclusion from taxable income is deeply rooted in our nation's tax history. In 1954, the provision was expanded to include the “cash” rental allowance paid in lieu of a provided dwelling. As recently as the Clergy Housing Allowance Clarification Act of 2002, Congress reinforced and clarified the provisions by adding language to the code about the fair rental value.



See: MEMO #12, “Who Is a Minister for Tax Purposes?”

Eligibility

Tax regulations limit the housing allowance exclusion to the amounts paid for the home provided “as remuneration for services which are ordinarily the duties of a minister of the gospel.” You will want to read MEMO #12, “Who Is a Minister for Tax Purposes?” to discover further details regarding eligibility.

Bivocational ministers can have a housing allowance, but only from their ministerial income. Generally, secular employers cannot give an employee a tax-free housing allowance, even though the employee is a minister.

Nazarene retired ministers can have a housing allowance too. Since the Nazarene Single Defined Benefit Pension Plan is a qualifying church plan under IRS definitions, the General Board has designated 100 percent of the benefits paid from it to Nazarene retired ministers as housing allowance. In addition, Nazarene retired ministers also may request that distributions from their Nazarene 403(b) Retirement Savings Plan



Caution! Bivocational ministers may use only their *ministerial* income as housing allowance.

be designated in whole or in part as housing allowance. The IRS generally does not differentiate between your church-employed status and your church-retired status for housing allowance purposes. So the same housing allowance rules apply unless noted otherwise.

Advance Designation

No advance designation of housing values is required when the minister lives in a church-provided parsonage. This is also generally held to be true when the church has a stated policy of paying 100 percent of the parsonage utilities. The very act of paying the full amount is designation. However, ministers living in church-provided parsonages may have part of their cash compensation designated as a tax-free housing allowance to cover the cost of furniture purchase and repair, as well as other expenses related to the maintenance of the home which are not reimbursed by the church employer. Such an amount must be *designated in advance* as discussed below.



Caution! The church board must designate, through “official” action **and** in advance of payment, the amount of the minister’s housing allowance. Otherwise, it will be “taxable income.”



Idea! Make the wording of the resolution “open ended.” That way, it will remain in effect until the church revises it with a different resolution.

Tax regulations specify that for the housing allowance to be excluded from federal income taxes it must be *designated in advance of payment* by official action of the employing church or integral agency. The designation must be in writing and may be contained in the minutes of the church board or finance committee, if appropriate. The designation does not need to be attached to the tax return or reported to the IRS except upon specific inquiry.

It is recommended that the wording of the resolution be “open ended” so that the designation would be effective from that point forward until it is revised by the church board. Suggested resolutions follow:

- A. For a minister in a church-provided parsonage:
“Compensation for Rev. _____ will include a church provided parsonage and the actual cost of utility expenses. For the purpose of covering additional housing-related expenses, \$_____ per year is designated as housing allowance. This designation shall be effective until modified by the church board.”
- B. For a minister purchasing his home or renting:
“The compensation for Rev. _____ shall include \$_____ per year designated as housing allowance. This designation shall be effective until modified by the church board.”
- C. For an evangelist:
“Compensation for Rev. _____, as evangelist, will include \$_____ designated as housing allowance.”

How Much of the Minister's Compensation Can Be Designated as Housing Allowance?

The Tax Code contains no specific percentage or dollar limitation as to how much can be designated as housing allowance. In the case of bivocational ministers and supply pastors, a reasonable designation may be up to 100 percent of the cash compensation. However, it should be noted that a minister’s cash housing allowance cannot exceed “reasonable compensation.” This would apply only where a minister was performing very little service for the church and was receiving compensation disproportionate to the amount of service provided.



Caution! A minister’s cash housing allowance cannot exceed “reasonable compensation.”

How Much Housing Allowance Can Be Excluded?

As indicated above, up to 100 percent of compensation can be des-



See: IRS Publication 517 for details of amounts allowable for parsonage allowance.

ignated as housing allowance, but this does not necessarily mean that this is the amount which can be excluded from income taxes. IRS Publication 517 provides a definition of how much parsonage allowance can be excluded for ministers:

“If you own your home and you receive as part of your pay a housing or rental allowance, you may exclude from gross income the smallest of the following:

- The amount actually used to provide a home,
- The amount officially designated as a rental allowance, or
- The fair rental value of the home, including furnishings, utilities, garage, etc.

You must include in gross income the amount of any rental allowance that is more than the smallest of your reasonable pay, the fair rental value of the home plus utilities, or the amount actually used to provide a home.”

Thus, it can be seen that the church employer cannot cause the minister to exclude “too much” by over-designating the amount of housing allowance, but can cause the minister to pay substantially more taxes than required by under-designating.

The liability for determining the appropriate amount of housing allowance that can be excluded is the minister's. The church has no responsibility beyond determining that the compensation is reasonable for the services performed. The minister is responsible to determine any excess designated housing allowance and to report that amount as taxable income on the annual tax return.

When ministers (whether active or retired) pay off their mortgages, they can still have a housing allowance. However, it cannot exceed the *actual cost* of maintaining the home. Some ministers who have paid off their homes erroneously exclude the “fair rental value” of their homes as housing allowance. This practice is not legal.



Remember! The *minister* must report excess housing allowance as taxable income.



Caution! After the minister's mortgage is paid off, *only the actual cost* of maintaining the home may be excluded as housing allowance.



Remember! Almost any expense related to providing or maintaining the home may be excluded from gross income.

What Expenses Can Be Used to Justify the Housing Allowance Exclusion?

Generally, any expense to provide or maintain the home can be used to justify the housing exclusion. Regulations do specifically state that expenses for groceries, paper products, personal toiletries, personal clothing, and maid service cannot be used. You may legitimately include the following: (1) rent, principal payments, or down payments plus the cost of buying the home; (2) taxes and mortgage interest (even if these are includable as itemized deductions); (3) utilities (heat, electric, basic telephone, water, etc.); (4) the purchase of furniture, appliances, dishes and cookware, and decorating items including rugs, pictures, curtains, bedspreads, sheets, towels, etc.; (5) insurance on the home and contents; and (6) miscellaneous expenses including improvements, repairs and upkeep of the home and its contents, snow removal, lawn mowing, light bulbs, cleaning supplies, etc.



Remember! While a housing allowance is excluded from federal income tax, it *must* be **included** for Social Security/Medicare tax purposes for ministers not retired.

Reporting Requirements and Taxes Saved

Qualifying payments for a housing allowance are excluded from federal income tax. [However, these amounts are included in the computation of Social Security/Medicare taxes (SECA) at the self-employment tax rate *unless* the minister is retired.] Generally, housing allowance payments are also exempt from state income tax.



Caution! Do not include the designated housing allowance on the minister's Form W-2.



Idea! Provide a separate written notice to the minister at year's end indicating the amount paid as cash housing allowance.

The minister's Form W-2 should not include any portion of the church-designated housing allowance. (See MEMO #3, "Tax and Reporting Procedures for Congregations.") Housing expense details, receipts, and records are not to be submitted to the employer. They are handled differently than professional business expenses and remain confidential. It is the individual minister's obligation to determine how much of the designation can actually be excluded and to report any unused portion of the designated amount as additional taxable income on the annual tax return.

It is recommended that the church treasurer provide a separate written notice at year's end to the minister indicating how much has been paid as designated cash housing allowance. This will be useful to the minister when he computes his Social Security/Medicare taxes (SECA) at the self-employment tax rate. A copy of the notification should be maintained in the church's file.

The church treasurer must issue a Form 1099-MISC for *unincorporated* evangelists if payments have been \$600 or more per year (excluding any housing allowance properly designated in advance, Nazarene 403(b) Retirement Savings Plan contributions, or reimbursed expenses).

Retired ministers will receive a Form 1099-R for their pension distributions. When reporting pension payments made as "housing allowance," the Form 1099-R will indicate "taxable amount not determined" since it is the individual minister's responsibility to determine the amount qualifying as an exclusion from taxes.

Conclusion

The proper designation of a cash housing allowance can result in significant tax savings for the qualifying minister. Here are the recommended steps for the minister to take in order to maximize the exclusion:

- 1a. If in a parsonage with utilities paid in full, estimate the anticipated expense to maintain the home above what is provided by the church. Remember, this amount will need to meet the guidelines as outlined in IRS Publication 517.
- 1b. If no parsonage is provided, compute the fair market rental value of your home plus utilities. You can include any fair market rental value of your furnishings.
2. Request the church to designate the amount determined in 1a or 1b above as housing allowance.
3. Maintain accurate records of appropriate expenses throughout the year to justify the housing allowance exclusion.
4. At the end of the tax year, determine if the housing allowance designated has been spent for the appropriate expenses. If not, then the difference between the amount designated and the amount spent must be included as additional taxable income when you fill out your federal income tax forms. Of course, this assumes the excluded amount does not exceed the "fair rental value," as discussed above.



See: IRS Publication 517 for guidelines.