

WHO IS A MINISTER FOR FEDERAL TAX PURPOSES?

Key Point: The IRS has its own criteria for determining who is a Minister for Tax Purposes. The criteria the IRS uses to determine who is a minister are not necessarily the same as those used by churches and denominations. Whether or not one qualifies as a Minister for Tax Purposes is a very important question, since special tax and reporting rules apply to ministers under federal tax law. These rules include:

- Eligibility for housing allowances
- Self-employed status for Social Security
- Exemption of wages from income tax withholding (ministers use the quarterly estimated tax procedure to prepay their taxes, unless they elect voluntary withholding)
- Eligibility, under very limited circumstances, to exempt themselves from SECA

These special rules apply only to persons qualifying as a minister and with respect to compensation received in the exercise of ministerial services.

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

According to the IRS, ministers are individuals who are duly ordained, commissioned, or licensed by a religious body constituting a church or church denomination. They are given the authority to conduct religious worship, perform sacerdotal functions, and administer ordinances or sacraments according to the tenets and practices of that church or denomination. If a church or denomination ordains some ministers and licenses or commissions others, anyone licensed or commissioned must be able to perform substantially all the religious functions of an ordained minister to be treated as a Minister for Tax Purposes. See IRS *Publication 517*.

ARE MINISTERS EMPLOYEES OR SELF-EMPLOYED FOR FEDERAL TAX PURPOSES?

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

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

1. Income taxes. For federal income tax reporting, most ministers are employees under the tests currently used by the IRS. This means that they should receive a *Form W-2* from their church at the end of each year (rather than a *Form 1099*). Formerly, it meant that they reported their employee business expenses on *Schedule A* rather than on *Schedule C*. (The deduction for employee business expenses as Miscellaneous Itemized Deductions on *Schedule A* is suspended through 2025, so employee business expenses are not deductible at this time.) A few ministers are self-employed, such as some traveling evangelists and some interim pastors. Also, many ministers who are employees of a local church are self-employed for other purposes. For example, the minister of a local church almost always will be an employee but will be self-employed with regard to guest speaking appearances in other churches and services performed directly for individual members (such as weddings and funerals).

Example: Pastor B is a minister at First Baptist Church. He is an employee for federal income tax reporting purposes with respect to his church salary. However, he is self-employed with respect to honoraria he receives for speaking in other churches and for compensation church members give him for performing personal services such as weddings and funerals. The church issues Pastor B a *Form W-2* reporting his church salary. Pastor B reports this amount as wages on line 1 of *Form 1040*. He reports his compensation and expenses from the outside self-employment activities on *Schedule C*.

Key Point: Most ministers will be better off financially being treated as employees, since the value of various

fringe benefits will be tax free, the risk of an IRS audit is substantially lower, and reporting as an employee avoids the additional taxes and penalties that often apply to self-employed ministers who are audited by the IRS and reclassified as employees.

Key Point: Ministers and other church staff members should carefully review their *Form W-2* to be sure it does not report more income than was actually received or fail to report taxable benefits provided by the church. If an error was made, the church should issue a corrected tax form (*Form W-2c*).

The Tax Court test. The United States Tax Court has created a seven-factor test for determining whether a minister is an employee or self-employed for federal income tax reporting purposes. The test requires consideration of the following seven factors: (1) the degree of control exercised by the employer over the details of the work; (2) which party invests in the facilities used in the work; (3) the opportunity of the individual for profit or loss; (4) whether or not the employer has the right to discharge the individual; (5) whether the work is part of the employer's regular business; (6) the permanency of the relationship; and (7) the relationship the parties believe they are creating. Most ministers will be employees under this test.

2. Social Security. The federal tax code treats ministers as self-employed for Social Security with respect to services performed in the exercise of their ministry — even if they report their income taxes as an employee. This means that ministers must pay SECA unless they have filed a timely exemption application (*Form 4361*) that has been approved by the IRS. As noted below, few ministers qualify for this exemption.

Key Point: While most ministers are employees for federal income tax reporting purposes, they are self-employed for Social Security with respect to services they perform in the exercise of their ministry. This means that ministers are not subject to the employee's share of Social Security and Medicare taxes (FICA), even though they report their income taxes as employees and receive a *Form W-2* from their church. A minister's *Form W-2* should not report any amounts in Boxes 3, 4, 5, and 6. Rather, they pay SECA by completing *Schedule SE* with their *Form 1040*.

EXEMPTION FROM SECA

If ministers meet several requirements, they may exempt themselves from SECA with respect to their ministerial earnings. Among other things, the exemption application (*Form 4361*) must be submitted to the IRS within a limited time period.

The deadline is the due date of the federal tax return for the second year in which a minister has net earnings from self-employment of \$400 or more, any part of which comes from ministerial services. Further, the exemption is available only to ministers who are opposed on the basis of religious considerations to the acceptance of benefits under the Social Security program (or any other public insurance system that provides retirement or medical benefits). A minister who files the exemption application may still purchase life insurance or participate in retirement programs administered by non-governmental institutions (such as a life insurance company). Additionally, the exemption does not require a minister to revoke all rights to Social Security benefits earned through his participation in the system through secular employment.

A minister's opposition must be to accepting benefits under Social Security (or any other public insurance program) that are related to services performed as a minister. Economic, or any other non-religious considerations, are not a valid basis for the exemption; neither is opposition to paying SECA.

The exemption is effective only when it is approved by the IRS. Few ministers qualify for the exemption. Many younger ministers opt out of SECA without realizing that they do not qualify for the exemption. A decision to opt out of SECA is irrevocable. But section 4.19.6.4.11.3 (02-13-2020) of the *Internal Revenue Manual* explicitly recognizes that under some conditions ministers who have exempted themselves from SECA solely for economic reasons can revoke their exemption. The IRS does have the authority to revoke a minister's decision to opt out of SECA if it is determined the decision is based on economic reasons rather than theological reasons. Check with a tax attorney, CPA, or EA for additional information.

An exemption from SECA applies only to compensation for ministerial services. Ministers who have exempted themselves from SECA must pay Social Security taxes on any non-ministerial compensation they receive. And they remain eligible for Social Security benefits based on their non-ministerial employment, assuming that they have worked enough quarters. Generally, 40 quarters are required. Also, the Social Security Administration (SSA) has informed the author of this text that ministers who exempt themselves from SECA may qualify for Social Security benefits (including retirement and Medicare) on the basis of their spouse's coverage, if the spouse had enough credits.

Key Point: The amount of earnings required for a quarter of coverage in 2021 is \$1,470. A quarter of coverage is the basic unit for determining whether a worker is insured under the Social Security program.

Key Point: Ministers who work after they retire must continue to pay SECA on their ministerial income and

wages (unless they exempted themselves from SECA as a minister and they are employed in a ministerial capacity). However, amounts received from retirement plans related to ministerial services are not subject to SECA.

HOW DO MINISTERS PAY THEIR TAXES?

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

As noted above, ministers' wages are exempt from federal income tax withholding. This means that a church may not withhold income taxes from a minister's paycheck without specific written permission. And, since ministers are self-employed for Social Security with respect to their ministerial services, a church does not withhold the employee's share of FICA from a minister's wages. Ministers must prepay their income taxes and SECA using the estimated tax procedure, unless they enter into a voluntary withholding arrangement with their church. Estimated taxes must be paid in quarterly installments. If your estimated tax paid for the current year is less than your actual tax, you may have to pay an underpayment penalty. You can amend your estimated tax payments during the year if your circumstances change. For example, if your income or deductions increase unexpectedly, you should refigure your estimated tax liability for the year and amend your remaining quarterly payments accordingly or submit additional payments.

You will need to make estimated tax payments for 2021 if you expect to owe at least \$1,000 in tax for 2021 after subtracting your withholding and credits and if you expect your withholding and credits to be less than the smaller of (1) 90% of the tax to be shown on your 2021 tax return or (2) 100% of the tax shown on your 2020 tax return (110% if AGI exceeds \$150,000 or, if married filing separately, more than \$75,000). Your 2020 tax return must cover all 12 months.

The four-step procedure for reporting and prepaying estimated taxes for 2021 is summarized below.

Step 1. Estimated tax payments may be paid using either of the following methods:

- Obtain a copy of IRS *Form 1040-ES* for 2021 before April 15, 2021. You can obtain forms by calling the **IRS toll-free forms hotline at 1-800-TAX-FORM (1-800-829-3676) or from the IRS website (*IRS.gov*)**. If you paid estimated taxes last year, you should receive a copy of your 2021 *Form 1040-ES* in the mail with payment vouchers preprinted with your name, address, and Social Security number (SSN).

- Enroll in the Electronic Federal Tax Payment System® (EFTPS) at *EFTPS.gov* and establish an online account to be used to submit payments. You may also use *IRS.gov/Payments* to submit payments.

Step 2. Compute your estimated tax for 2021 using the *Form 1040-ES* worksheet. Ministers' quarterly estimated tax payments should take into account both income taxes and SECA.

Step 3. Pay one-fourth of your total estimated taxes for 2021 in each of four quarterly installments as follows:

For the Period	Due Date
January 1–March 31	April 15, 2021
April 1–May 31	June 15, 2021
June 1–August 31	September 15, 2021
September 1–December 31	January 18, 2022

You must send each payment to the IRS accompanied by one of the four payment vouchers contained in *Form 1040-ES*. If enrolled in the EFTPS system, all four payments may be prescheduled for automatic payment at the scheduled dates. A refund associated with an overpayment of your taxes for 2020 may be applied to your estimated tax payments due for 2021.

Warning: If your 2020 tax return is not completed by April 15, 2021, you must go ahead and begin making your estimated tax payments to avoid potential underpayment penalties. A tax refund on your 2020 tax return can be used to adjust any estimated tax payment not made at the time of the filing of the return. Do not wait until your 2020 return is completed to determine and pay your 2021 estimated tax payments.

Step 4. After the close of 2021, compute your actual tax liability on *Form 1040*. Only then will you know your actual income, deductions, exclusions, and credits. If you overpaid your estimated taxes (that is, actual taxes computed on *Form 1040* are less than all of your estimated tax payments plus any withholding), you can elect to have the overpayment credited against your first 2022 quarterly estimated tax payment or spread it out in any way you choose among any or all of your next four quarterly installments. Alternatively, you can request a refund of the overpayment. If you underpaid your estimated taxes (that is, your actual tax liability exceeds the total of your estimated tax payments plus any withholding), you may have to pay a penalty.

Key Point: Ministers who report their income taxes as employees can request that their employing church **voluntarily** withhold income taxes from their wages.

Simply furnish the church with a completed *Form W-4 Employee's Withholding Certificate* or other written authorization. Since ministers are not employees for Social Security with respect to ministerial compensation, the church does not withhold the employee's share of FICA. However, ministers can request on *Form W-4* (line 4c) that an additional amount of income tax be withheld to cover their estimated SECA liability for the year. The excess income tax withheld is a credit that is applied against the minister's SECA liability. Many churches understandably withhold FICA in addition to income taxes for a minister who requests voluntary withholding. Such withholding must be reported as income tax withheld. Withholding income tax is a preferential method of paying taxes, since it is considered to have been equally paid throughout the year, no matter the date it is actually withheld. This means withholding can be adjusted later in the year, and it is treated as if it was paid evenly throughout the year, thus avoiding potential underpayment penalties.