

Frequently Asked Questions: Clergy Housing Allowance ("Parsonage")

Circular 230 Disclosure



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The 7 Important questions that Rabbis should ask about Parsonage*

*"Parsonage" and "Housing allowance" are used interchangeably. "Rabbis" and other clergy are also used interchangeably.

1) Do I qualify as a "Clergy"?

As an ordained Rabbi (students who are not yet ordained do not qualify) you must meet the following tests to qualify as a clergy under the IRS' regulations for parsonage:

- a) Be ordained
- b) Perform "ministerial duties" which are shown below
- c) Work in a qualified organization

The IRS' publication 517 defines 'ministerial duties' as:

"Ministerial service, in general, is the service you perform in the exercise of your ministry, in the exercise of your duties as required by your religious order..."

http://www.irs.gov/publications/p517/ar02.html#en_US_2010_publink100033572

The IRS' guide to such question is as follows:

Most services you perform as a minister, priest, rabbi, etc., are ministerial services. These services include:

- *Performing sacerdotal functions,*
- *Conducting religious worship, and*
- *Controlling, conducting, and maintaining religious organizations (including the religious boards, societies, and other integral agencies of such organizations) that are under the authority of a religious body that is a church or denomination.*

[Rabbis] are considered to control, conduct, and maintain a religious organization if you direct, manage, or promote the organization's activities.

The justification of ministerial duties can be subject to interpretation and facts and circumstances such as: is teaching an adult education group qualifies as "ministerial duty"? How about a day school teacher who is also a rabbi? The answer to these is often based on relevant facts. Suffice it to say that unless the

Rabbi performs regular worship service, that facts and circumstances need to be thoughtfully addressed.

The sale of religious books or articles of religious also qualifies as a ministerial service.

2) Does my organization qualify as a “qualified organization”?

A qualified organization, or as the IRS calls it a religious organization is one that

“A religious organization is under the authority of a religious body that is a church or denomination if it is organized for and dedicated to carrying out the principles of a faith according to the requirements governing the creation of institutions of the faith.”

In interpreting these rules, it’s important to note that regular, exclusively dedicated performance of religious rites is integral to the definition of a religious organization as a qualified organization for the purpose of parsonage.

The IRS makes an addition expansion of the rule of qualified organization as one that are not-dedicated to religious rites but for which the Rabbi performs only religious rites, for example: hospital chaplaincy where the Rabbi is solely employed for the purpose of religious purposes.

3) How much parsonage may I take?

The IRS requires the rabbis to take the **lower** of fair rental value (FRV) or the actual expenses used for furnishing and maintaining a house. These include:

- Down payment on house
- Mortgage payment (including both principle and interest)
- Payments on home improvement projects
- Rent payments
- Real estate taxes
- Property insurance for owners or personal property insurance for renters
- Utilities (gas, electricity, water, sewer, trash pick up, phone, etc.)
- Furnishings and appliances (purchase and repair)
- Structural repairs and remodeling
- Yard maintenance and improvements
- Maintenance items (household cleaners, light bulbs, etc.)
- Homeowners association dues
- Miscellaneous & household maintenance

The IRS treats Fair Rental Value (FRV) as follows:

Reference is made to IRS circular 230 disclosure that is included in this document.

"Fair Rental Value: As determined objectively and between unrelated parties, what it would cost to rent a comparable home (including furnishings) in a similar location".

The fair-rental value of a parsonage means the fair value of the apartment had it been purchased. This can be estimated in one of two ways: get a professional appraisal from a real estate broker (two would be even better) on what would the FRV be. Alternatively, clergy may include any furnishing costs in the year of purchase of the furniture. If furniture is brought in from another place before parsonage we designated, the clergy could use the cost of that furniture when it was originally bought. Be sure to retain all documentation regarding costs of furniture and/or appraisers. As always, you must take the lowest possible value.

The total amount that the rabbi determines to being parsonage needs to be designated by the employer as an estimate. **For example**, a rabbi requests their employer to designate \$20,000 as a housing allowance for the year 20x1 (this has to be done during 20X0). During 20x1 the rabbi incurs qualified expenses of \$25,000. The difference of \$5,000 between the estimated parsonage for 20x1 and the actual expenses for that year cannot be 'made up' during the year or at the end of the year. **Tax planning tip:** If, during 20x1 the rabbi becomes aware that the \$20,000 initially designated will be too low, the Rabbi could request a mid-year designation for the remainder of the year. As long as the designation process is done correctly, the exempt amount would be valid.

Example: A rabbi requests their employer to designate \$20,000 as housing allowance for 20x2 (this has to be done during 20x1). In 20x1, the rabbi incurs qualified expenses totaling \$18,000. The difference between the \$20,000 that were designated and the \$18,000 that were incurred should be reported as taxable income by the rabbi for the year 20x2.

4) What should my employer do?

The employer should obtain and "officially designate" the housing allowance (a/k/a 'Parsonage') to the Rabbi on a pro-rata basis.

IRS Tax Topic 417 states:

"The minister's employing organization must officially designate the allowance as a housing allowance before paying it to the minister."

The terms "officially designated" is not defined. One may read this term as approved by an officer, a group of officers or the board of the congregation. At the very least there

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should be an acknowledgment by an officer of the congregation that designates the elected amount, in advance to be parsonage. A board approval is preferred but not required. Proper documentation of the designation should be maintained by the employer and the rabbi.

The employer must officially designate the parsonage in advance of the payment. An employer with good governance structure should request, obtain and officially designate the rabbi's housing allowance in time before the payment: it can be either at the start of each calendar year or in advance of a contract. The important element is that the designation is done "**officially**" and **in advance of the actual payment** (see question 5 for what constitute an official designation). Generally, the employer's fiscal year end is of no significance for the purpose of reporting because the wage reporting on forms W2 or 1099 is based on a calendar year).

Employers should be wary of "auditing" or otherwise examining the basis of the clergy's parsonage allowance. When doing that, and accepting the basis of the allowance they may create a degree of reliance by the clergy on the employer's opinion.

For example, suppose that a Rabbi is told that his synagogue's policy is to examine, on an annual basis the reasonableness of the Rabbi's rent and other expenses, to ascertain that they are reasonable. The Rabbi provides the synagogue a signed lease and copies of utility bills totalling \$500 a month. The synagogue's treasurer informs the Rabbi that these expenses are acceptable and that the Rabbi's request for designating \$500 of his \$1,200 a month salary is reasonable. When the treasurer informs the Rabbi that the "expenses are reasonable", two situations could emerge:

- 1) The Rabbi can claim that the treasurer and by extension the entire Board had expressed an opinion which the Rabbi then relies upon. Should the IRS question the Rabbi, he could point to the synagogue as the body that examined the reasonableness. This could be a stronger claim (by the Rabbi) if the treasurer - or anyone sitting on the synagogue's Board at the time - is a CPA or an attorney.
- 2) The treasurer has opined or otherwise expressed a satisfaction about past payments as the a basis for *future* expenses which are not known or knowable. In this light, the treasurer accepted an estimate without any way to know if the *actual expenses* will be the same, higher or lower than the \$500 per month that they have examined.

5) What documentation should I keep?

Rabbis should maintain documentation of the basis for the parsonage and the actual expenses that qualify for parsonage exemptions. These include contracts, original

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receipts, cancelled checks, invoices, daily logs and all other acceptable documentation for purpose of demonstrating before the IRS that a tax position is reasonable.

Rabbis should retain worksheets and calculations used to arrive at their housing allowance and contracts that refer to payment terms. In addition, Rabbis should document the conversations they had and obtain the relevant minutes or a letter by the officer or governing body that officially designated their housing allowance.

Verbal conversations and agreements should be documented contemporaneously to the time of their occurrence. At times, a written confirmation of material facts may be a good idea especially when a verbal conversation has taken place.

All documentation and tax returns should be retained in accordance with the IRS regulations.

6) How does parsonage affect my taxes?

The parsonage calculation is somewhat complex and beyond the scope of this discussion. In general, the most common effects of having a housing allowance on an individual tax liability are:

- Reduction of taxable income
- Increase in self employment (SE) tax as calculated on all self-employment earnings, net of expenses and the designated housing allowance amount.
- Reduction of Adjusted Gross Income (AGI) based on a portion of the SE tax.
- A reduction of state income tax liability.

7) How does the parsonage relate to my salary negotiation?

Rabbis should be mindful that parsonage can only be utilized with qualified employers and while the rabbi (or other clergy) is dispensing ministerial duties. Educator/Rabbis for example may not qualify under the IRS rules because they are not discharging ministerial duties, rather they teach or run a school.

When negotiating a salary, the most important part is to be able to understand all the terms. For that purpose an attorney may be able to help (the author is not an attorney). Some issues that could be brought up in negotiation include:

Reference is made to IRS circular 230 disclosure that is included in this document.

- 1) What is the prospective employer's policy on parsonage?
- 2) Is the employer a qualified employer for parsonage purposes?
- 3) Is the position a qualified position for parsonage under the IRS rules?
- 4) What is the "official designation" method and documentation that the prospective employer plans to use, including language and frequency (annual, one time only)?
- 5) If the prospective employer plans to only designate parsonage once, does the language of the designation include specific enough terms to indicate until when it is in force?
- 6) What are the tax reporting competencies of the prospective employer? What forms will be used to report the clergy's salary and parsonage (1099, W2) and does the employer understand how to properly report the salary and parsonage amounts?
- 7) Is the negotiated compensation package amount based on the knowledge of all parties on the expected amount to be designated as parsonage? If so, what are the pre-tax and net-of-tax effects of the parsonage on all parties?

This list of questions is not all exclusive. Its purpose is only to highlight some of the questions that the parties may wish to discuss.

More questions to ask about parsonage

What is the treatment for purposes of parsonage of an unfurnished rented apartment?

The IRS treats Fair Rental Value (FRV) as follows:

"Fair Rental Value: As determined objectively and between unrelated parties, what it would cost to rent a comparable home (**including furnishings**) in a similar location".

The fair-rental value (aka FRV) of a housing allowance means the fair value of the apartment had it been purchased. This can be estimated in one of two ways: get a professional appraisal from a real estate broker (two would be even better) on what would the FRV be. Or, include any furnishing costs in the year of purchase of the furniture. If furniture is brought in from another place, use the cost of that furniture when it was bought. Be sure to retain all documentation regarding costs of furniture and/or appraisers. As always, you must take the lowest possible value.

Source: IRS Publication 517, Worksheet 1

<http://www.irs.gov/publications/p517/ar02.html>

What is the treatment of parsonage for retired clergy?

The IRS' publication 517 states, in connection with gross income. These are **exempt** from gross income:

"Pension payments or retirement allowances you receive for your past ministerial services"

Reference is made to IRS circular 230 disclosure that is included in this document.

and

"The rental value of a parsonage or a parsonage allowance provided to you after you retire"

Source: <http://www.irs.gov/publications/p517/ar02.html> (under Amounts Not Included in Gross Income)

What is 'official designation' of parsonage?

The IRS rules are that an official designation of parsonage is to be documented. This can be done most clearly in the minutes of the governing board. Other official designations could be in the budget, as approved by the board or finance committee, or any other document evidencing the designation in a clear manner. The word official may be interpreted to connote "official sanctioned", which could mean any document, contract, memo or even e-mail that is sanctioned by an officer of the employer such as a president, treasurer, secretary or other officers.

Do I have to pay Social Security and/or Medicare on my parsonage?

The Federal Insurance Contribution Act ("FICA") is the act that regulates the payments to the Social Security and Medicare systems respectively. All earnings – **regardless of source** – are subject to the FICA rules. The difference is how much the clergy pays and what is the mechanism for payment:

Salary: when a clergy is defined as an employee, the employer and employee share the burden of paying into the Social Security and Medicare system. Generally speaking, the share is 50%/50% between the employer and the employee. The information of how much was earned and withdrawn from gross pay, is reported on Federal Form W2.

Self-employment: when a clergy is defined as a non-employee, the clergy is known to be "self-employed". The clergy, in their personal income tax return, would report self-employment income, net of qualified expenses on Federal schedule SE which will calculate the Self-Employment tax ("SE"). The SE tax is equivalent to the Medicare and Social Security taxes. Generally, self-employment income is reported on Federal Form 1099-MISC. However, the parsonage portion of a salaried employee should be reported on Federal Form W2 in the "Other information" box.

The treatment of parsonage is to be included in the self-employment income (Schedule SE has a line for "Minister's parsonage and other earnings").

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Two comments about this tax treatment:

- First, being an employee or a self-employed contractor is not a “choice”. Under IRS rules, a person **may not** simply choose how to be treated. The IRS publishes a series of questions, and based on the answers the working person is defined as either “employee” or “self-employed” / contractor. The practice of “choosing” between the two is incorrect and possibly illegal. Only the IRS guidance can determine the classification: neither the person nor the employer may determine the status arbitrarily. Refer to IRS’ Publication 15-A for the definition of “employees” (<http://www.irs.gov/publications/p15a/ar02.html>).
- Second, when a self-employed person pays their SE tax: they do so with their net-earnings from self-employment income. This is commonly done by completing Federal Schedule C and applying any qualified expenses to the gross income received from self-employment. The net earnings is then aggregated along with the parsonage on Federal Schedule SE.