

The Committee on Ministry provides the following document to churches and ministers of Grace Presbytery for information purposes only. All ministers should consult with their own tax advisors concerning specific application of the explanation given.

**Committee on Ministry
April 25, 2006**

Clergy Housing Allowances

Clergy receive housing allowances that are excludable for income tax purposes. This continues to cause confusion in some congregations, so the following statement clarifies housing allowances as part of Grace Presbytery's Terms of Call for Pastors.

Please consult the Presbyterian Board of Pensions award-winning Web site at www.pensions.org. When you reach the home page you'll see "Tax Resource Center, 2006" that includes "tax help for ministers and churches."

Congress enacted the Clergy Housing Allowance Clarification Act in 2002, which limits the nontaxable portion of a church-designated housing allowance for ministers who own their home to the annual fair rental value of the home (furnished, plus utilities). IRS regulations also limit the housing allowance to the amount designated in advance by the church and by the actual amount spent by the minister for housing-related expenses.¹

Some question the amount of clergy housing allowances, particularly as such allowances appear to be the major part of official Terms of Call. As indicated above, if a Session designates the housing allowance *in advance* then the amount may be the annual fair rental value of the home (furnished, plus utilities).

This means that if a minister is making mortgage payments on a home that has a fair market value of \$200,000, then a ballpark estimate of the fair rental value is 1% per month of \$200,000 or \$24,000 per year *plus utilities*. The IRS does not place an upper limit on the fair market value of the minister's home, and it does not limit the housing allowance to a percentage of the total terms of call.

We often approve Terms of Call in which the minister asks that most of the compensation appear in the housing allowance. As long as the allowance meets the requirements outlined in the paragraph above, then that allowance is permissible.

For further information on the housing allowance provisions, refer to the *Tax Guide for Ministers* published by the Board of Pensions, talk with your tax advisor, or order IRS Publication 517 by calling 800-829-3676.

¹ Rick Warren, author of *The Purpose Driven Life*, took his entire compensation as housing allowance. IRS said he could not do that. He appealed to the 9th Circuit Court. IRS then said it would withdraw lawsuit if Congress would enact a law. The above Clarification Act is the result; it says a housing allowance is OK if it meets a 3-point test: 1) Maximum allowance is determined by organization in advance; 2) Housing allowance cannot be more than what is actually spent; and 3) The allowance should be the fair rental value of the house furnished plus utilities.

The following information concerning housing allowances for clergy is taken from *Tax Guide for Ministers & Churches, 2005 Tax Year*, by Richard R. Hammar and published by our Board of Pensions. This complete document was mailed to every minister member of Grace Presbytery. You will also find the complete document on the Board of Pensions web site.

Housing Allowance

Ministers who own or rent a home

The most important tax benefit available to ministers who own or rent their homes is the housing allowance exclusion. Ministers who own their home do not pay federal income taxes on the amount of their compensation that their employing church designates in advance as a housing allowance, to the extent that (1) the allowance represents compensation for ministerial services, (2) it is used to pay housing expenses, and (3) it does not exceed the annual fair rental value of the home (furnished, plus utilities). Housing-related expenses include mortgage payments, utilities, repairs, furnishings, insurance, property taxes, additions, and maintenance. Ministers who rent a home or apartment do not pay federal income taxes on the amount of their compensation that their employing church designates in advance as a housing allowance to the extent that the allowance represents compensation for ministerial services and is used to pay rental expenses such as rent, furnishings, utilities, and insurance. Please note that the expenses listed above are not an all-inclusive list.

Ministers who live in a church-owned manse

Ministers who live rent-free in a church-owned manse may exclude the lower of these two amounts, provided the exclusion is not greater than reasonable pay for your services:

1. The housing allowance designated by their church; or
2. Actual housing expenses not paid by the church (including utilities, furnishings, repairs and improvements).

Ministers who live rent-free in church manses should not include the fair rental value of the parsonage as income for federal income taxes. If these ministers incur any out-of-pocket expenses in maintaining the manse (such as utilities, property taxes, insurance, furnishings, or lawn care), they should be sure that their employing church designates in advance a portion of their annual compensation as a manse allowance. The amount so designated is not reported as wages on the minister's Form W-2 at the end of the year (if the allowance exceeds the actual expenses, the difference must be reported as income by the minister). This is a very important tax benefit for ministers living in church-provided manses. Unfortunately, many of these ministers are not aware of this benefit or are not taking advantage of it.

Retired Ministers

Retired Ministers can exclude from gross income the rental value of a home (plus utilities) furnished to you by your church as part of your pay for past services, or the part of your pension that was designated as a rental allowance. The Board of Pensions designates 100% of your pension as a housing (rental) allowance. The self-employment tax does not apply to the rental value of a manse provided after a minister retires or to pension designated as a housing allowance, received by a minister from a church plan after retirement.

Retirement Home Fees

Many ministers move into a retirement home following their retirement from ministry. There often are two costs associated with such living arrangements: (1) a lump sum entrance fee, and (2) monthly or annual “maintenance” fees. The IRS has ruled that a lump sum “entrance fee” paid by a retired minister to gain admission to a retirement community cannot be prorated over several years and claimed as a housing expense in those years. It can only be treated as a housing expense in the year that it is actually paid. IRS Letter Ruling 8348018 (1983).

What about monthly or annual maintenance fees? Can a retired minister’s housing allowance (designated by a pension board) be applied to these fees?

That depends. Section 107 of the tax code allows ministers to exclude from gross income the portion of their compensation designated in advance as a housing allowance, to the extent that the allowance is used to “rent or provide a home.” The regulations define this language as follows: “Circumstances under which a rental allowance will be deemed to have been used to rent or provide a home will include cases in which the allowance is expended (1) for rent of a home, (2) for purchase of a home, and (3) for expenses directly related to providing a home. Expenses for food and servants are not considered for this purpose to be directly related to providing a home.”

As a result, a retired minister’s housing allowance can be applied to any portion of a monthly “maintenance fee” charged by a retirement home that is “an expense directly related to providing a home.” The regulations prohibit housing allowances from being applied to the costs of “food and servants,” and therefore a housing allowance could not be applied to any portion of a maintenance fee that goes to food or housekeeping expenses.

How much should a church designate as a housing allowance?

Many churches base the allowance on their minister’s estimate of actual housing expenses for the new year. The church provides the minister with a form on which anticipated housing expenses for the new year are reported. For ministers who own their homes, the form asks for projected expenses in the following categories: down payment, mortgage payments, property taxes, property insurance, utilities, furnishings and appliances, repairs and improvements, maintenance, and miscellaneous. Many churches designate an allowance in excess of the anticipated expenses itemized by the

minister. Basing the allowance solely on a minister's actual expenses penalizes the minister if actual housing expenses turn out to be higher than expected. In other words, the allowance should take into account unexpected housing costs or inaccurate projections of expenses. Commissioned Lay Pastors ("CLP") may be able to exclude income designated as a housing allowance if they meet the IRS requirements for ministers (summarized above); the employing church designates a portion of the CLP's salary as housing allowance, in advance of payment; and the CLP complies with the requirements for documentation of the housing expenses outlined above.

Housing expenses to include in computing your housing allowance exclusion

Ministers who own their homes should take the following expenses into account in computing their housing allowance exclusion:

- Down payment on a home (but remember, a housing allowance is nontaxable only to the extent that it does not exceed the lesser of actual housing expenses or the annual fair rental value of a minister's home).
- Mortgage payments on a loan to purchase or improve your home (include both interest and principal).
- Real estate taxes.
- Property insurance.
- Utilities (electricity, gas, water, trash pickup, local telephone charges).
- Furnishings and appliances (purchase and repair).
- Structural repairs and remodeling.
- Yard maintenance and improvements.
- Maintenance items (pest control, etc.).
- Homeowners association dues.

Note that these exclusions are for federal income tax purposes only. Ministers cannot exclude the annual rental value of a manse or a housing allowance when computing their Social Security taxes. The housing allowance is available to ministers whether they report their income taxes as employees or as self-employed (whether the church issues them a W-2 or a 1099).

Example. A church designated \$12,000 of Reverend D's 2005 compensation as a housing allowance. Reverend D's housing expenses for 2005 were utilities of \$2,000, mortgage payments of \$6,000, property taxes of \$2,000, insurance payments of \$1,000, repairs of \$1,000, and furnishings of \$1,000. The annual fair rental value of the home (furnished, plus utilities) is \$10,000. Reverend D's housing allowance is nontaxable in computing his income taxes only to the extent that it is used to pay housing expenses and does not exceed the annual fair rental value of his home (furnished, plus utilities). Stated differently, the nontaxable portion of a housing allowance is the least of the following three amounts: (1) the housing allowance designated by the church; (2) actual housing expenses; (3) the annual fair rental value of the home (furnished, plus utilities). In this case, the lowest of these three amounts is the annual fair rental value of the home (\$10,000), and so this represents the nontaxable portion of Reverend D's housing allowance. Reverend D must report the

difference between this amount and the housing allowance designated by his church (\$2,000) on line 7 of Form 1040.

Example. Same facts as the previous example, except that the church designated \$9,000 of Reverend D's salary as a housing allowance. The lowest of the three amounts in this case would be \$9,000 – the church designated housing allowance, and so this represents the nontaxable amount. Note that the Reverend D's actual housing expenses were more than the allowance, and so he was "penalized" because of the low allowance designated by his church.

Example. Reverend Y owns a home and incurs housing expenses of \$12,000 in 2005. These expenses include mortgage principal and interest, property taxes, utilities, insurance and repairs. The church designated (in advance) \$12,000 of Reverend Y's 2005 compensation as a housing allowance. Reverend Y is able to itemize expenses on Schedule A (Form 1040). He is able to claim itemized deductions on Schedule A for both his mortgage interest and his property taxes, even though his taxable income was already reduced by these items because of their inclusion in the housing allowance. This is often referred to as the "double deduction." In reality, it represents an exclusion and a deduction.

Example. In preparing her income tax return for 2005, Reverend H discovers that her church failed to designate a housing allowance for her for 2005. She asks her church to pass a resolution retroactively granting the allowance for 2005. Such a resolution is ineffective, and Reverend H will not be eligible for any housing allowance exclusion in 2005.

Please note the following Manse/Housing Allowance Tips:

- Under no circumstances can a church designate a housing allowance retroactively. Unfortunately, many churches fail to designate housing allowances and thereby deprive ministers of an important tax benefit.
- Ministers who own their homes lose the largest component of their housing allowance exclusion when they pay off their home mortgage loan. Many ministers in this position have obtained home equity loans or a conventional loan secured by a mortgage on their otherwise debt-free home and have claimed their payments under these kinds of loans as a housing expense in computing their housing allowance exclusion. The Tax Court has ruled that this is permissible only if the loan was obtained for housing-related expenses.
- Ministers should be sure that the designation of a housing or parsonage allowance for the next year is on the agenda of the church (or session) for one of its final meetings during the current year. The designation should be an official action, and it should be duly recorded in the minutes of the meeting. The IRS also recognizes designations included in employment contracts and budget line items – assuming in each case that the designation was appropriately adopted in advance by the church and supported by underlying documentation as to each minister's anticipated housing expenses.

- A housing allowance must be designated in advance. Retroactive designations of housing allowances are not effective.
- A housing allowance can be amended during the year if a minister's housing expenses are more than expected. However, an amendment is only effective prospectively.
- The housing allowance designated by the church is not necessarily nontaxable. It is nontaxable (for income tax reporting purposes) only to the extent that it is used to pay for housing expenses, and, for ministers who own their home, does not exceed the fair rental value of their home (furnished, plus utilities).
- If the housing allowance designated by the church exceeds the amount that can be claimed, the excess housing allowance should be reported on line 7 of Form 1040.

Housing allowance expense worksheet for ordained ministers who own their home

Ordained ministers are permitted to exclude from their church income (for federal income tax purposes) a housing allowance designated in advance by their employing church, to the extent that the allowance is used to pay housing expenses. To assist the church in designating an appropriate amount, the minister can use this form to estimate 2006 housing expenses. It is designed for ministers who own their home.

Down payment on a home _____
Mortgage payments on a loan to purchase or improve your home _____
(include both principal and interest), or rental payments _____
Real estate taxes _____
Property insurance _____
Utilities (electricity, gas, water, trash pickup, local telephone charges) _____
Furnishings and appliances (purchase and repair) _____
Structural repairs and remodeling _____
Yard maintenance and improvements _____
Maintenance items: pest control, etc. _____
Homeowners association dues _____
Miscellaneous _____
Total estimated expenses for 2007 _____

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