

— M E M O #13 —

The Minister's Housing Allowance





A substantial tax benefit is provided to qualifying ministers based on Section 107 of the Internal Revenue Code. It consists of only one sentence which 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.



REMEMBER!

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

Eligibility

Tax regulations limit the housing allowance exclusion to the amount 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 more details regarding eligibility.

Bivocational ministers can have a housing allowance, but only from ministerial income. Generally, secular employers cannot give a tax-free housing allowance to an employee, even if that employee is a minister. Nazarene retired ministers can have a housing allowance too. Since the Nazarene Single Defined Benefit Plan is a qualifying church plan under IRS definitions, the General Board has designated 100% 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 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

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.

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 should be contained in the minutes of the church board or finance committee. 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 the designation is 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. <name of minister> will include a church provided parsonage. For the purpose of covering additional housing-related expenses, \$<dollar amount> per year is designated as housing allowance. This designation shall be effective until modified by the church board.”
- B. For a minister purchasing his/her home or renting:** “The compensation for Rev. <name of minister> shall include \$<dollar amount> per year designated as housing allowance. This designation shall be effective until modified by the church board.”
- C. For an evangelist:** “Compensation for Rev. <name of minister>, as evangelist, will include \$<dollar amount> designated as housing allowance.”



SEE

Memo #12: Who Is a Minister for Tax Purposes?



CAUTION

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



CAUTION

The church board must designate, through official action and in advance of payment, the amount of the minister's housing allowance. Otherwise, it becomes taxable income.

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

The Internal Revenue 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% of the cash compensation. However, it should be noted that a minister's cash housing allowance cannot exceed reasonable compensation. This applies where a minister received compensation disproportionate to the amount of service provided.

How Much Housing Allowance Can Be Excluded from Income Taxes?

As indicated above, up to 100% of compensation may be designated as housing allowance, but this may not be 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 receive part of your pay as 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.

The minister and the church board should make a reasonable attempt to estimate the amount it will cost to provide a home. The Minister's Tax & Financial Guide, an annual publication by the Evangelical Council for Financial Accountability (ECFA) available at nbusa.org, contains a worksheet that can be helpful in creating a realistic estimate.

The church should designate a reasonable amount as housing allowance. The church should not designate, for a minister who owns or rents a home, a housing allowance that is significantly above the minister's estimated housing expenses or the fair rental value of the home (furnished, plus utilities, etc.) 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



IDEA

Make the wording of the resolution open-ended. That way, it will remain in effect until the church revises it.



CAUTION

A minister's cash housing allowance cannot exceed reasonable compensation.



SEE

IRS Publication 517 for details of amounts allowance for parsonage allowance.

home (this includes real estate taxes, home insurance, etc.). Some ministers who have paid off their mortgages erroneously exclude the fair rental value of their homes as housing allowance. This practice is not legal.

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, 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, homeowners association dues, snow removal, lawn mowing, light bulbs, cleaning supplies, etc.

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.

Box 1 of the minister's Form W-2 should not include any portion of the church-designated housing allowance. (*See Memo #3: Tax and Reporting Procedures.*) 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. According to the ECFA's Minister's Tax & Financial Guide, this unused portion of the designated amount should be included in the amount for "Wages, salaries, tips, etc." on Form 1040.



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.





The church treasurer should provide a written notice at year's end to the minister indicating how much has been paid as designated cash housing allowance. This will be useful when the minister computes Social Security/Medicare taxes (SECA) at the self-employment tax rate. A copy of the notification should be maintained in the church's file. An alternative reporting method would be to include the housing allowance designation in Box 14 of the minister's Form W-2 for the tax year.

The church treasurer must issue a Form 1099-NEC for unincorporated evangelists if payments to them 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 from plans administered by Nazarene Benefits USA. When reporting pension payments made as housing allowance, the Form 1099-R indicates "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 the home plus utilities. Include any fair market rental value of 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 on federal income tax forms. Of course, this assumes the excluded amount does not exceed the fair rental value, as discussed above.



REMEMBER!

While income designated as housing allowance is excluded from federal income tax, it must be included for Social Security/Medicare tax purposes for ministers.



SEE

Memo #3:
Tax and Reporting Procedures.



IDEA

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

The information contained in this memo series is of a general nature reflecting USA Nazarene Church polity.

It is not offered as specific legal or tax advice. Each person, local church board, and district should evaluate their own unique situation in consultation with their local legal and tax advisors.



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- #4:** Strategies for Structuring Ministerial Compensation
- #5:** Minimizing Income Taxes for Church Employees
- #6:** Housing Allowance in Retirement
- #7:** Financially Caring for the Minister
- #8:** The Annual Church Audit
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- #11:** Auto and Other Business Expense Reimbursements
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