THE TAXATION OF MINISTERS: A NOT-SO-SIMPLE PROBLEM

by J. Kent Poff and Ruth B. Jones**

INTRODUCTION

This paper shows how an apparently simple tax problem can have many complex twists when it is explored in depth. The apparently simple problem explored here is the taxation of a minister. With notable exceptions, a minister is not a high-income taxpayer, so one might suspect there are no substantial tax problems. This intuition, however, is not correct. There are a number, of tax issues that are of interest. First, there is controversy about whether a minister is self-employed or an employee. The self-employed minister may deduct travel and other business expenses for adjusted gross income even if deductions are not itemized. The minister who is an employee may only deduct travel and other business expenses from adjusted gross income if deductions are itemized. This distinction is important because often a minister does not earn enough income to justify itemizing deductions and, therefore, effectively loses the business expenses when treated as an employee. Second, there is confusion about whether the minister has the same employment status for both income tax purposes and social security tax purposes. For example, a minister might assume that self-employment status for social security tax purposes implies self-employment status for income tax purposes. It is, however, possible that the minister is self-employed for social security purposes, but is an employee for income tax purposes. The employment status for social security purposes is important because the employee pays 7.65% of earnings for social security (with a 7.65% matching payment by the employer for a total of 15.3%), but the self-employed person pays the entire 15.3% of earnings for social security.

"Assistant Professor of Accounting, East Carolina University, Greenville, North Carolina
“Assistant Professor of Accounting, East Carolina University, Greenville, North Carolina

Third, there is confusion about the treatment of any housing allowance the minister may receive. The minister's housing allowance is excluded from taxable income, but the amount that can be excluded and the treatment for social security purposes is not so well understood.

The preceding discussion of the employment status of a minister, the issue of whether the employment status is the same for social security and income tax purposes, and the treatment of housing allowance suggests that the taxation of a minister is an example of an apparently simple tax problem that can become complex.

The remainder of this article is organized as follows. Section 2.0 discusses the definition of a minister under the tax code. Section 3.0 addresses the employment status of the minister, the consequences of the result, and whether the status is the same for social security and income tax purposes. Section 4.0 examines the housing allowance. Section 5.0 analyzes planning opportunities available. Section 6.0 presents a summary of the paper.

DEFINITION OF A MINISTER

Treas. Regs. § 1.1402(c)-5(a)(2) and 1.1402(c)-5(b)(2) may not have contemplated the wide variety of church staff titles that have emerged in legitimate churches. A few years ago a minister was easy to define because the pastor was the only staff member of the church. As time progressed, other staff members were added such as associate pastor, minister of music, minister of education, youth minister, minister of outreach/evangelism, principal of private school, and business administrator. In addition, there are individuals employed as chaplains (military/hospital) and college professors (seminary, Bible college, and state university) and those in the denominational hierarchy. This wide variety of job titles and potential employers raises the question of just who qualifies as a minister under the Internal Revenue Code.

A minister is defined by Treas. Regs. § 1.1402(c)-5(a)(2) as a "duly ordained, commissioned, or licensed minister of a church or a member of a religious order . . . engaged ... in the exercise of his ministry or in the exercise of duties required by such order." Treas. Regs. § 1.1402(c)-5(b)(2) says that "service performed by a minister in the exercise of his ministry includes the ministration of sacerdotal function[1] AND (emphasis added) the conduct of religious worship, AND (emphasis added) the control, conduct, AND (emphasis added) maintenance of religious organizations (including the religious boards, societies, and other integral agencies of such organizations),

1.The term sacerdotal is not deOned in the code or the regulations. The general understanding of the term involves administering the sacraments of the church such as communion, baptism, weddings, funerals, etc.

under the authority of a religious body constituting a church or church denomination."[2]

Notice that the exercise of the ministry includes sacerdotal functions, worship, etc., but it may also include other ministerial responsibilities. The minister is not constrained to performing exclusively the listed services, but the services MAY be included in the job. Given the definitions, a taxpayer has a safe harbor if the following tests are met:

1. The taxpayer MUST be either a duly ordained, commissioned, or

   licensed[3] minister of a church or a member of a religious order AND

2. The taxpayer MAY be involved in (not just qualified to perform):

   a. Sacerdotal functions OR
   b. Religious worship OR
   c. The control, conduct, OR maintenance of a religious organization.

Administrative rulings have not been so clear and in fact appear to conflict with the regulations. Rev. Rul. 78-301[4] defines a minister as "one who is authorized to administer sacraments, preach, and conduct services of worship" in addition to being ordained, commissioned, or licensed. This ruling "allow(s) a commissioned or licensed minister to be treated in the same manner as ordained ministers of the gospel when the commissioned or licensed ministers perform substantially all the religious functions within the scope of the tenets and practices of their religious denominations." Rev. Rul. 78-301 implies, but does not say, that the commissioned or licensed person who does not administer sacraments, preach, and conduct services is not a

2.One might argue that Treas. Reg. § 1.1402(c)-5(b)(2) requires that a taxpayer be involved in sacerdotal functions AND the conduct of religious worship, AND the control, conduct, AND maintenance of religious organizations. This interpretation logically fails because almost no taxpayers meet this definition. Furthermore, Treas. Reg. § 1.1402(c)-5(b)(2)(i) states, "Whether service performed by a minister constitutes the conduct of religious worship OR (emphasis added) the ministration of sacerdotal functions depends on the tenets and practices of the particular religious body . . . " This interpretation is supported by Treas. Reg. § 1.1402(c)-5(b)(2)(ii) which states, "Service performed by a minister in the control, conduct, and maintenance of a religious organization relates to directing, managing, or promoting the activities of such organization. Any religious organization is deemed to be under the authority of a religious body...if it is organized and dedicated to carrying out the tenets and principles of a faith . . . " The regulations seem to require that the taxpayer be involved in sacerdotal functions OR the conduct of religious worship, OR the control, conduct, OR maintenance of religious organizations.

3.Notice that I.R.C. § 1402 and Treas. Reg. § 1.1402(c)-5 make no distinction between an ordained, commissioned, or licensed minister.

4.1978-2 CB.103.

minister for tax purposes. Letter Ruling 8442130[5] takes this position further and says that a taxpayer who does not and does not intend to conduct worship services, preach, conduct funerals, administer the sacraments, etc., does not qualify as a minister for tax purposes.

Conversely, Rev. Rul. 78-301 and Letter Ruling 8442130 imply, but do not say, that an ordained person who does not administer sacraments, preach, conduct services, etc., IS a minister for tax purposes. Thus, these administrative pronouncements seem to require a commissioned or licensed taxpayer to perform a more restricted set of services than an ordained person if the taxpayer is to qualify as a minister for tax purposes. This Revenue Ruling is flawed because it creates a more restrictive definition of the term minister than is given in the regulations and seems to eliminate the possibility that the commissioned and licensed minister be involved in "the control, conduct, and maintenance of religious organizations." Congress clearly thought that "the control, conduct, and maintenance of religious organizations" is part of ministry, or that definition would not have been included in the tax code.

The effect of Rev. Rul. 78-301 leads to the rather bizarre result that a minister from a church that has multiple ministerial classifications (ordination, commissioning, or licensing) must adhere to a stricter standard than churches that only ordain. For example, an ordained taxpayer performing only administrative tasks in a church with a single ministerial classification clearly qualifies as a minister. A commissioned taxpayer performing only administrative tasks in a church with multiple ministerial classifications, however, does not qualify as a minister. The distinction is that Treas. Regs. § 1.1402(c)-5(a)(2) and 1.1402(c)-5(b)(2) recognize multiple ministry functions, while Rev. Rul. 78-301 recognizes only the traditional liturgical pastoral ministry for those taxpayers who are not fully ordained. The position of the ruling is inconsistent with the regulations, out of step with the modem church, and not in keeping with sacred pronouncements.[6]

Assuming that the taxpayer is ordained by a legitimate religious organization, based upon the definitions and tests of Treas. Reg. §1.1402(c)-5, the senior minister of a church clearly qualifies. The associate pastor and minister of music probably qualify because they normally are involved in the worship service. The minister of education is involved in the coordination of the religious education program of the church (including Sunday School) and presents a less obvious solution. One could legitimately argue that religious

[5] July 20. 1984. Note that a letter ruling may not be used for precedent under I.R.C. § 6110(j)(3), but it does reflect the thinking of the Internal Revenue Service.

[6] See Acts 6 for a discussion of helpers appointed to oversee ministering to the physical needs of the early church.
"And He Himself gave some to be apostles, some prophets, some evangelists,
and some pastors and teachers, for the equipping of the saints for the work of ministry, for the
edifying of the body of Christ . . ." (Ephesians 4:11,12)

education is an integral part of the worship process and thus the minister of education qualifies. The youth minister often performs all the sacerdotal and worship functions for youth and thus qualifies as a minister. The minister of outreach/evangelism often performs sacerdotal or worship functions outside of the church building and thus qualifies as a minister. The principal of a private school under the control of the church and the business administrator are involved in the control, conduct, and maintenance of a religious organization and thus qualify.

Assuming that the taxpayer is commissioned or licensed (but not ordained) by a legitimate religious organization with multiple ministry classifications, based upon the definitions and tests of Rev. Rul. 78-301, the senior minister of a church clearly qualifies. The associate pastor normally assists the senior pastor in "substantially all the religious functions within the scope of the tenets and practices of their religious denominations" and probably qualifies. The minister of music normally is restricted to music and is involved in worship, rather than sacerdotal functions. Because of this restriction, the minister of music probably does not qualify. Note that staff members that do not actually "perform substantially all the religious functions within the scope ... of the denomination" do not qualify, even if they are authorized to perform the functions. The minister of education typically also has restricted and specialized activities, so this position probably does not qualify. The youth minister often performs all the sacerdotal and worship functions for youth and thus qualifies as a minister. The minister of outreach/evangelism often performs sacerdotal or worship functions outside of the church building and thus qualifies as a minister. The principal of a private school under the control of the church and the business administrator are restricted in their activities and thus do not qualify.

If there is a question about whether an ordained, commissioned or licensed taxpayer is a minister for tax purposes, the person can assist in the ministration of sacerdotal functions or religious worship and obviously qualify. This may not be so easy as it seems for the mega-churches that have more than a few staff members.[7] The staff members that are not involved in sacerdotal or worship functions per se probably qualify under Treas. Reg. § 1.1402(c)-5(b)(2)(ii) because they typically are involved in "directing, managing, or promoting" the activities of the church. These same members of the staff probably do not qualify under Rev. Rul. 78-301.

Ordained[8] individuals employed as chaplains (military/hospital) and college professors (seminaiy, Bible college, and state university) and those in the denominational hierarchy present more problems because they do not

7.For example, Thomas Road Baptist Church in Lynchburg, Virginia, has more than 100 staff members.

8.See previous discussion for the distinction between ordained, commissioned, and licensed taxpayers.

work directly in the church setting. A chaplain who is involved in sacerdotal functions and the conduct of religious worship in general qualifies as a minister for tax purposes when the religious services are performed for a non-governmental organization, even if the organization is not religious.[5] The chaplain in general does not qualify as a minister for tax purposes if employed by a federal government (United States or foreign), a state or territorial government, or any political subdivision.[10] A chaplain employed by a non-military governmental unit is considered to be a minister for purposes of the housing allowance alone.[11] As a result of these rules, a chaplain employed by a private organization to work at a university, prison, or the military qualifies as a minister for tax purposes, but a chaplain employed by a governmental unit to work at a university, prison, or the military does not qualify as a minister for tax purposes. A chaplain employed by a governmental unit to work at a university or prison (but not the military), however, qualifies as a minister for purposes of the housing allowance.[12]

Seminary or Bible college professors employed by a private organization present a more difficult problem because they typically are not involved in sacerdotal functions and the conduct of religious worship. It is also hard to argue that the teaching professor (as opposed to an administrator or a department chair) is involved in the control, conduct, or maintenance of the organization. Rev. Rul. 70-549[13] takes a broader view of ministry and logically states that such an ordained teaching professor is performing service "in the exercise of his ministry,"[14] and thus qualifies as a minister for tax purposes. Like chaplains, even if they otherwise qualify, professors employed by any federal government, a state or territorial government, or any political subdivision do not in general qualify as ministers. An ordained individual employed in the denominational hierarchy appears to qualify as a minister for tax purposes because of involvement in the control, conduct, and maintenance of the religious organization.

In summary, I.R.C. § 1.1402(c)-5 clearly defines a minister as a "duly ordained, commissioned, or licensed minister of a church or a member of a religious order . . . engaged ... in the exercise of his ministry or in the exercise of duties required by such order" and specifies that "service performed by a minister in the exercise of his ministry" includes (but is not limited to)

9.Treas. Reg. § 1.1402(c>5(bX2)(iii).

10.Treas. Reg. § 1.1402(c>5(c)(3).

11.Treas. Reg. § 1.107-l(a). The non-military chaplain employed by a governmental unit has the best of both worlds. TTiis minister is not self-employed under l.R.C. § 1402 and thus pays *7.65%* for social security purposes instead of 153%, but is eligible for the housing allowance exclusion under I.R.C § 107. The housing allowance is discussed in section 3.0 of this paper.

12.Treas. Reg. § 1.107.1.

13.1970-2 CB. 16.

14.Recall that the exercise of the ministry is not limited to worship, sacerdotal functions, or control, conduct, and maintenance of religious organizations.

"the ministration of sacerdotal functions and the conduct of religious worship, and the control, conduct, and maintenance of religious organizations . . .

In contrast, Rev. Rul. 78-301 adds the requirement that a commissioned or licensed minister must be "one who is authorized to administer sacraments, preach, and conduct services of worship" and must "perform substantially all the religious functions within the scope of the tenets and practices of their religious denominations." This Revenue Ruling is not consistent with the Congressional intent and the regulations because it creates a more restrictive definition of the term minister than is given in the code and regulations and fails to fully recognize the multiple ministry responsibilities in the modem church.

EMPLOYEE OR SELF-EMPLOYED STATUS OF A MINISTER

A minister has the dual problem of determining the appropriate employment or self-employment status for both income tax purposes and social security tax purposes. The regulations do not specifically address the employment status of a minister for income tax purposes, but rather give general guidance (not specific rules) for any taxpayer trying to distinguish between employment and self-employment status. In contrast, the regulations specifically state that a minister is self-employed for social security purposes. Thus the minister likely has a dual status. The minister is likely an employee for income tax purposes, but is certainly self-employed for social security tax purposes.[15] This section of the paper will first discuss the minister's employment status for income tax purposes and will then discuss the minister's employment status for social security purposes.

First, Treas. Reg. § 31.3401(c)-l(b) gives the normal common law definition of an employee for income tax purposes as one who is "subject to the will and control of the employer not only as to what shall be done but how it shall be done . . . . If an individual is subject to the control or direction of another merely as to the result to be accomplished by the work and not as to the means and methods for accomplishing the result, he is not an employee." Other factors to be considered are the furnishing of tools and a place to work and the right to discharge.[16]

Rev. RuL 87-41[17] gives 20 tests to determine one's employment status for income tax purposes. These tests are more specific and more restrictive

15.The social security tax levied upon the self-employed person is called the self employment tax.

[16]One could weakly argue that Congress did not intend for a minister to be treated as an employee for income tax purposes because Treas. Reg. § 313401(c)-l(g) says that "the term 'employee' includes every individual who receives a supplemental unemployment compensation benrfit which is treated under paragraph (b)(14) of Treas. Reg. 5 313401(a)-l as if it were wages."

[17]1987-1 CB. 296.

than the general rules in § 31.3401(c)-l. Many ministers could probably qualify as self-employed under § 31.3401(c)-l, but are probably employees under Rev. Rul. 87-41. Although this is another example of the Internal Revenue Service legislating by Revenue Ruling, the result is probably consistent with the normal common law outcome.

Second, I.R.C. § 1401 levies a 15.3% tax on income for social security purposes.[18] I.R.C. § 1402(c)(2)(D) defines a minister's earnings to be from self-employment and thus subject to the 15.3% tax[19]

In summary, the minister is saddled with the confusing dual status of being self-employed for social security purposes, but being an employee for income tax purposes. This result is the worst of both worlds for the minister. This taxpayer must pay the 15.3% self-employment tax instead of the 7.65% social security tax the employee pays and also only gets to itemize business deductions in excess of the 2% of adjusted gross income floor (in lieu of the standard deduction).[20] If the minister were self-employed, business items could be deducted for adjusted gross income and the standard deduction could be taken. These disadvantages for the minister because of employment status must be contrasted with the advantages of the housing allowance discussed in section 4.0 of this paper.

THE HOUSING ALLOWANCE OF A MINISTER

Treas. Reg. § 1.107-1(a) states that a minister may exclude from gross income "(1) the rental value of a home, including utilities, furnished to him as a part of his compensation, or (2) the rental allowance paid to him as part of his compensation to the extent such allowance is used by him to rent or otherwise provide a home . . . . Home means a dwelling place (including furnishings) and appurtenances thereto, such as a garage." The rental allowance is used to provide a home when expended "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." This regulation makes NO indication that the exclusion is limited to the lower of the fair rental value or the out of pocket expenses of the residence.

Some administrative rulings have further restricted the code and regulations and have effectively limited the housing allowance to the lower of fair rental value or the out of pocket expenses of the residence. First, Rev.

18.It is not strictly correct to refer to social security tax for the self-employed person. The correct reference is to the self-employment tax. Social security is used in this paper so that the self-employment tax and self-employment status will not be confused.

19.Rev. Rul. 80-110 CB. 190.

20.Note that the minister can deduct these business expenses for social security tax purposes (but not income tax purposes) under I.R.C. § 1402(a).

Rul. 71-280[21] states that when out of pocket expenditures[22] exceed their fair rental value of the home, the exclusion is limited to the fair rental value.[23] Second, if the fair rental value is larger than the out of pocket expenses, the exclusion is logically limited to out of pocket items since these are the only amounts expended.

Treas. Reg. § 1.107-l(a) raises the question of just what expenses are directly related to providing a home. The distinction that must be made is the expense of providing the home (which is excludable) vs. the expense of sustaining the members of the household (which is not excludable). Clearly, rent payments on the original mortgage of the house, and maintenance of the house are expenses of providing a home. Just as clearly, food, clothing, and personal servants are expenses of sustaining the members of the household. Although a rule for the distinction is fairly easy to write, the application is much more difficult.

There are numerous examples of the difficulty of distinguishing between expenses of providing a home and expenses of sustaining the household that could be presented. First, for example, the cost of labor to repair or maintain the home is clearly excludable, while the cost of personal servants is clearly not excludable. The treatment of lawn assistance is not so clear. One could argue that lawn assistance is maintenance of the home, but one could also argue that this assistance is closer to having a servant. Second, household cleansers used to scrub the floor are expenses to maintain the home while hand soap and shampoo are expenses of sustaining the household. Although these items are highly debatable, they are not substantial in amount when compared to mortgage payments, utilities, taxes, insurance, etc.

PLANNING OPPORTUNITIES

The analysis of the legal issues developed in this paper suggests that there are opportunities for tax planning. For example, the housing allowance

21.1971-1 CB. *9Z*

[22]A large part of the purchase price of the home in this case.

23.The rationale for this discussion is logically suspect. The first part of the argument correctly states that Congress allowed the exclusion of the housing allowance to remove the preferential treatment ministers that lived in church-provided housing received compared to ministers that provided their own housing. The second part of the argument is suspect because it states that Congress intended to limit the exclusion to the lower of fair rental value or out of pocket costs because there was no intent to create more favorable treatment for those who receive a housing allowance than those who receive a rent free home. Surely Congress could have foreseen that some ministers would receive more benefit than others and could have placed any limitation in the code if there is any desire to do so. Fred B. Marine (47 TC 609) is cited as support for this Revenue Ruling, but the case is not on point. Marine used the proceeds from the sale of a previous house to purchase a new house and thus the housing allowance was not used to "rent or otherwise provide a home." Therefore. Marine had the correct solution, but the wrong reasoning.

is an advantageous tax treatment for a minister (the amount of the allowance times the marginal tax rate), but the self-employment tax is a disadvantageous tax treatment (earnings times the additional 7.65 %). In general, the minister in this situation likely has a net disadvantage. If this is the case, the minister should intentionally fail the tests for a minister put forth in section 2.0. The net result would be that the taxpayer would lose the housing allowance exclusion, but would be treated as an employee and pay 7.65% of earnings (which the "employer" would have to match) instead of 15.3% of earnings for social security. This scenario makes the unlikely assumption that the taxpayer's compensation will not change if the "employer" has to match social security. The more likely scenario is that the "employer" will adjust the salary based upon whether social security has to be matched, and thus the taxpayer would prefer to be a minister. A non-military chaplain employed by the government is not considered to be self-employed under Treas. Reg. § 1.1402, but is eligible for the housing allowance under Treas. Reg. § 1.107. This taxpayer has the advantage of the housing allowance but avoids the disadvantage of the additional 7.65% self-employment tax. This suggests that chaplaincy is a good career path for a minister.

Business expenses present another planning opportunity for the minister. Since the minister is normally an employee for income tax purposes, business expenses such as travel are normally only deductible as itemized deductions subject to the 2% floor. As discussed previously, this normally results in the deduction being fully or partially lost. Alternatively, the minister and the employer could reduce the taxpayer s compensation by the amount of the estimated business expenses and have the employer reimburse the minister after appropriate substantiation requirements are met.[24] The result is that the taxpayer is able to fully deduct the business expenses without regard to the standard deduction or 2% of adjusted gross income limitation.[25] A minister is often expected to dress in relatively expensive clothing. Later research will probe into possible methods of obtaining clothing on a before-tax basis (this will be tough).

SUMMARY

This paper presents an analysis of the taxation of a minister. The topic is an example of an apparently simple tax issue that is quite complex when all the twists are examined. The complexities start with the definition of a minister. Treas. Reg. § 1.1402(c) gives a definition that can be put into operation, but a Revenue Ruling and a Letter Ruling proceed to restrict the

24.I.R.C. 5 274.

25.Of course one could rationally argue that the "employer" should pay all business expenses without any salary reduction.

definition. The complexities continue when the regulations define an employee for income tax purposes, but a Revenue Ruling again makes the definition more restrictive. The result is that the minister is usually treated as an employee for income tax purposes, but is always self-employed for social security tax purposes. This is the worst of both worlds for the taxpayer. Another complexity occurs when the ministerial housing allowance is computed. The code and regulations give an operational definition of the amount of excludable housing allowance, but a revenue ruling again develops a more restrictive definition.

What's a minister to do? The Internal Revenue Service could improve the situation by making administrative rulings more consistent with the code and the regulations.