



# The Parsonage Exclusion from Federal Income Tax: Everything You Need to Know

KLR Not-for-Profit Services Group  
August 2017

## Demystifying the Parsonage Exclusion from Federal Income Tax

The prospect of a tax break always piques interest – because, well - no one likes paying taxes. Many tax breaks are not widely-known, thus there are many lost opportunities for saving money. Just take the parsonage exclusion from federal income tax, for example. A minister's housing allowance (sometimes called a parsonage allowance or a rental allowance) is excludable from gross income for income tax purposes but not for self-employment tax purposes.

### Who is Eligible?

The parsonage allowance may only be provided as payment for services that are the "duties of a minister." This includes:

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

Thus, most ministers qualify, but these individuals must be ordained, licensed or commissioned. There are various situations, where a minister can claim the parsonage allowance even if the actual duties are not being performed in a house of worship.

A rabbi working in a "rabbinic" capacity at a nursing home or hospital or an ordained minister carrying out the duties as head of school for a private religious school (provided the minister's church has approved the duties of the minister at the school) are two examples of where the parsonage allowance generally would apply. If you're unsure whether you qualify, it's important to seek professional guidance before using this exclusion.

According to the IRS, if you receive as part of your salary (for services as a minister), an amount officially designated (in advance of payment) as a housing allowance, and the amount isn't more than reasonable pay for your services, you can exclude from gross income the lesser of the following amounts:

- The amount officially designated (in advance of payment) as a housing allowance;
- The amount actually used to provide or rent a home; or
- The fair market rental value of the home (including furnishings, utilities, garage, etc.).

## How do you claim?

The parsonage allowance is an estimate of how much salary the employee will use for housing expenses that year. It must be designated by the employer before the employee earns any income.

The employee estimates his or her housing expenses for the year and submits the estimation to the employer for approval. The designation must be made by 'official action' of the employer (i.e., an employment contract, in the minutes of a board of trustees' meeting, or in an employer resolution). Parsonage, like most other tax laws, follows the calendar year – January through December. Since the expenses must be pre-designated, the designation should ideally happen each December or earlier for the following calendar year. When starting a new job mid-year, the designation should occur as soon as (if not before) the employee starts working.

## What kinds of items are considered "Housing Expenses"?

Basically everything that has to do with housing. A non-exhaustive list includes various expenses in buying or owning a home such as:

- The down payment on a home and other closing costs,
- Mortgage payments including interest and principal,
- Home equity payments (so long as the loan proceeds were used for other housing expenses), real estate tax and property insurance.
- For those renting, rental payments are also considered housing expenses.
- The cost of utilities (e.g. electricity, heat, water, non-business telephone line, gas, sewer charges),
- Cost of furnishings and appliances, household goods (including dishes, cookware, linens, lawn care tools, cleaning supplies, electrical supplies), building repairs, remodeling and home improvements, yard maintenance, landscaping, pest control, snow removal, local calls on the home phone, and internet service fees.

Be mindful that some items are deemed *not* to be housing expenses like the cost to purchase food, personal toiletries, CDs, computer software, automobile costs as well as the cost for services such as housekeeping and babysitting.

From one of the examples above- the Head of School (an ordained minister) estimated in January that he would need \$50,000 in housing expenses for the year

and the school went through the process of pre-designating by official action that amount from his salary (\$150,000). The school would pay the head of school the entire \$150,000, but the head of school's W-2 would only show \$100,000. (The parsonage amount of \$50,000 may be detailed in box 14 for "other income" but this is not required.) When it comes time to report, assuming the head of school actually used \$50,000 on housing expenses during that calendar year, he will only report and pay federal income tax on \$100,000 of his salary.

### **Does the employee have to pay Social Security/Medicare tax on his income?**

It's complicated. Yes, a parsonage exclusion only applies to federal income tax (as well as any state and local taxes that base their taxable income on the employee's federal 'adjusted gross income').

*Social security taxes, however, are a different story.* The employee is required to pay social security and Medicare tax on his entire income, both the parsonage as well as the non-parsonage amounts. Unfortunately for the employee, this burden of paying it falls completely on him – all 15.3% of it.

The Tax Code classifies 'ministers' with respect to ministerial services they perform as 'dual-status employees.' For social security purposes, **ministers are considered 'self-employed.'** so they fall under the SECA system (which stands for Self-Employment Contributions Act) which requires them to pay the entire 15.3% of their salary (parsonage and non-parsonage) themselves, just like any self-employed person. The minister would also be required to make quarterly estimated payments towards the SECA obligation and report it on IRS Form 1040-ES. But, as a self-employed person, the head of school *is* allowed an adjustment (also known as an 'above-the-line deduction') on his form 1040 equal to half his self-employment tax.

Some employers may have previously paid half of the head of school's social security tax as though the head of school was an ordinary employee and now (taking into consideration the above information) have decided to no longer cover any of the head of school's SECA obligation. In this situation, it is suggested that the employer increase the head of school's salary by the 7.65% that the employer was previously paying so that the head of school is not left with a net loss.

### **Can you claim the exclusion for a summer home?**

The parsonage exclusion may only be used to exclude housing expenses incurred for one home. Should the head of school incur expenses for more than one home, such expenses may be treated as housing expenses for the parsonage exclusion (expenses incurred while living in the second home). The catch is that during that time, any housing expenses incurred in connection with the head of school's primary residence are taxable.

### **What about state and local income taxes?**

Most state and local taxes base taxable income on the 'adjusted gross income' reported on the employee's federal tax return. Parsonage is an exclusion from gross income thus it is not included in the employee's AGI. Hence, for most jurisdictions, the parsonage amounts would also be excluded from SALT.

### **If you're eligible, should you always elect to accept parsonage?**

Well, not always. Accepting parsonage may affect whether the employee would be entitled to other tax benefits, so an employee should be sure to check with a qualified tax adviser before electing to accept parsonage. This will ensure that accepting parsonage would be in his financial best interest, given the totality of the employee's specific financial circumstances.

### **Wrap up**

While parsonage allowances are not completely tax-free, they nonetheless provide a significant tax break to many families that may be eligible. In actual practice, however, it is important to keep in mind the principles outlined above and to seek guidance from a tax advisor to ensure the exclusion is applied correctly.

## ABOUT OUR FIRM

KLR is a New England Regional Public Accounting Firm that is ranked among the Top 100 firms in the United States. From its locations in Boston, Newport, Providence, Shanghai and Waltham, the 250+ person firm provides assurance, tax, and business advisory services to private and publicly-held companies throughout the United States and abroad. KLR is a member of Leading Edge Global Alliance, the 2<sup>nd</sup> largest international professional association of independently-owned accounting, financial, and business advisory firms.

\*Please note that this whitepaper is a general summary of the law and omits many important details, footnotes and caveats. It is no substitute for informed advice from a tax professional based on your particular circumstances.

This publication contains general information only and is based on the experiences and research of Kahn, Litwin, Renza & Co., Ltd. (KLR) practitioners. Any statements contained herein are not intended or written by KLR to be used, and nothing contained herein can be used, by you or any other person, for the purpose of avoiding penalties that may be imposed under federal tax law. KLR is not, by means of this publication, rendering business, financial, investment, or other professional advice or services. This publication is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified trusted advisor. KLR, its affiliates, and related entities shall not be responsible for any loss sustained by any person who relies on this publication.

Please see [www.kahnlitwin.com](http://www.kahnlitwin.com) for a detailed description of Kahn, Litwin, Renza & Co., Ltd.

Copyright © 2017 Kahn, Litwin, Renza & Co., Ltd. All rights reserved.