

CLERGY HOUSING ALLOWANCE EXPLAINED

Pastors, are you maximizing the tax benefit of housing designations?

Churches, are you assisting clergy by designating an appropriate housing allowance?

UMC LEGAL SERVICES
SUPPORT 



A pastor's housing allowance (sometimes called a parsonage allowance or a rental allowance) is excludable from gross income for income tax purposes. This article will help you understand and make the most of the housing allowance. If you received a new church assignment at this year's Annual Conference session, now is a great time to evaluate your housing expenses so that you can work with the church to designate an accurate housing allowance.

THE BASICS

WHAT: A housing allowance is designed to be a portion of clergy's compensation package that is designated by their church to provide housing. This portion of income can be excluded from gross income reported for federal income tax purposes.

REMEMBER: The housing allowance is an exclusion from income, not a deduction, and does not extend to social security taxes. To be excludable, the amount designated by the employer must be used to provide housing, including, but not limited to, expenses for the rental of a home, mortgage, furnishings, various utilities, and even some necessary home repairs. It is possible for clergy to exclude the entire cost of owning, renting, and/or furnishing a home from his or her gross income.

The amount that can be excluded is the lesser of the following:

IRS Limitations

A.

The amount designated as the housing allowance by the church or salary paying entity



Example: A church pays its pastor an annual salary of \$45,000, of which \$10,000 is designated as a housing allowance. The pastor owns his own home and determines the fair rental value of his furnished home plus projected utilities is \$12,000 per year. At the end of the year, he determines his actual housing-related expenses are \$12,000. The amount that can be excluded from gross income is \$10,000 for federal income tax purposes. This means the pastor was limited by the housing designation and missed out on \$2,000 that could have been excluded.

B.

The amount of actual housing expenses



Example: A church pays its pastor an annual salary of \$45,000, of which \$10,000 is designated as a housing allowance. The pastor owns her own home and determines the fair rental value of her furnished home plus projected utilities is \$10,000 per year. At the end of the year, she determines her actual housing-related expenses are \$8,000. The amount that can be excluded from gross income is \$8,000 for federal income tax purposes. The "unused" \$2,000 of the housing designation made must be included in the pastor's gross income. This pastor cannot exclude more than her actual housing expenses because it is the lesser amount.

C.

The fair rental value of the property (furnished, plus utilities)



Example: A church pays its pastor a salary of \$45,000, of which \$20,000 is designated as a housing allowance. The pastor owns his own home and determines the fair rental value of his furnished home plus projected utilities is \$12,000 per year. At the end of the year, he determines his actual housing-related expenses are \$15,000. The amount that can be excluded from gross income is \$12,000 for federal income tax purposes because the fair rental value of his home (furnished, including utilities) is the lesser amount.

WHAT ABOUT CHURCH OWNED PROPERTY/PARSONAGE?

- If the pastor is living in a house provided by the church, an analysis will need to be made depending on who pays for housing related expenses.
- If the pastor is responsible for housing-related expenses, such as utilities, he or she needs to determine his or her projected cost for the year so this amount can be designated as an allowance at the beginning of the year. The total exclusion at the end of the year would be the fair market value of the house (paid by the church) and the actual housing-related expenses (paid by the pastor).
- If the church pays for all housing-related expenses, including furnishings, upkeep, and utilities, the exclusion should equal fair rental value of the furnished house plus utilities.

Q. *OKAY, SO I KNOW WHAT IT IS HOW. HOW DO I ACTUALLY DETERMINE THE HOUSING ALLOWANCE?*

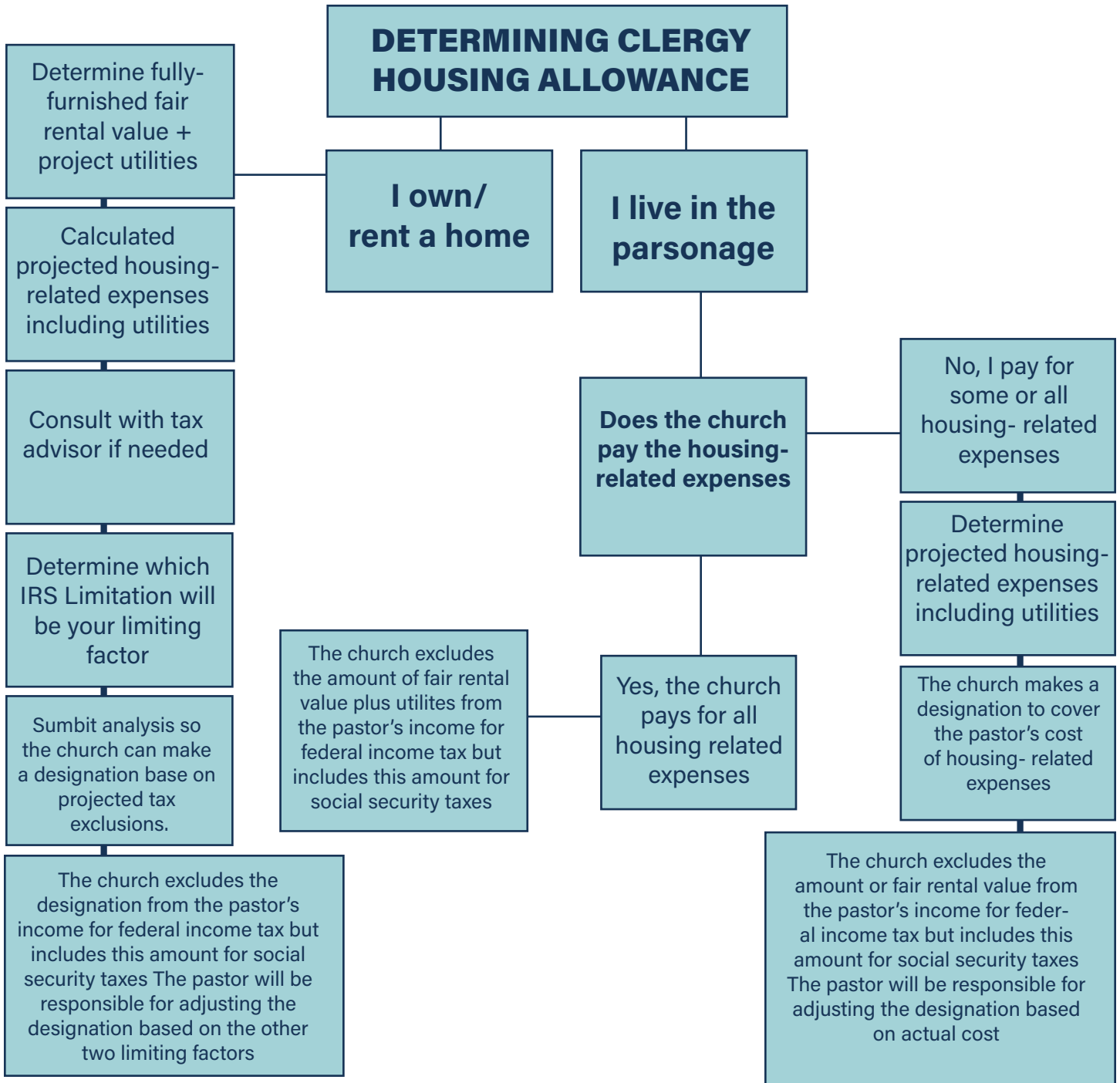
A. **Ultimately, the church and pastor should work together to determine a reasonable housing designation.**

DETERMINING HOUSING ALLOWANCE

- First, understand this. A pastor may not claim a housing allowance exclusion unless his or her local church has first established a housing allowance designation. In other words, **the designation must be made before the pastor is paid for the work.**
- Adopt a Housing Resolution. The recommended way of doing this is for the church council or charge conference to adopt a housing allowance resolution prior to each calendar year (or prior to the arrival of a new pastor) and record the resolution in the minutes of the meeting ([See the Sample Housing Allowance Resolution resource](#)). It is a good idea to have language in each resolution providing that the housing allowance will remain in effect in future years unless otherwise modified to ensure that a housing allowance will always be in place. Generally, churches should avoid designating a set percentage of compensation for housing allowance. The better approach is to estimate the anticipated expenses for the coming year and set the housing designation accordingly.
- Then, the pastor should complete a form. The pastor should complete a form estimating his or her anticipated housing-related expenses for the year. This is important because, as seen in the examples above, a difference in actual housing expenses and the designated housing allowance matters and could lead to tax consequences such as the pastor not being able to exclude as much income as he or she otherwise could or having to report additional income on his or her personal tax return.

CHURCHES:

In summary, since the exclusion from gross income cannot exceed the lesser of the designated housing allowance, the actual housing expenses, or the fair market rental value of the property plus utilities, make sure you are not limiting your pastor by capping their exclusion with the designated housing allowance set by the church. Generally, it is recommended to allow a slight buffer for higher than anticipated expenses because actual expenses could be more than projected at the end of the year. The designation made at the beginning of the year cannot be made changed.



LET'S GO OVER UTILITIES AND HOUSING EXPENSES

Understanding the types of housing-related expenses that can be included when calculating projected and actual expenses will help maximize this benefit. When utilizing the test to include what your actual home ownership expenses are (Example B in the IRS Limitations bubble above), one can include expenses such as:

- a down payment on a home,
- mortgage,
- interest on the mortgage payment,
- home equity loan payments (assuming loan proceeds are used for housing-related expenses),
- real estate taxes,
- property insurance,
- furnishings,
- appliances (including repairs),
- structural repairs (such as a new roof),
- remodeling,
- yard improvements,
- snow removal,
- maintenance items, and
- utilities.

For both B and C in the IRS Limitations bubble above you must calculate utilities. Utilities is not a term defined by the IRS and is interpreted differently among tax preparers to include a broad range of expenses but clearly includes things like electricity, water, and gas. But utilities could also include things like internet, garbage collection, cable television and streaming services, pest control, and lawn care. The IRS does exclude a few things from the definition including, the cost of food, toiletries, clothing, and maid service. If you are unsure of how to maximize this calculation, we recommend consulting with your tax advisor for guidance.



The [Housing Allowance Estimate Worksheet](#) can be used to help calculate estimated annual expenses. Also, expenses can only be included in the housing allowance for the year they are incurred (as the following example demonstrates).

Example:

In anticipation of needing to put a new roof on his house, a pastor requests, and the charge conference approves, an additional \$3,500 as part of the pastor's designated housing allowance for the upcoming year. However, the pastor waits until it is too late for the work to begin during that year. In this case, it is possible the pastor will not be able to exclude this additional \$3,500 from his income even though it was included as part of his housing allowance for the year. The pastor can only exclude expenses in the same year they are incurred. The best the pastor can do in this situation is to ask the church to again designate an additional \$3,500 as part of his housing allowance for the following year for the new roof.

WHAT HAPPENS IF THERE IS A DIFFERENCE IN YOUR ACTUAL EXPENSES AND THE DESIGNATION?

The goal is to project your housing expenses as accurately as possible for the upcoming year or at the beginning of a new appointment before making a designation.

It is possible for the designated amount and the actual amount calculated at tax return time to differ. As discussed above, the actual exclusion from gross income cannot exceed the lesser of the a) designated housing allowance, b) the actual housing expenses, or c) the fair rental value of the property plus utilities. If the amount of actual expenses is less than the designation made at the beginning of the year, the excess amount will need to be reported as income on the pastor's IRS Form 1040.

ADDITIONAL INFORMATION

The housing allowance does not result in additional cost to the church to the extent the church designates the allowance as a portion of the annual compensation it would otherwise pay to its pastor. Regardless, it is the Disciplinary obligation of every United Methodist church to provide housing for its pastor(s).

Per the Book of Discipline, par. 252.4, "housing shall not be considered as part of compensation or remuneration except to the extent provided for in denominational pension and benefit plans." This indicates that compensation and housing allowance should be treated separately.



Example: A church pays its pastor an annual salary of \$42,000, the minimum compensation rate set by its annual conference. The church also provides the pastor with a fully furnished parsonage to live with a fair rental value of \$12,000. At tax time, the church reports \$42,000 as salary on the pastor's Form W-2. However, the pastor's total compensation package, including housing, is \$54,000 (salary + housing) for benefit plans and social security taxes.

The housing allowance exclusion only applies for federal income tax purposes and does not extend to social security taxes. By law, clergy are considered self-employed for the purpose of paying social security taxes and the housing allowance and/or value of the parsonage is subject to self-employment taxes ("SECA").

For More Information

ADDITIONAL RESOURCES
[About IRS Publication 517](#)
[Housing Allowance Q&A](#)

GCFA Legal Services Department

legal@gcfa.org
www.gcfa.org



HOUSING ALLOWANCE Q&A

(FOR UNITED METHODIST CLERGY)



Table Of Contents

1. What is the housing allowance? Page 3

2. Is the housing allowance a deduction or exclusion from income? Page 3

3. What is the impact of the "Clergy Housing Allowance Clarification Act Of 2002"? Page 3

4. Can clergy exclude from gross income for federal income tax purposes the entire cost of owning, renting, and/or furnishing a home? Page 4

5. How do you determine the fair rental value of the parsonage or pastor's home? Page 5

6. What is the status of the litigation Warren V. Commissioner of Internal Revenue, which challenged the fair rental value test and raised issues regarding the constitutionality of section 107? Page 6

7. How should a pastor and church determine the amount of the housing allowance? Page 6

8. Does the housing allowance cost the church more money? Page 6

9. How is the housing allowance set up? Page 6

10. What types of housing related expenses can be included in the housing allowance? Page 7

11. What type of housing expense records should clergy should be keeping? Page 7

12. What happens if the pastor doesn't spend all of the designated housing allowance on housing expenses?	Page 8
13. If the designated housing allowance is greater than the amount that can be excluded under section 107 of the IRC, how does the church (and pastor) report the difference as gross income for federal income tax purposes?	Page 8
14. What type of records should the church be keeping regarding the pastor's housing allowance?	Page 9
15. Can the housing allowance resolution be adopted or amended mid-year?	Page 9
16. Is the housing allowance also excluded from earnings subject to social security taxes?	Page 9
17. How is the housing allowance reported for social security purposes?	Page 10
18. What is the Deason Rule?	Page 11
19. Our church provides our pastor with a parsonage, fully furnished, all utilities paid. He requests a \$12,000 housing allowance each year. We do not think this is right. What can/should we do?.....	Page 11
20. How does the housing allowance work for clergy couples?	Page 12
21. Can clergy take housing expenses on two homes at the same time?	Page 12
22. Can retired clergy receive their retirement benefits as a tax-free housing allowance?	Page 12
23. Can all church employees have a tax-free housing allowance?	Page 13
24. Does my housing allowance impact the number of contributions made to my 403 (B)-Pension Plan?	Page 13

1. What is the housing allowance?

When reporting gross income for federal income tax purposes, clergy can exclude a portion of their income designated by their church or salary paying unit as a “housing allowance” under Section 107 of the Internal Revenue Code (IRC). To be excludible, amounts designated as a housing allowance must be used to provide housing. In addition, there are limits on the amount that can be excluded. Note that a portion of the income of all wage earners is used to pay for housing. What makes the housing allowance unique is that some of the income used to provide housing can be excluded from gross income for federal income tax purposes.

Also, clergy who live in a parsonage provided by the church do not have to report the fair rental value of the parsonage as income. (Note this “free” housing provided to clergy would be taxable compensation for lay employees.)

The housing allowance is sometimes called a “parsonage allowance” for clergy who are provided with a parsonage and a “rental allowance” for clergy who rent their home.

Example: A church pays its pastor an annual salary of \$35,000. In addition, she is provided the rent-free use of a furnished home owned by the church. The parsonage’s annual fair rental value is \$10,000. The church and pastor do not have to report the \$10,000 fair rental value as income for federal income tax purposes.

2. Is the housing allowance a deduction or exclusion from income?

The housing allowance is an exclusion from income, not a deduction. This means it is not reported as part of gross income for federal income tax purposes. (It is never deducted because it is not reported as income in the first place.)

Example: In the example above, the pastor reports \$35,000 as income (on IRS Form W-2, box 1). She takes no deduction for the \$10,000 fair rental value of the home that is provided to her because that \$10,000 is never reported as income for federal income tax purposes.

3. What is the impact of the “Clergy Housing Allowance Clarification Act of 2002”?

The Clergy Housing Allowance Clarification Act of 2002 (“Act”) prospectively codifies the fair rental value limitation on the amount of a designated housing allowance that can be excluded from gross income for federal income tax purposes. That law amended Section 107 of the IRC to now read:

Sec. 107. Rental value of parsonages

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 part of his compensation, *and 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 new language added by the Act is shown in italics.)

This change is a statutory codification of the IRS's previous position on this issue and therefore, for most clergy, this is nothing new or different from the way the housing allowance has worked in the past. (The full text of the Clergy Housing Allowance Clarification Act of 2002 is included in the tax packet.)

The following question explains in more detail the three limitations on the housing allowance exclusion.

4. Can clergy exclude from gross income for federal income tax purposes the entire cost of owning, renting, and/or furnishing a home?

It depends. The amount that can be excluded is the lesser of:

- (a) the amount designated as the housing allowance
- (b) the amount of actual housing expenses, or
- (b) the fair rental value of the property (furnished, plus utilities).

Example: A church pays its pastor annual compensation of \$45,000, of which \$10,000 is designated as a housing allowance. The pastor owns his own home and the fair rental value (furnished, plus utilities) of his home is \$10,000 per year. The actual expenses of operating his home are \$10,000 per year. The church and pastor do not have to report the \$10,000 housing allowance as income for federal income tax purposes. (The church reports \$35,000 as salary on the pastor's Form W-2, box 1.)

Example: A church pays its pastor annual compensation of \$45,000, of which \$10,000 is designated as a housing allowance. The pastor owns her own home and the fair rental value (furnished, plus utilities) of her home is \$10,000 per year. The actual expenses of operating her home are \$8,000 per year. The church and pastor do not have to report \$8,000 (out of the \$10,000 housing allowance) as income for federal income tax purposes. However, the "unused" \$2,000 of the housing allowance must be included in the pastor's gross income. This is because the pastor cannot exclude more than her actual housing expenses, regardless of the amount her church designates as a housing allowance or the fair rental value (furnished, plus utilities) of the home.

Example: A church pays its pastor annual compensation of \$45,000, of which \$10,000 is designated as a housing allowance. The pastor owns his own home and the fair rental value (furnished, plus utilities) of his home is \$12,000 per year. The actual expenses of operating his home are \$10,000 per year. The church and pastor do not have to report the \$10,000 housing allowance for federal income tax purposes. The pastor cannot claim a housing allowance exclusion for the entire fair rental value (furnished, plus utilities) of the home because his designated housing allowance and actual housing expenses are less than the fair rental value. He can only exclude from income the lesser of the fair rental value (furnished, plus utilities), designated housing allowance, or actual housing expenses, in this case, \$10,000.

Example: A church pays its pastor annual compensation of \$45,000, of which \$11,000 is designated as a housing allowance. The pastor purchased her own home and the fair rental value (furnished, plus utilities) of her home is \$10,000 per year. The actual expenses of operating her home in this first year of purchase are \$30,000 which includes a \$20,000 down payment. The pastor can exclude a total of \$10,000 from income for federal income tax purposes. She cannot claim a housing allowance exclusion for all her actual housing expenses because the exclusion cannot exceed the fair rental value (furnished, plus utilities) of the home, in this case, \$10,000.

Example: A church pays its pastor annual compensation of \$45,000, of which \$8,000 is designated as a housing allowance. The pastor owns his own home and the fair rental value (furnished, plus utilities) of his home is \$10,000 per year. The actual expenses of operating his home are \$10,000 per year. The church and pastor do not have to report the \$8,000 housing allowance as income for federal income tax purposes. The pastor cannot claim a housing allowance exclusion for the entire amount of his expenses or for the entire fair rental value (furnished, plus utilities) of the home, because the exclusion cannot exceed the designated housing allowance, in this case, \$8,000.

5. How do you determine the fair rental value of the parsonage or pastor's home?

In general, the fair rental value of the property is a question of facts and circumstances based on the local real estate market. If the pastor rents his home, the amount of the rent would be presumptive evidence of the fair rental value (assuming the rental agreement was an "arm's-length" transaction). Other methods of substantiating the fair rental value might include calculations and written documentation drawn from listings with local realtors of comparable properties, verification of rent paid for comparable housing in the neighborhood, or a review of advertisements for rents of similar housing in the community. The best substantiation would be a letter estimating the fair rental value of the property written by a realtor who is familiar with your property and other rental property in your community.

6. What is the status of the litigation, Warren v. Commissioner of Internal Revenue, which challenged the fair rental value test and raised issues regarding the constitutionality of Section 107?

After passage of the Clergy Housing Allowance Clarification Act of 2002, the IRS agreed to dismiss its appeal of the case and the federal appeals court subsequently dismissed the case without ruling on any of the substantive issues raised.

7. How should a pastor and church determine the amount of the housing allowance?

Experience is the best test. If this is a “first time” situation, the Housing Allowance Estimate Worksheet, could be helpful. In addition, this worksheet can assist clergy in planning for out- of-the-ordinary housing expenditures in the upcoming year.

8. Does the housing allowance cost the church more money?

To the extent the church designates as a housing allowance a portion of the annual compensation it would otherwise pay to its pastor, designating the housing allowance results in no additional cost to the church. Regardless, it is important to remember it is the *Disciplinary* obligation of every United Methodist church to provide housing for its pastor(s). This obligation can be fulfilled either by providing a parsonage or a housing allowance for the pastor(s).

9. How is the housing allowance set up?

A pastor may not claim a housing allowance exclusion for federal income tax purposes unless her local church (or other salary paying unit) has first established or designated a housing allowance for her. The preferred way to do this is for the church council or charge conference to adopt a housing allowance resolution prior to each calendar year (or prior to the arrival of a new pastor) and record the resolution in the minutes of the meeting. However, to ensure that a housing allowance will always be in place for each calendar year, it is a good idea to have language in each resolution providing that the housing allowance will remain in effect in future years unless otherwise modified.

In determining the amount of the designated housing allowance, it can be helpful if the pastor completes a form estimating her anticipated housing expenses for the coming year. This is important because, as seen in some of the examples above, any “mismatch” between actual housing expenses and the designated housing allowance could have tax consequences (specifically, either the pastor may not be able to exclude from her income as much as she otherwise could or she has to report additional income on her personal tax return).

In general, churches should avoid designating a set percentage of compensation as a housing allowance. The better approach is to estimate the anticipated expenses for the coming year and set the housing allowance accordingly. This approach minimizes the unfavorable tax consequences discussed above.

If the church provides the pastor with a parsonage, the church should annually (or prior to the arrival of a new pastor) adopt a resolution stating that it provides its pastor rent-free use of a church-owned parsonage and designate the amount of the parsonage allowance (if any).

10. What types of housing related expenses can be included in the housing allowance?

Most reasonable household expenses can be included in the housing allowance, for example: down payment on a home, mortgage payments (including both interest and principal), home equity loan payments (assuming the loan proceeds are used for housing-related expenses), real estate taxes, property insurance, utilities, furnishings and appliances (including repairs), structural repairs, remodeling, yard maintenance and improvements, pest control, snow removal, maintenance items, and trash pickup. Note that the cost of food and servants may not be included in the housing allowance. Also, housing-related expenses can only be included in the housing allowance for the year in which they are incurred. (See the following example.)

Example: In anticipation of needing to put a new roof on his house, a pastor requests, and the charge conference approves, an additional \$3,500 as part of the pastor's designated housing allowance for the upcoming year. The pastor, however, waits until it is too late for the work to begin during that year. In that case, it is possible the pastor will not be able to exclude this additional \$3,500 from his income even though it was included as part of his housing allowance for the year. In short, the pastor can only exclude expenses in the same year they are incurred. The best the pastor can do in this situation is to ask the church to again designate an additional \$3,500 as part of his housing allowance for the following year and try to get the work done in that year.

11. What type of housing expense records should clergy be keeping?

Clergy need to keep careful housing expense records to determine whether any part of the designated housing allowance is unexcludible and hence, must be reported as gross income. Records are also important for estimating a reasonable housing allowance for the next year. Original receipts, invoices, canceled checks, credit card records, etc. are all essential. Clergy may find it helpful to have one credit card dedicated solely to household expenses, to use the "shoe box" method of collecting all receipts in one handy place, and/or to have a dedicated bank account for this purpose. Clergy may also wish to create a contemporaneous log of expenses in the event some of the receipts or back up data are misplaced or difficult to interpret later.

12. What happens if the pastor doesn't spend all of the designated housing allowance on housing expenses?

As noted above, the exclusion from gross income cannot exceed the lesser of the designated housing allowance, the actual housing expenses, or the fair rental value of the property (furnished, plus utilities). In particular, the exclusion from gross income can never exceed the actual housing expenses. Therefore, any "unused" portion of the designated housing allowance must be included in the pastor's gross income.

In general, any portion of the designated housing allowance that is not excludible because it is more than either the actual housing expenses or the fair rental value of the property, must include in the pastor's gross income.

Example: A church pays its pastor annual compensation of \$40,000, of which \$12,000 is designated as a housing allowance. The pastor owns his own home, and the fair rental value of his home is \$12,000 per year. The actual expenses of operating his home are \$10,000 per year. The church and the pastor do not have to report \$10,000 (out of the \$12,000 housing allowance) as income for federal income tax purposes. However, the \$2,000 "unused" portion of the housing allowance must be included in the pastor's gross income.

13. If the designated housing allowance is greater than the amount that can be excluded under Section 107 of the IRC, how does the church (and pastor) report the difference as gross income for federal income tax purposes?

The local church treasurer reports on the pastor's Form W-2 (box 1) the total amount of compensation paid to the pastor during the year less the entire amount designated as a housing allowance. If the amount designated as a housing allowance is greater than the actual housing expenses or the fair rental value of the home, then it is the pastor's responsibility to report the difference as "other income" on the pastor's IRS Form 1040.

Example: A church pays its pastor annual compensation of \$45,000, of which \$12,000 is designated as a housing allowance. She owns her own home, and the fair rental value of the home is \$12,000 per year. The pastor had only \$11,500 of housing-related expenses in the prior year. Under the estimated exclusion method, the church treasurer reports \$33,000 on the pastor's Form W-2, box 1 and the pastor reports the "excess" \$500 as income on her Form 1040.

Also note that the church may, but is not required to, report in box 14 of Form W-2 the amount of the designated housing allowance it did not include in the pastor's gross income. If the church does not fill in box 14 of Form W-2, it should independently inform the pastor of this amount. As discussed above, it is essential for the pastor to know this amount when computing her federal income taxes and when computing his self-employment taxes (see below).

14. What type of records should the church be keeping regarding the pastor's housing allowance?

The church (or other salary-paying unit) should maintain copies of the documents pertaining to the designation of the housing allowance, for example, the minutes of the meeting during which the housing allowance resolution was adopted. It is advisable for the church to maintain a separate housing allowance file with copies of these minutes, the annual housing expense estimate that some pastors provide to their churches, and any other related documentation.

15. Can the housing allowance resolution be adopted or amended mid-year?

Yes. The housing allowance resolution can be adopted or amended at any time. However, it can only be applied prospectively. That is why it is important for the housing allowance resolution to be adopted by the church council or annual charge conference prior to each new calendar year (or prior to the arrival of a new pastor) and for pastors to accurately estimate their housing expenses in advance.

Example: A local church waits until June 30 to establish its calendar year housing allowance of \$10,000. In that case, at most \$5,000 of the \$10,000 housing allowance can be excluded from the pastor's gross income in that calendar year.

Example: A pastor realizes in March that she has significantly underestimated her housing expenses for the year. There is still "room" under the fair rental value test to exclude her anticipated housing expenses, but she is limited by the amount of her designated housing allowance. Therefore, at her request, the church council adopts a resolution, effective April 1, increasing the pastor's housing allowance from \$10,000 to \$12,400. However, the pastor may only exclude from gross income 3/4, or \$1,800, of the extra \$2,400 added to her housing allowance (that is, her maximum excludible housing allowance for the year is \$11,800). She cannot exclude 1/4, or \$600, of the extra amount because 1/4 of the year (January, February, and March) has already passed before the amended housing allowance resolution was adopted by the church council.

16. Is the housing allowance also excluded from earnings subject to social security taxes?

No. The housing allowance exclusion only applies for federal income tax purposes. Like most everyone else, clergy must pay both federal income taxes and social security taxes. Employees pay social security taxes through the Federal Insurance Contributions Act ("FICA") system and self-employed individuals pay social security taxes through the Self-Employment Contributions Act ("SECA") system. By law, clergy are considered self-employed for the purposes of paying social security taxes (more

commonly referred to as self-employment taxes) and the housing allowance is subject to self-employment taxes. Also, the fair rental value of a parsonage provided to a pastor (including the cost of any utilities and furnishings provided) must be included as self-employment earnings subject to the self-employment tax. (See IRS Publication 517).

Example: A church pays its pastor an annual salary of \$35,000 and provides her with the use of a church-owned parsonage. The church pays for all expenses of maintaining the home. The fair rental value of the parsonage (furnished, plus utilities) is \$10,000 per year. The pastor's gross income for federal income tax purposes is \$35,000, but for self-employment tax purposes her gross earnings are \$45,000 (\$35,000 salary + \$10,000 fair rental value of the parsonage).

Example: A church pays its pastor an annual salary of \$35,000 and provides him with the use of a church-owned parsonage. The church pays for all expenses of maintaining the home. The church serves an affluent community where the average price of a home is \$500,000. Hence, the fair rental value of the parsonage (furnished, plus utilities) is quite high, in this case, \$30,000 per year. While the pastor will not have to report the fair rental value of the parsonage as income for federal income tax purposes, he will have to include the \$30,000 fair rental value of the parsonage as gross earnings for self-employment (social security) tax purposes, inflating his reportable earnings to \$65,000.

This often seems unfair to pastors, who in this type of situation are required to produce a sizeable amount of money to pay the self-employment tax. However, it is important to keep in mind that the pastor is still receiving a significant income tax "break," because he received a \$30,000 benefit (i.e., free housing) that is not reported as income for federal income tax purposes. But some churches do establish a (taxable) "social security allowance," increasing the cash compensation of the pastor to help defray the extra cost of the self-employment tax in this type of situation.

Example: A church pays its pastor annual compensation of \$45,000, of which \$10,000 is designated as a housing allowance. The pastor owns her own home, and the fair rental value of her home is \$10,000 per year. The actual expenses of operating her home are \$10,000 per year. The church and the pastor report \$35,000 as income for federal income tax purposes (the \$10,000 housing allowance is not reported). However, the pastor must report the entire amount of her compensation, \$45,000, as gross earnings for self-employment (social security) tax purposes.

17. How is the housing allowance reported for social security purposes?

It is reported by the pastor on Schedule SE of Form 1040, together with salary. It is important to note that when the local church completes the annual W-2 Form for clergy, Box 3 should be left blank (for clergy only). Box 3 on the W-2 Form is used only to report FICA wages, not SECA wages (clergy wages are considered SECA wages for purposes of social security). See above and the example W-2 for further information. IRS Publications 517 and 525 are also useful on these points.

18. What is the Deason rule?

It is an interpretation of the Internal Revenue Code followed by the IRS based on a tax case going back to 1964 and reaffirmed by the U.S. Tax Court in a subsequent decision in 1988, and in a tax court decision in 1992 (see Deason v. Commissioner, 41 T.C. 465 (1964); Dalan v. Commissioner, T.C. Memo. 1988-106; and McFarland v. Commissioner, T.C. Memo. 1992-440). The rule applies only to clergy who can take a business expense deduction for unreimbursed business expenses, which is becoming increasingly uncommon for United Methodist clergy. The rule provides that a clergy person who claims an exclusion from gross income for the housing allowance must reduce their business expense deduction by the percentage of income that is excluded from income tax reporting for the housing allowance.

Example: A clergy person receives a salary of \$36,000, plus a housing allowance of \$18,000. He has unreimbursed business expenses of \$6,000, which, for purposes of this example, are assumed to be deductible. His total "ministry" income is \$54,000 (\$36,000 plus \$18,000 housing allowance). The exempt portion of his income (the \$18,000 housing allowance) is 33.33% of the total. Thus, he is only able to deduct 66.66% of the \$6,000 in deductible business expenses (\$4,000).

19. Our church provides our pastor with a parsonage, fully furnished, all utilities paid. He requests a \$12,000 housing allowance each year. We do not think this is right. What can/should we do?

The church PPR/SPRC chair and/or the treasurer should sit down with the pastor to discuss what items and expenses are part of the \$12,000 housing allowance request. The church should also be familiar with the fair rental value of a fully furnished (with all utilities paid) comparable house in the area. With this information as background, the church can then evaluate whether the \$12,000 request is truly a problem. If it is, then the church treasurer and chair of the staff pastor/parish relations committee should discuss with the pastor the church's concerns, reviewing the estimated expenses the pastor will be making and the IRS rules regarding the fair rental value and other limitations on what can be excluded from gross income as a housing allowance. The pastor may have misunderstood the IRS rules or may have a logical explanation and reporting position for the housing allowance. If, after this meeting, the church is still concerned and the matter has not been resolved, then the chair of the SPRC and treasurer may want to involve the district superintendent in a follow-up meeting.

Ultimately, it is up to the charge conference to approve the housing allowance resolution each year, and the church is certainly not required to approve a resolution in the amount requested by the pastor, if it believes in good conscience based on accurate factual information that the amount requested by the pastor is significantly too high.

20. How does the housing allowance work for clergy couples?

Each clergy person can claim a housing allowance exclusion (assuming the appropriate steps have been taken with a housing allowance resolution), but the combined total amount of the exclusion may not exceed the fair rental value of their home or the actual expenses, whichever is less. In some circumstances, because of the nature of the United Methodist polity on itinerancy, each of the two clergy persons may live in separate homes and be provided with separate housing allowances **(for example: appointments in two separate locations, each with a parsonage, and with each salary paying unit requesting that the clergy person live in the parsonage)**. In these situations, the clergy couple should have a solid reporting position that the two housing allowances may be excluded from gross income for federal income tax purposes. The reporting position will be more tenable if the clergy couple has good documentation of the reasons for and professional necessity of maintaining two separate homes, and if the amounts claimed on their face for each home are reasonable.

21. Can clergy take housing expenses on two homes at the same time?

No. The housing allowance exclusion is limited to one home at a time. *(Except possibly for the clergy couple exception discussed above)*

Example: If the clergy person is building or has acquired a retirement home or vacation home, and still lives in the parsonage as his or her main home, then none of the expenses of the second home are includable for housing allowance purposes.

22. Can retired clergy receive their retirement benefits as a tax-free housing allowance?

Yes, subject to the three limitations set forth above. Each year the annual conference (or general agency or other United Methodist entity) needs to adopt a housing allowance resolution stating that all the pension payments received by the clergy person from the General Board of Pension and Health Benefits qualify as a housing allowance for retired clergy. Retired clergy can receive up to 100% of their official United Methodist retirement benefits from the General Board of Pension & Health Benefits as a tax-free housing allowance (subject to the limitations set forth above).

23. Can all church employees have a tax-free housing allowance?

No. Section 107 of the IRC allows only a “minister of the gospel” to have a housing allowance. Thus, only taxpayers who are serving as clergy under IRS rules for tax purposes are eligible for a housing allowance. **For example, a church custodian or secretary cannot have a housing allowance.** (Of course, such staff as lay employees do get the benefit of having the church pay one half their social security). United Methodist elders in full connection appointed to serve at the local church are “ministers of the gospel” and are eligible for a housing allowance, as are appointed local pastors. Many deacons appointed to the local church also will be eligible for a housing allowance (see the separate Q&As on the clergy status of United Methodist deacons elsewhere in this tax packet). separate Q&As on the clergy status of United Methodist deacons elsewhere in this tax packet).

24. Does my housing allowance impact the number of contributions made to my 403(b) pension plan?

Yes, there could be an impact since the income designated as a housing allowance is **not** part of the “includible compensation” for certain contribution limitations established by IRS rules. Therefore, while the new tax law changes generally increase previous limitations, clergy still need to be mindful of 403(b) contribution rules when part of their salary is designated as housing allowance.

The General Council on Finance and Administration is not engaged in providing legal or accounting services. The service of a competent professional should be sought for legal and tax advice.

[Please see IRS Publication 517 for more information](#)

**For More
Information**

GCFA Legal Services Department
615-329-3393
legal@gcfa.org
www.gcfa.org



SAMPLE HOUSING ALLOWANCE RESOLUTION

(To be inserted in the minutes)

The chairperson informed the meeting that under the tax law, a minister of the gospel is allowed to exclude from gross income: (1) the rental value of a home furnished to him or her as part of his or her compensation; or (2) a housing allowance paid to him or her as part of his or her compensation, to the extent used by him or her 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 (charge conference or church council) on the _____ day of _____, after discussing the amount to be paid to Rev. _____ as a housing allowance, on motion duly made and seconded, adopted the following resolution:

Rev. _____ shall receive salary of \$ _____ for the year. Rev. shall also receive a housing allowance of \$ _____ for the year _____ and all future years unless otherwise provided.

(If the clergy person is to have rent-free use of a home, also state: "Rev. _____ shall also have rent-free use of the home located at _____ for the year _____ and for every year thereafter so long as he/she is minister of the _____ United Methodist Church unless otherwise provided.")

The housing allowance (and/or rent-free use of a home) shall be so designated in the official church records.

**For More
Information**

GCFA Legal Services Department
[615-329-3393](tel:615-329-3393)
legal@gcfa.org
www.gcfa.org



LEGAL
SERVICES



SAMPLE HOUSING ALLOWANCE NOTIFICATION BY THE CHURCH

Date _____

Dear _____:

This is to notify you of the action taken establishing your housing allowance at a meeting held on _____. A copy of the Resolution is attached.

Under Section 107 of the Internal Revenue Code, a minister of the gospel is allowed to exclude from gross income (1) the rental value of a home furnished to him or her as part of his or her compensation; or (2) a housing allowance paid to him or her as part of his or her compensation, to the extent used by him or her 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.

You should keep an accurate record of your expenditures to rent or provide a home in order to be able to substantiate any amounts excluded from gross income when filing your federal income tax return. In the event of an audit, clergy receiving a housing allowance will have the responsibility of substantiating the use of such funds. Also, remember that the housing allowance (including the fair rental value of a provided parsonage) must be included as part of your earnings for self-employment tax purposes.

Sincerely yours,

Name
Title

Attachment



**For More
Information**

GCFA Legal Services Department
[615-329-3393](tel:615-329-3393)
legal@gcfa.org
www.gcfa.org





HOUSING ALLOWANCE ESTIMATE WORKSHEET

EXPENSE ITEM

ESTIMATE

- utilities (ex: electricity, heat, water, trash pickup, and local telephone) \$ _____
- furniture and appliances (purchases and repair) \$ _____
- building repairs and remodeling \$ _____
- property insurance \$ _____
- yard maintenance, landscaping and improvements \$ _____
- maintenance items (cleaning and maintenance supplies, electrical supplies) \$ _____
- miscellaneous \$ _____

FOR OWNERS

- real estate taxes \$ _____
- mortgage payments/down payment \$ _____
- improvements \$ _____

FOR RENTERS

- rent payments \$ _____

TOTAL \$ _____



**For More
Information**

GCFA Legal Services Department
615-329-3393
legal@gcfa.org
www.gcfa.org

