



B.O.P. Memo #3

## Tax and Reporting Procedures for Congregations

This memo is written as a help guide for the Church of God

The tax and reporting requirements with which churches must comply often seem to complicate the task of the local church treasurer. Many treasurers who volunteer their services to the church feel the special tax treatment of ministers adds another level of complexity to an already time-consuming task. Following is an overview of many of the basic federal tax and reporting issues.

This federal tax information is only a guide to help local churches with the legal requirements of being an employer. It is intended to provide some resources for further investigation. No attempt has been made to cover state and local income taxes or Workers' Compensation which would differ for each local church. Federal Unemployment Tax is not discussed either. Churches are generally exempt from this tax.

### Classification of Employees

Since legal and tax obligations of the church board as employer differ for the lay and ministerial employee, it is important that the classification of each employee is determined accurately. One of the most significant differences in the tax treatment of lay and ministerial employees relates to Social Security/Medicare tax. Lay employees are always subject to the Federal Insurance Contributions Act (FICA) type of Social Security/Medicare tax. Conversely, ministerial employees are always subject to the Self-Employment Contributions Act (SECA) type of Social Security/Medicare tax.

The church may have employees who are considered to perform ministerial duties by the church board, but who are actually lay employees by IRS definition. Most churches will have at least one employee, the pastor. This is usually a **ministerial employee**, since most pastors are either ordained or licensed ministers. If a pastor holds a local minister's license, this person's tax status with the IRS is that of a lay employee.

Staff associates who are ordained or licensed ministers are generally ministerial employees as long as they are performing ministerial functions as outlined in MEMO #9 "Who is a Minister for Tax Purposes?". Other employees (e.g., secretaries and custodians) are **lay employees** even if ordained or licensed ministers.

The following classification summary may be helpful:

#### **Self-employed:**

Itinerant evangelists and song evangelists who are *not* incorporated

#### **Employees:**

##### Ministerial:

- Pastor who is an ordained or licensed minister
- Staff member who is an ordained or licensed minister and who is performing ministerial or administrative duties

## Lay:

- Pastor who is not ordained or licensed
- Church secretaries and church custodians
- Staff members who are not ordained or licensed ministers

These distinctions may not be consistent with the way the role of the individual is seen in the local church. However, they are important to understand because they are based on IRS guidelines.

## **The Ministerial Employee**

Each year, the church should issue Form W-2 to each of its employees including all ministerial employees. However, the issuance of Form W-2 *does not* affect how a ministerial employee pays income tax and Social Security/Medicare tax (SECA) (using the self-employment tax rate) to the IRS.

A minister can make estimated quarterly tax payments to the IRS (Form 1040-ES). Or, the minister and the local church may enter into a *voluntary* arrangement whereby the church withholds federal (and possibly state and local) income taxes. (The local church has no obligation to withhold federal income tax from the ministerial employee. However, each church will need to check the applicable rules regarding withholding state and local income taxes.)

If the church withholds income taxes under a voluntary arrangement, the income tax withheld must be remitted to the IRS on at least a quarterly basis. Quarterly payroll tax returns (Form 941) must also be filed. Ministers should have a thorough understanding of this process before entering into a voluntary withholding agreement. Your local tax consultant can help.

Any "allowance" given by the local church for the minister's SECA tax liability must be reported as taxable income on Form W-2 (Box 1). Furthermore, it is also taxable for Social Security (SECA) purposes when the ministerial employee files Schedule SE with the yearly income tax return.

## **The Lay Employee**

Upon hiring a lay employee, the church becomes obligated to withhold federal (and state and local as applicable) income tax and Social Security/Medicare tax (FICA) from the employee's salary and to report that salary and withholding to the IRS and to the individual. Failure to withhold and report can result in penalties and serious problems which should be carefully avoided. Obligations, procedures, and tables for withholding federal income tax and Social Security/Medicare tax (FICA) are in IRS Publication 15 "Circular E--Employer's Tax Guide" (available from [www.irs.gov](http://www.irs.gov) or by calling 800-TAX-FORM).

ALL lay employees (both full-time and part-time) are automatically covered by Social Security/Medicare under the FICA plan. This requires withholding one-half of the taxes from the employee, paying a matching amount from the employer's own funds, remitting the funds to the proper depository institution, and reporting this total to the IRS on Form 941 each quarter.

## **The Employer Identification Number**

Your congregation is required to report employment taxes (federal income taxes and Social Security/Medicare taxes withheld) and give Form W-2 to employees, including the minister, whether or not taxes are withheld. Your church should already have a federal Employer Identification Number (EIN) and, in some states, a state identification number. Your congregation must use the EIN on all items sent to the IRS.

If your church does not have a number, contact Church of God Ministries for instructions in securing this number. Form SS-4, used to request the federal EIN, can be secured from the IRS ([www.irs.gov](http://www.irs.gov) or by calling 800-TAX-FORM). The absence of the appropriate identification number may cause unnecessary and improper reporting of amounts withheld for income and/or Social Security/Medicare taxes. It might also cause unnecessary scrutiny of an employee's tax records for previous years.

If your church has an EIN, but is not receiving quarterly and annual payroll tax forms, call the IRS, provide them with your EIN, state that you now have a requirement to file tax returns, and ask them to provide you with a copy of IRS Publication 15 "Circular E--Employer's Tax Guide" and the necessary reporting forms.

## **What is Taxable for Federal Income Tax Purposes?**

**For the ministerial employee**, taxable income consists of cash salary paid as compensation, any cash bonuses or "love offerings," automobile or other "allowances" (if not paid under an "accountable reimbursement plan"), Social Security/Medicare tax "allowances," and taxable fringe benefits.

It does not include:

- properly designated housing allowance or the fair market rental value of a church-owned parsonage
- tax-sheltered annuity contributions
- business and professional expense reimbursements (e.g., business-related transportation/travel, meals, books, dues, office supplies, etc.), provided such reimbursements are paid under an "accountable reimbursement plan"
- any other tax-free benefits allowed by the IRS such as health and dental insurance when premiums are paid or reimbursed by the church

Also, not included are reimbursements made under a formal health reimbursement arrangement (HRA), a formal healthcare flexible spending account (FSA), or contributions made to a formal health savings account (HSA). (See MEMO #11 "Health Reimbursement Arrangements.") Subject to certain housing allowance limitations, the greatest exclusion for the ministerial employee is the value of housing and utilities provided, or the cash compensation designated as housing allowance and which is used for that purpose.

**For the lay employee**, taxable income consists of cash salary paid as compensation, any cash bonuses or "love offerings," automobile or other "allowances" (if not paid under an "accountable reimbursement plan"), Social Security/Medicare tax "allowances," taxable fringe benefits, and housing.

It does not include:

- tax-sheltered annuity contributions
- business and professional expense reimbursements (e.g., business-related transportation/travel, meals, books, dues, office supplies, etc.), provided such reimbursements are paid under an "accountable reimbursement plan"
- any other tax-free benefits allowed by the IRS such as health and dental insurance when premiums are paid or reimbursed by the church

Also, not included are reimbursements made under a formal health reimbursement arrangement (HRA), a formal healthcare flexible spending account (FSA), or contributions made to a formal health savings account (HSA). The cash housing allowance or the fair market rental value of housing provided and utilities must be reported as taxable income for lay employees. Only ordained or licensed ministers

performing ministerial or administrative duties may claim the housing exclusion provided by Section 107 of the Internal Revenue Code. (See MEMO #10 "The Minister's Housing Allowance.")

## **Business Expense Reimbursements**

Requirements for business expense reimbursements are based on IRS Regulation 1.62-2(d)(3). These requirements apply to every church and affect all employees. They are not optional - they must be followed, or the church employee may pay significantly greater amounts of unnecessary taxes.

The IRS regulations require that business reimbursements be included on Form W-2 as taxable income to the individual unless paid through an "accountable reimbursement plan" which has been "formally" adopted by the church board. The requirements for the accountable reimbursement plan are three-fold: 1) The church may reimburse only those business expenses that an employee substantiates within 60 days of the expenditure with receipts and/or in writing as to the date, amount, place, and business nature. 2) The employee must return any "excess" reimbursements (i.e., unused expense advances) within 120 days of the expenditure. The excess reimbursement may not be treated as a bonus or gift. 3) Any advance must be made within 30 days of when the expense is paid or incurred.

Form W-2 income cannot simply be reduced "after the fact." In other words, the IRS will not allow the reimbursements to be paid through a retroactive reduction of salary. In order for reimbursements to be paid and qualify under an accountable reimbursement plan, properly substantiated expense reimbursements must be paid separately from the employee's salary. The salary amount and the accountable reimbursement plan must be established in advance of payment. If the church establishes a dollar limit on the expense plan (instead of reimbursing 100% of expenses), any balance remaining in the expense plan at year-end must remain with the church to avoid negative tax consequences. The payment of the balance to the employee makes all payments made to the employee under the plan during the year reportable as taxable income on Form W-2.

## **Income Tax Withholding**

**For the ministerial employee**, federal (and possibly state and local) income tax may be withheld if the minister and the church enter into a voluntary arrangement. Otherwise, the ministerial employee generally will need to file and pay estimated tax (Form 1040-ES) to cover federal income tax and Social Security/Medicare tax (SECA) obligations. For married couples filing a joint return, the minister's spouse could choose to have additional income tax withholding from his or her pay to cover the total liability for the couple. Even if a voluntary withholding arrangement is used, *FICA taxes should never be withheld from a minister.*

**For the lay employee** (both full-time and part-time), the employer **MUST** withhold income tax according to the provisions of the tax law. There are fines and penalties for failing to comply. The employer must secure Form W-4 on which the employee claims any exemptions for self and dependents. The amount withheld is then determined by using the charts provided by the IRS in Publication 15 "Circular E-- Employer's Tax Guide." Care must be taken with lay employees to withhold on all taxable income, including a cash housing allowance or the value of housing and utilities provided.

## **Social Security/Medicare Tax Withholding**

**For the ministerial employee**, the church should never withhold for Social Security/Medicare (FICA) taxes as it does for lay employees. The law provides that payment be made directly by the ministerial employee as if self-employed. The tax is based on the current self-employment rates. This rate must be applied on taxable income (i.e., salary, cash bonuses or "love offerings," automobile or other "allowances," Social Security/Medicare tax "allowances," taxable fringe benefits) and housing allowance (whether a cash allowance or the fair market rental value of housing and utilities provided).

**For the lay employee,** Social Security laws state that ALL lay employees (both full-time and part-time) are covered automatically by Social Security/Medicare tax withholding rules under FICA. Therefore, all church employers MUST withhold FICA at the current employee rates from the lay employee's wages that are subject to Social Security/Medicare taxes (including any "salary reduction" contributions) and pay a matching amount from their own church funds. The total is then paid to the government for the individual. Many churches may want to give an allowance to the lay employee equal to the full amount withheld. Such an allowance becomes taxable income similar to allowances paid to ministers (see previous paragraph).

## **Form W-4**

All employees, whether part-time or full-time, should complete a Form W-4 "Employee's Withholding Allowance Certificate." That form reports the number of withholding allowances requested by the employee and is the basis upon which the amount of federal income tax to be withheld is determined. Unless an employee is exempt from federal income tax withholding, a Form W-4 remains valid until a new one is filled out. All W-4 Forms are retained by the employer. However, W-4 Forms remain subject to review by the IRS, but employers need to submit them only when directed to do so by the IRS.

You should keep on file your minister's Form W-4 noting that no federal taxes are to be withheld pursuant to Section 3401(a)(9) of the Internal Revenue Code which specifically exempts a minister's wages from income tax withholding. Of course, if the minister and church have agreed to voluntary withholding of income taxes (not Social Security-FICA taxes), then the Form W-4 should indicate the correct number of withholding allowances and any amount of extra withholding requested.

Employees who had no income tax liability in the previous year, and do not expect to pay a tax in the current year, may request that no income taxes be withheld in the current year by completing the appropriate lines on Form W-4. (Note: some exceptions apply.)

On another line of Form W-4, employees may request that additional federal income tax be withheld. If your minister elects to have income taxes withheld and desires additional income tax to be withheld in order to cover the personal obligation of the Social Security/Medicare (SECA) tax payment (which must be paid at the self-employment rate), that amount should be shown on the proper line.

## **Deposit of Withheld Amounts**

Taxes deducted from wages are to be segregated into separate accounts in the treasurer's bookkeeping system. There are very specific instructions on the frequency of depositing these funds. IRS Publication 15 "Circular E--Employer's Tax Guide" explains this process in detail. Deposits must be made properly and on a timely basis to avoid late penalties. Each quarter, Form 941 must be filed to report the amounts withheld to IRS.

## **Form 941**

You should receive Form 941 automatically each quarter from the IRS. These forms are to be used to report the taxes your congregation has withheld and which are owed for each quarter. This form is used to report both federal income taxes and FICA taxes withheld.

By the last day of the month following the end of each quarter, Form 941 must be filed. There are penalties for not doing so. You may wish to file the form even if no taxes are withheld. There is no requirement to file when no tax is withheld.

As soon as you owe more than \$2,500 for employment taxes (withholding of federal income and FICA taxes, as well as the employer's FICA taxes), your congregation must pay that money by the method

required by the IRS. (You should automatically receive instructions for making those payments along with a supply of IRS computer-readable forms unless you must use an electronic payment process.) All federal employment taxes due must be paid at least quarterly and more frequent deposits may be required.

**Here are a few of the items you will report on Form 941:**

**On line 2,** report total of all wages paid and any other compensation paid by the employer, whether or not the employer is required to withhold federal income tax or Social Security tax. Therefore, this line includes the minister's salary.

**On line 3,** report total federal income tax withheld from wages. (If you wish, you may indicate in the lower margin of the form the number of ministerial employees included on line 1 and their compensation you had to include on line 2 which is "not subject to withholding pursuant to IRC Section 3401(a)(9)".)

**On lines 5a and 5c,** report the appropriate totals for applicable FICA wages paid and Medicare wages paid (these may not be the same amounts as reported on line 2) and the amount of tax due on those wages (employee and employer taxes). Since your ministerial employees are not subject to FICA and Medicare withholdings, do not include their compensation in these totals.

**On line 10,** report total taxes. This will include withheld taxes and the taxes due from the employer for both FICA and Medicare.

**On line 11,** report any deposits made for accumulated withholdings. A record of tax liability (not deposits) for each month of the quarter is also required on line 15. Upon filing Form 941, any taxes still due must be paid.

## **Form W-2**

If your congregation does not receive a supply of employment tax forms before the end of the year, you will want to request them by calling the IRS (800-TAX-FORM). By January 31, each employee must be given Form W-2 reporting wages paid during the preceding tax year.

The IRS, in publication 517, has indicated clearly for a number of years that the church employer should provide the minister with a Form W-2 at the end of the tax year. This is true even though there may have been no withholding for federal income tax due to the exemption and even though the minister's wages are not subject to withholding for Social Security/Medicare tax (FICA).

The lay employee must also receive Form W-2 from the church. Since the employer is required to withhold for federal income tax and any applicable Social Security/Medicare taxes, the treasurer can determine the amount withheld and the amount of taxable wages from the accounting records. Taxable wages must include cash housing allowance and the value of any housing or utilities provided.

Form W-2 requires the employer's name, address, ZIP code, and Employer Identification Number (EIN), as well as the employee's name, address, ZIP code, and Social Security number. In Box 1, show wages paid. In Box 2, show any federal income tax withheld. Boxes 3, 4, 5, and 6 are completed with dollar amounts only for lay employees. (For ministers, Boxes 3, 4, 5, and 6 should be left blank.) The following statements give general guidelines that apply to the minister's Form W-2 and the lay employee's Form W-2. Specific instructions can be secured from any local IRS office, their website [www.irs.gov](http://www.irs.gov), or by calling 800-TAX-FORM.

**On the minister's Form W-2,** report salary (cash and noncash) paid in Box 1. Include any Social Security allowance; automobile or other "allowances" (if not paid under an "accountable reimbursement plan"); taxable fringe benefits; and church-paid "love offerings." Exclude any auto or other business reimbursements which have been paid through an accountable reimbursement plan; contributions to a 403(b) retirement plan; and any designated housing allowance or the value of any housing or utilities provided. If federal income tax has been withheld from a minister's wages, fill in Box 2; otherwise leave it blank. Leave Boxes 3, 4, 5, and 6 blank.

**On the lay employee's Form W-2,** report salary (cash and noncash) paid in Box 1 just as you did for the minister, but also include any housing allowance. (The *cash* housing allowance *or* the fair market rental *value* of a parsonage and utilities must be reported as taxable income for lay employees. Only ordained ministers serving in a ministerial capacity can exclude it from income taxes.) Automobile and other business reimbursements paid through an accountable reimbursement plan are excluded from Boxes 1, 3, and 5. All 403(b) retirement plan contributions are excluded from Box 1; however, only employer-paid contributions over and above salary are excluded from Social Security/Medicare wages, Boxes 3 and 5. Voluntary salary reduction 403(b) contributions are included in Boxes 3 and 5 and tax withheld must be reported on these funds, Boxes 4 and 6.

**Box 12-** Follow the Form W-2 instructions carefully. Any entry made should be carefully entered and labeled according to IRS codes provided in your Form W-2 instructions to avoid confusion in reporting these amounts. If more than four items need to be reported in Box 12, use a separate Form W-2. The following items may need to be considered when completing Box 12.

Group Term Life Insurance- If the church employer pays for more than an aggregate of \$50,000 of group term life insurance for an employee, the cost of the coverage over \$50,000 must be reported both in Box 12 using Code C and in Box 1 (also in Boxes 3 and 5 if a lay employee).

Deferred Compensation- Any contributions made through the church to an employee's 403(b) retirement plan under a voluntary salary reduction agreement must be reported in Box 12 using Code E. This amount should not be included in Box 1 for either ministerial or lay employees. This amount should be included in Boxes 3 and 5 for a lay employee.

Moving Expenses- Qualified moving expenses paid for or reimbursed to an employee do not represent taxable income. However, any nonqualified moving expenses paid for or reimbursed to an employee represent taxable income reportable in Box 1 for ministers and in Boxes 1, 3, and 5 for lay employees (since these payments are subject to Social Security and Medicare tax for lay employees). Excludable moving expenses paid directly to an employee must be reflected in Box 12 using Code P. No Form W-2 reporting is required for employer payments of qualified moving expenses paid directly to a vendor for an employee.

Health Savings Accounts- Any contributions made by the church employer to an HSA must be reported in Box 12 using Code W. Contributions that do not exceed annual contribution limits will not be included in Boxes 1, 3, and 5.

**Box 13-** One item may apply to church employees. It is "Retirement Plan." Box 13 must be checked if the employee is an active participant (for any part of the calendar year) in a retirement plan maintained by the church employer.

All employees performing ministerial duties who are licensed ministers or ordained ministers, and who have served as either pastors or as full-time associates earning their full livelihood from that ministry, must have Box 13, "Retirement Plan," checked. Employers who have contributed to a 403(b) retirement plan (such as the Church of God Retirement Plan) on an "above salary" basis for either a minister or a lay employee must also check this box. A lay employee having a 403(b) contribution *only* under a voluntary salary reduction basis should not check this box, since it would already be reflected in Box 12 using Code E.

**Box 14-** If the church owns or leases a vehicle for an employee's use, the value of the "personal and non-business" use of that vehicle is taxable income. The value of the use of the vehicle is established by using official tables available from the IRS ([www.irs.gov](http://www.irs.gov) or 800-TAX-FORM). The amount of the personal and non-business use must be included in Box 1 and in Box 14 (and in Boxes 3 and 5 if a lay employee). The employee must maintain a mileage log or similar records to substantiate business and personal use of the vehicle and submit this to the employer. If not substantiated, the employer must report 100 percent of the use of the vehicle as taxable income.

If the employee fully reimburses the employer for the value of the personal use of the vehicle, then no value would be reported in either Box 1 or in Box 14. You may want to refer to IRS Publication 535 for more information on vehicle usage valuation and reporting.

## **Form W-3**

In order to transmit the W-2 Forms to the IRS, your congregation must file Form W-3 "Transmittal of Wage and Tax Statements." Form W-3 will be provided to your congregation at year's end with the supply of employment forms from the IRS.

The purpose of Form W-3 is to summarize for the IRS the number of W-2 Forms being transmitted. Information required includes the name, address, ZIP code, and EIN of the employer; the number of W-2 Forms being transmitted; the total amount of wages, federal income taxes withheld, Social Security/Medicare (FICA) taxes withheld, and FICA wages reported on all of the W-2 Forms. Totals on Form W-3 should balance to the aggregate of the totals reported on any 941 Forms filed for the year.

Form W-3 and all attached W-2 Forms must be submitted to the IRS by the last day of February (unless that day falls on a weekend, and then by the following Monday). No money is sent with the Form W-3.

## **Form 1099-MISC**

While the church generally is not required to withhold taxes from non-employees, Form 1099-MISC must be filed for payments to a self-employed person or unincorporated business if payments have been \$600 or more per year. This includes payments to independent contractors and unincorporated evangelists (excluding any housing allowance properly designated in advance, 403(b) retirement contributions, or reimbursed expenses). Payment of attorney's fees must be reported even if the firm providing the legal services is incorporated. Transmit copies of Form 1099-MISC to the IRS with Form 1096.

## **Records**

Your congregation must keep accurate records of all wages paid and taxes withheld. Keep an individual ledger sheet or computer log for each employee plus a similar summary sheet for all wages paid to all employees.

## **Checklist for Procedures**

1. Employer requests Employer Identification Number (EIN) if not already assigned.
2. All employees should have a valid Form W-4 on file with the employer.
3. Employer withholds federal income taxes and any applicable Social Security/Medicare (FICA) taxes from each paycheck, except paychecks of the clergy in the exercise of ministry unless the clergy and church have entered into a voluntary agreement for withholding federal income taxes.
4. Employer files Form 941 by the end of the month following each quarter and pays any balance due of taxes withheld.
5. At year's end, the employer issues a Form W-2 to all employees and files Form W-3 transmittal.
6. Issue Form 1099-MISC to whom necessary and file Form 1096 with the IRS.

## CHECKLIST FOR FILLING OUT BOX 1 OF FORM W-2

Minister Only	Both	Layman Only	
	yes		Salary
no		yes	Housing/furnishings allowance (designated in advance)
no		yes	Parsonage rental value
no		yes	Utilities paid by church
	yes		Social Security/Medicare "allowance"
	no		Transportation/travel and other business and professional expense reimbursements <u>only</u> if paid under a board-adopted accountable reimbursement plan
	yes		"Reimbursements" if not paid under an accountable reimbursement plan
	yes		Church love offerings or cash gifts in excess of \$25
	no		Contributions to your 403(b) retirement plan
	no		Health/dental insurance premiums paid or reimbursed by the church
	no		Group term life insurance premiums (for up to \$50,000 coverage) paid directly by the church
	no		Moving expense reimbursements that do not exceed deductible moving expenses
	yes		Employee's contributions to a Health Savings Account (HSA)

### Disclaimer

The information contained in this MEMO series is of a general nature. It is not offered as specific legal or tax "advice." Each person and local church board should evaluate their own unique situation in consultation with their local legal and tax advisors.

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