

DO CLERGY PAY PAYROLL TAXES?

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Churches and other religious entities are exempt from some Federal income tax under Section 501(c) of the Internal Revenue Code. However, this tax exemption relates only to certain revenues earned by the organization, not to the salaries and wages which such tax-exempt organizations may pay to others.

At the same time, to ensure that churches are free from the political control of government, there are some special payroll tax rules unique to churches as employers. Some individuals are not subject to certain payroll taxes for the services they perform for a church employer. For other individuals, although ultimately subject to personal income taxation, the withholding of tax at the time of payment may not be required.

As one special category of church worker, "ministers" and "clergy" are defined by the IRS to be individuals who are ordained, commissioned, or licensed by a religious body constituting a church or church denomination. They are given the authority to conduct religious worship and administer ordinances and sacraments according to the prescribed tenets and practices of that religious organization.

If a minister performs services for a church, subject to the will and control of the church, is he or she an "employee?" Applying the normal common law definition of "employee," a minister is an employee. However, there are several ways in which the minister-employee is treated differently from other employees. This causes some observers to believe that they are not employees at all . . . but, the I.R.S leaves us with no doubt about it.

Federal Income Tax Withholding

As a general rule, lay employees who work for a church are subject to Federal income tax withholding on the wages paid for their services. Their status is no different from that of common law employees in general.

However, no Federal income tax withholding is required in the cases of ministers and members of religious orders. Their wages for religious duties are not subject to mandatory withholding. But, any compensation not related to religious duties IS subject to Federal income tax withholding. For example, a person who is both a member of a tax-exempt religious order and a registered nurse working in a church-operated hospital, is subject to withholding on the wages paid to her by the hospital.

Note that the rental value of a church-provided parsonage, or the rental allowance paid to a minister and used to rent or provide a home, are not subject to Federal income tax withholding. The term "rental allowance" includes amounts designated to pay for utility costs, up to actual cost. The housing or "parsonage" allowance must be designated as a rental allowance in an employment contract, budget, minutes of the church or other organization, or other official instrument.

Interestingly, fees for marriages, baptisms and funerals, paid directly to a minister are income from self-employment, not compensation paid by the church.

A minister may request VOLUNTARILY that the church withhold income tax from the compensation paid him or her by the church, by completing and filing with the church-employer a Form W-4 ("Employee's Withholding Allowance Certificate"). Some ministers find this to be the most convenient way to manage their income tax liability during the year.

Withholding for Social Security and Medicare Taxes

For many years, employees of non-profit organizations were not subject to withholding for Social Security and Medicare taxes. Beginning in 1984, however, withholding for Social Security and Medicare taxes became applicable to all employees of non-profit organizations earning \$100 or more a year, except ministers and members of religious orders.

The exemption from Social Security/Medicare taxes applies to services performed by duly ordained, commissioned or licensed ministers of a church in the exercise of their ministry. The exemption also applies to members of a religious order in the exercise of duties required by the order. However, their compensation IS subject to Self-Employment Tax, which is a responsibility of the individual, not of the church-employer. Note that while rental value or parsonage allowance are NOT subject to Federal income tax, the Self-Employment Tax DOES apply to this benefit.

Federal Unemployment Tax Act (FUTA)

A non-profit organization generally is exempt from FUTA tax if the organization falls under Section 501(c)(3) of the Internal Revenue Code. This exemption cannot be waived. Organizations exempt from FUTA tax include those that are:

- 1.) organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary or educational purposes; or for the prevention of cruelty to children or animals; AND
- 2.) operated on a non-profit basis; AND
- 3.) devote no substantial part of their activities to lobbying or political activities.

Form W-2

In Publication 15-A ("Employer's Supplemental Tax Guide, Supplement to Circular E"), the IRS states the Form W-2 reporting requirements for clergy. First, all taxable compensation paid to an ordained minister should be reported as wages in Box 1 ("Wages, tips, other compensation"). Included in this amount should be any expense allowances or reimbursements paid under a non-accountable plan. However, not included in this amount are a parsonage or rental allowance (excludable housing allowance), utilities allowance or the rental value of church-provided housing, although these may be reported as employer/employee reference information in a separate statement or in Box 14 ("Other") on Form W-2. If income tax was withheld from the minister under a voluntary agreement, this amount should be shown in Box 2 on Form W-2, as Federal income tax withheld.

As to Social Security and Medicare taxes, the church-employer is instructed not to show on the minister's Form W-2 any amount as Social Security or Medicare wages, or any withholding for Social Security or Medicare taxes.

State Requirements

Generally, the state and local jurisdictions which have an income tax follow the Federal view that requires withholding from the wages paid to employees of non-profit organizations. Again, however, income tax withholding is not required on compensation paid to ministers and members of religious orders.

In the area of state unemployment insurance, as a condition for approving specific state laws for FUTA tax credit purposes, the states were required in the 1970's to extend their state unemployment insurance coverage to certain employees of non-profit organizations. The state coverage was required to be extended to non-profit organizations employing four or more persons for twenty weeks in the current or preceding calendar year. However, schools (other than "institutions for higher learning"), and certain specific types of services are not required to be covered. The states are not required to include in the extended coverage the services rendered by duly ordained ministers, or by members of religious orders, in the exercise of their religious work. In some states, none of the services performed for a church by clergy or lay employees are required to be covered by state unemployment insurance.

Generally, those states with required employee and/or employer participation in disability programs follow the taxability and coverage rules established for the unemployment insurance of the same state.

State and Federal laws are constantly changing, please check with your state to see what rules apply.

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