



Clergy Finance Letter

CLERGY FINANCIAL SERVICES
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Tax Preparation 2008

tax
tax

tax talk

WHAT'S NEW FOR YOUR 2007 RETURN?

As you begin your preparation of your federal tax return for 2007 it is important to note the changes that may affect your work. Here, as is our annual tradition, we flag the most important changes of interest to clergy.

1. Bracket Adjustments

The base upon which you calculate your tax continues to be adjusted for inflation. Accordingly, your tax rates will be will not be increased merely because you received an increase in gross income. We say "rates" because most clergy pay tax calculated at several different rates. For example, a married pastor earns \$65,000 of taxable income and is "in the 25% bracket." However, her tax rates are 10% on the first \$15,650, 15% on the next \$48,050 and 25% on the \$1,300 within the 25% bracket. Here are the brackets that apply to most clergy.

	Joint	Single
10%	\$0-15,650	\$0-7,800
15%	\$15,651-63,700	\$7,801-31,650
25%	\$63,701-128,500	\$31,651-72,100
28%	\$128,501-198,850	\$72,101-160,850

2. Personal Exemptions & Standard Deductions

Personal exemptions increase to \$3,400 per person. This applies to you and any eligible dependents. This is also the earnings limit for those you claim as dependents other than your children. The dependency rules continue to be relaxed and allow you an exemption for your children in college or elsewhere who may be receiving scholarships or other benefits that reduce your percentage of support below 50%. As long as the children themselves do not provide more than 50% you may continue to claim the exemption. This is especially important where other parties provide partial support - grandparents, scholarships, etc. **Standard Deductions** increase to \$10,700 for marrieds and \$5,350 for singles. Head of Household gets \$7,850.

3. Standard Mileage Rates

The IRS standard mileage rate for all of 2007 was \$.485 per mile for professional driving and 20 cents for medical and moving mileage. Charitable driving can be deducted at 14 cents per mile. An exception was established for any charitable driving related to Hurricane Katrina relief efforts. Such travel qualified for a special 32-cent rate per Katrina mile. **Note: 2008 rate for professional travel rises to 50.5 cents while medical and moving actually decline to 19 cents.**

4. Higher Pension Contribution Limits

As continued proof that Uncle Sam wants you to save for your own retirement the maximum limits for Tax-Deferred Annuity contribu-

tions increased yet again and offer plenty of room for significant personal contributions. The elective deferral limits, what you can contribute through salary reduction arrangements, was \$15,500 for 2007 while clergy age 50+ can contribute an additional \$5,000 for a total of \$20,500. Remember that these deferrals are in addition to employer payments not funded with salary reduction. **IRA and Roth IRA** limits for 2007 were \$4,000 while age 50+ could save an additional \$1,000 for a total of \$5,000.

5. New Kiddie Tax Rules

2007 brought another shock to the plans some parents had for avoiding capital gains taxes, the extension of application of the so-called *Kiddie Tax*. This tax is due on unearned income, generally interest and investment returns. During 2006 the age for application of *kiddie tax* was raised from 14 years to 18. During 2007 another change extended the age for the tax to 24 years in some circumstances. If your child was a student or otherwise eligible to be claimed as your dependent and investment income they may have earned in excess of \$1,700 will be taxed at the parent's marginal rate. Note that this increase in age for dependents takes effect in 2008. For 2007 the age continues at 18 or less.

6. Tougher Charitable Deduction Rules

Congress is apparently convinced that a lot of people cheat on their charitable giving deductions. Accordingly, several rules for deducting charitable gifts have been tightened up. Beginning January 1, 2007 any gift of cash must have a receipt in order to claim any deduction. For example, that \$5 bill you put in the Salvation Army kettle is no longer eligible for a deduction. The same gift made with a check may have qualified. Even checks may require a receipt if written for \$250 or more. Gifts of personal property (clothing, furniture, computers, etc.) must be in "good condition" to be deductible if contributed any time during 2007.

7. Private Mortgage Insurance Premiums Now Deductible

Many clergy must pay Private Mortgage Insurance (PMI) when they purchase their first homes. Generally lenders will require such insurance whenever your down-payment is less than 20% of the purchase price. For 2007 you may deduct these premiums as if they were mortgage interest expenses on Schedule A. Note that this deduction is a one-time opportunity. It is not extended for 2008 unless congress acts to do so.

8. Retirement Saver's Credit

This relatively new credit has been made permanent and the income thresholds have been indexed for inflation. This means that married clergy with incomes below \$50,000 will receive at least a 10% credit for contributions you make to your own pension account. It's too late to make those payments for 2007 but this could be an incentive for early career clergy to save for retirement. Here's how the tax deferrals and credit can reduce the cost of saving. Assume a \$1,000 contribution into your 403b account (PIP for United Methodists). The contribution will save you \$150 of federal income tax, \$153 of self-employment tax, and the credit saves an additional \$100 or more. The net costs to you are no more than \$597. That's the equivalent of receiving a government grant for \$403!



HOW TO HANDLE PROFESSIONAL EXPENSES

Although ministry is not a “business” there are business-related expenses common to our profession. Travel, books, publications, continuing education, office equipment, vestments and a wide array of other “tools of the trade” all add to the cost of doing business as a clergy person.

Clergy Finance Letter continues to believe that the fairest method of handling professional expenses is to have the pastor fully reimbursed by the church. Under an accountable reimbursement plan the costs of ministry are properly absorbed by the church. This is the most tax-wise and cost equitable arrangement. We recommend reimbursement for the following four reasons.

1. Equity - the church only pays for actual expenses. The church never pays more than the cost of doing business and the pastor never has to underwrite the church’s expenses.
2. Transactions of an accountable plan are free of tax without regard to issues of self-employment.
3. This avoids the 50% of cost limitations on the deductibility of certain expenses. Business meals and entertainment expenses may only be deducted at 50% of the actual costs whereas they may be fully reimbursed.
4. Reimbursement avoids running afoul of the court’s recent Deason rule for allocating professional expenses. In *Deason v. Commissioner* the court declared that clergy receiving tax-free income such as housing must reduce the deductible amounts of professional expenses by the percentage of income received tax-free. While we believe the Deason ruling to be a misapplication of another case (*Dalan*), reimbursement avoids the problem entirely.

Receiving reimbursement through an “allowance,” while often a well-intended effort, seldom accomplishes a tax-wise result. “Allowances” paid to the pastor without documentation requirements are not considered an accountable plan under IRC274. As far as the IRS is concerned your “travel allowance” is salary. It must be declared as taxable income.

If you receive reimbursement from a non-accountable plan (an arrangement where you receive a predetermined amount irrespective of your actual expenses) declare the income and deduct the expense.

Clergy who file as employees must use form 2106 “Employee Business Expense.” The major problems with 2106 are that the deduction is taken on Schedule A, not available to non-itemizers, and that itemizers must still reduce the deductible total by an amount equal to 2% of your adjusted gross income (AGI). This 2% threshold is particularly unfair to clergy with employed spouses. Even if you had all the employee business expenses you must still reduce them by 2% of your joint income. (Pastors with high-income spouses may wish to explore filing separately.)

Reimbursement under an “accountable plan” is the only real solution

for employee clergy. Your plan will be considered to be an acceptable “accountable plan” if it conforms to the following standards:

A. The policy of reimbursement must be established in advance. It is not necessary for the exact amount to be a line item in the budget. It is recommended, however, that the church budget for this in the same way that utilities and other variable expenses are handled.

B. Payments are made only where actual expenses are incurred. This should be documented with voucher or receipt. (Receipts are required for expenditures of \$75.00 or more.)

C. Any balance in the account at year-end is forfeited. Receiving the balance either as a “bonus” or any other way renders the entire reimbursement taxable and no longer an “accountable” plan. Beware of the tax advisors who counsel that only the non-vouchered balance need to be declared as income. These advisors are confusing the tax treatment of clergy housing allowance with these professional expense accounts.

HOW TO HANDLE HONORARIA

Do you ever receive money for officiating at weddings, funerals, bar mitzvahs or other ceremonies? Most clergy do. The question is, are these payments “gifts” which have no tax consequence or are they “fees” which are taxable? The IRS is emphatic that such payments are *fees*, professional compensation, and are fully subject to both income and self-employment tax.

Declare these on Schedule C - line 6. This is necessary no matter how you disclose your salary; both employees and self-employed clergy are self-employed when it comes to honoraria.

Don’t try to take the position that these payments are “*gifts*” just because you have no standard fee for weddings and the like. The IRS assumes that you would not have received the money at all if you had not performed the service — that makes it a *fee* and part of your taxable income.

If you are accustomed to endorsing the check over to the church you must still declare the income. Itemizers will be able to deduct this as a charitable contribution and avoid the income tax liability. Nevertheless, you will still have to pay the 15.3% self-employment tax on this money. A better way is to direct the funeral home or any wedding clients to make the check payable to the church. You will not have received any income and will not owe any tax.

EXPENSE REIMBURSEMENT VOUCHER

Date _____ Amount \$ _____

Pay: Name _____
Address _____

Nature of Expense _____

Business Purpose of Expense _____

Location _____ Time _____

Receipt: Attached No

Budget Line Item # _____

Authorized Signature _____

READ 'EM AND REAP!

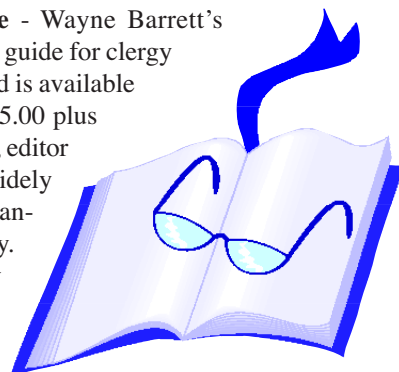
Check out these resources to help in your tax planning and preparation. All are available exclusively from *Clergy Financial Services*. Use the handy order coupon below for ordering.

Clergy Tax Planning Manual - This resource, used by thousands of clergy across America is rapidly becoming recognized as the most reliable tax publication in the United Methodist Church and several other major denominations. The authors of this book have created an instrument that is praised for its clarity, authority, and absolute integrity. *Clergy Financial Services* is proud to be the national distributor of this manual and is now able to offer readers of *Clergy Finance Letter* a 20% discount off the national cover price of \$15.00. Send only \$12.00 for each manual (postage

& handling extra) and we'll speed this helpful manual to you via first class mail. In a hurry? Order from our website www.clergy-financial.com and get your order even faster.

Exempt From What? - This local church guidebook was written by *Clergy Finance Letter* contributing editor Fred Leasure, CFRE, to help you and your church treasurer handle the many payroll management issues that occur between budget and W-2. In simple, straightforward language Leasure presents a helpful guide that can provide just the documentation your treasurer will appreciate to differentiate employees from independent contractors, housing compensation from wages, and fringe benefits from those subject to FICA and SECA. This booklet is a must for each local church treasurer and pastors should have their own copies as well.

Clergy Personal Finance - Wayne Barrett's best-selling financial planning guide for clergy has been up-dated for 2007 and is available for the discounted price of \$15.00 plus shipping and handling. Barrett, editor of *Clergy Finance Letter*, is widely recognized as the leading financial voice in the church today. This resource will help early career pastors get control of their spending, mid-career pastors make sound saving/investment decisions, and pre-retirement pastors make wise decisions about retirement housing and other related matters. Clergy spouses testify to the helpfulness of Barrett's book as well.



Order Form Mail all orders to: CFS, PO Box 6007
Grand Rapids, MI 49516-6007

Clergy Tax Planning Quantity _____ @ \$12.00 _____

Exempt From What? Quantity _____ @ \$ 4.95 _____

Clergy Personal Finance Quantity _____ @ \$15.00 _____

Total Purchases _____

Name _____ S & H _____

Address _____ Total Payable _____

City/State _____ Zip _____

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Rates? As low as \$130 for Federal returns. Send for our tax preparation profile. We'll be glad to take the hassle out of this ordeal for you. Let us do the work. Write us at: Clergy Financial Services, PO Box 6007, Grand Rapids, MI 49516.



CALCULATING SELF-EMPLOYMENT TAXES

Perhaps the most confusing component of clergy tax is the calculation of self-employment (social security) tax. Many of the rules that apply to federal income tax do not apply when it comes to social security taxes. For example, while courts consistently require clergy to file as employees for income tax purposes, all clergy are subject to self-employment tax. Similarly, while clergy housing income is exempt from income tax it is fully subject to social security tax - even that portion received in kind such as the rental value of a church-provided house. Here is a quick five-step process to follow in calculating your dreaded SECA.

STEP ONE: Calculate income subject to SECA

Begin with W-2 wages. Add net Schedule C income. Subtract any unreimbursed employee business expense. (Note that all are deductible for this purpose even though they may not be deductible on Schedule A.)

STEP TWO: Add any clergy housing income

Calculate Fair Rental Value of Parsonage/Manse. Add any church-paid parsonage utilities. Add any cash allowances paid for housing or furnishings.

STEP THREE: Reduce this subtotal by 7.65%

Since employer's share of FICA is exempt, self-employed get a similar deduction here. (Hint: this calculation is easiest when multiplying subtotal by $.9235 = 100\% - 7.65\%$)

STEP FOUR: Multiply net taxable income by SECA rate - 15.3%

Determine your tax by multiplying income subject to SECA (the product of steps 1-3) by SECA rate of .153.

STEP FIVE: Remember to take Income Tax deduction for half of SECA

50% of your total self-employment tax is deductible from your taxable income for federal income tax purposes. Take this on line 27 of 1040.

Here's a worksheet to assist with calculations associated with steps one and two. (Note: you may wish to share this information with your personnel committee to help them appreciate that clergy housing income is not really "tax free").

Self-Employment Tax Worksheet	
Net Salary (W-2)	_____
Plus Housing:	_____
1. Housing Allowance	_____
2. Utilities Paid by Church	_____
3. Rental Value of Parsonage	_____
Plus Schedule C income (if any)	_____
Less unreimbursed Business Expenses	_____
Total Self-Employment Income	_____
Note: You may want to add a similar worksheet to your 1040)	

The Best Tax Advice of All ...WRITE IT DOWN!



Good Records Make All The Difference

How Long Should Tax Records Be Kept?

As many of you already know, the IRS has three years in which to challenge a tax return. This does not automatically imply that records be kept for only three years, however. Clergy Finance Letter recommends that you retain all tax records for seven years or more. Here's why:

In addition to the automatic three years for challenge of a return, the Service may go back six years for substantially understated income. For example, an auditor rules that your current method of keeping travel documentation is inadequate. In addition reducing your travel deductions for the current year you may have to substantiate all travel deductions for the past six years. Without records you may have no substantiated deductions at all - a huge tax bill.

Moral of the story? Keep records for seven years and copies of your returns indefinitely. Oh yes, one more thing. If the IRS suspects fraud (failure to pay SECA on housing, for instance) there is no time limit on the number of years that can be included in such an audit.

Do it right the first time and keep your records. Then relax. Otherwise, that ticking sound you hear may be an old tax return.



CLERGY HOUSING ALLOWANCE EXCLUSION

The *Clergy Housing Allowance Exclusion* (sometimes referred to as parsonage allowance, furniture and furnishings allowance, etc.) is a way in which qualifying clergy can receive housing, whether it be in kind or by allowance without having to pay income tax on this form of compensation.

It should be clearly understood that this provision of the IRS Code is an “exclusion” and not a “deduction” from income.

Section 107 of the Internal Revenue Code of 1986 provides that:

“In the case of a minister of the gospel, gross income does not include -

(1) the rental value of a home furnished as part of compensation; or

(2) the rental allowance paid as part of compensation, to the extent used to rent or provide a home and to the extent that such allowance does not exceed the fair value of the home, including furnishing and appurtenances such as a garage, plus the cost of utilities”

The only items which the Internal Revenue Service has specifically said can *not* be excluded are the cost of food and domestic help.

Because the IRS has taken a rather broad interpretation of this provision, “provide a home” has been understood to include almost anything connected with living in a home. The list of possibilities includes but is not necessarily limited to:

Insurance - tenant or home owner’s

Repairs - to the home, appliances, lawn equipment, TV, etc.

Furniture - appliances, TV, VCR, stereo, bed, desk, etc.

Decorating accessories - drapes, pictures, rugs, linens, lamps, ect.

Utilities - garbage, sewage, cable TV, telephone, gas, water, electricity, etc.

Miscellaneous ~ lawn care, snow removal, tools, plants, etc.

It is absolutely vital that this allowance for furnishings/housing be properly established. Here’s how.

1. Allowance must be established in advance. It is not possible to create this relationship retroactively. You will need a resolution declaring a portion of your compensation to be an “Allowance For Housing/Furnishing.

2. To qualify for the housing exclusion the funds must actually be expended for the intended purpose. This means that simply calling your salary a “housing allowance” will not, by that action, exclude it from tax. You must keep careful records of all housing/furnishing expenditures. If you fail to spend all of your allowance, the unused balance must be declared as additional taxable income. Conversely, expenditures in excess of the pre-established amount do not qualify for the exclusion. **NOTE:** in spite of what some tax advisors are advocating, the expenditure requirement seemingly would invalidate attempts to take a “rental allowance” for existing furniture. This

strategy attempts to shelter income with a type of depreciation for furniture purchased in prior years. While seemingly convincing arguments may be presented for the alleged equity of this arrangement, Clergy Finance Letter believes that the strategy fails the “expense test” since no expenditure is made.

3. Excluded amounts may not exceed the “fair rental value” of the property. For furnishings this suggests that the maximum amount excludable in a given year would be the fair rental value of all your furniture.

It is important to recognize that this amount is an “exclusion,” not a deduction. This means that the allowance for housing/furnishings should NOT be included on a church-provided W-2 or a 1099.

In spite of the fact that housing, received in a parsonage or through an allowance, is excluded from income for income tax purposes it is subject to social security tax. This means that the amount of income you declare on Form 1040 SE will be higher than the amount declared on the front of 1040 (line 7 or 13).

SAMPLE CLERGY HOUSING ALLOWANCE RESOLUTION

The _____ Church of _____ has established the cash salary for the Rev. _____ to be \$ _____ for the period from _____ to _____. In addition to the cash salary, the church will also provide a parsonage located at _____ and all utilities.

Whereas Section 107 of the Internal Revenue Code of 1986 has provided that a minister of the Gospel may exclude from gross income the rental value of a home provided and any allowance to provide a home;

Therefore be it resolved that the use of the parsonage located at _____, plus all utilities, and \$ _____ of the cash salary of \$ _____, provided to Rev. _____ to the extent it is used to provide a home, be considered to be Clergy Housing Allowance Exclusion and excluded from reportable compensation under Section 107 of the Internal Revenue Code of 1986.

(Signed and Dated by Board Chair and Secretary)

Q A
A Q

questions & answers

- Q:** I'm confused about tax credits. I know that a credit is a complete reduction of my tax payments, but I understand that I may not qualify for all my credits. Which credits do I get and which ones are not necessarily available?
- A:** I think the object of your confusion may be the matter of "refundable" and "non-refundable" tax credits. In general, a tax credit only serves to reduce a tax you already owe. In other words, to receive a \$1,000 tax credit you must actually owe at least \$1,000 in federal income tax. There are a few exceptions, however, that actually pay you back for certain credits even if you don't owe that much money. The largest "refundable" tax credit is the *Earned Income Credit*. This credit rewards the working poor by paying them money, as much as \$4,716 in certain circumstances, whether they owed any income tax or not. Most clergy do not qualify for this credit because the earnings are based upon self-employment tax liability, which includes housing income from a parsonage. A common credit that may be refundable to clergy is the *Child Tax Credit*. This is a credit of \$1,000 for each child under the age of 17 years. The credit is refundable, but only potentially. The calcu-

lation for the refundable basis for the credit is 15% of parental earned income in excess of \$11,750. Accordingly, a family with two children and earned income of \$45,000 would qualify for the entire \$2,000 of credits as a refund because their income was sufficient to qualify the credit. Use Form 8812 to claim this credit. *The Child Care Credit*, on the other hand, is always non-refundable and can only be claimed if you owed that amount or more of federal income taxes. *The Hope and Lifetime Learning Credits* similarly are non-refundable. A special rule applies for the *Adoption Credit*. This credit is only available in the year that the adoption becomes final but allows a full \$11,390 credit even if the expenses in that final year were less than \$11,390. In this case, as long as total adoption-related costs in previous years and the final year equaled \$11,390 or more, the entire \$11,390 credit can be claimed in the final year. In cases where this credit exceeded the income tax liability, the balance is not refundable but is eligible for a "carry over" into future tax years until used up or 5 years, whichever comes first. *The Saver's Credit* (see page 1) is always non-refundable.

TAX PLANNING FOR 2008

As you begin the preparation of your 2007 income tax return it is also important to consider steps you can take to reduce your tax cost for 2008. Here are a few reminders of steps you should take or changes that will affect your 2008 taxes.

1. A new standard mileage rate is in effect as of 1/1/2008. The professional travel rate is 50.5 cents per mile. Make certain that the church treasurer is aware of the new rate and will be reimbursing you appropriately all year long. Remember not to ask for reimbursement for commuting miles. If you incur mileage costs for medical treatments or associated with moving in 2008 the rate is actually less than last year, 19 cents for '08.
2. IRA and Roth IRA contribution limits increase by \$1,000 to \$5,000 for 2008. Clergy age 50 or more get an additional \$1,000 for a total contribution of \$6,000.
3. Tax-deferred annuity accounts may be rolled into a Roth IRA subject to certain conversion rules. In general this is limited to tax-payers earning less than \$100,000 and the rollover is taxable unless a portion is from after-tax contributions. For taxpayers under age 59 1/2 the 10% penalty for withdrawals does not apply.
4. A new capital gains tax rate of 0% may apply to certain taxpayers. Beginning this year you owe no long term capital gains tax if your marginal tax bracket (See page 1) was 10% or 15%. If you earned even \$1 of income subject to the 25% rate, your capital gains rate jumps to 15%.
5. Higher income clergy will pay more self-employment tax. The maximum income subject to self-employment tax rises this year to \$102,000 but remember that the Medicare portion of the tax, 2.9%, is unlimited so make adequate quarterly estimates or have enough withheld by the church to cover all these costs.
6. Clergy who already receive social security benefits may earn a little more in 2008 without losing benefits. Clergy between age 62 and 66 by the end of '08 may earn up to \$13,560 before benefits are reduced. Pastors turning 66 this year may earn up to \$36,120 before their 66th birthday and not lose benefits. After reaching age 66 there is no cap on earnings.