Orthodox Church in America
Tax Help for Parish Treasurers

INTRODUCTION

Taxes in the United States are complex and consequences for noncompliance can be significant. Furthermore, there are nuances in the tax laws as they pertain specifically to churches and clergy. This material is intended to introduce parish treasurers to and assist them in meeting their church's federal income and employment tax responsibilities.

As noted, taxes are complex. The information provided here should be viewed as introductory and not as a substitute for professional tax advice on the law itself.* In addition, state and local tax issues must be addressed locally because those laws vary by jurisdiction.

1) INITIAL CONSIDERATIONS FOR A PARISH

a) IRS group tax exemption

Parishes of the Orthodox Church in America are eligible to be included under the church's group federal income tax exemption and do not need to seek a separate determination of tax-exempt status from the Internal Revenue Service. Please contact the OCA Finance Office at 516-922-0550 for further instructions.

b) Employer Identification Number ("EIN")

Following incorporation, parishes should request a federal employer identification number using Internal Revenue Service (IRS) Form SS-4, Application for Employer Identification Number. This number is required for payroll tax reports that the parish will file with IRS and is also generally required for banking and other purposes.

A sample form is provided in the "Sample Forms and References" section. It is also available on the IRS website at www.irs.gov or by phone at 800-829-3676.

Form SS-4 can be filed by mail, phone, or fax. An EIN can be obtained immediately when application is made by phone by an authorized person. See the form's instructions for more detailed information.

c) Sales tax exemption

Sales taxes are imposed at the state and local level and vary from jurisdiction to jurisdiction. However most sales tax laws exempt purchases made by tax-exempt organizations such as churches. Sales by churches may also be exempt from sales tax under certain conditions. You will have to check the rules for your particular state and locality.

Usually, an application for exemption must be filed with the state. The state will then issue a Sales Tax Exemption Certificate to be presented to the vendor when making a purchase. It generally makes sense to apply for sales tax exemption after the employer identification number has been obtained and the group exemption with OCA is established.

Most states make forms and information available on their websites. A link to state tax websites is available at www.taxsites.com/state.html#links or from the IRS website at www.irs.gov/businesses/small/article/0,,id=99021,00.html. Some states may combine the sales tax exemption application with registration for state payroll and/or other tax and reporting purposes.

d) Other tax exemptions

The property tax exemption is probably the most significant other tax exemption for churches. Property taxes are imposed locally and, as such, are subject to great variation. You should contact your local tax assessor and a local tax attorney at the time you acquire any real estate. You should also look into any state or local personal property or intangible taxes and determine what exemptions are available and the steps to establish exemption or comply with the requirements.

e) State payroll registration

Most states will require employer registration when you hire and pay employees. The states generally make their forms and information available on their websites. A link to state tax websites is available at www.taxsites.com/state.html#links or from the IRS website at www.irs.gov/businesses/small/article/0,,id=99021,00.html. Some states may combine the payroll registration with registration for state sales and/or other tax and reporting purposes.

2) EMPLOYER RESPONSIBILITIES

a) Federal and state wage and hour laws

The Federal Fair Labor Standards Act sets the federal minimum wage rate, restricts child labor, and sets overtime pay requirements. Each state generally also has wage and hour laws which may set requirements that are more stringent than the federal requirements. The state laws may also cover other aspects of employment, such as method and frequency of payment. You should obtain appropriate professional advice to ensure your parish complies with applicable requirements.

b) Employee vs. Independent Contractor

A basic question that must be addressed when you pay someone for their work is whether the individual is an employee or an independent contractor. Employees - whether short-term (temporary) or long-term, part-time or full-time - are subject to payroll tax and payroll reporting rules. Independent contractors are not subject to payroll tax, but are subject to tax reporting rules (Form 1099).

The first, and sometimes difficult, step is to determine the category in which the individual belongs. For most parishes, the priest, sexton and any regular office staff will fall in the employee category. “Supply” priests that conduct worship when the parish priest is absent would generally be independent contractors. The general rule is that the determination of “employee” status is based on facts and circumstances under the common law definition of employee.

The primary inquiries fall into three categories. Who has financial control of the job? Who can exercise control over how the worker performs the specific task? And how do the parties themselves view the relationship? The following factors should be evaluated keeping in mind that the determination is based on the whole picture, not just a single factor:

Workers are more likely to be classified as independent contractors if they:

- Make a significant investment in business property (a home computer is not significant);
- Pay their own business expenses;
- Receive a flat fee that is not based on an hourly or similar rate;
- Are not prohibited from doing work for other companies;

- Can pay subcontractors to get the job done;
- Are not performing services as an integral part of your regular business;
- Have a contract with an enforceable liquidated damages provision;
- Can make a profit;
- Can suffer a loss.

Workers are more likely to be classified as employees if they:

- Are given specific instructions and on-going training in how to get the work done;
- Cannot work for others;
- Have expenses paid by your organization;
- Are paid with a salary or hourly wage;
- Do not have a significant investment in their trade or business;
- Are an integral part of your regular operations;
- Receive direct reimbursement for all, or almost all, expenses;

Less important is:

- Whether or not the work is performed on the church's premises;
- Whether the worker has flexibility in setting hours;
- Whether the relationship is temporary or short-term;
- Whether the work is full- or part-time;
- Whether the worker performs services for one or more businesses.

The IRS established a “20 Factor Test” in Revenue Ruling 87-41 (see Sample Forms and References – “IRS Twenty Questions”). Also included in Sample Forms and References is a checklist for evaluating workers.

c) Form 1099

Payments to workers that have been classified as independent contractors (rather than employees) and other vendors that provide services to the parish must be reported annually to the IRS on Form 1099MISC and may be subject to "backup withholding" of income tax. Although the Form 1099 is an annual report to the IRS, compliance with this tax requirement begins before payment is made.

The first step is to obtain the vendor's tax identification number (Employer Identification Number or Social Security Number) using IRS Form W-9. A sample form, instructions, and sample vendor transmittal letter is provided in the "Sample Forms and References" section. Form W-9 is also available on the IRS website at www.irs.gov or by phone at 1-800-829-3676.

If a vendor does not provide a tax identification number or the Form W-9 submitted indicates the vendor is subject to backup withholding, you must withhold income tax at a rate of 29% (28% after 12/31/05). Hopefully you will not encounter this circumstance, but IRS resources (Publication 1679 "A Guide to Backup Withholding for Missing and Incorrect Name/TINs" and telephone assistance 866-455-7438, 304-263-8700, or e-mail mccirp@irs.gov) can help if you do. If you are required to, but do not withhold, the parish could be responsible for paying the taxes that should have been withheld, plus penalties and interest. Therefore, it is important to obtain the tax identification number and it is generally easier to do so before you have made the payment to the vendor.

Forms 1099MISC are prepared once a year to report calendar year payments of $600 or more to vendors for services rendered (not purchases of goods). One copy is mailed to the vendor by the end of January following the calendar year. Copies of all Forms 1099MISC issued are filed with the IRS by the end of February following the calendar year and are accompanied by a summary on Form 1096. See "Sample Forms and References". There are some exceptions to the requirement to file Form 1099MISC. Most notable is that the form is not required for payments made to corporations (but must be issued to attorneys, even if incorporated), if it is clear from the name that the payee is incorporated ("Inc.", "Corp.", etc. but not "Co.", "LLC",etc.). See the IRS instructions for more details.

The Form 1099MISC copies and Form 1096 that are submitted to IRS are special scannable forms and cannot be downloaded from the internet. They can be ordered from the IRS (1-800-829-3676), but are also readily available at office stationers and retailers.

d) New Hires

When an employee is first hired, there are two federal forms to be completed: Form W-4 (Employee's Withholding Allowance Certificate) and Form I-9 (Employment Eligibility Verification). Individual states may also have their own income tax withholding form. Form W-4 is an IRS form available from IRS sources (internet, phone) and is used to specify the number of exemptions for calculating income tax withholding. Form I-9 is an Immigration Services form that verifies an individual's eligibility to work in the United States based on citizenship, residency, or appropriate visas. It is available from the Immigration Services website at http://uscis.gov/graphics/formsfee/forms/i-9.htm. See "Sample Forms and References". Both forms are to be retained in the employer's files and are not usually submitted to the government.

There is also a "New Hire Reporting" program under which employers must advise the state when a new employee has been hired. This is done in order to assist the government in enforcing court ordered child support. Many states accept a copy of Form W-4 with employer information added. More information is available from the Office of Child Support Enforcement (202-401-9267 or www.acf.dhhs.gov/programs/cse/newhire).

e) Income Tax Withholding

When you pay an employee, you are required to withhold federal (and state, if applicable) income tax from the employee's paycheck. The amount of withholding is determined based on tables or methods specified in IRS Publication 15 – "Circular E, Employer's Tax Guide" and the withholding allowances specified in the employee's withholding allowance certificate (Form W-4, discussed in d) New Hires). Each state that has an income tax will generally have a comparable publication for state income tax withholding purposes.

The income taxes withheld must then be deposited according to a specific time schedule and methodology. ***Late remittances and improper deposit methods result in significant penalties! In addition, because such taxes are considered "trust funds", responsible parties may be held personally liable for taxes that are not properly remitted***.

Deposit method - Federal payroll taxes must be deposited by mailing or delivering a check to an authorized depositary for Federal taxes (most commercial banks are authorized depositaries), accompanied by a Federal tax deposit coupon, Form 8109. Deposit coupons with preprinted employer information are "automatically" mailed to employers, but can be obtained by calling the IRS (1-800-829-3676) if they have not been received. Large employers (generally those having payroll taxes over $200,000 a year) must make electronic tax deposits using the Electronic Federal Tax Payment System (EFTPS).

Deposit schedule – Most small employers (those having payroll taxes under $50,000 a year) and new employers are on a monthly deposit schedule with deposits due by the 15th day of the following month. Employers with larger payroll tax liabilities are required to deposit on a semi-weekly schedule.

Quarterly Reports, Form 941 – Federal income tax withholding must be reported quarterly to the IRS on Form 941, Employer's Quarterly Federal Tax Return. The due date for each calendar quarter (quarters ending March, June, September, and December) return is the last day of the month following the end of the quarter. The due date is extended to the next business day if it falls on a weekend or holiday. The IRS automatically mails preprinted forms to the employer each quarter, but they are also available from IRS sources (www.irs.gov or 1-800-329-3676).

f) Social Security Taxes

In addition to income tax withholding, employers must withhold Social Security taxes pursuant to the Federal Insurance Contributions Act (FICA). There are two components – Social Security (6.2% of wages) and Medicare (1.45% of wages) for a combined rate of 7.65%. The employee pays 7.65% and the employer must pay a like amount, so the government actually gets 15.3% (7.65% X 2) in FICA taxes.

The maximum earnings subject to Social Security tax each year is limited, but the ceiling varies each year. For 2005, the ceiling for Social Security taxes (the 6.2% component) is $90,000. There is no limit on the amount of earnings subject to the Medicare (1.45%) component.

Social Security taxes - both the employer and employee shares – must be deposited along with federal income tax withholding, using the method and schedule described in e) Income Tax Withholding. The income tax withholding and Social Security taxes are combined when evaluating the frequency and method of deposit requirements based on payroll tax liability.

g) Unemployment Taxes, Workers Compensation, Disability Insurance

Like other tax exempt organizations, churches are exempt from federal unemployment taxes. However, state unemployment taxes might apply to some or all church employees. You should consult state resources. In addition, there are state (but not federal) workers compensation and disability laws that may apply. Your parish may need or want to obtain appropriate workers compensation or disability insurance. Some states may also have options to "self-insure".

h) Annual W-2 Reporting

Forms W-2 are prepared once a year to report employees' calendar year wages, federal and state income tax withholding, social security and medicare wages and withholding, and certain other tax items related to an employee's compensation and benefits.

One copy must be given to the employee by the end of January following the calendar year. Copies of all Forms W-2 are filed with the Social Security Administration (not IRS) by the end of February following the calendar year and are accompanied by a summary on Form W-3. See "Sample Forms and References". Some states may require that employers send them W-2 forms also; others do not – check your state sources.

Forms W-2 copies and Form W-3 that are submitted to the Social Security Administration are special scannable forms and cannot be downloaded from the internet. They can be ordered from the IRS (1-800-829-3676), but are also readily available at office stationers and retailers.

3) CLERGY PAYROLL

a) "Dual" status employees, Self – employment tax

Ministers are treated as "dual-status" employees under Internal Revenue Service payroll tax rules. That is, except for income tax withholding, FICA taxes, and ministers' housing allowances, ministers are treated like any other employee. However, ministers' compensation for services performed as a minister is not subject to income tax withholding or FICA (Social Security and Medicare) taxes. Instead, such earnings are subject to self-employment tax (the substitute for Social Security and Medicare taxes for self-employed persons), unless exempt pursuant to IRS approval for conscientious objectors.

Self-employment tax is not withheld or paid by employers – it is reported on the individual's Schedule SE filed with their annual Form 1040 income tax return. Ministers may voluntarily elect to have income taxes withheld from their wages, but are not required to do so. Their estimated income tax requirements can be met either through quarterly estimated tax payments or voluntary income tax withholding. Ministers' compensation is reported by the employer on quarterly payroll tax returns and annual Forms W-2.

Under IRS regulations, all ordained clergy employed by a church are considered to be performing services as a minister and the church should not withhold and pay FICA taxes on ministers' compensation. Minister employees may choose to have income tax withheld from their pay, and should be encouraged to do so. They should submit a signed Form W-4 that specifies the amount to be withheld from each paycheck (line 6 of the current W-4 form). That amount can be calculated to include the ministers' self-employment tax liability.

Although there are similarities in the two, the self-employment tax and FICA tax are not the same. The taxes are imposed under different sections of the tax law, and the tax bases defined by those statutes are not the same. For example, the self-employment tax base is <u>net</u> earnings from self-employment. This means that in addition to taxable compensation, the self-employment tax base for ministers <u>includes tax-exempt housing</u> (whether a housing allowance or church rectory - see b) Minister Housing discussion) but is reduced by unreimbursed professional expenses.

Many religious organizations pay minister employees "Self-employment tax allowances" equivalent to what would be the employer's share of FICA taxes for non-clergy employees. Such payments are taxable compensation to the minister and are reported for payroll tax purposes in the same manner as cash salary. They are often referred to as "SECA allowances", short for Self-Employment Contributions Act.

See "Sample Forms and References" for illustrations of these tax rules and the applicable tax reporting forms.

b) <u>Minister Housing</u>

Qualified ministers of the gospel are permitted under Internal Revenue Code (IRC) section 107 to exclude from federal taxable income the amount of their properly designated housing allowance to the extent actually used to provide a home.

The tax rules - IRC section 107 and the related regulations are relatively brief. Copies are included in “Sample Forms and References”. Although qualifying ministers’ housing allowances are excludible from federal taxable income for income tax purposes, they are nevertheless subject to self-employment tax under IRC section 1402.

In order to qualify for the section 107 income tax exclusion, there are 4 requirements that must be met:

1) Ministerial status
2) Ministerial service
3) Designation of housing allowance
4) Actual expenditure for housing costs

1) Ministerial status The individual must qualify as “ordained, licensed, or commissioned”. An individual duly ordained as a minister by an official church body generally meets this requirement. If one is licensed or commissioned, consideration is given to other factors: whether the individual administers sacraments, conducts worship services, is considered a spiritual leader by his religious body, and the performance of services in the “control, conduct, and maintenance of a religious organization”. Documentation for each priest should be retained in your files.
2) Ministerial service The individual’s service must either be for a church or church-controlled entity, or another entity pursuant to a valid church assignment or sufficient performance of worship or sacerdotal functions. Any service performed by a minister for a church or church-controlled entity is considered ministerial service. Therefore, all priests serving your parish qualify for the minister housing allowance.
3) Designation of housing allowance Tax regulations require that the employing organization designate the amount of allowance pursuant to official action taken in advance of payment. It may be evidenced in an employment contact, in minutes of or in a resolution by the organization or in its budget, or in “any other appropriate instrument evidencing such official action”. It is considered sufficient if it permits a payment or a part thereof to be identified as a payment of housing allowance as distinguished from salary or other remuneration. The IRS “Tax Guide for Churches and Other Religious Organizations” states “Only one parsonage or rental allowance may be provided to a minister, and the parsonage or rental allowance must be reasonable in amount.” The

amount to be designated should be determined by the minister's submission of an estimate of housing costs and fair rental housing value. See sample Board Resolution and Minister's Housing Allowance Worksheet in "Sample Forms and References".

4) Actual expenditure for housing costs Any portion of the housing allowance received by the minister that is not actually spent for housing must be included on his personal income tax return in gross income in the taxable year that it is received. In addition, the amount that can be excluded from income is limited to the fair rental value of the home. The parish should report the amount of a priest's housing allowance on the individual's year end W-2 in box 14 "Other". This is not required but suggested by the IRS. We strongly recommend reporting the housing allowance because it provides the priest with information that he needs in preparing his personal income tax return. He must report as taxable income, the excess of the housing allowance over his actual housing costs or fair rental value of his housing, and must include this amount in his self-employment earnings. By including it on the W-2, it helps to ensure that the minister does not overlook these income tax reporting obligations.

   Fair rental value of the priest's home – whether it is a church rectory or a home owned or rented by the priest – should be determined annually. For the church rectory, the fair rental value is included in the priest's self-employment tax base. For the priest's owned or rented home, the fair rental value limits the housing allowance that can be excluded from taxable income.

   Fair rental value is determined based on the facts and circumstances of each case, but in all cases is based on a furnished property plus utilities. It can be ascertained by an expert's appraisal who bases the valuation on comparable fair rental values of similar properties or the fair market value of the property and rate of return on investment that an unrelated lessor of comparable property would require.

c) Equity Allowances

Despite the significant benefit of living in parish-owned rectories, such priests do experience a disadvantage because they do not acquire equity in a home. At retirement when they are no longer living in a rectory they are faced with the problem of providing their own home and have not accumulated any equity in a home. Some parishes may wish to reduce this adverse economic impact by providing an "equity allowance" over and above their stated compensation.

Since the purpose of such an allowance is to assist the priest in obtaining suitable housing at retirement, an appropriate vehicle would be to deposit the equity allowance in a tax-favored retirement program.

4) SAMPLE FORMS AND REFERENCES

a. Form SS-4, Application for Employer Identification Number
b. IRS "Twenty Questions" (Worker Classification)
c. Employee v. Independent Contractor Checklist
d. Form W-9, Request for Taxpayer Identification Number
e. Form W-9 Vendor Transmittal Letter
f. Form 1099MISC
g. Form 1096
h. Form W-4, Employee's Withholding Allowance Certificate
i. Form I-9, Employment Eligibility Verification
j. Form 8109, Federal Tax Deposit Coupon
k. Form 941
l. Form W-2
m. Form W-3
n. IRC section 107 (Minister housing)
o. IRS Regulation 1.107-1 (Minister housing)
p. Minister Housing Resolution-rectory
q. Minister Housing Resolution-no rectory
r. Minister's Housing Worksheet
s. Tax calendar
t. "OCA Church" Illustrative forms and worksheet
u. "OCA Priest" Illustrative income tax returns

5) OTHER RESOURCES

a. Church & Clergy Tax Guide, Richard R. Hammar, Christian Ministry Resources, Matthews, NC 28106, 704-821-3845
b. IRS Phone Numbers:
    1) Forms 1-800-829-3676 (phone)
    2) Forms 703-368-9694 (fax)
    3) Information/Assistance 1-800-829-4933 (business)

4) Information/Assistance 1-800-829-1040 (individual)
5) Local phone numbers – see IRS website www.irs.gov

c. IRS Publications:
1) # 1828, IRS Tax Guide for Churches and Religious Organizations
2) # 15, Circular E, Employer's Tax Guide
3) # 15A, Employer's Supplemental Tax Guide
4) # 517, Social Security and Other Information for Members of the Clergy and Religious Workers

d. Ministers Guide for 2004 Income Tax, Conrad Teitell

e. Websites:
1) IRS (Internal Revenue Service) www.irs.gov
2) State tax links http://www.taxsites.com/state.html#links