



MODULE

Tax Treatment of Deacon Compensation Paid by Parishes and Other Diocesan Institutions

January 1, 2006

The federal and state reporting requirements referred to here must have been implemented by January 1, 2006.

Deacons in the Diocese of Green Bay are treated, for tax purposes, similarly to Diocesan priests in regard to the compensation they receive from parishes and other Diocesan institutions for performing ministerial duties. The contents of these guidelines should be shared with each deacon. Because the deacon has much to consider in planning his tax year, he should review these guidelines with his tax preparer for planning purposes. Certain approvals must be in place before the tax year begins.

The payroll for deacons who perform non-ministerial duties (for example, work on the maintenance staff) should be processed the same as lay employees. The determination of whether a deacon is performing ministerial duties, *as defined by the Internal Revenue Service*, may not be a simple decision. It is determined after considering several factors outlined by the courts and Internal Revenue Service. It is **not an option** of the deacon, pastor, trustees, or the parish finance council. Please call the diocesan Financial Consultant for a determination.

Tax Status of Deacons Receiving Compensation for Performing Ministerial Duties

Deacons are considered “dual status” employees. “Dual status” means that deacons are considered employees for income tax purposes but self-employed for Social Security purposes. This means that deacons should receive a W-2 each year, but Social Security and Medicare taxes cannot be withheld from their checks and Social Security and Medicare wages cannot be listed on their W-2s. Deacons are required to pay self-employment taxes with their personal tax returns.

Housing Allowance

Deacons Who Rent or Own Their Own Home

The parish or other Diocesan institution may designate part of the salary it pays to a deacon for performing ministerial duties to be a housing allowance. This provides a tax benefit to the deacon since the amount designated as a housing allowance is not taxable for income tax purposes. The housing allowance amount is taxable for self-employment taxes.

The Church & Clergy Tax Guide 2004 Edition by Richard R. Hammar, J.D., LL.M., CPA, on page 173 lists the following as items deacons may include in their housing allowance calculation:

Down payment on a home

Mortgage payments on a loan to purchase or improve your home (include both principal and interest). Payments on home equity loans and second mortgages where the proceeds are not used for housing (for example, a second mortgage is taken out to pay for a child's college tuition) can **not** be included.

Real estate taxes

Property insurance

Utilities (gas, electricity, water, trash pickup, local telephone charges)

Furnishings and appliances (purchase and repair)

Structural repair and remodeling

Yard maintenance and improvements

Maintenance items (cleaning supplies, light bulbs, pest control, etc.)

Homeowners' association dues

Rental payments can also be included in the housing allowance calculation.

An *Estimated Housing Costs* form can be used by deacons to calculate their housing allowance amount. The form can be found on the diocesan website under finance info. This form must be prepared and signed by the deacon, and approved by the pastor, parish director, priest administrator or trustee before January 1st each year. The approval should be noted in the minutes of a Finance Council meeting.

It is important to note that the amount the deacon can exclude from his federal and state taxable wages is limited to the lessor of:

- 1) The amount actually used to provide a home
- 2) The amount officially designated as a housing allowance
- 3) The fair rental value of the home, including furnishings, utilities, etc.

Also note these other considerations when setting the housing allowance amount.

- 1) The housing allowance amount is not considered “compensation” when calculating the amount that can be contributed to a 403(b) or a 125 plan. Designating a housing allowance amount reduces the amount that can be contributed to a 403(b) plan.
- 2) If you receive a tax-free housing allowance, a portion of your business expenses must be allocated to the tax-free income and thus becomes nondeductible. Example: Deacon Smith receives total compensation of \$20,000, \$5,000 of which is designated as a tax-free housing allowance. Therefore, if Deacon Smith has \$4,000 of business expenses, only \$3,000 ($15,000/20,000 \times 4,000$) can be deducted on his tax return since one fourth ($5,000/20,000$) of his income is a tax-free housing allowance. Additionally, a statement must be attached to the deacon’s tax return in order to deduct a portion of his business expenses. The statement must include the following information:
 - a. A list of each item of taxable ministerial income by source plus the amount.
 - b. A list of each item of tax-free ministerial income by source (housing allowance) plus the amount.
 - c. A list of each item of otherwise deductible ministerial expenses plus the amount.
 - d. How you figured the nondeductible part of your otherwise deductible expenses.
 - e. A statement that the other deductions claimed on your tax return are not allocable to your tax-free income.

An example statement is contained in Publication 517 – Social Security and Other Information for Members of the Clergy and Religious Workers.

Note: this allocation does not apply to deductions of home mortgage interest or real estate taxes on a deacon’s home.

- 3) Designating a portion of a deacon's salary as tax-free housing allowance reduces the limitation thresholds for some itemized deductions such as the 7.5% floor for medical expenses, the 2% floor for miscellaneous deductions and the 50% ceiling for charitable contributions.

Deacons Who Live in Parish-owned Housing (Parish Directors)

The value of housing provided to deacons is not subject to income tax. However, it must be added to the deacon's taxable salary when calculating his self-employment taxes.

Payroll Withholding

Since deacons are considered self-employed for Social Security purposes, no Social Security or Medicare taxes should be withheld from their checks (additionally, no Social Security or Medicare wages should be included on their W-2s). Deacons are also exempt from normal income tax withholding. However, deacons may enter into a voluntary agreement with their employer to have both federal and state income tax withheld. The basic form used for such an agreement is Internal Revenue form W-4. Deacons who have income taxes withheld from their paychecks should have enough taken out to cover any self-employment taxes that will be due. Deacons that do not have income taxes withheld from their checks should make estimated quarterly payments to both the federal and state revenue agencies.

Retirement Contributions

Amounts contributed to 403(b) retirement plans are not subject to federal and state taxes. Additionally they do **not** have to be included in the calculation of self-employment tax. This is a major tax advantage that ordained deacons have over lay employees.

Amounts designated as a housing allowance are **not wages** and are excluded for the computation of the contribution to the diocesan retirement plan.