CLERGY HOUSING ALLOWANCE EXPLAINED

Pastors, are you maximizing the tax benefit of housing designations?

Churches, are you assisting clergy by designating an appropriate housing allowance?

A pastor's housing allowance (sometimes called a parsonage allowance or a rental allowance) is excludable from gross income for income tax purposes. This article will help you understand and make the most of the housing allowance. If you received a new church assignment at this year's Annual Conference session, now is a great time to evaluate your housing expenses so that you can work with the church to designate an accurate housing allowance.

THE BASICS

WHAT: A housing allowance is designed to be a portion of clergy's compensation package that is designated by their church to provide housing. This portion of income can be excluded from gross income reported for federal income tax purposes.

REMEMBER: The housing allowance is an exclusion from income, not a deduction, and does not extend to social security taxes. To be excludible, the amount designated by the employer must be used to provide housing, including, but not limited to, expenses for the rental of a home, mortgage, furnishings, various utilities, and even some necessary home repairs. It is possible for clergy to exclude the entire cost of owning, renting, and/or furnishing a home from his or her gross income.

IRS Limitations

The amount that can be excluded is the lesser of the following:

A. The amount designated as the housing allowance by the church or salary paying entity

Example: A church pays its pastor an annual salary of $45,000, of which $10,000 is designated as a housing allowance. The pastor owns his own home and determines the fair rental value of his furnished home plus projected utilities is $12,000 per year. At the end of the year, he determines his actual housing-related expenses are $12,000. The amount that can be excluded from gross income is $10,000 for federal income tax purposes. This means the pastor was limited by the housing designation and missed out on $2,000 that could have been excluded.

B. The amount of actual housing expenses

Example: A church pays its pastor an annual salary of $45,000, of which $10,000 is designated as a housing allowance. The pastor owns her own home and determines the fair rental value of her furnished home plus projected utilities is $10,000 per year. At the end of the year, she determines her actual housing-related expenses are $8,000. The amount that can be excluded from gross income is $8,000 for federal income tax purposes. The "unused" $2,000 of the housing designation made must be included in the pastor's gross income. This pastor cannot exclude more than her actual housing expenses because it is the lesser amount.

C. The fair rental value of the property (furnished, plus utilities)

Example: A church pays its pastor a salary of $45,000, of which $20,000 is designated as a housing allowance. The pastor owns his own home and determines the fair rental value of his furnished home plus projected utilities is $12,000 per year. At the end of the year, he determines his actual housing-related expenses are $15,000. The amount that can be excluded from gross income is $12,000 for federal income tax purposes because the fair rental value of his home (furnished, including utilities) is the lesser amount.

WHAT ABOUT CHURCH OWNED PROPERTY/PARSONAGE?

- If the pastor is living in a house provided by the church, an analysis will need to be made depending on who pays for housing related expenses.

- If the pastor is responsible for housing-related expenses, such as utilities, he or she needs to determine his or her projected cost for the year so this amount can be designated as an allowance at the beginning of the year. The total exclusion at the end of the year would be the fair market value of the house (paid by the church) and the actual housing-related expenses (paid by the pastor).

- If the church pays for all housing-related expenses, including furnishings, upkeep, and utilities, the exclusion should equal fair rental value of the furnished house plus utilities.

Q. *OKAY, SO I KNOW WHAT IT IS, HOW DO I ACTUALLY DETERMINE THE HOUSING ALLOWANCE?*

A. **Ultimately, the church and pastor should work together to determine a reasonable housing designation.**

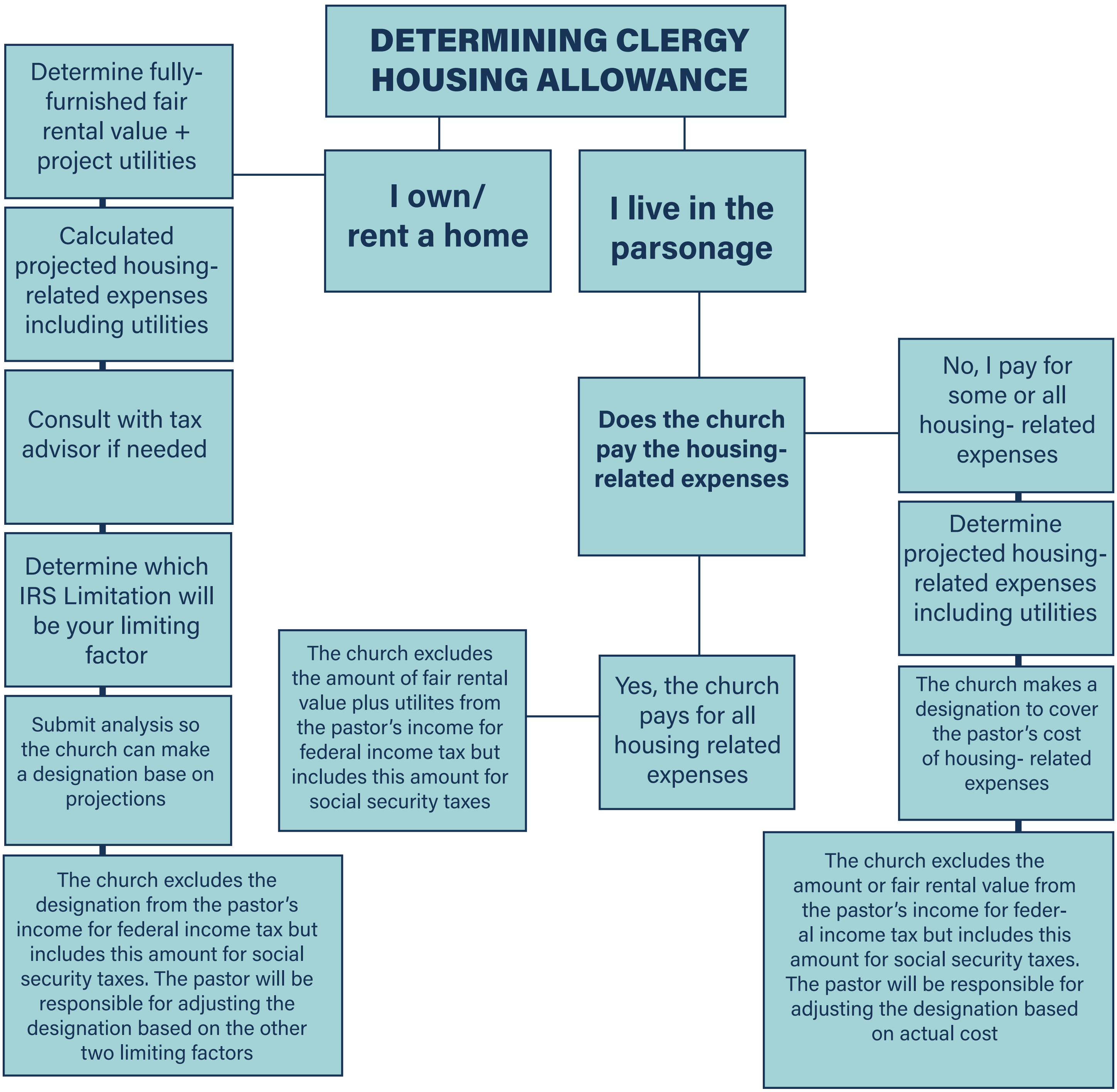
DETERMINING HOUSING ALLOWANCE

- First, understand this. A pastor may not claim a housing allowance exclusion unless his or her local church has first established a housing allowance designation. In other words, **the designation must be made before the pastor is paid for the work.**

- Then, the pastor should complete a form. The pastor should complete a form estimating his or her anticipated housing-related expenses for the year. This is important because, as seen in the examples above, a difference in actual housing expenses and the designated housing allowance matters and could lead to tax consequences such as the pastor not being able to exclude as much income as he or she otherwise could or having to report additional income on his or her personal tax return.

- Adopt a Housing Resolution. The recommended way of doing this is for the church council or charge conference to adopt a housing allowance resolution prior to each calendar year (or prior to the arrival of a new pastor) and record the resolution in the minutes of the meeting (See the Sample Housing Allowance Resolution resource). It is a good idea to have language in each resolution providing that the housing allowance will remain in effect in future years unless otherwise modified to ensure that a housing allowance will always be in place. Generally, churches should avoid designating a set percentage of compensation for housing allowance. The better approach is to estimate the anticipated expenses for the coming year and set the housing designation accordingly.

CHURCHES: *In summary, since the exclusion from gross income cannot exceed the lesser of the designated housing allowance, the actual housing expenses, or the fair market rental value of the property plus utilities, make sure you are not limiting your pastor by capping their exclusion with the designated housing allowance set by the church. Generally, it is recommended to allow a slight buffer for higher than anticipated expenses because actual expenses could be more than projected at the end of the year. The designation made at the beginning of the year cannot be changed retroactively.*



LET'S GO OVER UTILITIES AND HOUSING EXPENSES

Understanding the types of housing-related expenses that can be included when calculating projected and actual expenses will help maximize this benefit. When utilizing the test to include what your actual home ownership expenses are (Example B in the IRS Limitations bubble above), one can include expenses such as:

- **a down payment on a home,**
- **mortgage,**
- **interest on the mortgage payment,**
- **home equity loan payments (assuming loan proceeds are used for housing-related expenses),**
- **real estate taxes,**
- **property insurance,**
- **furnishings,**
- **appliances (including repairs),**
- **structural repairs (such as a new roof),**
- **remodeling,**
- **yard improvements,**
- **snow removal,**
- **maintenance items, and**
- **utilities.**

For both B and C in the IRS Limitations bubble above you must calculate utilities. Utilities is not a term defined by the IRS and is interpreted differently among tax preparers to include a broad range of expenses but clearly includes things like electricity, water, and gas. But utilities could also include things like internet, garbage collection, cable television and streaming services, pest control, and lawn care. The IRS does exclude a few things from the definition including, the cost of food, toiletries, clothing, and maid service. If you are unsure of how to maximize this calculation, we recommend consulting with your tax advisor for guidance.

The Housing Allowance Estimate Worksheet can be used to help calculate estimated annual expenses. Also, expenses can only be included in the housing allowance for the year they are incurred (as the following example demonstrates).

Example:

In anticipation of needing to put a new roof on his house, a pastor requests, and the charge conference approves, an additional $3,500 as part of the pastor's designated housing allowance for the upcoming year. However, the pastor waits until it is too late for the work to begin during that year. In this case, it is possible the pastor will not be able to exclude this additional $3,500 from his income even though it was included as part of his housing allowance for the year. The pastor can only exclude expenses in the same year they are incurred. The best the pastor can do in this situation is to ask the church to again designate an additional $3,500 as part of his housing allowance for the following year for the new roof.

WHAT HAPPENS IF THERE IS A DIFFERENCE IN YOUR ACTUAL EXPENSES AND THE DESIGNATION?

The goal is to project your housing expenses as accurately as possible for the upcoming year or at the beginning of a new appointment before making a designation.

It is possible for the designated amount and the actual amount calculated at tax return time to differ. As discussed above, the actual exclusion from gross income cannot exceed the lesser of the a) designated housing allowance, b) the actual housing expenses, or c) the fair rental value of the property plus utilities. If the amount of actual expenses is less than the designation made at the beginning of the year, the excess amount will need to be reported as income on the pastor's IRS Form 1040.

ADDITIONAL INFORMATION

The housing allowance does not result in additional cost to the church to the extent the church designates the allowance as a portion of the annual compensation it would otherwise pay to its pastor. Regardless, it is the Disciplinary obligation of every United Methodist church to provide housing for its pastor(s).

Per the Book of Discipline, par. 252.4, "housing shall not be considered as part of compensation or remuneration except to the extent provided for in denominational pension and benefit plans." This indicates that compensation and housing allowance should be treated separately.

Example: A church pays its pastor an annual salary of $42,000, the minimum compensation rate set by its annual conference. The church also provides the pastor with a fully furnished parsonage to live with a fair rental value of $12,000. At tax time, the church reports $42,000 as salary on the pastor's Form W-2. However, the pastor's total compensation package, including housing, is $54,000 (salary + housing) for benefit plans and social security taxes.

The housing allowance exclusion only applies for federal income tax purposes and does not extend to social security taxes. By law, clergy are considered self-employed for the purpose of paying social security taxes and the housing allowance and/or value of the parsonage is subject to self-employment taxes ("SECA").

For More Information

ADDITIONAL RESOURCES
About IRS Publication 517
Housing Allowance Q&A

GCFA Legal Services Department
615-329-3393
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www.gcfa.org