

# Clergy Taxation: Housing Allowances, W-2 Reporting, Retirement, Gifts, and Social Security

MONDAY, JUNE 7, 2021, 1:00-2:50 pm Eastern

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# Clergy Taxation: Housing Allowances, W-2 Reporting, Retirement, Gifts, and Social Security

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June 7, 2021

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# Determining Who Is Treated As A Minister

# Step 1: Who is a “minister”?

There is no legal definition, so the courts have worked to define “who is minister” and the most popular is *Knight vs Commissioner*, 92 TC 199. In *Knight*, a “minister” is defined through a balancing of the following factors with only the last factor being mandatory:

- Can administer the sacraments
- Can conduct religious worship services
- Is considered as a religious leader by those around them
- Management responsibility in the local church or denomination
- Is ordained, licensed or commissioned by a church

Other authority on this issue includes *Wingo v. Commissioner*, 89 T.C. 922 (1987) *Haimowitz v. Commissioner*, T.C. Memo 1997-40; *Brannon v. Commissioner*, TC Memo 1999-370 and PLR 19991005.

# Step 2: Are they performing ministerial duties?

## When working for a church:

- Performance of sacerdotal functions
- Conduct religious worship services
- Control, conduct or maintenance of religious organizations or
- Teaching at theological seminaries
- On assignment by a church

## If not working for a church:

- Performance of sacerdotal functions
- Conduct of religious worship services

Should be performing more than 50% of the time

• **EMPLOYEES WHO MEET THE ABOVE TWO STEPS MUST BE TREATED AS MINISTERS! THIS ISN'T OPTIONAL! A MINISTER MAY NOT PICK AND CHOOSE HIS/HER TAX TREATMENT BECAUSE OF THE WAY THE INTERNAL REVENUE CODE IS WRITTEN IN REGARD TO INCOME EARNED BY THESE TAXPAYERS.**

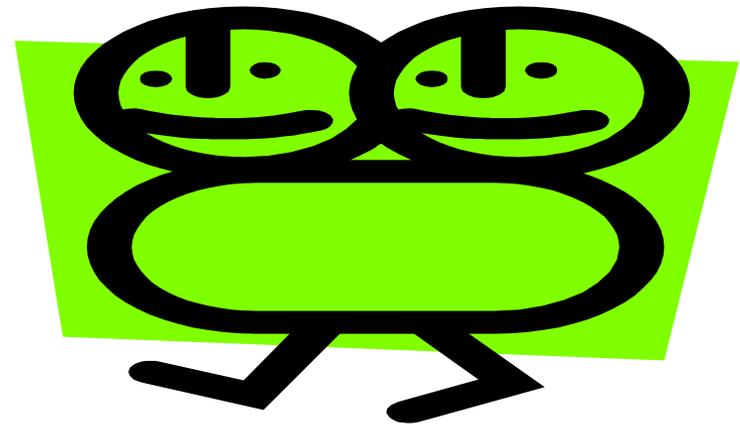


# So, Someone is a minister, what does that mean?

There are two main questions for tax purposes:

- How is a minister classified for federal income tax purposes?
  - Answer: Determined by worker classification analysis, but always exempt from mandatory federal income tax withholding under IRC Sec. 3401(a)(9)
- How is a minister classified for social security tax purposes?
  - Answer: Always, always, always subject to self-employment tax under IRC Sec. 1402 even if considered an employee under the worker classification analysis and never creates FICA wages under IRC Section 3121(b)(8)(A).

TWO PEOPLE IN ONE



Because ministers can be classified differently for different tax purposes it is considered that they have “dual tax” status.

# Documentation

Employers should maintain documentation to prove an employee qualifies as a minister including:

- Copy of the minister's credentials
- Job descriptions that support the duties as being ministerial duties





# The Minister & Worker Classification

# Worker Classification

- Despite unusual tax withholding requirements, it is still necessary to consider the proper classification of a minister. The IRS uses an 11-point test exploring three areas of the work relationship:
  - Behavioral Control
  - Financial Control
  - Type of Relationship

The following cases are considered to have defined the law in this area:

- *Weber v. Commissioner*, 60 F.3d 1104 (4<sup>th</sup> Cir. 1995);
- *Radde v. Commissioner*, T.C. Memo 1994-490;
- *Shelley v. Commissioner*, T.C. Memo 1994-432;
- *Greene v. Commissioner*, T.C. Memo 1996-531 and
- *Alford V. US*, 116 F.3d 334 (8<sup>th</sup> Cir. 1997).

# When Is A Minister An Employee for Federal Income Tax?



- Income earned from a regular employer that meets the above analysis, for example when all the income is from one primary source, and the proper classification is “employee”.
  - Classified as a common law employee
  - DO NOT REPORT ON SCHEDULE C (even if the worker receives a 1099-NEC)
  - Classification as an employee determines:
    - Participation in Benefit Plans
    - The taxability of health insurance premiums
    - Form W-2 reporting of income not on a Form 1099-NEC
    - Income tax withholding optional. A minister must give the church specific permission to withholding tax.

# When Is A Minister Self-Employed for Federal Income Tax?



- Income earned when not an “employee” and typically outside of regular work arrangements for a primary employer, i.e., honorariums for speaking, funerals, weddings, etc.
  - Income reported by payer on Form 1099-NEC
  - Income reported by the minister on Schedule C of the Form 1040
  - Any expenses related specifically to this work; i.e., mileage, hotels, etc., may be deducted on Schedule C.

# Minister's Form W-2

Optional Withholding

22222		a Employee's social security number		OMB No. 1545-0008	
b Employer identification number (EIN)		1 Wages, tips, other compensation		2 Federal income tax withheld	
c Employer's name, address, and ZIP code		3 Social security wages		4 Social security tax withheld	
		5 Medicare wages and tips		6 Medicare tax withheld	
		7 Social security tips		8 Allocated tips	
d Control number		9		10 Dependent care benefits	
e Employee's first name and initial		Last name		11 Nonqualified plans	
f Employee's address and ZIP code		13 Statutory employee <input type="checkbox"/>		12a	
		Retirement plan <input type="checkbox"/>		12b	
		Third-party sick pay <input type="checkbox"/>		12c	
		14 Other		12d	
15 State	Employer's state ID number	16 State wages, tips, etc.	17 State income tax	18 Local wages, tips, etc.	19 Local income tax
				20 Locality name	

These boxes are always empty

Housing Allowance Optional

Form **W-2** Wage and Tax Statement  
Copy 1—For State, City, or Local Tax Department

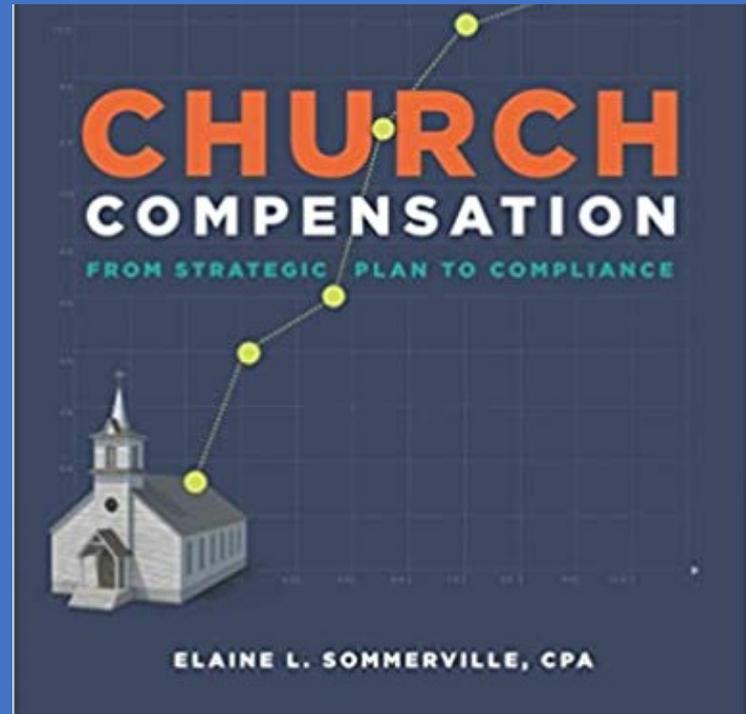
2021

Department of the Treasury—Internal Revenue Service

# The Minister & Income

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**Church Compensation: From Strategic Plan  
to Compliance** by Elaine Sommerville, CPA.



## JAIL TIME ANYONE?



- Rev. Ellis took his pay out of the offering plate on Sundays. [*United States v. Ellis*, KTC 2006-68 (7<sup>th</sup> Cir. 2006)]
- Rev. Clark had the church pay his personal expenses such as auto payments & credit cards. [*United States v. Clark*, 103 AFTR 2d 2009-1349 (D. C. Ala. 2009)]
- Bishop Jinwright failed to report honorariums, personal expenses and employer provided autos to name a few. (His wife went to jail also.)
- Rev. Springer failed to report love gifts that he had received. [*Springer v. U.S.*, 2010 U.S. Dist. LEXIS 6906 (N.D. Ok. 2010)]

# The Tax Foundation

- Everything that benefits a person is taxable until you find the specific authority in the Internal Revenue Code that says it is not taxable.

# Items of Income

- Salary
  - Housing Allowance
  - Outside honorariums
  - Love offerings & gifts
  - Clothing allowances
  - Auto allowances or provision of auto
  - Discretionary funds
  - Educational expenses
  - Loans
- 
- Expenses reimbursed under a nonaccountable expense reimbursement plans
  - Adoption assistance
  - Tuition reduction plans
  - Cell phones
  - Transportation costs
  - Sabbatical expenses
  - Dependent care
  - Spousal travel
  - Kids go to camp for free

# Gifts

## Appreciation, Retirement or Special Occasion

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Key court cases in this area include:

- *Commissioner v. Duberstein*, 363 U.S. 278 (1960)
  - *Goodwin v. United States*, 67 F.3d 149 (8<sup>th</sup> Cir. 1995)
  - *Banks v. Commissioner*, T.C. Memo. 1991-641 (1991)
  - *Swaringer v. Commissioner*, T.C. Summary Opinion 2001-37.
- Taxable from the church/employer according to IRC Section 102(c)
    - Goes in Box 1 on Form W-2
    - Church cannot be conduit for members
    - Church must control amount
    - Can be cash or noncash gifts
  - Nontaxable if from a relative or a close friend but taxable if from a recipient of ministry activity
  - Key for non-taxation: detached and disinterested generosity



REDUCING FEDERAL  
INCOME TAX:  
DESIGNATED  
HOUSING EXCLUSION

# HOUSING EXCLUSION

- The Clergy housing exclusion (26 US Code § 107) is called by many names, yet each represents the same thing: the mechanism by which Clergy are permitted to exclude some or all of their income from being subject to federal income tax.
  - Housing allowance or exclusion
  - Parsonage allowance or exclusion
  - Rental allowance or exclusion
  - Utilities allowance or exclusion

# HOUSING EXCLUSION

- Ordained, commissioned, or licensed Clergy performing ministry services \***should**\* designate **all or part** of their total compensation from their employer as housing exclusion.
- The amount designated as housing exclusion can then be excluded from income for federal income tax purposes (subject to certain rules).

# HOUSING EXCLUSION

- However, all Clergy income is subject to self-employment tax, including both the officially designated housing exclusion &/or the Fair Rental Value (FRV) of a provided Parsonage & the cost of all Utilities paid by the congregation.



# HOUSING EXPENSES

## HOUSING EXPENSES:

rent/mortgage payments (in full)

real estate taxes (in full)

renter's/homeowner's insurance

homeowner's assn./condo fees

repairs & maintenance

furnishings & decorations

lawn care & snow removal

cleaning services

(26 CFR §1.107-1(c)(3))

## UTILITIES:

electricity

heating oil

natural gas

water/sewer/trash

pest control

security systems

internet/tv/streaming

land-line phone OR

personal-use cell phone

etc.

# HOUSING EXPENSES

- 26 CFR § 1.107-1 Rental value of parsonages
- (c) . . . “Circumstances under which a rental allowance will be deemed to have been used to rent or provide a home will include cases in which the allowance is expended (1) for rent of a home, (2) for purchase of a home, and (3) for expenses directly related to providing a home. **Expenses for food and servants are not considered for this purpose to be directly related to providing a home.”**

# PARSONAGES

- Rules for Clergy Living in Parsonages:
  - The Fair Rental Value (FRV) of a Parsonage (including utilities) is automatically excluded from income before federal income tax is calculated.
  - The FRV of a Parsonage (including utilities) is automatically included in income before self-employment tax is calculated.

# PARSONAGES

- Rules for Clergy Living in Parsonages:
  - The FRV must be reasonable for its location, but it benefits the Clergy's self-employment tax bill if it is on the low end of the range of rentals in the area.
  - Clergy should still designate an additional housing exclusion to cover household items beyond the building &/or utilities (see list). This additional housing exclusion is subject to the Housing Exclusion Rules (next).

# RULES

- Housing Exclusion Rules:
  - The amount officially designated as housing exclusion must be specified in writing, in an official document of the employer, before any housing exclusion payment is made.
    - It can be a dollar amount or a percentage.
    - It can be time limited or in perpetuity.
  - The amount must be used to provide or rent the Clergy member's home.
  - The amount cannot be more than reasonable pay for Clergy services.
    - It can be 100% of Clergy compensation.

# RULES

- The amount that can be excluded from income before federal income tax is calculated is the SMALLEST of the following 3 amounts:
  - Amount officially designated in writing as the housing exclusion
  - Amount actually spent to provide the home
  - Fair Rental Value (FRV) of the home, including utilities, furnishings, etc. — basically, everything in the home except food & clothing!

# FAIR RENTAL VALUE

- The FRV of a Parsonage is calculated based on an empty building, garage, & any utilities paid by the congregation on the Clergy's behalf.
  - A realtor can give an accurate range of Parsonage rental values for the area.
- But for purposes of calculating the excludable housing amount, calculating the FRV of the home you rent or own is VERY DIFFERENT than calculating the FRV of a Parsonage.

# FAIR RENTAL VALUE

- The FRV of a Home you rent or own is calculated based on the home, landscaping, garage, utilities — WITH EVERYTHING STILL IN IT (except food & clothing)
- Look around your house & **really see all the STUFF you own**. What would it cost to rent it all? There is no way to calculate this FRV amount.
- Since underestimating the FRV of your home can cost you significant tax savings, here's my rule:

Never allow the FRV of your home to be the smallest of those 3 amounts!

# FAIR RENTAL VALUE

- In the year of purchase of a new home or of major remodeling or other large expenses, the FRV becomes a more critical calculation.
  - For the building, a fairly accurate rule of thumb is to start with the Sale or Appraisal Value of your home. Take 1% (monthly FRV) X 12 = FRV of the empty building. Or ask a Realtor.
  - For your furnishings, be sure to adjust for the age & condition of your furniture, but also your artwork, collectibles, & BOOKS.

# EXCLUSION

- If the amount that was officially designated in writing as the housing exclusion is the smallest of these 3 amounts:
  - Amount officially designated
  - Amount actually spent
  - FRV of the home (never the smallest number!)
- Then that amount can be excluded from income before federal income tax can be calculated.

# EXCLUSION

- But if the amount that was officially designated in writing as the housing exclusion is not the smallest of these 3 amounts?
- Then:
  - the excess of the designated housing exclusion
  - over the smallest of these 3 amounts (it better not be the FRV of the home!)
  - must be added back into income as “excess housing” before federal income tax is calculated.

# EXCLUSION

- Ideally, the officially designated housing exclusion should always be higher than the Clergy employee's actual expenses.
- This way Clergy can take advantage of any unexpected expenses (e.g., repairs, furniture, disasters) to further reduce their income before federal income tax is calculated.
- If designated correctly, Clergy will have a small amount of excess housing exclusion added back into wages each year.

# SUPPLY PREACHERS

- Rules for Clergy Serving as Supply Preachers:
  - The official designation of a housing exclusion amount can be made by the congregation who holds the Clergy's membership & to whom they are accountable.
  - This is also true for Clergy pension payments from a qualified 403(b)(9) church retirement plan, if not already designated by the plan.

# SUPPLY PREACHERS

- Rules for Clergy Serving as Supply Preachers:
  - Language used by the congregation can include something similar to “100% of all income received from ministry services is designated as housing exclusion, until further notice.”
  - If this designation has been made, no IRS reporting is required. A copy of this signed & dated statement should be given to the Supply Preacher on official letterhead to keep in their files.

# RETIRED CLERGY

- Retired Clergy do not pay self-employment tax on pension payments or retirement allowances received for past ministry services.
- Retired Clergy do not pay federal income tax on the FRV of a provided Parsonage.
- Retired Clergy do not pay federal income tax on pension payments which have been officially designated as housing exclusion—provided they are properly excluded from income.



REDUCING SELF-  
EMPLOYMENT TAX:  
CLERGY  
BUSINESS EXPENSES

# CLERGY EXPENSES

- Business Mileage (IRS Mileage Log Requirements)
- **BOOKS !** & Subscriptions
- Computer & Internet
- Religious Material; Anointing Oil
- Education (Seminars & Conferences)
- Robes, Vestments, Collars, etc. (& dry cleaning)
- Office Supplies
- Portion of Cell Phone Bill Used for Ministry

# IRS MILEAGE LOG

- Record Odometer at beginning & end of the tax year to track total miles driven for all purposes during the year.
- For each Trip, write: Date, Start Odometer, Start Location, Purpose of Trip, End Location, End Odometer, Total Mileage for Trip (use trip odometer for this).
- Keep all receipts of work done on vehicle to prove 3rd-party verification of odometer readings.

# BUSINESS EXPENSES

- In IRS Publication 463, "Travel, Entertainment, Gift, and Car Expenses," IRS defines business expenses as "ordinary & necessary business-related expenses."
- An ordinary expense is one that is common & accepted in your trade or business.
- A necessary expense is one that is helpful & appropriate for your business. An expense doesn't have to be required to be considered necessary.

# ATTRIBUTION

- Expenses are attributed to 1 of the 3 types of Clergy income (& reported on the tax return on the following forms):
  - Salary-related expenses  
reported on Clergy Worksheet 3, Line 6
  - Housing Exclusion-related expenses  
reported on Clergy Worksheet 1; Schedule A
  - Self-Employment-related expenses  
reported on Schedule C

# SE TAX

- How Clergy expenses are deducted from income:
  - For Self-Employment Tax purposes:  
Because all Clergy income is subject to self-employment tax, **deduct all expenses.**

# FEDERAL INCOME TAX

- For Federal Income Tax purposes:  
Because not all Clergy income is subject to federal income tax, **deduct only those expenses that are attributable to taxable income**. Expenses must be allocated across taxable & nontaxable income.
- Reduce all expenses by the proportion (percent) of non-taxable housing exclusion to total Clergy income, as follows:

$$\frac{\text{Non-Taxable Housing Exclusion}}{\text{Total Ministry Income}}$$

# CLERGY WORKSHEETS

- **Use the IRS Clergy Worksheets**  
at the end of IRS Publication 517  
to calculate these amounts!
- Worksheet 1. Figuring the Percentage of Tax-Free Income
- Worksheet 2. Figuring the Allowable Deduction for Schedule C or C-EZ Expenses
- Worksheet 3. Figuring Net Self-Employment Income for Schedule SE (Form 1040)

# HANDOUTS

- 2020 IRS Pub. 517 Clergy Worksheets
- 2021 Clergy Housing Allowance Exclusion Items



# Fringe Benefits

# Fringe Benefits

- A fringe benefit is any cash, property, or service that clergy employees receive from a congregation in addition to salary. All fringe benefits are taxable income to employees unless exempted by the Internal Revenue Code
- Many fringe benefits can be provided by a congregation to clergy without any dollar limitation (health insurance is an example), while other fringe benefits are subject to annual limits (dependent care is an example).

# Fringe Benefits

- To qualify for exclusion from income, many fringe benefits must be nondiscriminatory. In other words, the benefits must be offered to all employees or employees in certain classes. .
- Other fringe benefits may be offered to some employees and not to others

# Fringe Benefits

- Some of the most important fringe benefits for ministers includes:
  - Health insurance. If the congregation pays the group medical insurance premiums (2 qualifying employees or more) directly to the insurance carrier or reimburses clergy for the premiums based on only one qualifying employee, the premiums are generally tax-free to clergy.
  - Disability insurance. If the congregation pays the disability insurance premiums (and clergy is the beneficiary) as a part of the compensation package, the premiums are excluded from income.
  - Group-term life insurance. If the group life coverage provided under a nondiscriminatory plan does not exceed \$50,000 for clergy, the life insurance premiums are generally tax-free to clergy.

# Fringe Benefits

- • Out-of-pocket medical expenses (all of the following plans are subject to the nondiscriminatory rules):
- Flexible spending account (FSA). The FSA should generally be the plan of choice for clergy and congregations. The FSA is simple to establish and easy to administer by the congregation.
- Health savings account (HSA). Within limits, HSA contributions made by congregations are excludable from income tax and social security wages (Employees must have a high deductible health plan) Withdrawals from HSA's to pay medical expenses are tax-free.
- Health reimbursement arrangement (HRA). The same HRA benefit must be provided to all employees. This makes this concept very limiting since out-of-pocket costs significantly vary employee-to-employee.

# Fringe Benefits

- **One Person HRA Plan**

HRAs are Medical Expense Reimbursement Plans that allow you to save substantial tax dollars on insurance premiums and out-of-pocket medical expenses not covered by insurance. HRA One-Person Plans are designed specifically for smaller churches with one qualifying employee.

Establishing a Section 105 HRA through a benefits writer enables the church to reimburse individual insurance premium and out-of-pocket medical, dental, and vision expenses and save thousands of tax dollars you couldn't deduct otherwise.

# Fringe Benefits

- **QSEHRA Plans** (with less than 50 employees without group health insurance)

If a church (with less than 50 employees) does **not offer a group health plan** to any of your employees, then it can set up QSEHRA plan to offer pre-tax benefits for insurance premiums and health expenses to **all eligible employees.**

The maximum 2020 individual amount is \$5,300, and maximum for an employee and family contribution is \$10,700. The annual maximum must be prorated for employees who are not working a full year, meaning if someone starts mid-year you cannot bump up their monthly contribution amounts to allow them to receive the full yearly amount. The cost of the QSEHRA benefit must be entirely covered by the church.

# Fringe Benefits

- Health FSA Plan
- Health Flexible Spending Accounts (FSA) are a type of Medical Reimbursement Plan. Health FSAs are one way for employees to use pre-tax dollars to pay for medical expenses, such as doctor visit copays, vision expenses, and prescription drug costs. FSAs are established by employers and are (usually) 100% employee funded.

The Health FSA reduces payroll taxes for both the church and the employee making it a popular benefit option. Qualifying Health Flexible Spending Account expenses include but not limited too: Vision Expenses including Glasses and Contacts, Health Plan Deductibles Rx – Prescription Drugs, Health Plan Co-Payments, Orthodontic Procedures, Chiropractic, Dental Charges, Blood Work, X-ray, and other Qualifying Medical Expense.

# Fringe Benefits

- Dependent Care FSAs allow employees to use pre-tax dollars to pay dependent care expenses.  
Due to COVID rulings; instead of losing unused FSA funds at the end of the year, employers can modify their FSA plans to allow a worker's unused funds from 2020 to be used in 2021 and unused funds from 2021 to be used in 2022. As an alternative, an extended grace period for using FSA funds after the end of the year is allowed. Normally, FSA plans can offer a grace period of up to 2½ months (i.e., to March 15). However, a grace period of up to 12 months is allowed for using 2020 and 2021 FSA funds. Workers can also contribute more to a dependent care FSA in 2021. Instead of the normal \$5,000-per-year limit on tax-free contributions, a family can sock away up to \$10,500 in a dependent care FSA this year without paying tax on the contributions.

# Fringe Benefits

- Properly focusing on tax-free and tax-deferred fringe benefits can make a significant difference in the stewarding of funds expended by a congregation on behalf of clergy. Federal tax laws help congregations and clergy by subsidizing tax-free fringe benefits and delaying the taxation of tax-deferred benefits.
- Source – EFCA, Richard Hammar, Kiplinger

# Retirement plans for Clergy

# Retirement Plans for Clergy

TRADITIONAL IRA	ROTH IRA	403B(9) CHURCH PLAN
A <b>traditional IRA</b> (individual retirement account) allows individuals to direct pre-tax income toward investments that can grow tax-deferred. ... Individual taxpayers can contribute 100% of any earned compensation up to a specified maximum dollar amount.	A <b>Roth IRA</b> is an individual retirement account ( <b>IRA</b> ) that allows qualified withdrawals on a tax-free basis provided certain conditions are satisfied. ... <b>Roth IRAs</b> are funded with after-tax dollars; the contributions are not tax-deductible.	<b>403(b)(9)</b> plans offer retired ministers the ability to <b>have</b> retirement distributions designated as <b>housing allowance</b> . All employees are eligible to participate unless the plan specifically excludes them. (only ministerial allowed the housing allowance benefit)
Contributions are sometimes income-tax deductible	Distributions are generally not taxable after age 59½	Contributions avoid income tax
Earnings are tax-deferred	Contributions can be withdrawn any time without tax or IRS penalty	Earnings are tax-deferred
Distributions are generally taxable	Earnings can be withdrawn tax-free after age 59½	Avoids Social Security tax for clergy but not for lay workers
<b>Typical federal tax savings on \$4000 of contributions:</b> \$480, but only if you're eligible to deduct the contributions	<b>Typical federal tax savings on \$4000 of contributions:</b> \$0	<b>Typical federal tax savings on \$4000 of contributions:</b> \$1045 for clergy )not exempt from Social Security
<b>Annual contribution limit:</b> \$6,000 (\$7,000 if over age 50)	<b>Annual contribution limit:</b> \$6,000 (\$7,000 if over age 50)	<b>Annual contribution limit:</b> \$19,500 (\$26,000 if over age 50) in addition to employer contributions

# Retirement Plans for Clergy

SOCIAL SECURITY	403B(9)ROTH	HSA
<p>Clergy have the decision of staying in social security or exempting out (to be made before they file their second tax return as clergy status). If they decide to stay in, they will pay social security and medicare tax on their salary plus housing. It is true that many who exempt out of social security and medicare will still be eligible to receive this benefit when they retire as well.</p>	<p>Allows employees to pay taxes on their contributions today while enjoying tax free distributions when they withdraw in the future. A minister would likely want to continue to make contributions pre-tax to the 403(b) because he/she can then make tax-free withdrawals in retirement utilizing the housing allowance. Many clergy are choosing to utilize both, though, knowing that they will not be spending all their retirement money on housing.</p>	<p>Health Savings Accounts can accumulate throughout a clergy's employment. You can contribute to an HSA until you enroll in Medicare, even when you're not working. They are a great way to pay for medical expenses while in retirement AND you never have to take out a required minimum distribution.</p>
<p>Distributions taxable up to 85%</p>	<p>Distributions are generally not taxable after age 59½</p>	<p>Distributions are made for eligible qualified medical expenses.</p>
<p>Contributions are made on salary plus housing allowance</p>	<p>Contributions can be withdrawn any time without tax or IRS penalty if the plan allows.</p>	<p>Contributions avoid income tax and social security and medicare tax.</p>
<p>Earnings – N/A</p>	<p>Earnings can be withdrawn tax-free after age 59½</p>	<p>Earnings are never taxed</p>