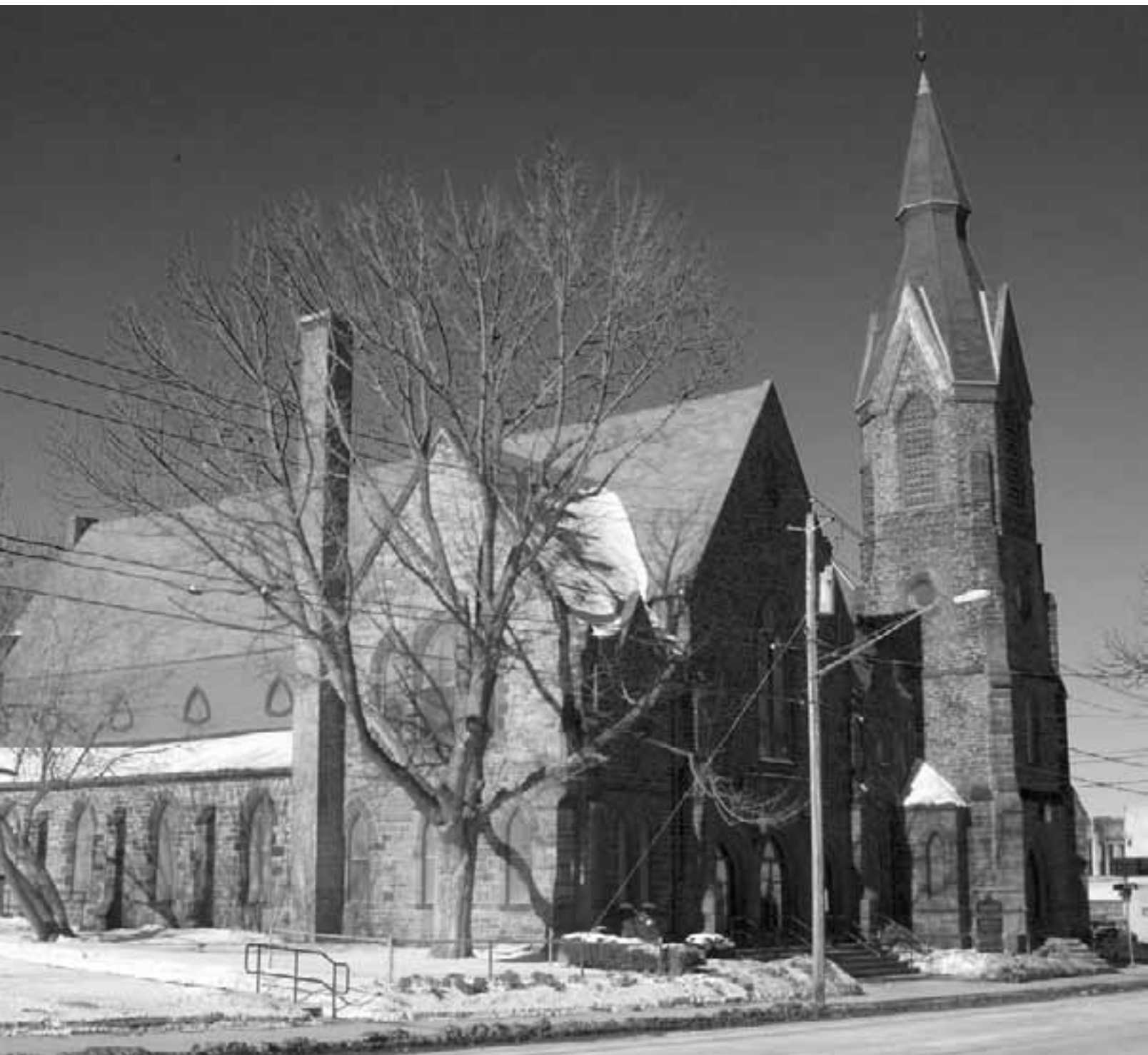


# TAX GUIDE FOR MINISTERS FILING 2006 RETURNS

Prepared by Richard R. Hammar, J.D., LL.M., CPA

| M | M | B | B |



Prepared for The Ministers and Missionaries Benefit Board (MMBB). Copyright © 2006 Church Law & Tax Report. All rights reserved. We grant permission for material in the book to be photocopied for use in a local-church setting provided that:

1. no more than 1,000 copies are made;
2. the material is distributed free, and no charge is made for admission to the class or event; and
3. the copies include the notice "Copyright 2006 Church Law & Tax Report. Prepared for The Ministers and Missionaries Benefit Board (MMBB)."

No part of this book may be reproduced, stored in a retrieval system or transmitted in any form or by any means, electronic, mechanical, photocopying, recording or otherwise without prior written permission from the publisher, except as noted in the text and in the case of brief quotations embodied in critical articles and reviews.

This publication is intended to provide a timely, accurate and authoritative discussion of tax reporting compliance and the impact of recent changes in tax laws. It is not intended as a substitute for legal, accounting or other professional advice. If legal, tax or other expert assistance is required, the services of a competent professional person should be sought. Although we believe this book provides accurate information, there may be changes resulting from IRS or judicial interpretations of the Tax Code, new tax regulations or technical corrections that occurred after printing of this edition that are not reflected in the text.

Circular 230 Disclaimer: This Guide should not be viewed as legal, tax or other advice. Any tax advice contained in the body of this material was not intended or written to be used, and cannot be used, by the recipient for the purpose of 1) avoiding penalties that may be imposed under the Internal Revenue Code or applicable state or local tax provisions, or 2) promoting, marketing or recommending to another party any transaction or matter addressed herein.

Throughout this document tax examples are given that include fictional names of ministers, lay employees and churches. The names for the persons and places in these examples were chosen at random and do not refer to any particular ministers, lay employees, churches or institutions related to The Ministers and Missionaries Benefit Board.

Visit our Web site: [www.churchlawtoday.com](http://www.churchlawtoday.com)

**Published by**  
**The Ministers and Missionaries Benefit Board**

475 Riverside Drive, Suite 1700  
New York, NY 10115-0049

**Tel:** 800.986.6222

**Fax:** 800.986.6782

**[www.mmbb.org](http://www.mmbb.org)**

# Table of Contents

|   |    |
|---|----|
| <b>Part 1. Introduction</b> .....   | 5  |
| How to use this guide .....   | 5  |
| Tax highlights for 2006 .....   | 5  |
| Preliminary Questions .....   | 8  |
| <b>Part 2. Special Rules for Ministers</b> .....                                    | 9  |
| Who is a minister for federal tax purposes?.....                                    | 9  |
| Are ministers employees or self-employed for federal tax purposes? .....            | 9  |
| Exemption from Social Security (self-employment) taxes .....                        | 10 |
| How do ministers pay their taxes?.....  | 11 |
| <b>Part 3. Step-by-Step Tax Return Preparation</b> .....                            | 12 |
| Tax forms and schedules .....   | 12 |
| Form 1040 .....   | 12 |
| Step 1: Label and general information .....   | 12 |
| Step 2: Filing status .....   | 12 |
| Step 3: Exemptions .....  | 12 |
| Step 4: Income .....  | 13 |
| Line 7. Wages, salaries, tips, etc.....   | 13 |
| Housing Allowance .....   | 14 |
| Housing allowance expense worksheet for ordained ministers who own their home ..... | 15 |
| Housing expenses to include in computing your housing allowance exclusion .....     | 15 |
| How much should a church designate as a housing allowance? .....                    | 17 |
| Section 403(b) plans .....  | 18 |
| Qualified scholarships .....  | 19 |
| Sale or exchange of your principal residence.....                                   | 19 |
| Line 8a. Interest income: attach Schedule B if over \$1,500 .....                   | 20 |
| Line 9. Dividend income: attach schedule B if over \$1,500 .....                    | 20 |
| Line 12. Business income (or loss): attach schedule C or C-EZ.....                  | 20 |
| Line 13. Capital gain (or loss): attach schedule D .....                            | 20 |
| Line 16a. Total pensions and annuities .....  | 20 |
| Taxation of distributions from 403(b) plans .....                                   | 20 |
| Line 20a. Social Security benefits .....  | 21 |
| Line 21. Other income: list the type and amount .....                               | 21 |
| Step 5: Adjustments to income.....  | 21 |
| Line 26. Moving expenses.....   | 21 |
| Line 27. One-half of self-employment tax.....                                       | 22 |
| Line 32. Payments to an individual retirement account (IRA) .....                   | 22 |
| Step 6: Adjusted Gross Income.....  | 24 |
| Line 37. Compute adjusted gross income .....  | 24 |
| Step 7: Tax computation .....   | 24 |
| Line 40. Itemized deductions or standard deduction.....                             | 24 |
| Line 42. Personal exemptions .....  | 24 |
| Line 44. Compute tax.....   | 24 |
| Step 8: Credits .....   | 24 |
| Line 48. Credit for child and dependent care expenses: attach Form 2441.....        | 24 |
| Line 53. Child tax credit .....   | 24 |
| Line 55. ....   | 24 |



**Tax Guide for Ministers Filing 2006 Returns**

|  |           |
|--|-----------|
| Step 9: Other taxes .....  | 24        |
| Line 58. Self-employment tax: attach Schedule SE (also see line 27).....         | 24        |
| Step 10: Payments .....  | 24        |
| Line 64. Federal income tax withheld .....                                       | 24        |
| Line 65. 2006 Estimated tax payments .....                                       | 25        |
| Line 66. Earned income credit.....   | 25        |
| Line 71.....   | 25        |
| Step 11: Refund or amount you owe .....  | 25        |
| Step 12: Sign here .....   | 25        |
| Other forms and schedules .....  | 26        |
| Schedule A .....   | 26        |
| Step 1: Medical and dental expenses (lines 1-4).....                             | 26        |
| Step 2: Taxes you paid (lines 5-9) .....   | 26        |
| Step 3: Interest you paid (lines 10-14) .....                                    | 27        |
| Step 4: Gifts to charity (lines 15-18) .....                                     | 27        |
| Step 5: Casualty and theft losses (line 19) .....                                | 28        |
| Step 6: Job expenses and most other miscellaneous deductions (lines 20-26) ..... | 28        |
| Employee business expenses .....   | 29        |
| Local transportation expenses.....   | 29        |
| Travel expenses .....  | 29        |
| Entertainment Expenses.....  | 30        |
| Educational expenses .....   | 30        |
| Subscriptions and books.....   | 31        |
| Personal computers.....  | 31        |
| Office in the home .....   | 31        |
| How to report employee business expenses.....                                    | 32        |
| Schedule B .....   | 34        |
| Step 1: Interest income (lines 1-4).....   | 34        |
| Step 2: Dividend income (lines 5-6).....   | 34        |
| Step 3: Foreign accounts and foreign trusts .....                                | 34        |
| Schedule C.....  | 34        |
| Step 1: Introduction.....  | 34        |
| Step 2: Income (lines 1-7).....  | 34        |
| Step 3: Expenses (lines 8-27).....   | 34        |
| Schedule C-EZ .....  | 35        |
| Schedule SE .....  | 35        |
| Step 1: Section A (line 2).....  | 35        |
| Step 2: Section A (line 4).....  | 36        |
| Step 3: Section A (line 5).....  | 36        |
| Form 2106 .....  | 36        |
| Step 1: Enter your expenses .....  | 36        |
| Step 2: Enter amounts your employer gave you for expenses listed in Step 1.....  | 36        |
| Step 3: Figure expenses to deduct on Schedule A (Form 1040) .....                | 36        |
| Form 2106-EZ.....  | 36        |
| <b>Part 4. Comprehensive Example and Forms.....</b>                              | <b>37</b> |
| Example One: Senior Minister .....   | 37        |
| Example Two: Retired Minister .....  | 45        |

# Tax Guide for Ministers Filing 2006 Returns

---

## Part 1. Introduction

---

### *How to use this guide*

This book contains the basic information you need to complete your 2006 federal income tax return. It gives special attention to several forms and schedules and the sections of each form most relevant to ministers.

🔑 **Key Point.** Congress, the courts, or the IRS may cause tax changes at any time, in some cases retroactively. This guide includes only the law in effect at the time of preparation. Be certain to refer to the final instructions to Form 1040 when completing your tax return.

*This guide is divided into the following sections:*

**Part 1: Introduction** – This section reviews tax highlights for 2006 and presents several preliminary questions you should consider before preparing your tax return.

**Part 2: Special Rules for Ministers** – In this section, you learn whether or not you are a minister for tax purposes, whether you are an employee or self-employed for both income tax and Social Security purposes, and how you pay your taxes.

**Part 3: Step-By-Step Tax Return Preparation** – This section explains how to complete the most common tax forms and schedules for ministers.

**Part 4: Comprehensive Examples and Sample Forms** – This section shows a sample tax return prepared for an ordained minister and spouse and for a retired minister and spouse.

### *Tax highlights for 2006*

Congress enacted three major tax laws in 2006 (the Tax Relief and Health Care Act, the Pension Protection Act, and the Tax Increase Prevention and Reconciliation Act). These laws contain several provisions that will affect tax reporting by both ministers and churches for 2006 and future years. Here is a run down of some of the key provisions:

#### *Tax Relief and Health Care Act*

(1) The Act extends the state and local sales tax deduction through 2007.

- (2) The Act extends the popular above-the-line deduction for higher education expenses through 2007. This provision allows taxpayers to deduct up to \$4,000 (depending on their income) of higher education expenses in lieu of claiming the Hope or Lifetime Learning tax credits.
- (3) The Act extends the above-the-line deduction for teacher classroom expenses through 2007. This provision allows teachers to deduct up to \$250 of out-of-pocket costs incurred to purchase books, supplies and other classroom equipment.
- (4) The Act allows taxpayers to make tax-deductible contributions to an Archer medical savings account to pay for health care expenses through 2007.
- (5) The Act provides a one-year extension of the 30 percent tax credit for the purchase of residential solar water heating, solar electric equipment and fuel cell property through 2008.
- (6) The Act includes several provisions designed to improve Health Savings Accounts (HSAs). For example, the Act (a) permits rollovers from “health flexible spending arrangements (FSAs)” and health reimbursement arrangements (HRAs) into an HSA; (b) repeals the annual plan deductible limitation on HSA contributions; and (c) permits one-time rollovers from IRAs to HSAs.
- (7) The Act increases the penalty for frivolous tax return submissions from \$500 to \$5,000 and expands the penalty to all taxpayers and all types of federal taxes.

#### *Pension Protection Act of 2006*

- (8) Several favorable retirement plan provisions that were scheduled to expire at the end of 2010 were made permanent. These include:
  - the maximum annual dollar contribution limit for IRA contributions (\$4,000 for 2005 through 2007, \$5,000 for 2008 with inflation adjustments thereafter in \$500 increments).
  - annual “catch-up contributions” to an IRA of an additional \$1,000 for persons who are 50 years of age or older.
  - more generous contribution limits for contributions to 403(b) retirement accounts (\$15,000 in 2006, \$15,500 in 2007).
  - “catch-up contributions” to a 403(b) retirement account of up to an additional \$5,000 for per-

sons who are 50 years of age or older (remains \$5,000 in 2007).

- “Roth” contributions by 403(b) participants.
  - rollovers of after-tax contributions to a 403(b) account.
- (9) The Act allows tax-free “qualified charitable distributions” of up to \$100,000 from an IRA to a church or other charity by IRA owners who are age 70½ or older. This provision is effective only for qualified charitable contributions made during 2006 and 2007.
- (10) The Act modifies the information return requirements that apply upon the disposition of donated property by a charitable organization (Form 8282). The return requirement is extended to dispositions made within *three years* after receipt (up from two years under prior law). The charity also must provide, in addition to the information already required on the return, a description of its use of the property and a statement of whether this use was related to its exempt purposes.
- (11) The Act amended the tax code to require all cash contributions, regardless of amount, to be substantiated by either a bank record (such as a cancelled check) or a written communication from the charity showing the name of the charity, the date of the contribution, and the amount of the contribution. The recordkeeping requirements may not be satisfied by maintaining other written records. In the past, donors could substantiate cash contributions of less than \$250 with “other reliable written records” if no cancelled check or receipt was available. This is no longer allowed. Additional substantiation requirements apply to individual contributions of \$250 or more, and these must be satisfied as well. This change will only affect taxpayers who itemize their taxes. The new law is effective for most taxpayers for contributions made after December 31, 2006.
- (12) Under prior law, the IRS could assess a penalty against “managers” of a church or other charity who approved an “excess benefit transaction” unless a manager could demonstrate that his or her approval was “not willful and due to reasonable cause.” This penalty consisted of an excise tax of up to 10% of the amount of the excess benefit, with a maximum of \$10,000 per manager (but the total tax on all managers could not exceed \$10,000). The Act increases the 10% amount to 20%. It also doubles the dollar limitation on managers for participation in excess benefit transactions from \$10,000 per transaction to \$20,000 per transaction.
- (13) The Act amended the tax code to deny a charitable contribution deduction for a contribution of cloth-

ing or household items unless the clothing or household items are in “good used condition or better.” The IRS is authorized to deny a deduction for any contribution of clothing or a household item that has minimal monetary value, such as used socks or undergarments. This change is effective for contributions made after August 17, 2006.

- (14) In order for donors to deduct most contributions of noncash property valued at more than \$5,000 they must obtain a qualified appraisal from a qualified appraiser and attach a qualified appraisal summary (Form 8283) to the tax return claiming the deduction. The Act amended the definitions of “qualified appraisals” and “qualified appraisers.” It also created a civil penalty the IRS can assess against any person who prepares an appraisal that is to be used to support a tax position if the appraisal results in a substantial or gross valuation misstatement.
- (15) The Act amended the tax code to make the annual unrelated business income tax return (Form 990-T) subject to public inspection. Churches are required to file this form if they generate more than \$1,000 in unrelated business income from an unrelated trade or business.

#### ***The Tax Increase Prevention and Reconciliation Act of 2005 (“TIPRA”)***

- (16) For taxable years beginning before 2009, the maximum rate of tax on the adjusted net capital gain of an individual is 15 percent. Any adjusted net capital gain which otherwise would be taxed at a 10 or 15 percent ordinary income rate is taxed at a five percent rate (zero for taxable years beginning after 2007. TIPRA extends through 2010 the lower capital gain rates that were scheduled to expire at the end of 2008.
- (17) TIPRA extends for two years the current provisions relating to lower dividend tax rates (through 2010).
- (18) The Act amends the tax code to require a taxpayer to make partial payments to the IRS while the taxpayer’s offer in compromise is being considered by the IRS. For lump-sum offers, taxpayers must make a down payment of 20 percent of the amount of the offer with any application (in addition to the applicable user fee). A lump-sum offer includes single payments as well as payments made in five or fewer installments. For periodic payment offers, the provision requires the taxpayer to comply with the taxpayer’s own proposed payment schedule while the offer is being considered. Offers submitted to the IRS that do not comply with these payment requirements may be returned to the taxpayer as unprocessable and immediate enforcement action is permitted.

**Other provisions of relevance to churches and church employees**

- (19) You may be able to claim the earned income credit for 2006 if (1) a child lived with you and you earned less than \$32,001 (\$34,001 if married filing jointly); (2) two or more children lived with you and you earned less than \$36,348 (\$38,348 if married filing jointly); or (3) a child did not live with you and you earned less than \$12,120 (\$14,120 if married filing jointly).
- (20) You may be able to take an IRA deduction even if you were covered by a retirement plan if your 2006 modified AGI is less than \$60,000 (\$85,000 if married filing jointly or a qualifying widow or widower).
- (21) The dollar limit on annual elective deferrals an individual may make to a 403(b) retirement plan increased to \$15,000 in 2006. This amount is adjusted for inflation after 2006 in \$500 increments, and increases to \$15,500 in 2007.
- (22) The catch-up contribution limit on elective deferrals to a 403(b) retirement plan was increased to \$5,000 in 2006 for individuals who had attained age 50 by the end of the year. It remains at \$5,000 for 2007.
- (23) The personal exemption amount increased to \$3,300 for 2006.
- (24) The standard business mileage rate was 44.5 cents per mile for business miles driven during 2006. The standard business mileage rate for 2007 is 48.5 cents per mile.
- (25) The IRS maintains that a minister's housing allowance is "earned income" in determining eligibility for the earned income credit for ministers who have not opted out of Social Security by filing a timely Form 4361. For ministers who have opted out of Social Security the law is less clear, and the IRS has not provided guidance.
- (26) Recent tax cuts enacted by Congress will result in lower taxes, and lower estimated tax payments, for many taxpayers. Be sure your estimated tax calculations or withholdings take into account the most recent tax law changes.
- (27) Recent Tax Court rulings indicate that there will be no relaxation in the strict substantiation requirements that apply to the business use of cell phones.
- (28) Many churches employ persons who have retired and are receiving Social Security retirement benefits. But persons younger than full retirement age may have their Social Security retirement benefits cut if they earn more than a specified amount. The full retirement age for persons born in 1942 is 65 years and 10 months. Persons below this age will have their benefits reduced by \$1 for every \$2 of earned income in excess of \$12,960. For persons who reach full retirement age during 2007, their Social Security retirement benefits will be reduced by \$1 for every \$3 earned in excess of \$2,870 each month until the month they reach full retirement age. After reaching full retirement age, employees can receive their full Social Security retirement benefits amount, no matter how much they earn.
- (29) The IRS amended the "use it or lose it" rule for flex plans. The amendment allows employers to amend their flex plan to provide for a "grace period" of 2 and a half months. Expenses for qualified benefits incurred during the grace period may be paid or reimbursed from benefits or contributions remaining unused at the end of the preceding plan year.
- (30) The IRS has issued an updated Form 1098-C, which must be used by churches to report to the IRS donations of used vehicles (cars, boats, planes) valued by the donor at more than \$500. The same form can be used to provide donors with a written acknowledgment of their donation.
- (31) The IRS unveiled a new Form 944 in 2006 which replaces Form 941 (Employer's Quarterly Tax Return) for eligible small employers. The purpose of new Form 944 is to reduce burden on the smallest employers by allowing them to file their employment tax returns annually, and in most cases pay the employment tax due with their return. Some small churches will be eligible to file this form.
- (32) If you were billed after February 28, 2003, and before August 1, 2006, for the federal telephone excise tax on long distance or bundled service, you may be able to request a credit for the tax paid. You can request a "standard amount" or the actual amount you paid. If you believe you paid more than the standard amount, it can be to your benefit to request the actual amount. See the instructions to Form 8913 for details.
- (33) Congress enacted the Energy Tax Incentives Act in 2005 to encourage energy efficiency and reduce dependence on foreign oil. From January 2006 through December 2009, the Act allows a tax credit of \$1,700 to \$3,000 on a one-time basis for the purchase of a hybrid vehicle. The amount of the credit is based on the estimated amount of fuel saved by the hybrid compared with a 2002 model of similar size class. The credit only applies to the first 60,000 hybrid cars sold by a given manufacturer.
- (34) The Energy Tax Incentives Act contains a number of provisions that promote energy efficiency in



personal residences. These include a credit for highly energy efficient principal residences, and a credit for the purchase of qualified photovoltaic property and qualified solar water heating property (used for purposes other than heating swimming pools and hot tubs).

(35) For 2006, the following three inflation adjustments took effect:

- The amounts of income you need to earn to boost you to a higher tax rate were adjusted for inflation.
- The “personal exemption amount” (the amount you can deduct for yourself, your spouse, and each dependent) was adjusted for inflation. For 2006, the amount increased to \$3,300 per person (up from \$3,200 in 2005).
- The “standard deduction” (the amount you can deduct if you cannot itemize your deductions) increased to \$10,300 in 2006 for married couples filing jointly—up from \$10,000 in 2005. This is twice the amount of the standard deduction for single taxpayers (\$5,150) for 2006. Single taxpayers who are 65 years of age or older, or blind, get a \$1,250 increase in their standard deduction for 2006. Married taxpayers who are 65 years of age or older, or blind, get a \$1,000 increase in their standard deduction for 2006.

(36) The IRS has announced that more people than ever are using “Where’s My Refund,” the popular Internet-based service used by taxpayers to check on their federal income tax refunds. More than 21 million requests have been received on “Where’s My Refund” so far this year, representing a growth of more than 20 percent compared to the same period last year. Taxpayers can securely access their personal refund information through the IRS Web site, [www.irs.gov](http://www.irs.gov). All you need to do is enter your Social Security number, filing status and the exact amount of your expected refund.

(37) Will Congress give ministers another opportunity to revoke an exemption from Social Security? It does not look likely, at least for now. Last year, Congressman David Camp (R-MI) introduced a bill (H.R. 451) that would have allowed ministers a limited time to revoke an exemption from Social Security. The same opportunity has been granted three times by Congress over the past 30 years. The current attempt gained no cosponsors, and is now dead.

## **Preliminary Questions**

Below are several questions you should consider before preparing your 2006 federal tax return.

### **Q. Must ministers pay federal income taxes?**

A. Yes. Ministers are not exempt from paying federal income taxes.

### **Q. How much income must I earn to be required to file a tax return?**

A. Generally, ministers are required to file a federal income tax return if they have earnings of \$400 or more. Different rules apply to some ministers who are exempt from self-employment taxes.

### **Q. Can I use the simpler Forms 1040A or 1040EZ rather than the standard Form 1040?**

A. Most ministers must use the standard Form 1040.

### **Q. What records should I keep?**

A. You should keep all receipts, canceled checks, and other evidence to prove amounts you claim as deductions, exclusions or credits.

### **Q. What is the deadline for filing my federal income tax return?**

A. April 16, 2007.

### **Q. What if I am unable to file my tax return by the deadline?**

A. You can obtain an automatic six-month extension (from April 16 to October 15, 2007) to file your 2006 Form 1040 if you file Form 4868 by April 16, 2007 with the IRS service center for your area. Your Form 1040 can be filed at any time during the six-month extension period. An extension only relieves you from the obligation to file your return; it is not an extension of the obligation to pay your taxes. Therefore, you must make an estimate of your tax for 2006 and pay the estimated tax with your Form 4868.

### **Q. Should I prepare my own tax return?**

A. The answer depends on your ability and experience in working with financial information and in preparing tax returns. Keep in mind: Ministers’ taxes present a number of unique rules, but these rules are not complex. Many ministers will be able to prepare their own tax returns if they understand the unique rules that apply. This is not hard. These rules are summarized below. On the other hand, if you experienced unusual events in 2006, such as the sale or purchase of a home or the sale of other capital assets, it may be prudent to obtain professional tax assistance. The IRS provides a service called Taxpayer Assistance, but it is not liable in any way if its agents provide you with incorrect answers to your questions. Free taxpayer publications are available from the IRS and many of these are helpful to ministers.

➤ **Recommendation.** If you need professional assistance, here are some tips that may help you find a competent tax professional:

- Ask other ministers in your community for their recommendations.
- If possible, use a CPA who specializes in tax law and who is familiar with the rules that apply to ministers. A CPA has completed a rigorous educational program and is subject to strict ethical requirements.
- Ask local tax professionals if they work with ministers and, if so, with how many.
- Ask local tax professionals a few questions to test their familiarity with ministers' tax issues. For example, ask whether ministers are employees or self-employed for Social Security. Anyone familiar with ministers' taxes will know that ministers always are self-employed for Social Security with respect to their ministerial duties. Or, ask a tax professional if a minister's church salary is subject to income tax withholding. The answer is no, and anyone familiar with ministers' taxes should be able to answer this question.

---

## Part 2. Special Rules for Ministers

---

### *Who is a minister for federal tax purposes?*

⚡ **Key Point.** The IRS has its own criteria for determining who is a minister for tax purposes.

Whether or not one qualifies as a minister for tax purposes is a very important question, since special tax and reporting rules apply to ministers under federal tax law. These rules include:

- eligibility for housing allowances;
- self-employed status for Social Security purposes;
- exemption of wages from income tax withholding (ministers use the quarterly estimated tax procedure to pay their taxes, unless they elect voluntary withholding);
- eligibility under very limited circumstances to exempt themselves from self-employment taxes.

These special rules only apply with respect to services performed in the exercise of ministry.

📎 **Example.** Rev. J is an ordained minister at his church. In addition, he works a second job for a

secular employer. Assume that Rev. J qualifies as a minister for federal tax purposes. Since his church duties constitute services performed in the exercise of ministry, the church can designate a housing allowance for him. However, the secular employer cannot designate any portion of Rev. J's compensation as a housing allowance, since this work would not be service in the exercise of ministry.

To determine if a person is a minister for federal tax purposes, the following five factors must be considered: (1) is the person ordained, licensed, or commissioned; (2) does the person administer sacerdotal functions; (3) does the person conduct religious worship; (4) does the person have management responsibilities in the church; (5) is the person considered to be a religious leader by the church?

⚡ **Key Point.** The IRS has issued audit guidelines for its agents to follow when auditing ministers. The guidelines reject the narrow view that a minister must satisfy all five of the factors listed above. In general, to be considered a "minister" for federal tax purposes, you must be ordained, licensed, or commissioned and meet a majority of the remaining four factors.

Consult IRS Publication 517 for more information.

### *Are ministers employees or self-employed for federal tax purposes?*

⚡ **Key Point.** Most ministers are considered employees for federal income tax purposes under the tests currently used by the IRS and the courts and should receive a Form W-2 from their church or employer reporting their taxable income. However, ministers are self-employed for Social Security purposes (with respect to services they perform in the exercise of their ministry).

Ministers have a *dual* tax status. For federal income taxes they ordinarily are employees, but for Social Security they are self-employed with regard to services performed in the exercise of ministry. These two rules are summarized below:

**1. Income taxes.** For federal income tax reporting, most ministers are employees under the test currently used by the IRS. This means that they should receive a Form W-2 from their church at the end of each year (rather than a Form 1099). It also means that they report their business expenses on Schedule A rather than on Schedule C. A few ministers are self-employed, such as some traveling evangelists and interim pastors. Also, many ministers who are employees of a local church are self-employed for other purposes. For

example, the minister of a local church almost always will be an employee, but will be self-employed with regard to guest speaking appearances in other churches and services performed directly for individual members (such as weddings and funerals).

⚡ **Key Point.** The IRS has issued audit guidelines for its agents to follow when auditing ministers. The guidelines inform agents that the *very first issue* to be resolved in auditing a minister's tax return is whether or not the minister is an employee or self-employed for income tax reporting purposes.

📎 **Example.** Rev. B is a minister at First Church. She is an employee for federal income tax reporting purposes with respect to her church salary. However, she is self-employed with respect to honoraria she receives for speaking in other churches and for compensation church members give her for performing personal services such as weddings and funerals. The church issues Rev. B a Form W-2 reporting her church salary. Rev. B reports this amount as wages on line 7 of Form 1040. She reports her compensation from self-employment activities on Schedule C.

⚡ **Key Point.** Most ministers will be better off being treated as employees, since the value of various fringe benefits will be tax free, the risk of an IRS audit is substantially lower, and reporting as an employee avoids the additional taxes and penalties that often apply to self-employed ministers who are audited by the IRS and reclassified as employees.

💰 **Tax Savings Tip.** Ministers and other church staff members should carefully review their W-2 form to be sure that it does not report more income than was actually received. If an error was made, the church should issue a corrected tax form (Form W-2c).

**The Tax Court Test.** The United States Tax Court has created a seven factor test for determining whether a minister is an employee or self-employed for federal income tax reporting purposes. The test requires consideration of the following seven factors: (1) the degree of control exercised by the employer over the details of the work; (2) which party invests in the facilities used in the work; (3) the opportunity of the individual for profit or loss; (4) whether or not the employer has the right to discharge the individual; (5) whether the work is part of the employer's regular business; (6) the permanency of the relationship; and (7) the relationship the

parties believe they are creating. Most ministers will be employees under this test.

2. **Social Security.** The tax code treats ministers as self-employed for Social Security with respect to services performed in the exercise of their ministry—even if they report their income taxes as an employee. This means that ministers must pay self-employment taxes (Social Security taxes for the self-employed) unless they have filed a timely exemption application that has been approved by the IRS. As noted below, few ministers qualify for this exemption.

⚡ **Key Point.** While most ministers are employees for federal income tax reporting purposes, they are self-employed for Social Security with respect to services they perform in the exercise of their ministry. This means that ministers are not subject to the employee's share of Social Security and Medicare taxes, even though they report their income taxes as employees and receive a Form W-2 from their church. Rather, they pay the self-employment tax (SECA).

## Exemption from Social Security (self-employment) taxes

⚡ **Key Point.** The benefit plans administered by MMBB assume participation in Social Security, and the plans' benefits may not be adequate for a secure retirement or disability without Social Security benefits.

If ministers meet several requirements, they may exempt themselves from self-employment taxes with respect to their ministerial earnings. Among other things, the exemption (Form 4361) must be filed within a limited time period. The deadline is the due date of the federal tax return for the second year in which a minister has net earnings from self-employment of \$400 or more, any part of which comes from ministerial services. Further, the exemption is available only to ministers who are opposed on the basis of religious considerations to the acceptance of benefits under the Social Security program (or any other public insurance system that provides retirement or medical benefits). As a result, a minister who files the exemption application may still purchase life insurance or participate in retirement programs administered by nongovernmental institutions (such as a life insurance company).

A minister's opposition must be to accepting benefits under Social Security (or any other public insurance program). Economic or any other nonreligious considerations are not a valid basis for the exemption, nor is opposition to paying the self-employment tax.

The exemption is only effective when it is approved by the IRS. Few ministers qualify for exemption. Many younger ministers opt out of Social Security without realizing that they do not qualify for the exemption. A decision to opt out of Social Security is irrevocable. Congress did provide ministers with a brief “window” of time to revoke an exemption by filing a Form 2031 with the IRS. This opportunity expired in 2002, and has not been renewed.

An exemption from self-employment taxes applies only to ministerial services. Ministers who have exempted themselves from self-employment taxes must pay Social Security taxes on any non-ministerial compensation they receive. They remain eligible for Social Security benefits based on their non-ministerial employment assuming that they have worked enough quarters. Generally, 40 quarters are required. Also, the Social Security Administration has informed the author of this text that ministers who exempt themselves from self-employment taxes may qualify for Social Security benefits (including retirement and Medicare) on the basis of their spouse’s coverage, if the spouse had enough credits. However, the amount of these benefits will be reduced by the so-called “windfall elimination provision.” Contact a Social Security Administration office for details.

❖ **Key Point.** The amount of earnings required for a quarter of coverage in 2007 is \$1,000. A quarter of coverage is the basic unit for determining whether a worker is insured under the Social Security program.

❖ **Key Point.** Ministers who work after they retire must pay Social Security tax on their wages (unless they exempted themselves from Social Security as a minister and they are employed in a ministerial capacity).

### ***How do ministers pay their taxes?***

❖ **Key Point.** Ministers must prepay their income taxes and self-employment taxes using the estimated tax procedure, unless they have entered into a voluntary withholding arrangement with their church with respect to federal income tax only.

As noted above, ministers’ wages are exempt from federal income tax withholding. This means that a church does not have to withhold income taxes from a minister’s paycheck. And, since ministers are always self-employed for Social Security with respect to their ministerial services, a church does not withhold the employee’s share of Social Security and Medicare taxes. Ministers must prepay their income taxes and self-employment taxes by using the estimated tax procedure, unless they have entered into a voluntary withholding arrangement with their church. Estimated taxes must be paid in quarterly installments. If your estimated taxes for

the current year are less than your actual taxes, you may have to pay an underpayment penalty. You can amend your estimated tax payments during the year if your circumstances change. For example, if your income or deductions increase unexpectedly, you should refigure your estimated tax liability for the year and amend your remaining quarterly payments accordingly.

You will need to make estimated tax payments for 2007 if you expect to owe at least \$1,000 in tax for 2007 after subtracting your withholding and credits and if you expect your withholding and credits to be less than the smaller of (1) 90% of the tax to be shown on your 2007 tax return or (2) 100% of the tax shown on your 2006 tax return (110% if adjusted gross income exceeds \$150,000). Your 2006 tax return must cover all 12 months.

The four-step procedure for reporting and prepaying estimated taxes for 2007 is summarized below.

*Step 1.* Obtain a copy of IRS Form 1040ES before April 16, 2007. You can obtain forms from the IRS Web site (<http://www.irs.gov>) or by calling the IRS toll-free forms hotline at 800.TAX.FORM.

*Step 2.* Compute estimated taxes for 2007. Compute your estimated tax for 2007 using the Form 1040-ES worksheet.

*Step 3.* Pay one-fourth of your total estimated taxes for 2007 in each of four quarterly installments as follows:

| <b>FOR THE PERIOD</b>     | <b>DUE DATE</b>    |
|---------------------------|--------------------|
| January 1 - March 31      | April 16, 2007     |
| April 1 - May 31          | June 15, 2007      |
| June 1 - August 31        | September 17, 2007 |
| September 1 - December 31 | January 15, 2008   |

If the due date for making an estimated tax payment falls on a Saturday, Sunday or legal holiday, the payment will be on time if you make it on the next day that is not a Saturday, Sunday, or legal holiday. You must send each payment to the IRS, accompanied by one of the four payment vouchers contained in Form 1040-ES.

*Step 4.* Compute actual taxes at the end of the year. After the close of 2007, compute your actual tax liability on Form 1040. Only then will you know your actual income, deductions, exclusions, and credits. If you overpaid your estimated taxes (that is, actual taxes computed on Form 1040 are less than all of your estimated tax payments plus any withholding), you can elect to have the overpayment credited against your first 2007 quarterly estimated tax payment or spread it out in any way you choose among any or all of your next four quarterly installments. Alternatively, you can request a refund of the overpayment. If you underpaid your estimated taxes (that is, your actual tax liability exceeds the total of your estimated tax payments plus any withholding), you may have to pay a penalty.

⊕ **Key Point.** Ministers who report their income taxes as employees can request that their employing church *voluntarily* withhold income taxes from their wages. Simply furnish the church with a completed W-4 (withholding allowance certificate). Since ministers are not employees for Social Security purposes, the church must not withhold the employee's share of Social Security and Medicare taxes. However, ministers can request on Form W-4 that an additional amount of income tax be withheld to cover their estimated self-employment tax liability for the year. The excess income tax withheld is a credit that can be applied against the minister's self-employment tax liability.

---

## Part 3. Step-by-Step Tax Return Preparation

---

### *Tax forms and schedules*

This step-by-step analysis covers these forms and schedules:

**Form 1040** is the basic document you will use. It summarizes all of your tax information. Details are reported on supplementary schedules and forms.

**Schedule A** is for itemized deductions for medical and dental expenses, taxes, interest, contributions, casualty and theft losses, and miscellaneous items. Some expenses related to ministerial income may also be deducted on Schedule A.

**Schedule B** is for reporting dividend and interest income.

**Schedule C** is for reporting your income and expenses from business activities you conduct other than in your capacity as an employee. Examples would be fees received for guest speaking appearances in other churches or fees received directly from members for performing personal services, such as weddings and funerals.

**Schedule SE** is for Social Security taxes due on your self-employment income and on your salary and housing allowance as an employee of the church, if you are an ordained minister.

**Form 2106** is used to report expenses you incur in your capacity as an employee of the church.

These forms and schedules, along with others, are included in the illustrated example in Part 4 of this guide. These forms and schedules are the ones most commonly used by ministers, but you may have a need

for others. These forms may be obtained at your local post office or IRS office. Or, you can obtain them by calling the *IRS toll-free forms hotline at 800.TAX.FORM (800.829.3676)*. They also are available on the *IRS Web site (www.irs.gov)*.

### **Form 1040**

#### **Step 1: Label and general information**

You should affix the name and address label that you received in the mail from the IRS at the top of your Form 1040. Address changes or other corrections should be made directly on the label. Make sure you report your Social Security number and that of your spouse if you are filing jointly (Social Security numbers no longer are printed on the labels you receive from the IRS). If you are on a January 1 through December 31 (calendar) tax year, you do not need to write in the beginning and ending dates of your tax year.

If you want \$3 to go to the presidential election campaign fund, check the box labeled "yes." Regardless of your answer, the amount of taxes you owe or the amount of refund you receive will not change.

#### **Step 2: Filing status**

Select the appropriate filing status from the five options listed in this section of the Form 1040.

#### **Step 3: Exemptions**

To claim a dependency exemption for a qualifying child, the child must be a United States citizen or resident, and meet the following four tests:

1. *Relationship test.* The child must be your child (including an adopted child, stepchild, or eligible foster child).
2. *Residency test.* The child must live with you for more than half of the year. Temporary absences for special circumstances, such as for school, vacation, medical care, military service, or detention in a juvenile facility count as time lived at home. A child who was born or died during the year is considered to have lived with you for the entire year if your home was the child's home for the entire time he or she was alive during the year.
3. *Age test.* A child must be under 19 years of age at the end of the year, or under age 24 at the end of 2006 if a student, or any age if permanently and totally disabled.
4. *Support test.* The child cannot have provided over half of his or her own support during the year.

To claim a dependency exemption for a qualifying relative, the person must be a relative and meet all of the following conditions.

- The person must be either your relative or any other person (other than your spouse) who lived in your home all year as a member of your household. If the person is not your relative, your relationship must not violate local law. A relative includes a brother, sister, stepbrother, stepsister, or a descendent of one of these relatives.
- The person cannot be the qualifying child of another person in 2006.
- The person must have gross income of less than \$3,300.
- You must have provided over half of the person's support in 2006 (some exceptions apply).

#### Step 4: Income

Several items of income are reported on lines 7 through 22. The most important of these (for ministers) are discussed below.

- ⊛ **Key Point.** Some items, such as the housing allowance, are not reported as income. They are called exclusions and are explained below.

#### Line 7. Wages, salaries, tips, etc.

- ⊛ **Key Point.** The amount reported on line 7 ordinarily will be the same as reported by the church as wages in box 1 of the minister's Form W-2.

As an employee, you should receive a Form W-2 from your church reporting your wages at the end of each year. Report this amount on line 7. Then, determine if this amount reflects all of your church income. If it does not, report the remaining income on line 21 as other income.

*Determining church wages or salary.* Besides a salary, ministers' wages may include several other items; some items are:

- Bonuses.
- Excess housing allowance (the amount by which a housing allowance exceeds the lesser of a minister's actual housing expenses or the fair rental value of the minister's home).
- The cost of sending a minister to the Holy Land (if paid by the church).
- Most Christmas and special occasion offerings.
- Retirement gifts paid by a church.
- The portion of a minister's Social Security tax paid by a church to the minister.
- Personal use of a church-provided car.
- Purchases of church property for less than fair market value.
- Business expense reimbursements under a nonaccountable plan.

- Reimbursements the church made for the minister's moving expenses (but not if the minister substantiated the reimbursed expenses under an accountable arrangement).
- Imputed cost of group term life insurance coverage (including death benefits under the Benefits for Life program) exceeding \$50,000 and cost of coverage of spouse and dependents over \$2,000 which is paid by the church.
- Church reimbursements of a spouse's travel expenses incurred while accompanying a minister on a business trip; this represents income to the minister unless the spouse's presence serves a legitimate business purpose and the spouse's expenses are reimbursed under an accountable arrangement.
- "Discretionary funds" established by a church for a minister to spend on current needs—if the minister is allowed to distribute funds for his or her personal benefit.
- "Below-market interest loans" of at least \$10,000 made by a church to a minister.
- Cancellation of a minister's debt to a church.
- Severance pay.
- Payment of a minister's personal expenses by the church.
- ⊛ **Key Point.** The IRS can assess intermediate sanctions in the form of a substantial excise taxes against a minister, and in some cases against church board members, if the minister is paid an excess benefit. Excess benefits may occur if a church pays a minister an excessive salary, makes a large retirement or other special occasion "gift" to a minister, gives church property (such as a parsonage) to the minister, or sells church property to the minister at an unreasonably low price. A rebuttable presumption arises that compensation is reasonable if it is approved by an independent board on the basis of "comparable data" or independent compensation surveys and the basis for the board's decision is documented.
- ⊛ **Key Point.** The IRS has ruled that ministers receive "automatic" excess benefits resulting in intermediate sanctions, regardless of amount, if they use church assets (vehicles, homes, credit cards, computers, cell phones, etc.) for personal purposes, or receive nonaccountable expense reimbursements (not supported by adequate documentation of business purpose), *unless* such benefits are reported as taxable income by the church on the minister's W-2, or by the minister on Form 1040, for the year in which the benefits are provided. Only ministers who are church offi-

cers or members of the church board are covered. The concept of automatic excess benefits will directly affect the compensation practices of most churches, and expose some ministers and church board members to intermediate sanctions.

If some of these items were not reported on your Form W-2, they still must be reported as income. Either have your church issue a “corrected” Form W-2 (Form W-2c) or report the items as other income on line 21. If this is the case, be sure this is addressed and corrected for future years.

*Items not reported on line 7.* Some kinds of income are not taxable. These items are called exclusions. Most exclusions apply in computing both income taxes and self-employment taxes. The housing allowance is an example of an exclusion that applies only to income taxes and not to self-employment taxes. Some of the more common exclusions for ministers include:

- Gifts, so long as they are not compensation for services. However, employers generally are not permitted to give tax-free gifts to employees.
- Life insurance proceeds and inheritances.
- Medical insurance premiums paid by an employer for employees (and their spouses and dependents). This exclusion is not available to self-employed individuals.
- Amounts received under an employer-financed “accident and health plan” as payments for permanent injury or loss of bodily function or as reimbursements of medical expenses. The payments can be made on behalf of a spouse or dependent of the employee. This exclusion assumes that the employer has established an “accident or health plan.” Unfortunately, the requirements for such a plan are not specified in the tax code. Employers may reimburse employee medical expenses under either a *self-insured* plan (for example, reimbursements are paid out of the employer’s own funds rather than through an insurance policy) or an *insured* plan. However, if reimbursements are made under a self-insured plan, nondiscrimination rules apply. Generally, these rules require that the plan not discriminate in favor of *highly compensated individuals* with regard to either *amount of benefits* or *eligibility to participate*.
- The cost of employer-provided group term life insurance so long as the amount of coverage does not exceed \$50,000.
- ❖ **Key Point.** The group term life insurance benefit for the Benefits for Life program generally exceed the \$50,000 limit. Your W-2 should include imputed income reporting the taxable

cost of these benefits. See *Federal Reporting Requirements for Churches* published by MMBB.

- Qualified tuition reductions provided by an employer. A qualified tuition reduction is a reduction in tuition charged to employees or their spouses or dependent children by an employer that is an educational institution.
- The value of free child-care services provided by a church to its employees, if the benefit is based on a written plan that does not discriminate in favor of highly compensated employees. Other conditions apply.

There are four other exclusions that will be discussed separately—the housing allowance, tax-sheltered annuities, qualified scholarships, and sale of one’s home.

### **Housing Allowance**

The most important tax benefit available to ministers who own or rent their homes is the housing allowance exclusion. Ministers who own their home do not pay federal income taxes on the amount of their compensation that their employing church designates in advance as a housing allowance, to the extent that (1) the allowance represents compensation for ministerial services, (2) it is used to pay housing expenses, and (3) it does not exceed the fair rental value of the home (furnished, plus utilities).

Housing-related expenses include mortgage payments, utilities, repairs, furnishings, insurance, property taxes, additions and maintenance. Ministers who rent a home or apartment do not pay federal income taxes on the amount of their compensation that their employing church designates in advance as a housing allowance to the extent that the allowance represents compensation for ministerial services and is used to pay rental expenses such as rent, furnishings, utilities and insurance. Under no circumstances can a church designate a housing allowance retroactively. Unfortunately, many churches fail to designate housing allowances and thereby deprive ministers of an important tax benefit.

Ministers who live in a church-owned parsonage do not pay federal income taxes on the fair rental value of the parsonage.

- § **Tax Savings Tip.** Ministers who live in church parsonages and incur any out-of-pocket expenses in maintaining the parsonage (such as utilities, property taxes, insurance, furnishings, or lawn care) should be sure that their employing church designates in advance a portion of their annual compensation as a parsonage allowance. The amount so designated is not reported as wages on the minister’s Form W-2 at the end of the year (if the allowance exceeds the actual

**Housing Allowance Expense Worksheet for Ordained Ministers Who Own Their Home**

Ordained ministers are permitted to exclude from their church income (for federal income tax purposes) a housing allowance designated in advance by their employing church, to the extent that the allowance is used to pay housing expenses. To assist the church in designating an appropriate amount, the minister can use this form to estimate 2007 housing expenses. It is designed for ministers who own their own home.

| <i><b>HOUSING EXPENSE</b></i>   | <i><b>ESTIMATED 2007 AMOUNT</b></i> |
|---|-------------------------------------|
| ● Down payment on home .....  | _____                               |
| ● Mortgage payments on a loan to purchase or improve your home (include both principal and interest)..... | _____                               |
| ● Real estate taxes.....  | _____                               |
| ● Property insurance .....  | _____                               |
| ● Utilities (electricity, gas, water, trash pickup, local telephone charges) .....                        | _____                               |
| ● Furnishings and appliances (purchase and repair) .....  | _____                               |
| ● Structural repairs and remodeling.....  | _____                               |
| ● Yard maintenance and improvements.....  | _____                               |
| ● Maintenance items (household cleansers, light bulbs, pest control, etc.) .....                          | _____                               |
| ● Homeowners association dues .....   | _____                               |
| ● Miscellaneous.....  | _____                               |
| <b>TOTAL ESTIMATED EXPENSES FOR 2007</b>  | _____                               |

expenses, the difference must be reported as income by the minister). This is a very important tax benefit for ministers living in church-provided parsonages. Unfortunately, many of these ministers are not aware of this benefit or are not taking advantage of it.

§ **Tax Savings Tip.** Ministers who own their homes lose the largest component of their housing allowance exclusion when they pay off their home mortgage loan. Many ministers in this position have obtained home equity loans or a conventional loan secured by a mortgage on their otherwise debt-free home and have claimed their payments under these kinds of loans as a housing expense in computing their housing allowance exclusion. The Tax Court has ruled that this is permissible only if the loan was obtained for housing-related expenses.

§ **Tax Savings Tip.** Ministers should be sure that the designation of a housing or parsonage allowance for the next year is on the agenda of the church (or church board) for one of its final meetings during the current year. The designation should be an official action, and it should be duly recorded in the minutes of the meeting. The IRS also recognizes designations included in employment contracts and budget line items—assuming in each case that the designation was appropriately adopted in advance by the church and supported by underlying docu-

mentation as to each minister’s anticipated housing expenses.

The rental value of a parsonage, and a housing allowance, are exclusions only for federal income tax reporting purposes. Ministers cannot exclude a housing allowance or the fair rental value of a parsonage when computing self-employment (Social Security) taxes *unless they are retired*. The tax code specifies that the self-employment tax does *not* apply to “the rental value of any parsonage or any parsonage allowance provided after the [minister] retires.”

The housing allowance is available to ministers whether they report their income taxes as employees or as self-employed (whether the church issues them a W-2 or a 1099).

***Housing expenses to include in computing your housing allowance exclusion***

Ministers who own their homes should take the following expenses into account in computing their housing allowance exclusion:

- Down payment on a home (but remember, a housing allowance is nontaxable only to the extent that it does not exceed the lesser of actual housing expenses or the fair rental value of a minister’s home).
- Mortgage payments on a loan to purchase or improve your home (include both interest and principal).



- Real estate taxes.
- Property insurance.
- Utilities (electricity, gas, water, trash pickup, local telephone charges).
- Furnishings and appliances (purchase and repair).
- Structural repairs and remodeling.
- Yard maintenance and improvements.
- Maintenance items (pest control, etc.).
- Homeowners association dues.

*Please note the following:*

- A housing allowance must be designated in advance. Retroactive designations of housing allowances are not effective.
- The housing allowance designated by the church is not necessarily nontaxable. It is nontaxable (for income taxes) only to the extent that it is used to pay for housing expenses, and, for ministers who own their home, does not exceed the fair rental value of their home (furnished, plus utilities).
- A housing allowance can be amended during the year if a minister's housing expenses are more than expected. However, an amendment is only effective prospectively. Ministers should notify their church if their actual housing expenses are significantly more than the housing allowance designated by their church. Remember, however, that it serves no purpose to designate a housing allowance greater than the fair rental value of a minister's home (furnished, plus utilities).
- If the housing allowance designated by the church exceeds the amount that can be claimed, the excess housing allowance should be reported on line 7 of Form 1040 on the line designated as "excess housing allowance."
- The housing allowance exclusion is an exclusion for federal income taxes only. Ministers must add the housing allowance as income in reporting self-employment taxes on Schedule SE (unless they are exempt from self-employment taxes).
- The fair rental value of a church-owned home provided to a minister as compensation for ministerial services is not subject to federal income tax.

✎ **Example.** A church designated \$12,000 of Rev. D's 2006 compensation as a housing allowance. Rev. D's housing expenses for 2006 were utilities of \$2,000, mortgage payments of \$6,000, property taxes of \$2,000, insurance payments of \$1,000, repairs of \$1,000, and furnishings of \$1,000. The fair rental value of the home (including furnish-

ings) is \$10,000. Rev. D's housing allowance is nontaxable in computing income taxes only to the extent that it is used to pay housing expenses and does not exceed the fair rental value of his home (furnished, plus utilities). Stated differently, the nontaxable portion of a housing allowance is the least of the following three amounts: (1) the housing allowance designated by the church; (2) actual housing expenses; (3) the fair rental value of the home (furnished, plus utilities). In this case, the lowest of these three amounts is the fair rental value of the home (\$10,000), and so this represents the nontaxable portion of Rev. D's housing allowance. Rev. D must report the difference between this amount and the housing allowance designated by his church (\$2,000) on line 7 of Form 1040, designated on that line as "excess housing allowance."

✎ **Example.** Same facts as the previous example, except that the church designated \$9,000 of Rev. D's salary as a housing allowance. The lowest of the three amounts in this case would be \$9,000—the church designated housing allowance, and so this represents the nontaxable amount. Note that the Rev. D's actual housing expenses were more than the allowance, and so he was penalized because of the low allowance designated by his church.

✎ **Example.** Rev. Y owns a home and incurs housing expenses of \$12,000 in 2006. These expenses include mortgage principal and interest, property taxes, utilities, insurance and repairs. The church designated (in advance) \$12,000 of Rev. Y's 2006 compensation as a housing allowance. Rev. Y is able to itemize expenses on Schedule A (Form 1040). She is able to claim itemized deductions on Schedule A for both her mortgage interest and her property taxes, even though her taxable income was already reduced by these items because of their inclusion in the housing allowance. This is often referred to as the "double deduction." In reality, it represents an exclusion and a deduction.

✎ **Example.** In preparing his income tax return for 2006, Rev. H discovers that his church failed to designate a housing allowance for him for 2006. He asks his church to pass a resolution retroactively granting the allowance for 2006. Such a resolution is ineffective, and Rev. H will not be eligible for any housing allowance exclusion in 2006.

★ **Key Point.** The Sarbanes-Oxley Act makes it a crime to knowingly falsify any document with the intent to influence "the investigation or proper administration of any matter within the

jurisdiction of any department or agency of the United States . . . or in relation to or contemplation of any such matter or case,” and this provision contains no exemption for churches or pastors. It is possible that a pastor’s backdating of a board resolution to qualify for a housing allowance for the entire year violates this provision in the Sarbanes-Oxley Act, exposing the pastor to a fine or imprisonment. Even if the pastor’s action does not violate the Act, it may result in civil or criminal penalties under the tax code.

§ **Tax Savings Tip.** Ministers should be sure that the designation of a housing or parsonage allowance for the next year is on the agenda of the church board for one of its final meetings during the current year. The designation should be an official action, and it should be duly recorded in the minutes of the meeting. The IRS also recognizes designations included in employment contracts and budget line items—assuming in each case that the designation was duly adopted in advance by the church.

### **How much should a church designate as a housing allowance?**

Many churches base the housing allowance on their minister’s estimate of actual housing expenses for the new year. The church provides the minister with a form on which anticipated housing expenses for the new year are reported. For ministers who own their homes, the form asks for projected expenses in the following categories: down payment, mortgage payments, property taxes, property insurance, utilities, furnishings and appliances, repairs and improvements, maintenance, and miscellaneous. Many churches designate an allowance in excess of the anticipated expenses itemized by the minister. Basing the allowance solely on a minister’s actual expenses penalizes the minister if actual housing expenses turn out to be higher than expected. In other words, the allowance should take into account unexpected housing costs or inaccurate projections of expenses.

⊛ **Key Point.** The housing allowance is available only if two conditions are met: (1) the recipient is a minister for tax purposes (as defined above), and (2) the allowance is compensation for services performed in the exercise of ministry.

Churches sometimes neglect to designate a housing allowance in advance of a new calendar year. For example, a church may discover on March 1, 2007, that it has failed to designate a housing allowance for its pastor for 2007. It is not too late to act. The church should immediately designate a portion of its minister’s remaining compensation in 2007 as a housing or parsonage

allowance. This unfortunate problem can be avoided by stipulating in each annual housing allowance designation that the allowance shall be for the current year *and for all future years unless otherwise provided*. If such a resolution had been adopted in the December 2006 meeting, it would not matter that the church neglected to designate a minister’s 2007 allowance until March of 2007, since the previous designation would have carried over. Such “safety net” designations are not a substitute for annual housing allowances. Rather, they provide a basis for claiming a housing allowance if a church neglects to designate one.

⊛ **Key Point.** Remember—churches cannot designate a housing allowance retroactively.

⊛ **Key Point.** Retired ministers are eligible for a housing allowance exclusion if the following conditions are satisfied: (1) a portion of a retired minister’s pension income is designated as a housing allowance by the church pension board of a denominational pension fund; (2) the retired minister has severed his or her relationship with the local church and relies on the fund for a pension; (3) the pensions paid to retired ministers “compensate them for past services to the local churches of the denomination or to the denomination.” MMBB designates 100% of retired ministers’ annuity payments and other distributions as housing allowance. However, they must report as taxable income the lesser of (1) the fair market value of the furnished home, plus utilities, or (2) actual housing expenses. This is a very attractive benefit for retired ministers that is not available with some other kinds of retirement plans.

The self-employment tax does not apply to the rental value of a parsonage, a housing allowance provided after a minister retires, or any other retirement benefit received by a minister from a church plan after retirement.

Keep in mind that your housing allowance is *not* counted as income when figuring federal income taxes but is included in figuring Social Security (SECA) until you actually retire.

⊛ **Key Point.** Ministers who own their homes lose the largest component of their housing allowance exclusion when they pay off their home mortgage loan. Many ministers in this position have obtained home equity loans or a conventional loan secured by a mortgage on their otherwise debt-free home and have claimed their payments under these kinds of loans as a housing expense in computing their housing allowance exclusion. The Tax Court has ruled that this is permissible only if the loan was obtained for housing-related expenses.

### Section 403(b) plans

For 2006, payments made by your church and your salary reduction contributions to a 403(b) plan are not reportable income for tax purposes as long as the total amount credited to your retirement account does not exceed contribution limits under Sections 415(c) and 402(g) of the tax code.

✪ **Key Point.** One of the most popular supplemental retirement savings offerings for ministers is The Annuity Supplement (TAS) administered by MMBB.

### Contribution limits

For 2006 total annual additions (employer contributions, salary reduction and tax paid contributions) could not exceed the lesser of 100% of your includable compensation (excluding a minister's housing allowance) or \$44,000. This rule is known as the "section 415(c) limit." If your annual addition exceeds this limit, then the excess amount plus earnings must be distributed and included in gross income. Furthermore, the excess amount reduces your exclusion allowance for future years. The distributed excess amount may not be rolled over to another 403(b) plan or to an IRA.

*New in 2007.* The \$44,000 limit increases to \$45,000.

### Minister's housing allowance and contribution limits

For 2006, the Section 415(c) limit restricts 403(b) contributions to the lesser of 100% of [includable] compensation or \$44,000 (\$45,000 for 2007). Does the term "includable compensation" include a minister's housing allowance? This is an important question for ministers, since the answer will determine how much can be contributed to a 403(b) plan. If the housing allowance is treated as compensation, then ministers will be able to contribute larger amounts. The tax code specifies that the term "compensation" for purposes of applying the section 415(c) limit to a TSA "means the participant's includable compensation determined under section 403(b)(3)." Section 403(b)(3) defines compensation to include "the amount of compensation which is received from the employer . . . and which is includable in gross income." Section 107 of the tax code specifies that a minister's housing allowance (or the annual rental value of a parsonage) is not included in the minister's gross income for income tax reporting purposes. Therefore, it would appear that the definition of compensation for purposes of computing the Section 415(c) limit would not include the portion of a minister's housing allowance that is excludable

from gross income, or the annual rental value of a parsonage. The IRS Web site contains the following question and answer affirming this conclusion:

*Question.* I am an employee minister in a local church. Each year, my church permits \$25,000 as a yearly tax-free housing allowance. I would like to use my yearly housing allowance as compensation to determine my annual contribution limits (to a TSA) under section 415(c) of the Internal Revenue Code. May I do so?

*Answer.* No. For purposes of determining the limits on contributions under section 415(c) of the Internal Revenue Code, amounts paid to an employee minister, as a tax-free housing allowance, may not be treated as compensation pursuant to the definitions of compensation under section 1.415-2(d) of the income tax regulations.

### Salary reduction contributions (Section 402(g))

In addition to the section 415(c) limit there is an annual limit on elective deferrals such as TAS. The limit applies to the total of all elective deferrals contributed (even if contributed by different employers) for the year on your behalf to a variety of retirement plans, including 403(b) plans. Generally, you cannot defer more than an allowable amount each year for all plans covering you. For 2006, the allowable limit was \$15,000. If you defer more than the allowable amount for a tax year, you must include the excess in your taxable income for that year.

*New in 2007.* The dollar limit on annual elective deferrals increases to \$15,500.

The limit on elective deferrals increases for individuals who have attained age 50 by the end of the year. The additional amount that may be made is the lesser of (1) the "applicable dollar amount", or (2) the participant's compensation for the year reduced by any other elective deferrals of the participant for the year. The applicable dollar amount is \$5,000 for 2006 and 2007. Catch-up contributions are not subject to any other contribution limits and are not taken into account in applying other contribution limits.

### Nonrefundable credit to certain individuals for elective deferrals

A temporary nonrefundable tax credit is available in 2006 for contributions made by eligible taxpayers to a qualified retirement plan. The maximum annual contribution eligible for the credit is \$2,000. The credit rate depends on the adjusted gross income ("AGI") of the taxpayer. Only joint returns with

AGI of \$50,000 or less (\$25,000 or less for single persons) are eligible for the credit.

The credit is available to individuals who are 18 or over, other than individuals who are full-time students or claimed as a dependent on another taxpayer's return. The credit is available with respect to elective deferrals to a 403(b) plan such as TAS. This provision expires at the end of 2006. The amount of the credit is described in the following table.

| Adjusted Gross Income |                    |                 |                               |
|-----------------------|--------------------|-----------------|-------------------------------|
| Joint Returns         | Heads of Household | Single Filers   | Credit Rate (\$2,000 maximum) |
| \$0-30,000            | \$0-22,500         | \$0-15,000      | 50%                           |
| \$30,000-32,500       | \$22,500-24,376    | \$15,000-16,250 | 20%                           |
| \$32,500-50,000       | \$24,375-37,500    | \$16,250-25,000 | 10%                           |
| over \$50,000         | over \$37,500      | over \$25,000   | 0%                            |

### Qualified scholarships

**Key Point.** Qualified scholarships are excludable from taxable income.

Only amounts received as a qualified scholarship by a candidate for a degree may be excluded from gross income. A qualified scholarship is any grant amount that, in accordance with the conditions of the grant, is used for tuition and course-related expenses. Qualified tuition and related expenses are those used for (1) tuition and fees required for the enrollment or attendance at an educational institution or (2) fees, books, supplies, and equipment required for courses of instruction at the educational institution. The scholarship need not specify that it is to be used only for qualified tuition and related expenses. All that is required is that the recipient uses the scholarship for such expenses and that the scholarship does not specify that it is to be used for nonqualified expenses (such as room and board).

Any amount received in excess of the qualified tuition and related expenses (such as amounts received for room and board) is not eligible for this exclusion.

Any amount received that represents payment for teaching, research, or other services required as a condition for receiving a qualified scholarship cannot be excluded from gross income. In addition, amounts paid by a church for the education of a pastor or other church employee cannot be treated as a nontaxable scholarship if paid "as compensation for services."

**Example.** First Church establishes a scholarship fund for seminary students. Robert is a church member who is pursuing a master's degree at a seminary. The church votes to award him a scholarship of \$1,500 for 2007. So long as Robert uses the scholarship award for tuition or other course-related expenses, he need not report it as income

on his federal tax return, and the church need not issue him a 1099MISC. The better practice would be for the church to stipulate that the scholarship is to be used for tuition or other course-related expenses (for example, fees, books, supplies), or for the church to pay the expenses directly to the educational institution. This will ensure that the scholarship does not inadvertently become taxable income because its specific use was not designated and the recipient used it for nonqualified expenses.

### Sale or exchange of your principal residence

For sales of principal residences occurring after May 6, 1997, the following rules apply:

**Higher nontaxable amounts.** A married couple (who file a joint return) can exclude up to \$500,000 of gain from the sale or exchange of a principal residence. Single taxpayers can exclude up to \$250,000.

**Holding period.** To qualify for the full exclusion, a taxpayer must have owned and occupied the residence as a principal residence for at least two of the five years before the date of sale or exchange. But, the tax benefit may not be lost completely if this "holding period" is not satisfied. Taxpayers who sell a home without meeting this requirement get a partial benefit if they had to sell their home on account of a change of place of employment, health, or other unforeseen circumstances. The partial benefit is the fraction of \$500,000 (or \$250,000 for single taxpayers) equal to the fraction of two years that the home was owned and occupied as a principal residence. To illustrate, assume that Rev. B and his wife purchased a home on July 1, 2006, for \$150,000, and sell it on July 1, 2007, for \$200,000 because of a change in place of employment. Since they owned and occupied the home for only half of the minimum requirement of two years, they can exclude up to half of \$500,000—this means that their entire gain is nontaxable.

**Multiple sales allowed.** Taxpayers can claim the \$500,000 exclusion every two years, and there is no minimum age requirement.

**Remarriages.** Assume that John is a single taxpayer who has never excluded gain from the sale of a home under the new rules. He marries Jane, who has used the exclusion within two years before their marriage. John can still claim up to a \$250,000 exclusion of gain from the sale of residence. Once two years have passed since the last exclusion was allowed to either of them, they can exclude up to \$500,000 of gain on a joint return.

**Example.** Rev. T is 60 years old, married, and considering moving into a smaller and less expensive home. She has owned her present home for several years, and is concerned that she may have to pay taxes on the gain she would realize from

selling her home and buying a less expensive home. She need not be concerned. Any gain she realizes from selling her current home and buying a less expensive home will be nontaxable gain—assuming that she lived in the old home for at least two years and the gain is less than \$500,000. And, if she later decides to relocate to another home, she again can exclude the gain from tax.

⊕ **Key Point.** Current law does not force taxpayers to replace a current residence with a residence of equal or greater cost to avoid capital gains tax.

**Line 8a. Interest income: attach Schedule B if over \$1,500**

Complete this line only if you had taxable interest income. If you had taxable interest income of more than \$1,500, complete parts I and III of Schedule B. Report tax-exempt interest income on line 8b.

**Line 9. Dividend income: attach schedule B if over \$1,500**

Complete this line only if you had dividend income. If you had dividend income of more than \$1,500, complete parts II and III of Schedule B.

**Line 12. Business income (or loss): attach schedule C or C-EZ**

Complete this line only if you have any net earnings from self-employment activities. These include:

- Compensation reported to you on a Form 1099-MISC.
- Fees received directly from church members for performing personal services (such as marriages and funerals).
- Honoraria you received for guest speaking appearances in other churches.

If you received income from any of these kinds of activities, compute your net earnings on Schedule C and transfer this amount to line 12. Schedule C is discussed more fully on pages 34–35 of this book. You may be able to use the simpler Schedule C-EZ if several conditions are met. See the instructions to Schedule C-EZ for details.

**Line 13. Capital gain (or loss): attach schedule D**

Complete this line only if you have any gains or losses from the sale of capital assets. These include stocks, bonds, and property. Gain or loss is reported on Schedule D.

**Line 16a. Total pensions and annuities**

The retirement benefits you receive from MMBB are taxable under federal and some state income tax laws. The 1099-R form you receive from MMBB reports to

the IRS the gross amount of the annuity payments and any other distributions and any amount withheld for income taxes.

MMBB designates 100% of the annuity payments and other distributions for retired ministers as a housing allowance. Consistent with that designation, if you are a minister, the 1099-R will show that the taxable amount of the annuity income is “not determinable.” If you are a retired minister, you may exclude all or a portion of your annuity payments and other distributions from your gross income reported on line 16a of form 1040 if (1) you can document that the monies were actually spent on housing-related expenses during the tax year, and (2) the amount excluded does not exceed the fair rental value of the home (furnished, including utilities).

⊕ **Key Point.** Do not report the amount of pension income excluded as housing allowance as earned income in computing self-employment taxes.

⊕ **Key Point.** Lay retirees and surviving spouses are not entitled to exclude any portion of their benefits as housing allowance.

In January MMBB will send you additional information regarding your 1099-R and the reporting of your annuity payments and other distributions.

**Taxation of distributions from a 403(b) plan**

Amounts you contribute through salary reduction, and the earnings attributable to these contributions, generally cannot be withdrawn before you reach age 59½, separate from service, die, or become disabled. In some cases of hardship, you may withdraw your own salary reduction contributions (but not the earnings on these) prior to the occurrence of any of the above events. These restrictions on withdrawals do not apply to amounts attributable to salary reduction contributions made before January 1, 1989. Pre-1989 salary reduction contributions, and the earnings on these, may be distributed prior to these events, but may be subject to penalty.

Once amounts are distributed, they are generally taxable as ordinary income unless properly designated as a minister’s housing allowance. In addition, if amounts are distributed prior to your reaching age 59½, you will be assessed an additional tax of 10% of the amount which is includable in income, unless one of the following exceptions applies:

1. The distributions are part of a series of substantially equal periodic payments made over your life or the lives of your beneficiaries and after you separate from service.
2. The distributions are made after you separate from service on or after age 55.

3. The distributions do not exceed the amount of medical expenses that you could deduct for the current year.
4. The distributions are made after your death, or after you become disabled.
5. The distributions are made to an alternate payee pursuant to a qualified domestic relations order.

The additional tax is computed on Form 5329.

### **Line 20a. Social Security benefits**

✪ **Key Point.** Individuals who receive Social Security retirement, disability, or survivor benefits may have to pay taxes on a portion of their benefits.

If you received Social Security benefits other than supplemental security income benefits (SSI) in 2006, part of the amount you received may be taxable. If you received Social Security benefits during 2006, you will receive Form SSA-1099 before Jan. 31, 2007 showing the amount of benefits you received. Consider the following guidelines when determining whether your 2006 Social Security benefits are taxable:

1. In general, if the only income (including any retirement benefits) you received during 2006 was your Social Security benefits, your benefits probably will not be taxable and you probably will not have to file a return.
2. If you received other income in addition to Social Security benefits in 2006, your benefits generally will not be taxable unless your income is over a certain amount.
3. Your Social Security benefits generally are not taxable if your “provisional income” (adjusted gross income plus tax-exempt interest and some other forms of tax-exempt income plus half of your Social Security benefits) received during the year is less than \$25,000 if you are single or \$32,000 if you are married and file a joint return.
4. If your provisional income (defined above) received during the year is more than \$25,000 but less than \$34,000 if you are single, or more than \$32,000 but less than \$44,000 if you are married and file a joint return, then some of your Social Security benefits will be taxable. You are taxed on the lesser of (1) half of your Social Security benefits, or (2) half of the amount by which your total income exceeds \$25,000 (if you are single) or \$32,000 (if you are married and file jointly).
5. If your provisional income (defined above) received during the year is more than \$34,000 if you are single or more than \$44,000 if you are

married and file a joint return, then you may have to pay tax on up to 85% of your benefits.

**Working after you retire.** Persons younger than “full retirement age” who elect to begin receiving Social Security retirement benefits may see their benefits reduced if they continue to work and earn more than a specified amount. The full retirement age for persons born in 1942 is 65 years and 10 months. In 2007, persons below this age who begin to receive Social Security retirement benefits will have their benefits reduced by \$1 for every \$2 of earned income in excess of \$12,960. For persons who reach full retirement age during 2007, their Social Security retirement benefits will be reduced by \$1 for every \$3 earned in excess of \$2,870 each month until the month they reach full retirement age. After reaching full retirement age, employees can receive their full Social Security retirement benefits amount, no matter how much they earn.

While the Social Security Administration has never officially addressed the issue, it is likely that a minister’s housing allowance counts as earnings for purposes of the annual earnings test.

### **Line 21. Other income: list the type and amount**

➤ **Recommendation.** If you have other income to report on line 21, consider enclosing an explanation of your other income with your Form 1040 or write a brief explanation in the space provided next to line 21. This will help to avoid confusion.

Complete this line only if you have other income. This includes the following items:

- A canceled debt or a debt paid for you by another person (unless the person who canceled or paid your debt intended it to be a gift).
- The fair market value of a free tour you receive from a travel agency for organizing a group of tourists (in some cases this may be reported on Schedule C).
- Most prizes and awards.

### **Step 5: Adjustments to income**

You may deduct certain adjustments from gross income in computing your adjusted gross income. Report the adjustments on lines 23 through 35 of Form 1040. The most relevant adjustments to ministers are summarized below.

### **Line 26. Moving expenses**

If your “allowable moving expenses” are not reimbursed by your employer, or they are reimbursed under a nonaccountable plan, you compute your moving expense deduction on Form 3903 and report your deduction on line 26. If your employer reimburses your

allowable moving expenses under an accountable plan, the reimbursements are not reported by the employer as taxable income, and you have no deduction to report on line 26. To be an accountable plan, your employer's reimbursement arrangement must require you to meet all three of the following rules: (1) your expenses would have been deductible had you paid them yourself; (2) you must adequately account to your employer for these expenses within a reasonable period of time; and (3) you must return any excess reimbursement or allowance within a reasonable period of time.

Allowable moving expenses are expenses you incurred because of a change of jobs or your acceptance of a new job, if you satisfy the following conditions:

- Your new job location is at least 50 miles farther from your former home than your old job location was. For example, if your old job was three miles from your former home, your new job must be at least 53 miles from that home (measured according to the shortest of the more commonly traveled routes between those points).
- If you report your income taxes as an employee, you must work full-time for at least 39 weeks during the first 12 months after you arrive in the general area of your new job location. You do not have to work for one employer for the 39 weeks. However, you must work full-time within the same general commuting area. If you are married and file a joint return and both you and your spouse work full-time, either of you may satisfy the full-time work test. However, you may not combine your weeks of work.
- Your move must be closely related, both in time and place, to the start of work at your new job location. In general, moving expenses incurred within one year from the date you first reported to work are considered closely related in time to the start of work at the new location. It is not necessary that you make arrangements to work before moving to a new location, as long as you actually do go to work. If you do not move within one year, you ordinarily may not deduct the expenses unless you can show that circumstances existed that prevented the move within that time. A move is generally not closely related in place to the start of work if the distance from your new home to the new job location is greater than the distance from your former home to the new job location.

**Deductible moving expenses include the following:**

*Moving your household goods and personal effects.* You may deduct the cost of packing, crating and transporting your household goods and personal effects

from your former home to your new one. You may also deduct the cost of storing and insuring household goods and personal effects within any consecutive 30-day period after the day your things are moved from your former home and before they are delivered to your new home.

*Travel expenses.* You may deduct the cost of transportation and lodging (but not meals) for yourself and members of your household while traveling from your former home to your new home. You may deduct expenses of only one trip to your new home. However, all of the members of your household do not need to travel together.

You may not deduct any of the following expenses as moving expenses: pre-move house-hunting expenses, temporary living expenses, the expenses of disposing of your former home and obtaining your new home, home improvements to help you sell your former home, loss on the sale of your former home, mortgage penalties, any part of the purchase price of your new home, meal expenses incurred while moving to your new home, and real estate taxes. Use Form 3903 to compute the deduction.

As noted above, if your employer reimburses your allowable moving expenses under an accountable arrangement, the reimbursements are not reportable as taxable income to you and there are no deductions to report.

***Line 27. One-half of self-employment tax***

⊕ **Key Point.** Every minister who pays Social Security taxes on ministerial income qualifies for this deduction. Some are not claiming it.

All ministers are self-employed for Social Security purposes with respect to their ministerial income. They can deduct half of their actual self-employment taxes as an adjustment on line 27 of Form 1040, whether or not they are able to itemize deductions on Schedule A.

***Line 32. Payments to an individual retirement account (IRA)***

An individual retirement account (IRA) is a savings plan that lets you set aside money for your retirement. Contributions to an IRA may be tax deductible, and earnings are not taxed until they are distributed to you. Anyone who has compensation is eligible to set up or contribute to an IRA. Compensation includes an employee's salary or a self-employed person's earnings (less Keogh deductions), or any other amounts you receive for performing personal services. Compensation does not include rental income, interest income, dividend income, or any amount received as a pension, annuity, or deferred compensation. Further, compensa-

tion does not include a minister's housing allowance or the fair rental value of a church-provided parsonage.

For 2006 the contribution ceiling for an IRA is the lesser of \$4,000 or 100% of your annual compensation. All IRA contributions must be made by the due date of your tax return, not including extensions. This means that your 2006 IRA contribution must be made by April 16, 2007, even if you obtain an extension for filing this return.

Married persons who receive no compensation can contribute up to \$4,000 annually to an IRA—if the compensation of their spouse is at least as much as the combined amount of their IRA contributions.

If you or your spouse were covered by an employer retirement plan at any time during 2006 and you made IRA contributions, your allowable IRA deduction may be less than your contributions. Your allowable deduction may be reduced or eliminated, depending on your filing status and the amount of your income. The deduction begins to decrease (phase out) when your income rises above a certain amount and is eliminated altogether when it reaches a higher amount. (See Table 18-1 of IRS Publication 17.) The amounts vary depending on your filing status. The W-2 form you receive from your church or other employer has a box used to show whether you were covered for the year. The "Pension Plan" box should have a mark in it if you were covered. Employer retirement plans include 403(b) tax-sheltered annuities.

Even if your spouse is covered by an employer-sponsored retirement plan, you can deduct your contributions to an IRA if you are not covered by an employer plan.


Individuals who cannot claim a deduction for an IRA contribution still can make nondeductible IRA contributions, subject to the lesser of \$4,000 or earned income limits. Earnings on these amounts continue to accumulate on a tax-deferred basis. When distributions are made from the IRA, special rules apply in figuring the tax on the distributions when both deductible and nondeductible contributions were made to the IRA. Form 8606 is used to designate a contribution as nondeductible and must be filed or the full amount of future withdrawals may be taxed. Withdrawals before age 59½ are subject to a 10% penalty tax that also applies to deductible IRA contributions.

No further contributions to an IRA are permissible once you reach age 70½, and distributions from an IRA must begin no later than the end of the year in which you reach that age. The IRS has interpreted this rule to mean that distributions must begin by April 1, of the year following the year you reach age 70½. If this rule applies to you, you should consult your tax adviser.

Summarized below are a few important rules that pertain to IRAs.

1. Taxpayers can make early withdrawals from an IRA to pay for qualified higher education expenses of the taxpayer or the taxpayer's spouse, child, or grandchild—without triggering the 10% penalty that applies to early distributions from an IRA.
2. The deductible IRA "phaseout" ranges are increased if either you or your spouse is an active participant in an employer-sponsored retirement plan.
3. Subject to income limitations, taxpayers can make annual nondeductible contributions of up to \$4,000 to a Roth IRA, and distributions from such an IRA are not taxed if they are made after a five-year holding period and are made as a result of the account holder's attaining age 59½ or older, death, disability, or purchase of a first home. Earnings on Roth IRAs accumulate tax-free.
4. Taxpayers can withdraw up to \$10,000 from their IRA prior to age 59½ for first-time homebuyer expenses without triggering the 10% penalty that in prior years applied to "premature distributions."
5. The Pension Protection Act of 2006 contains a number of other changes to IRAs, including the following:
  - The IRS is directed to develop forms under which all or a portion of a taxpayer's tax refund may be deposited in an IRA of the taxpayer (or the spouse of the taxpayer in the case of a joint return).
  - Qualified charitable distributions of up to \$100,000 may be made from an IRA to a church or other charity. A qualified charitable distribution is any distribution from an IRA directly by the IRA trustee to a charitable organization, including a church, that is made on or after the date the IRA owner attains age 70½. This provision is effective for distributions made in 2006 and 2007.

***New in 2006.*** *The maximum annual dollar contribution limit for IRA contributions is \$4,000 for 2006 and 2007, and \$5,000 for 2008. Also, the contribution limit for an individual who has attained age 50 before the end of the taxable year increases by \$1,000 for 2006 and thereafter.*

 **Example.** A church has a senior pastor who is 52 years old, and a youth pastor who is 30 years old. The church does not participate in a retirement program for its staff. In 2006, the senior pastor could contribute \$5,000 (maximum annual contribution of \$4,000 plus a "catch-up" contribution of \$1,000), and the youth pastor could contribute \$4,000. In 2008, the senior pastor will be able to



contribute \$6,000 (maximum annual contribution of \$5,000 plus a “catch-up” contribution of \$1,000), and the youth pastor will be able to contribute \$5,000.

## Step 6: Adjusted Gross Income

### Line 37. Compute adjusted gross income

Subtract your total adjustments (line 36) from your total income (line 22) to compute your adjusted gross income (line 37). Carry this amount to line 38 at the top of page 2 of your Form 1040.

## Step 7: Tax computation

### Line 40. Itemized deductions or standard deduction

- ❖ **Key Point.** Itemize your deductions on Schedule A only if they exceed the standard deduction for your filing status.

On line 40 you enter either your itemized deductions from Schedule A or a standard deduction amount. Itemized deductions are discussed under Schedule A, beginning on page 26 of this guide. For 2006, the standard deduction amounts are as follows:

| Filing Status                                  | Standard Deduction Amount |
|--|---------------------------|
| Single   | \$5,150                   |
| Married filing jointly or qualifying widow(er) | \$10,300                  |
| Married filing separately                      | \$5,150                   |
| Head of household                              | \$7,550                   |

### Line 42. Personal exemptions

For 2006, the personal exemption amount is \$3,300. Multiply this amount times the number of exemptions claimed on line 6 and enter the total on line 42. Personal exemptions are phased out for certain high-income ministers. The instructions to Form 1040 contain a worksheet that should be used to compute this reduced exemption amount.

### Line 44. Compute tax

Most ministers can use the tax tables to determine their income taxes. Some higher income ministers must use the tax rate schedules (a spouse’s income is considered in deciding whether or not to use the tax rate schedules).

## Step 8: Credits

### Line 48. Credit for child and dependent care expenses: attach Form 2441

Complete this line if you are eligible for a credit for child or dependent care expenses. This credit is computed on Form 2441, as illustrated at the end of this guide.

### Line 53. Child tax credit

If you have one or more children under 17 years of age (at the end of 2006), and you earn less than \$110,000 if married or \$75,000 if single, you will be able to claim a \$1,000 credit on your 2006 tax return for each child. To qualify for the credit, you must have a child who (1) is under 17 years of age; (2) is your child, descendent, stepson or stepdaughter, or foster child; and (3) is claimed by you as a dependent on your tax return. The child care credit is phased out for high-income taxpayers. The child tax credit is in addition to the dependent care credit you can claim if you pay someone to care for your dependent child who is under 13 (or a disabled dependent) so that you can work.

### Line 55.

Congress enacted the Energy Tax Incentives Act in 2005 to encourage energy efficiency and reduce dependence on foreign oil. From January 2006 through December 2009, the Act allows a tax credit of \$1,700 to \$3,000 on a 1-time basis for the purchase of a hybrid vehicle. The amount of the credit is based on the estimated amount of fuel saved by the hybrid compared with a 2002 model of similar size class. The credit only applies to the first 60,000 hybrid cars sold by a given manufacturer. If you placed a new electric vehicle in service in 2006, see Form 8834 to determine if you are eligible for the credit.

## Step 9: Other taxes

Now that you have subtracted credits from your federal income tax, you report other taxes you may owe.

### Line 58. Self-employment tax: attach Schedule SE (also see line 27)

- ❖ **Key Point.** All ordained ministers must pay self-employment taxes on compensation received from the exercise of their ministry, unless they have received IRS recognition of exempt status.

All ordained ministers are self-employed for Social Security purposes with respect to their ministerial income. They compute their self-employment taxes on Schedule SE and report the total tax on line 58 of Form 1040.

## Step 10: Payments

### Line 64. Federal income tax withheld

Ordained Ministers’ wages are exempt from federal income tax withholding. As a result, only those ministers who have entered into a voluntary withholding arrangement with their church will have income taxes withheld and reported on line 64. The church should report the amount of voluntarily withheld taxes on the minister’s Form W-2.

● **Key Point.** Ministers who enter into voluntary withholding arrangements will have federal income taxes withheld from their wages. Under no circumstances should a church withhold the employee's share of Social Security and Medicare taxes from the wages of such a minister, since ministers are self-employed for Social Security purposes with respect to their ministerial duties. Ministers can request (on Form W-4) that their church withhold an additional amount of income taxes to cover their expected self-employment tax liability. These additional withholdings must be treated as income taxes withheld (on Form W-2 and 941 forms) rather than the employee's share of Social Security and Medicare taxes. These ministers must still complete Schedule SE.

### Line 65. 2006 Estimated tax payments

Compensation paid to ministers for ministerial duties is not subject to tax withholding. As a result, ministers must prepay their income tax and Social Security (self-employment) taxes by using the quarterly estimated tax procedure, unless they have entered into a voluntary withholding agreement with their employing church. The estimated tax procedure is summarized above on page 11. The total amount of estimated tax payments made to the IRS is reported as a payment of taxes on line 65.

### Line 66. Earned income credit

**New in 2006.** The amount of the credit increased in 2006. The maximum credit is: (1) \$2,747 with one qualifying child; (2) \$4,536 with more than one qualifying child; or (3) \$412 without a qualifying child.

The earned income credit reduces tax you owe and may give you a refund even if you do not owe any tax. For 2006, the credit can be as much as \$412 if you do not have a qualifying child, \$2,747 if you have one qualifying child, or \$4,536 if you have more than one qualifying child. A qualifying child is a child who (1) is your son, daughter, adopted child, grandchild, stepchild, or foster child; (2) was (at the end of 2006) under age 19, under age 24 and a student, or any age and permanently and totally disabled; and (3) lived with you in the United States for more than half of 2006 (all of 2006 if a foster child).

You are not eligible for the credit if your earned income (or modified adjusted gross income, if greater) is more than:

- \$12,120 (\$14,120 if married filing jointly) if you do not have a qualifying child.
- \$32,001 (\$34,001 if married filing jointly) if you have one qualifying child.

- \$36,348 (\$38,348 if married filing jointly) if you have more than one qualifying child.

There are a number of technical requirements that must be met in order to qualify for this credit. The IRS will compute the credit for you if you like (see the instructions to Form 1040). Or, you can compute the credit yourself. To figure the amount of your earned income credit, you must use the EIC Worksheet and EIC Table in the instruction booklet for Form 1040 (see the instructions to line 66). In most cases, the amount of your earned income credit depends on (1) whether you have no qualifying child, one qualifying child, or two or more qualifying children, and (2) the amount of your earned income and modified adjusted gross income.

The IRS continues to take the position that a minister's housing allowance (and fair rental value of a parsonage) counts as earned income in determining eligibility for the earned income credit, but only for those ministers who have *not* opted out of Social Security by filing a timely Form 4361. Ministers who *have* opted out of Social Security do not treat the housing allowance (or fair rental value of a parsonage) as earned income in computing the earned income credit. This understanding is reflected in the instructions to line 66 of Form 1040.

### Line 71.

If you were billed after February 28, 2003, and before August 1, 2006, for the federal telephone excise tax on long distance or bundled service, you may be able to request a credit for the tax paid. You can request a "standard amount" from \$30 to \$60 based on the number of exemptions claimed on your 2006 tax return or the actual amount you paid. If you believe you paid more than the standard amount, it can be to your benefit to request the actual amount. See the instructions to Form 8913 for details.

### Step 11: Refund or amount you owe

After totaling your payments, you can calculate whether you owe the government or a refund is due you. If you owe a tax, be certain to attach to the return a check payable to the Internal Revenue Service. Include your daytime phone number, your Social Security number, and write Form 1040 for 2006 on the check. You also may have to pay an underpayment penalty (refer to line 76 of Form 1040).

If you have overpaid your taxes, you have two options: (1) request a full refund, or (2) apply the overpayment to your 2007 estimated tax.

### Step 12: Sign here

You must sign and date the return at the bottom of page 2. If you are filing a joint return, your spouse must

also sign the return. In the “your occupation” space, enter your occupation. Ministers should enter *minister*.

## Other forms and schedules

### Schedule A

🔑 **Key Point.** If your itemized deductions exceed your standard deduction, you should report your itemized deductions on Schedule A (Form 1040). This section will summarize the itemized deductions.

#### Step 1: Medical and dental expenses (lines 1–4)

You may deduct certain medical and dental expenses (for yourself, your spouse, and your dependents) if you itemize your deductions on Schedule A, but only to the extent that your expenses exceed 7.5% of your adjusted gross income. You must reduce your medical expenses by the amounts of any reimbursements you receive for those expenses before applying the 7.5% test. Reimbursements include amounts you receive from insurance or other sources for your medical expenses (including Medicare). It does not matter if the reimbursement is paid to the patient, the doctor, or the hospital.

*The following expenses ARE deductible as medical expenses:*

- Fees for medical services.
- Fees for hospital services.
- Meals and lodging provided by a hospital during medical treatment (subject to some limits).
- Medical and hospital insurance premiums that you pay.
- Special equipment.
- Medicare A premiums you pay if you are exempt from Social Security and voluntarily elect to pay Medicare A premiums.
- Medicare B premiums you pay.
- Medicare Supplement premiums you pay (or are deducted from your pension).
- Long-term care insurance premiums, subject to certain limitations on the amount that may be deducted.
- Special items (false teeth, artificial limbs, eyeglasses, hearing aids, crutches, etc.).
- Transportation for necessary medical care. For 2006, the standard mileage rate for medical travel was 18 cents per mile. It increases to 20 cents per mile in 2007.
- Medicines and drugs requiring a prescription.

- The portion of a life-care fee or founder’s fee paid either monthly or in a lump sum under an agreement with a retirement home that is allocable to medical care.
- Wages of an attendant who provides medical care.
- The cost of home improvements if the main reason is for medical care.
- Exercise expenses (including the cost of equipment to use in the home) if required to treat an illness (including obesity) diagnosed by a physician, and the purpose of the expense is to treat a disease rather than to promote general health and the taxpayer would not have paid the expense but for this purpose.

*The following items are NOT deductible as medical expenses:*

- Funeral services.
- Health club dues (except as noted above).
- Household help.
- Life insurance.
- Maternity clothes.
- Nonprescription medicines and drugs.
- Nursing care for a healthy baby.
- Program to stop smoking.
- Toothpaste, cosmetics, toiletries.
- Trip for general improvement of health.

#### Step 2: Taxes you paid (lines 5–9)

Generally, real estate, state and local income, and personal property taxes actually paid during 2006 are deductible. Ministers who own their homes and pay real property taxes can include the full amount of such taxes in computing their housing allowance exclusion. They may also fully deduct the amount of the taxes as an itemized deduction on Schedule A. Federal income tax and gasoline taxes are not deductible for federal income tax purposes.

You can elect to deduct state and local general sales taxes instead of state and local income taxes as an itemized deduction on Schedule A. Generally, you can use either your actual expenses or the Optional State Sales Tax Tables (in IRS Publication 600) to figure your state and local general sales tax deduction. See the Instructions for Schedule A for details.

💰 **Tip.** While the sales tax deduction will mainly benefit taxpayers with a state or local sales tax but no income tax (Alaska, Florida, Nevada, New Hampshire, South Dakota, Tennessee, Texas, Washington and Wyoming) it may give a larger

deduction to any taxpayer who paid more in sales taxes than income taxes. For example, a person who purchased a new car in 2006 may have sales taxes in excess of state income taxes.

### Step 3: Interest you paid (lines 10-14)

Interest is an amount paid for the use of borrowed money. Interest that you pay for personal reasons (that is, interest on a car loan, credit card, or a personal loan) is *not* deductible as an itemized deduction on Schedule A. In most cases, you will be able to deduct all of your mortgage interest on any loans secured by your main home, including first and second mortgages, home equity loans, and refinanced mortgages. Whether your home mortgage interest is deductible under these rules depends on the date you took out the mortgage, the amount of the mortgage, and your use of the proceeds. If all of your mortgages fit into one of the following categories, you can deduct all of your interest and report it on Schedule A (Form 1040):

- Mortgages you took out on your main home on or before October 13, 1987.
- Mortgages you took out on your main home after October 13, 1987, to buy, build or improve your home, but only if these mortgages (plus any mortgages in the preceding category) total \$1 million or less throughout 2006, (\$500,000 if married filing separately).
- Mortgages you took out after October 13, 1987, on your main home, other than to buy, build or improve your home, but only if these mortgages total \$100,000 or less throughout 2006 (\$50,000 if married filing separately).

If you had a main home and a second home, the dollar limits explained in the second and third categories described above apply to the total mortgage on both homes.

- ✦ **Key Point.** Ministers who own their homes can deduct mortgage interest payments as an itemized deduction even though such payments were included in computing the housing allowance exclusion (the so-called double deduction). However, ministers are subject to the limitations on mortgage loans discussed in this section.

The term “points” is sometimes used to describe certain charges paid by a borrower. They are also called loan origination fees, maximum loan charges, or premium charges. If the payment of any of these charges is *only* for the use of money, it ordinarily is interest paid in advance and must be deducted in installments over the life of the mortgage (not deducted in full in the year of payment). However, points are deductible in the year paid if the following requirements are satisfied: (1) your loan is secured by your main home; (2) paying points is

an established business practice in your area; (3) the points you paid were not more than the points generally charged in your area; (4) you use the cash method of accounting; (5) the points were not paid in the place of amounts that ordinarily are stated separately on the settlement statement, such as appraisal fees, attorney fees, and property taxes; (6) you use your loan to buy or build your main home; (7) the points were computed as a percentage of the principal amount of the mortgage; (8) the amount is clearly shown on the settlement statement; (9) the funds you provided at or before closing, plus any points the seller paid, were at least as much as the points charged.

### Step 4: Gifts to charity (lines 15-18)

Cash contributions to churches, schools, and most other public charities are deductible up to 50% of adjusted gross income. Contributions of property are subject to different limitations. See IRS Publication 526. Contributions of cash or checks are reported on line 15, while contributions of noncash property are reported on line 16. If you do not itemize deductions, you cannot deduct any of your charitable contributions.

The value of personal services is never deductible as a charitable contribution, but unreimbursed expenses incurred in performing services on behalf of a church or other charity may be. For example, if you drive to and from volunteer work on behalf of a charity, you may deduct the actual cost of gas and oil or you may claim the standard charitable mileage rate of 14 cents for each substantiated mile (for 2006). Unreimbursed travel expenses incurred while away from home (whether within the United States or abroad) in the course of donated services to a tax-exempt religious or charitable organization are deductible as a charitable contribution. There are two ways to do this.

Individuals performing the charitable travel can keep track of their own travel expenses and then claim a charitable contribution for the total on Schedule A. Or, these individuals could provide their church or charity with a travel report substantiating all travel expenses. In such a case, the church or charity could issue the individual a charitable contribution receipt for the total amount of the substantiated travel expenses. Travel expenses that can be receipted include airfare, lodging, meals and incidental expenses.

No charitable deduction is allowed for travel expenses incurred while away from home in performing services for a religious or charitable organization unless there is no significant element of personal pleasure, recreation, or vacation involved in the travel.

- ✦ **Example.** Rev. J goes on a trip to Europe. He is in Europe for 10 days and conducts one-hour services on two of those days. Rev. J will not be

able to claim a charitable contribution deduction for the travel expenses that he incurs in making this trip. The same rule would apply if Rev. J's spouse or children go along on the trip.

Charitable contributions must be claimed in the year they are delivered. One exception is a check that is mailed to a charity—it is deductible in the year the check is mailed (and postmarked), even if it is received early in the next year.

Charitable contributions generally are deductible only to the extent they exceed the value of any premium or benefit received by the donor in return for the contribution.

There are limits on the amount of a contribution that can be deducted. Generally, cash contributions to churches, schools, and other public charities are deductible up to a maximum of 50% of adjusted gross income. In some cases, contributions that exceed these limits can be carried over and claimed in future years. Some charitable contributions are limited to 20% or 30% of adjusted gross income, depending on the recipient and the form of the contribution.

Designated contributions are those that are made to a church with the stipulation that they be used for a specified purpose. If the purpose is an approved project or program of the church, the designation will not affect the deductibility of the contribution. An example is a contribution to a church building fund. However, if a donor stipulates that a contribution be spent on a designated individual, no deduction is allowed unless the church exercises full administrative control over the donated funds to ensure that they are being spent in furtherance of the church's exempt purposes. Designated contributions that ordinarily are not deductible include contributions to church benevolence or scholarship funds that designate a specific recipient. Contributions to benevolence or scholarship funds ordinarily are deductible if the donor does not earmark a specific recipient.

Contributions to a church or missions board that specify a particular missionary may be tax-deductible if the church or missions board exercises full administrative and accounting control over the contributions and ensures that they are spent in furtherance of the church's mission. Direct contributions to missionaries, or any other individual, are not tax-deductible, even if they are used for religious or charitable purposes.

Charitable contributions must be properly substantiated. Individual cash contributions of less than \$250 may be substantiated by a canceled check or a receipt from the charity. Current rules govern the substantiation of individual contributions of cash or property of \$250 or more. These rules are explained in *Federal Reporting Requirements for Churches* published by MMBB.

If you contribute property that you value at \$500 or more, you must include a completed Form 8283 with your Form 1040. Complete only section A if the value claimed is \$500 or more but less than \$5,000. If you claim a deduction of more than \$5,000 for a contribution of non-cash property, then you must obtain a qualified appraisal of the property and include a qualified appraisal summary (section B of Form 8283) with your Form 1040.

⊛ **Key Point.** The Tax Court ruled that a donor who contributed property worth more than \$10,000 to a church was not eligible for a charitable contribution deduction, even though there was no dispute as to the value of the property, because he failed to attach a qualified appraisal summary (Form 8283) to the tax return on which the contribution was claimed.

### Step 5: Casualty and theft losses (line 19)

Most taxpayers have at some time suffered damage to their property as a result of hurricanes, earthquakes, tornadoes, fires, vandalism, car accidents, floods, or similar events. When property is damaged or destroyed by such events, it is called a casualty. If your property is stolen, you may also have a deductible theft loss. You must itemize your deductions on Schedule A to be able to claim a casualty or theft loss to nonbusiness property. To determine your deduction, you must reduce the amount of your casualty and theft losses by any insurance or reimbursement you receive. No deduction is allowed for a casualty or theft loss that is covered by insurance unless a timely insurance claim for reimbursement has been filed. In addition, each individual loss must be reduced by \$100, and your total losses are then reduced by 10% of your adjusted gross income.

To claim a casualty or theft loss, you must be able to show that the loss in fact occurred. In addition, the loss generally is defined as the lesser of (1) the decrease in fair market value of the property as a result of the casualty or theft or (2) your adjusted basis in the property before the casualty or theft.

Calculate non-business casualty and theft losses on Form 4684, and report them on Schedule A as an itemized deduction.

⊛ **Key Point.** Congress enacted legislation in 2005 waiving the 10% and \$100 floors for persons affected by Hurricane Katrina, allowing them to fully deduct their losses.

### Step 6: Job expenses and most other miscellaneous deductions (lines 20–26)

You may deduct certain miscellaneous expenses on Schedule A. These deductions are in addition to the itemized deductions for medical expenses, taxes, interest, charitable contributions, and casualty and theft losses.

Most miscellaneous itemized expenses are deductible only to the extent that they exceed 2% of adjusted gross income. Miscellaneous expenses subject to the 2% floor include:

- Unreimbursed and nonaccountable reimbursed employee business expenses (discussed more fully below).
- Professional society dues.
- Safety deposit box rental.
- Employee educational expenses.
- Tax counsel and assistance.
- Office.
- Home expenses-work.
- Related supplies.
- Expenses of looking for a new job.
- Investment counsel fees.
- Professional books and periodicals.
- Investment expenses.
- 50% of unreimbursed business meals and entertainment.
- IRA custodial fees.

Certain miscellaneous expenses are not subject to the 2% floor. However, these expenses ordinarily are not available to ministers.

### ***Employee business expenses***

- ⊛ **Key Point.** Most ministers incur business expenses. How these expenses are handled, by both the minister and the church, significantly impacts whether (and to what extent) they are deductible.

The more common examples of ministerial business expenses are summarized below.

#### **Local transportation expenses**

Expenses incurred in driving your car for business purposes within your community represent one of the most important business expenses for ministers. A common example would be driving your car from your church to a hospital to visit members. Commuting to and from work is never a business expense. However, if you drive to a hospital (or some other business location) on the way home from church, the expenses incurred in driving from the church to the second business location are business expenses even though you are on the way home. The remaining miles between the second business location and your home are nondeductible commuting expenses.

These expenses can be deducted using either a standard mileage rate or the actual costs of operating the car for business miles. Most ministers choose the standard mileage rate because of its simplicity. However, it is available only if it is selected for the first year a car is used in your trade or business. The actual expense method is very complex and is explained fully in IRS Publication 917.

The standard business mileage rate for 2006 was 44.5 cents per mile.

- ⊛ **Key Point.** The standard business mileage rate for 2007 is 48.5 cents per mile.

Ministers should consider the advantages of using a church-owned car for their business travel. This will eliminate most record-keeping and reporting requirements. Some conditions apply. See the illustration at the end of this guide (page 37) for a summary of the various tax options pertaining to business use of a car.

#### **Travel expenses**

Travel expenses are the expenses that you incur while traveling away from home overnight for your work or business. A common example would be automobile, lodging, and meal expenses you incur in traveling to a convention meeting. You can deduct these expenses if you can substantiate them, as explained below.

*Deductible travel expenses include:*

- Air, rail, and bus fares.
- Operating and maintaining your car.
- Taxi fares or other costs of transportation between the airport or station and your hotel, or from one work site to another.
- Meals and lodging while you are away from home on business.
- Cleaning and laundry expenses.
- Telephone and telegraph expenses.
- Tips.

IRS regulations clarify that while a non-employee spouse's travel expenses incurred while accompanying a minister on a business trip are not deductible as a business expense, the reimbursement of those expenses by the church will not represent taxable income so long as the spouse's presence on the trip serves a legitimate business purpose and the spouse's expenses are reimbursed under an accountable arrangement.

One way for the *unreimbursed* travel expenses of a non-employee spouse to be deductible would be if

the spouse performed substantial church-related activities during the trip. Under these circumstances, the spouse's unreimbursed travel expenses could be claimed as a charitable contribution deduction.

### Entertainment expenses

You may be able to deduct entertainment expenses you incur for your ministry. You may take the deduction only if you can demonstrate that the amounts spent are either (1) directly related to the active conduct of your ministry or (2) associated with the active conduct of your ministry, and the entertainment occurred directly before or after a substantial business discussion. These two tests are summarized below:

*Directly related test.* To show that entertainment was directly related to the active conduct of your business, you ordinarily must be able to demonstrate that (1) you had more than a general expectation of deriving income or some other specific business benefit at some indefinite future time; (2) you did engage in business during the entertainment period; and (3) the main purpose of the entertainment was the transaction of business.

*Associated entertainment.* To show that entertainment was associated with the active conduct of your ministry, you must be able to demonstrate that you had a clear business purpose in incurring the expense, and that the meal or entertainment directly preceded or followed a substantial business discussion.

Entertainment includes any activity generally considered to provide entertainment, amusement, or recreation. This covers entertaining guests at restaurants, social or athletic facilities, sporting events, or on hunting, fishing, vacation, or similar trips. Expenses are not deductible when business acquaintances take turns picking up each other's entertainment checks without regard to whether any business purposes are served. Ministers incur entertainment expenses in a variety of situations. Common examples include entertaining denominational leaders, guest speakers, church groups (youth, choir, the deacons, etc.), or meeting with members at a restaurant for counseling purposes.

❖ **Key Point.** You may deduct only 50% of your business-related entertainment expenses, including meals. This 50% limitation is incorporated directly into the tax returns (see Form 2106). This rule does not apply to expenses you incur that are reimbursed by your employer under an "accountable reimbursement plan" (described elsewhere in this guide).

Entertainment expenses incurred in your home are especially scrutinized by the IRS. You must be able to demonstrate that your expenses were not purely social but rather had a primary business purpose.

Entertainment expenses of spouses may also be deductible if their presence serves a legitimate business purpose or if it would be impractical under the circumstances to entertain the business associate without including his or her spouse. If a spouse's entertainment expenses are deductible because it is impractical to entertain his or her spouse without the spouse being included, your spouse's entertainment expenses incurred on the same occasion will also be deductible. For example, your spouse joins you because your business associate's spouse will be present.

The IRS frequently challenges entertainment expenses, and so you should be prepared to fully substantiate such expenses as described below.

🍷 **Example.** Rev. S invites the members of the church board to his home for dinner and a meeting. The expenses incurred by Rev. S and his guests for food and beverages ordinarily will constitute entertainment expenses.

🍷 **Example.** Rev. S invites a friend and fellow minister to his home for dinner. The friend resides in another state and is visiting Rev. S for the day. Ordinarily, such a visit will be a social visit and the expenses associated with it will not be deductible.

🍷 **Example.** Rev. K is the head of staff of her church. She takes a prospect for a ministerial staff position out to dinner, where they discuss the person's background and suitability for the position. The person's spouse comes along because it would be impractical to discuss the position solely with the prospect. Further, Rev. K's spouse accompanies his wife because the other spouse is present. Rev. K pays everyone's meal expense. The cost of the meals of all four people is a deductible entertainment expense.

### Educational expenses

Certain educational expenses are deductible by ministers. You may deduct expenses you have for education, such as tuition, books, supplies, correspondence courses, and certain travel and transportation expenses, even though the education may lead to a degree, if the education satisfies one or both of the following conditions:

- the education is required by your employer, or by law or regulation, to keep your salary, status, or job; or

- the education maintains or improves skills required in your present work.

However, you may not deduct expenses incurred for education, even if one or both of the requirements mentioned above are met, if the education is required to meet the minimum educational requirements to qualify you in your trade or business or is part of a program of study that will lead to qualifying you in a new trade or business, even if you did not intend to enter that trade or business.

📖 **Example.** The minister at First Church takes a counseling course at a local university. Expenses associated with the course are deductible educational expenses if the course maintains or improves job skills and is not a part of a program of study that will qualify the minister for a new trade or business.

### **Subscriptions and books**

Ministers often subscribe to a number of periodicals and purchase books that are directly relevant to the performance of their professional duties. The cost of a subscription is a legitimate business expense if it is related to the minister's duties at the church. Minister's journals and specialized periodicals clearly satisfy this test. News magazines may also qualify if a minister can demonstrate that the information contained in such periodicals is related to his or her ministry (for example, sources of illustrations for sermons). The cost of a general circulation daily newspaper is not deductible.

The unreimbursed cost of books that are related to your ministry is a professional business expense and accordingly is deductible.

### **Personal computers**

Many ministers have purchased personal computers that they use at home. Since computers lend themselves to personal as well as business use, they are singled out for special treatment. If you report your income taxes as an employee (or you report as self-employed but are reclassified as an employee by the IRS in an audit) and you purchase a home computer that you use in connection with your work, you must meet the following tests to claim any deduction:

- your use of the computer in your home must be *for the convenience of your employer*; and
- your use of the computer in your home is *required as a condition of your employment*.

What do these terms mean? *For the convenience of your employer* means that you can clearly demonstrate that you cannot perform your job without the home

computer. The fact that the computer enables you to perform your work more easily and efficiently is not enough. Further, you must prove that the computers available at your place of employment are insufficient to enable you to properly perform your job. Obviously, this is a difficult test to satisfy. *Required as a condition of your employment* means that you must not be able to properly perform your duties without the computer. It is not necessary that your employer explicitly requires you to use the computer. On the other hand, it is not enough that your employer merely states that your use of the home computer is a condition of your employment. If you are an employee and these tests are not met, you cannot deduct any of the cost of your home computer.

If you are an employee and you meet both tests described above, you can claim a business deduction if you use your home computer more than 50% of the time during the year in your work. You can claim a deduction for the entire purchase price in the year of purchase (you do not need to depreciate the computer). Of course, the price must be reduced by the percentage of use that is personal as opposed to business related.

### **Office in the home**

Most ministers have an office in their home. For the costs of such an office to be deductible as a business expense, several conditions must be satisfied. These include:

- The costs must not have been excluded as minister's housing allowance.
- The home office must be your principal place of business.
- The home office must be exclusively used in your trade or business. This means that the home office must not be used by other family members (for example, to watch television or do homework). The use of a part of your home for both personal and business purposes does not meet the exclusive use test.
- The home office must be used on a regular basis in your trade or business. This means that you must use the home office on a continuous basis for professional purposes (for example, preparing sermons, conducting counseling, doing research, contacting members, writing correspondence, preparing for church meetings). Occasional or incidental use of the office for such purposes is not enough, even if the office is used for no other purposes.
- If you are an employee, the home office must be for the convenience of the employer. This



means that the home office must do more than make the employee's job easier or efficient—it must be essential to the performance of your job.

Very few ministers will satisfy all of these conditions, which means that a home office deduction generally is not available.

⊛ **Key Point.** The IRS audit guidelines for ministers instruct IRS agents to take the position that a minister who excludes all of his housing expenses as a housing allowance exclusion has in effect already “deducted” all of the expenses associated with an office in the home and accordingly should not be able to claim any additional deduction of such expenses as an itemized (home office) deduction on Schedule A.

### **How to report employee business expenses**

The deductibility of your business expenses depends on whether you are an employee or self-employed, whether or not the expenses are reimbursed by the church, and whether any reimbursed expenses are paid under an accountable or a nonaccountable reimbursement plan. This section addresses the tax treatment of business expenses for ministers who report their income taxes as employees. The tax treatment of business expenses for ministers with self-employment income is discussed below (under the section on Schedule C).

The business expenses of ministers who are employees for federal income tax reporting purposes (this includes most ministers as explained earlier) can be handled in any of the following three ways:

#### **Method 1: Unreimbursed expenses**

⊛ **Key Point.** Unreimbursed expenses are expenses that are not reimbursed by the church. They may be deducted only as a miscellaneous itemized deduction on Schedule A to the extent they exceed 2% of a minister's adjusted gross income.

Many ministers incur unreimbursed business expenses. These are expenses that are not reimbursed by the church. Ministers who are employees for income tax reporting purposes claim their unreimbursed business expenses on Schedule A—if they are able to itemize, and only to the extent that such expenses exceed 2% of adjusted gross income.

⊛ **Key Point.** Ministers who are employees for income tax reporting purposes cannot claim any deduction for *unreimbursed* employee business expenses for which an employer reimbursement was available.

#### **Method 2: Nonaccountable reimbursed expenses**

⊛ **Key Point.** Ministers who are employees for income tax reporting purposes deduct any business expenses reimbursed by their church under a nonaccountable reimbursement plan on Schedule A if they are able to itemize and only to the extent that such expenses exceed 2% of adjusted gross income. The full amount of the church's reimbursements must be included in the minister's income whether or not the expenses are deductible. A church has a nonaccountable plan if it reimburses ministers (or other employees) for business expenses without requiring adequate substantiation of the amount, date, place, and business purpose of the expenses, or not requiring excess reimbursements to be returned to the church.

It is very common for churches to reimburse a minister's business expenses without requiring any substantiation of actual expenses or a return of reimbursements in excess of substantiated expenses (for example, excess reimbursements). The most common example is the monthly car allowance. Many churches pay their minister a monthly allowance to cover business use of an automobile, without requiring any substantiation of actual expenses or a return of the amount by which the allowances exceed actual expenses. Such a reimbursement arrangement is called a nonaccountable reimbursement arrangement, since the minister is not required to account for (substantiate) the actual amount, date, place, and business purpose of each reimbursed expense. Another common example would be a church that reimburses expenses that are claimed by a minister without adequate substantiation.

For ministers who are employees, the full amount of the church's reimbursements or allowances must be reported as income on the minister's Form W-2 (and 1040). The minister can deduct actual expenses only as a miscellaneous itemized deduction on Schedule A to the extent these expenses exceed 2% of adjusted gross income. These rules are especially harsh, since the church's reimbursements are fully reported as income to the minister who in many cases is unable to claim any deduction because of insufficient itemized expenses to use Schedule A.

☑ **Caution.** Nonaccountable expense reimbursements that are not reported as taxable income on a minister's W-2 or Form 1040 are classified as an “automatic excess benefit” by the IRS, meaning that the minister and church board members are exposed to substantial excise taxes (called “inter-

mediate sanctions”). Only ministers who are an officer or director are subject to this rule.

The IRS has advised ministers to comply with the so-called *Deason* allocation rule when computing deductions for unreimbursed business expenses as well as business expenses reimbursed by a church under a nonaccountable arrangement. This rule requires ministers to reduce their business expense deduction by the percentage of their total compensation that consists of a tax-exempt housing allowance. This rule does not apply to the computation of self-employment taxes since the housing allowance is not deductible in computing these taxes. *The Deason rule can be avoided if a church adopts an accountable business expense reimbursement arrangement.*

🔑 **Key Point.** The IRS audit guidelines for ministers instruct agents to apply the so-called *Deason* allocation rule when auditing ministers.

### Method 3: Accountable reimbursed expenses

🔑 **Key Point.** The limitations on the deductibility of unreimbursed and nonaccountable reimbursed employee business expenses can be avoided if the church adopts an accountable reimbursement plan. Reimbursements paid by the church under an accountable arrangement are not reported as income to the minister, and the minister need not claim any deductions.

The best way for ministers to handle business expenses is to have their employing church adopt an accountable business expense reimbursement arrangement. Under such an arrangement, (1) a church agrees to reimburse ministers (and other church workers, if desired) for those business expenses that are properly substantiated as to date, amount, place, and business purpose, and (2) ministers are required to return any excess reimbursements (in excess of substantiated expenses) to the church. Reimbursements of business expenses under such an arrangement are not reported as taxable income on the minister’s Form W-2 or Form 1040, and there are no deductions to claim. In effect, the minister is reporting to the church rather than to the IRS.

An accountable business expense reimbursement arrangement should be established by the church in an appropriate resolution. In adopting a resolution, pay special attention to the following rules:


- Condition the reimbursement of any expense on adequate substantiation. This will include written evidence for all expenses and receipts for expenses of \$75 or more. The evidence must substantiate the amount, date, place, and business nature of each expense. The key point is this: A church must

require the same degree of substantiation as would be required for a deduction on the minister’s income tax return.

- Expenses must be substantiated, and excess reimbursements returned to the church, within a reasonable time. Expenses will be deemed substantiated within a reasonable period of time if they are substantiated within 60 days. Excess reimbursements will be deemed to be returned to the employer within a reasonable period of time if they are returned within 120 days.
- Business expense reimbursements cannot be funded under an accountable plan out of a minister’s own salary (for example, through salary reductions).

📎 **Example.** Rev. R is senior minister at First Church. He reports his federal income taxes as an employee, and the church reimburses him for all of his business and professional expenses (by means of a credit card or cash reimbursements). However, Rev. R is not required to account for such expenses by providing the church treasurer with receipts documenting the amount, time and place, business purpose, and business relationship of each expense. Rev. R simply informs the treasurer at the end of each month of the total expenses incurred during that month. Assume further that Rev. R cannot itemize deductions on Schedule A (he does not have sufficient deductions). If Rev. R received reimbursements of \$4,000 in 2006: (1) the church would report the entire reimbursements (\$4,000) as income on Rev. R’s W-2, and Rev. R would report them as income (salary) on his Form 1040; and (2) Rev. R cannot deduct the reimbursed expenses as a miscellaneous itemized deduction on Schedule A since he does not have sufficient expenses to itemize. In other words, all of Rev. R’s business expense reimbursements are includable in his income for tax purposes, but he cannot offset any of this income by deducting any portion of his business expenses. Even if Rev. R could itemize deductions, his nonaccountable reimbursed expenses would be treated just like unreimbursed expenses—they are deductible only as miscellaneous itemized deductions, and then only to the extent that they (along with most other miscellaneous expenses) exceed 2% of his adjusted gross income. Clearly, the tax impact of these rules can be costly for ministers who do not account to their employing church for their business expenses. Further, if the church and Rev. R neglect to report the reimbursements as taxable income, the reimbursements become an “automatic excess

benefit” triggering intermediate sanctions against (1) Rev. R (assuming he is an officer or director, or the relative of one) of up to 225% of the excess benefit (\$9,000), and (2) the board, up to a maximum penalty of \$10,000.

 **Example.** Same facts as the previous example, except that the church adopts an accountable reimbursement plan, and Rev. R is reimbursed for \$4,000 of substantiated expenses. Under these facts, the church would not report the \$4,000 of reimbursements as income on Rev. R’s Form W-2, and Rev. R would not have to report the reimbursements or claim the expenses on his Form 1040.

Churches occasionally reimburse ministers for nonbusiness expenses. Such reimbursements, though they require an accounting, ordinarily must be included in the minister’s wages for income tax reporting purposes, and they are not deductible by the minister. Such personal, living, or family expenses are not deductible, and the entire amount of a church’s reimbursement must be included on the minister’s Form W-2 and Form 1040.

Business expenses must be substantiated by adequate evidence to support an income tax deduction or an expense reimbursement under an accountable reimbursement plan of an employer. Stricter substantiation rules apply to transportation, travel, and entertainment expenses.

## Schedule B

Schedule B is used to report taxable interest income and dividend income of more than \$1,500.

### Step 1: Interest income (lines 1-4)

List (on line 1) the name of each institution or individual that paid you taxable interest if you received more than \$1,500 of taxable interest in 2006. Be sure the interest you report on line 1 corresponds to any 1099-INT forms you received from such institutions. Do not include tax-exempt interest.


### Step 2: Dividend income (lines 5-6)


List (on line 5) the name of each institution that paid you dividends if you received more than \$1,500 in dividends in 2006. Be sure the dividends you report on line 1 correspond to any 1099-DIV forms you received from such institutions.


### Step 3: Foreign accounts and foreign trusts

Be sure to complete this part of the schedule if you had more than \$1,500 of either taxable interest or dividends.

## Schedule C

 **Key Point.** Most ministers who serve local churches or church agencies are employees for federal income tax purposes with respect to their church salary. They report their church salary on line 7 of Form 1040 and receive a Form W-2 from the church. They do not report their salary as self-employment earnings on Schedule C.

 **Key Point.** Use Schedule C to report income and expenses from ministerial activities you conduct other than in your capacity as a church employee. Examples would be fees received for guest speaking appearances in other churches, and fees received directly from church members for performing personal services, such as weddings and funerals.

 **Recommendation.** Some ministers are eligible to use the simpler Schedule C-EZ.


### Step 1: Introduction

Complete the first several questions on Schedule C. Ministers should list the code 813000 on line B, since this is the code that refers to ministers and chaplains. Some ministers who report their church compensation as self-employed point to this code as proof that ministers serving local churches can report as self-employed. This is not so. This code applies to the incidental self-employment activities of ministers who report their church salaries as employees. It also applies to those few ministers who are self-employed, such as traveling evangelists.

### Step 2: Income (lines 1-7)

Report on line 1 your gross income from your self-employment activity.

### Step 3: Expenses (lines 8-27)

 **Warning.** Many ministers continue to report their income taxes as self-employed. One so-called advantage to this arrangement is the ability of the minister to fully deduct business expenses on Schedule C whether or not the minister can itemize deductions on Schedule A. This advantage is illusory. Most ministers, if audited by the IRS, would be reclassified as employees and their Schedule C deductions disallowed. This could result in substantial additional taxes, penalties, and interest, particularly if the minister is not able to use Schedule A. The best way for all ministers to handle their business expenses is through an accountable expense reimbursement arrangement.

Report any business expenses associated with your self-employment earnings on lines 8 through 27. For example, if you incur transportation, travel or entertain-

ment expenses in the course of performing self-employment activities, you deduct these expenses on lines 8 through 27 of Schedule C.

Since self-employed ministers list only their net self-employment earnings (that is, after deducting all business and professional expenses) as a component of gross income on line 12 of Form 1040, they in effect are able to deduct 100% of their business and professional expenses even if they do not have enough itemized deductions to use Schedule A.

Self-employed people, like church employees, can deduct only 50% of business meals and entertainment. Further, self-employed people who use Schedule C to report their business deductions are not subject to the 2% floor that applies to the deduction of employee business and professional expenses that are either unreimbursed or reimbursed under a nonaccountable reimbursement plan. Some ministers point to these as advantages of reporting church income as self-employed rather than as employees. Nothing could be further from the truth. The IRS considers most ministers serving local churches and church agencies to be employees rather than self-employed for federal income tax reporting purposes. The so-called advantage of being able to deduct all of one's business expenses on Schedule C is of little value in the event of an IRS audit and reclassification as an employee. In addition, a minister who reports his church income as self-employed is taxed on the value of certain fringe benefits (including employer-paid medical insurance).

✦ **Key Point.** One of the reasons the audit rate is much higher for self-employed taxpayers is that only 30% of all taxpayers have sufficient itemized expenses to use Schedule A. If the IRS can reclassify taxpayers from self-employed to employee status, it will generate far more tax dollars since only 30% of taxpayers can itemize deductions on Schedule A. Expenses that could have been claimed by a self-employed taxpayer on Schedule C are lost if that taxpayer is reclassified as an employee and has insufficient expenses to itemize on Schedule A.

📎 **Example.** Rev. M reports her income taxes as a self-employed person. She has \$4,000 of business expenses in 2006 that were not reimbursed by her church. She deducted all of them on Schedule C. She did not have enough expenses to itemize deductions on Schedule A. Rev. M is later audited by the IRS, and she is reclassified as an employee. She will not be able to deduct any of the \$4,000 of business expenses since they are deductible, by an employee, only as an itemized deduction on Schedule A. Further, Rev. M will have to pay interest and possibly penalties in addition to the additional taxes.

## Schedule C-EZ

The IRS has released a simpler form of Schedule C that can be used by some people with self-employment earnings. The new Schedule C-EZ can be used instead of Schedule C if you meet all of these requirements:

- You had business expenses associated with your trade or business of \$5,000 or less in 2006.
- You use the cash rather than the accrual method of accounting.
- You did not have an inventory at any time during the year.
- You did not have a net loss from your trade or business.
- You had only one business as a sole proprietor.
- You had no employees.
- You do not use Form 4562 to compute a depreciation deduction with regard to your trade or business.
- You do not claim a deduction for the business use of your home.

Many ministers who report their church compensation as employees will be able to use this form to report small amounts of self-employment earnings they receive during the course of a year as honoraria for occasional guest speaking appearances or as fees received directly from church members for services rendered on their behalf (for example, marriages and funerals).

## Schedule SE

✦ **Key Point.** Use Schedule SE to report Social Security taxes on any income you earned as a minister if you have not applied for and received IRS approval of an exemption application (Form 4361). Remember, ministers always are self-employed for Social Security purposes with respect to their ministerial services. They pay self-employment taxes, and never FICA taxes, with respect to such services.

✦ **Key Point.** Ministers who have received IRS approval of an application for exemption from self-employment taxes (Form 4361) do not pay any Social Security taxes on compensation received for their ministerial services. They do not use Schedule SE.

### Step 1: Section A (line 2)

Most ministers use the short Schedule SE rather than the long Schedule SE. This means that they complete section A on page 1 of the schedule rather than Section B on page 2.

Ministers report their net self-employment earnings on line 2 of Section A. This amount is computed as follows:

1. Add the following to the church salary:
  - other items of church income (including taxable fringe benefits)
  - self-employment earnings from outside businesses
  - annual rental value of parsonage, or nontaxable portion of housing allowance
  - business expense reimbursements made under a nonaccountable plan
2. Next, subtract the following from the above total:
  - unreimbursed business expenses (disregard the *Deason* reduction rule)
  - business expenses reimbursed under a nonaccountable plan (disregard the *Deason* reduction rule)
  - most income tax exclusions other than the housing allowance, the fair rental value of a parsonage, and the foreign earned income exclusion

### **Step 2: Section A (line 4)**

Ministers (and other taxpayers who are considered self-employed for Social Security purposes) can reduce their taxable earnings by 7.65%, which is half the Social Security and Medicare tax paid by employers and employees. To do this, multiply net earnings from self-employment times 0.9235 on line 4. Self-employment taxes are paid on the reduced amount.

### **Step 3: Section A (line 5)**

The self-employment tax for 2006 is computed on this line. The self-employment tax rate for 2006 is 15.3%, which consists of the following two components:

- (1) a Medicare hospital insurance tax of 2.9% and
- (2) an old-age, survivor and disability (Social Security) tax of 12.4%. For 2006, the 2.9% Medicare tax applies to all net earnings from self-employment regardless of amount. The 12.4% Social Security tax applies to only the first \$94,200 of net self-employment earnings (in 2006).

## **Form 2106**

- ⊕ **Key Point.** Use Form 2106 to compute your employee business expenses claimed on Schedule A.

### **Step 1: Enter your expenses**

On lines 1 through 6, you report your employee business expenses. For most ministers, the most signifi-

cant employee business expense is the business use of a car. This expense is computed on Part II (side 2) of Form 2106 and then reported on line 1 of Part I. Ministers may use the actual expense method of computing their car expenses, or the standard mileage rate. Most ministers elect the standard mileage rate. Under this method, substantiated business miles are multiplied times the current standard mileage rate (44.5 cents per mile for business miles driven during 2006, and 48.5 cents per mile for business miles driven during 2007). You compute your vehicle expenses using the standard mileage rate in Section B of Part II (line 22).

Those ministers using the actual expense method compute their car expenses in Section C of Part II. Some restrictions apply to use of the standard mileage rate. First, you must maintain adequate records to substantiate your business miles, and second, you must use the standard mileage rate for the first year you began using your car for business purposes.

On line 3, you report your travel expenses incurred while away from home overnight on business. This would include travel to other cities to perform weddings or funerals, or trips to denominational meetings. Do not include meals and entertainment on line 3 (these items are reported separately on line 5). On line 4, report business expenses other than local transportation, overnight travel, and meals and entertainment. This would include education, publications, and the other kinds of business expenses discussed previously in this guide.

### **Step 2: Enter amounts your employer gave you for expenses listed in Step 1**

If your employer (church) reimbursed some or all of your business expenses and does not report them as income in box 1 of your Form W-2, report the amount of these reimbursements on line 7. This would include any amount reported under code L in box 13 of your Form W-2 (substantiated car expense reimbursements up to the standard business mileage rate), and reimbursements of business expenses under an accountable arrangement.

### **Step 3: Figure expenses to deduct on Schedule A (Form 1040)**

On lines 8 through 10, you compute the amount of your business expense deduction to be claimed on Schedule A. The deduction will be limited to the amount that exceeds 2% of your adjusted gross income.

## **Form 2106-EZ**

Employees can use a simplified Form 2106-EZ to compute their business expense deduction for 2006 if their employer did not reimburse business expenses and they use the standard mileage rate for computing automobile expenses.

## Part 4. Comprehensive Example and Forms

### Example One: Senior Minister

*Note: This example is based on an illustrated example contained at the end of IRS Publication 517.*

Rev. John Michaels is the minister of the First United Church. He is married and has one child. The child is considered a qualifying child for the child tax credit. Mrs. Michaels is not employed outside the home. Rev. Michaels is a common-law employee of the church, and he has not applied for an exemption from SE tax. The church paid Rev. Michaels a salary of \$45,000. In addition, as a self-employed person, he earned \$4,000 during the year for weddings, baptisms, and honoraria. He made estimated tax payments during the year totaling \$12,000. He taught a course at the local community college, for which he was paid \$3,400. Rev. Michaels owns a home next to the church. He makes a \$1,125 per month mortgage payment of principal and interest only. His utility bills and other housing-related expenses for the year totaled \$1,450, and the real estate taxes on his home amounted to \$1,750 for the year. The church paid him \$1,400 per month as his parsonage allowance. The home's fair rental value is \$1,380 per month (including furnishings and utilities). The parts of Rev. and Mrs. Michaels' income tax return are explained in the order they are completed. They are illustrated in the order that the Rev. Michaels will assemble the return to send it to the IRS.

#### Form W-2 from Church

The church completed its Form W-2 for Rev. Michaels as follows:

**Box 1.** The church entered Rev. Michaels' \$45,000 salary.

**Box 2.** The church left this box blank because Rev. Michaels did not request federal income tax withholding.

**Boxes 3 through 6.** Rev. Michaels is considered a self-employed person for purposes of Social Security and Medicare tax withholding, so the church left these boxes blank.

**Box 14.** The church entered Rev. Michaels' total parsonage allowance for the year and identified it.

#### Form W-2 from College

The community college gave Rev. Michaels a Form W-2 that showed the following.

**Box 1.** The college entered Rev. Michaels' \$3,400 salary.

**Box 2.** The college withheld \$272 in federal income tax on Rev. Michaels' behalf.

**Boxes 3 and 5.** As an employee of the college, Rev. Michaels is subject to Social Security and Medicare withholding on his full salary from the college.

**Box 4.** The college withheld \$210.80 in Social Security taxes.

**Box 6.** The college withheld \$49.30 in Medicare taxes.

#### Schedule C-EZ (Form 1040)

Some of Rev. Michaels' entries on Schedule C-EZ are explained here.

**Line 1.** Rev. Michaels reports the \$4,000 from weddings, baptisms, and honoraria.

**Line 2.** Rev. Michaels reports his expenses related to the line 1 amount. The total consisted of \$87 for marriage and family booklets, and \$204 for 459 miles of business use of his car, mainly in connection with honoraria. Rev. Michaels used the standard mileage rate to figure his car expense. He multiplied the standard mileage rate of 44.5 cents by 459 miles to get \$204. These expenses total \$291 (\$204 + \$87). However, he cannot deduct the part of his expenses allocable to his tax-free parsonage allowance. He attaches the required statement, Attachment 1 (shown later) to his return, showing that 25 percent (or \$73) of his business expenses are not deductible because they are allocable to that allowance. He subtracts the \$73 from the \$291 and enters the \$218 difference on line 2.

**Line 3.** He enters his net profit of \$3,782 both on line 3 and on Form 1040, line 12.

**Lines 4 through 8b.** Rev. Michaels fills out these lines to report information about his car.

#### Form 2106-EZ

Rev. Michaels fills out Form 2106-EZ to report the unreimbursed business expenses he had as a common-law employee of First United Church.

**Line 1.** Before completing line 1, Rev. Michaels fills out Part II because he used his car for church business. His records show that he drove 2,600 business miles, which he reports in Part II. On line 1, he multiplies 2,600 miles by the mileage rate of 44.5 cents for the year. The result is \$1,157.

**Line 4.** He enters \$219 for his professional publications and booklets.

**Line 6.** Before entering the total expenses on line 6, Rev. Michaels must reduce them by the amount allocable to his tax-free parsonage allowance. On the

required Attachment 1 (shown later), he shows that 25 percent (or \$344) of his employee business expenses are not deductible because they are allocable to the tax-free parsonage allowance. He subtracts \$344 from \$1,376 and enters the result (\$1,032) on line 6. He also enters \$1,032 on line 20 of Schedule A (Form 1040).

### **Schedule A (Form 1040)**

Rev. Michaels fills out Schedule A as explained here.

**Line 5.** Rev. and Mrs. Michaels do not pay state income tax, and, at the time this publication went to print, the deduction for state and local general sales taxes had expired and would not apply to 2006. Therefore, no deduction is shown on line 5. However, Congress was considering legislation that would extend the deduction for 2006. Before completing your 2006 Form 1040, go to [www.irs.gov](http://www.irs.gov) to find out if this legislation was enacted, and for more details. Once there, click on *More Forms and Publications*, and then on *What's Hot in Forms and Publications*, or see *IRS Publication 553*. Also look for revised instructions on how to claim the deduction for sales taxes if it is revived as expected.

**Line 6.** Rev. Michaels deducts \$1,750 in real estate taxes.

**Line 10.** He deducts \$6,810 of home mortgage interest.

**Line 15.** Rev. and Mrs. Michaels contributed \$4,800 in cash during the year to various qualifying charities. Each individual contribution was less than \$250.

**Line 20.** Rev. Michaels enters his unreimbursed employee business expenses from Form 2106-EZ, line 6.

**Lines 24, 25, and 26.** He can deduct only the part of his employee business expenses that exceeds 2 percent of his adjusted gross income. He fills out these lines to figure the amount he can deduct.

**Line 28.** The total of all the Michaels' itemized deductions is \$13,434, which they enter on line 28 and on Form 1040, line 40.

### **Schedule SE (Form 1040)**

After Rev. Michaels prepares Schedule C-EZ and Form 2106-EZ, he fills out Schedule SE (Form 1040). He reads the chart on page 1 of the schedule, which tells him he can use *Section A—Short Schedule SE* to figure his self-employment tax. Rev. Michaels is a minister, so his salary from the church is not considered church employee income. Thus, he does not have to use *Section B—Long Schedule SE*. He fills out the following lines in Section A.

**Line 2.** Rev. Michaels attaches a statement (see Attachment 2, later) that explains how he figures the amount (\$64,133) to enter.

**Line 4.** He multiplies \$64,133 by .9235 to get his net earnings from self-employment (\$59,227).

**Line 5.** The amount on line 4 is less than \$94,200, so Rev. Michaels multiplies the amount on line 4 (\$59,227) by .153 to get his self-employment tax of \$9,062. He enters that amount here and on Form 1040, line 58.

**Line 6.** Rev. Michaels multiplies the amount on line 5 by .5 to get his deduction for one-half of self-employment tax of \$4,531. He enters that amount here and on Form 1040, line 27.

### **Form 1040**

After Rev. Michaels prepares Form 2106-EZ and the other schedules, he fills out Form 1040. He files a joint return with his wife. First, he fills out the address area and completes the appropriate lines for his filing status and exemptions. Then, he fills out the rest of the form as follows:

**Line 7.** Rev. Michaels reports \$48,640. This amount is the total of his \$45,000 church salary, \$3,400 college salary, and \$240—the excess of the amount designated and paid to him as a parsonage allowance over the lesser of his actual expenses and the fair rental value of his home (including furnishings and utilities). The two salaries were reported to him in box 1 of the Forms W-2 he received.

**Line 12.** He reports his net profit of \$3,782 from Schedule C-EZ, line 3.

**Line 27.** He enters \$4,531—half his SE tax from Schedule SE, line 6.

**Line 40.** He enters the total itemized deductions from Schedule A, line 28.

**Line 53.** The Michaels can take the child tax credit for their daughter, Jennifer. Rev. Michaels figures the credit by completing the *Child Tax Credit Worksheet* (not shown) in the instructions for Form 1040, page 42. He enters the \$1,000 credit.

**Line 58.** He enters the self-employment tax from Schedule SE, line 5.


**Line 64.** He enters the federal income tax shown in box 2 of his Form W-2 from the college.

**Line 65.** He enters the \$12,000 estimated tax payments he made for the year.

Tax Guide for Ministers Filing 2006 Returns

|  |                            |  |                     |   |                     |   |  |
|--|----------------------------|--|---------------------|---|---------------------|---|--|
| a Control number   |                            | CMB No. 1545-0008                        |                     | Safe, accurate, FAST! Use  |                     | Visit the IRS website at <a href="http://www.irs.gov/efile">www.irs.gov/efile</a> . |  |
| b Employer identification number (EIN)<br>00-0246810   |                            |  |                     | 1 Wages, tips, other compensation<br>45,000.00  |                     | 2 Federal income tax withheld   |  |
| c Employer's name, address, and ZIP code<br><br>First United Church<br>1042 Main Street<br>Hometown, Texas 77099 |                            |  |                     | 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 Employee's social security number<br>011-00-2222   |                            |  |                     | 9 Advance EIC payment   |                     | 10 Dependent care benefits  |  |
| e Employee's first name and initial  |                            | Last name                                |                     | Suff.   |                     | 11 Nonqualified plans   |  |
| John E. Michaels   |                            | 1040 Main Street                         |                     | Hometown, Texas 77099   |                     | 12a See instructions for box 12   |  |
| 13 <input type="checkbox"/> Statutory employee   |                            | 13 <input type="checkbox"/> Retired plan |                     | 13 <input type="checkbox"/> Third party sick pay  |                     | 12b   |  |
| 14 Other<br>Parsonage Allowance<br>16,800.00   |                            |  |                     | 12c   |                     | 12d   |  |
| f Employee's address and ZIP code  |                            |  |                     |   |                     |   |  |
| 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  |  |

Form **W-2** Wage and Tax Statement **2006** Department of the Treasury—Internal Revenue Service  
 Copy B—To Be Filed With Employee's FEDERAL Tax Return.  
 This information is being furnished to the Internal Revenue Service.

|  |                            |  |                     |   |                     |   |  |
|--|----------------------------|--|---------------------|---|---------------------|---|--|
| a Control number   |                            | CMB No. 1545-0008                        |                     | Safe, accurate, FAST! Use  |                     | Visit the IRS website at <a href="http://www.irs.gov/efile">www.irs.gov/efile</a> . |  |
| b Employer identification number (EIN)<br>00-1357913   |                            |  |                     | 1 Wages, tips, other compensation<br>3400.00  |                     | 2 Federal income tax withheld<br>272.00   |  |
| c Employer's name, address, and ZIP code<br><br>Hometown College<br>40 Honor Road<br>Hometown, Texas 77099 |                            |  |                     | 3 Social security wages<br>3400.00  |                     | 4 Social security tax withheld<br>210.80  |  |
|  |                            |  |                     | 5 Medicare wages and tips<br>3400.00  |                     | 6 Medicare tax withheld<br>49.30  |  |
|  |                            |  |                     | 7 Social security tips  |                     | 8 Allocated tips  |  |
| d Employee's social security number<br>011-00-2222   |                            |  |                     | 9 Advance EIC payment   |                     | 10 Dependent care benefits  |  |
| e Employee's first name and initial  |                            | Last name                                |                     | Suff.   |                     | 11 Nonqualified plans   |  |
| John E. Michaels   |                            | 1040 Main Street                         |                     | Hometown, Texas 77099   |                     | 12a See instructions for box 12   |  |
| 13 <input type="checkbox"/> Statutory employee   |                            | 13 <input type="checkbox"/> Retired plan |                     | 13 <input type="checkbox"/> Third party sick pay  |                     | 12b   |  |
| 14 Other   |                            |  |                     | 12c   |                     | 12d   |  |
| f Employee's address and ZIP code  |                            |  |                     |   |                     |   |  |
| 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  |  |

Form **W-2** Wage and Tax Statement **2006** Department of the Treasury—Internal Revenue Service  
 Copy B—To Be Filed With Employee's FEDERAL Tax Return.  
 This information is being furnished to the Internal Revenue Service.



**SCHEDULE C-EZ (Form 1040)** **Net Profit From Business** (Sole Proprietorship)  
 Attach to Form 1040, 1040NR, or 1041. See instructions on back.  
 Department of the Treasury  
 Internal Revenue Service

**2106-EZ** **Unreimbursed Employee Business Expenses**  
 Attach to Form 1040 or Form 1041NR.  
 Department of the Treasury  
 Internal Revenue Service

OMB No. 1545-0047 **2006**  
 Attachment  
 Schedule No. 544

Name of proprietor: John E. Michaels  
 Social Security number: 011 00 2222

Name of partner: John E. Michaels  
 Social Security number: 011 00 2222

**Part I General Information**

**You May Use Schedule C-EZ Instead of Schedule C Only If You:**

- Had business expenses of \$5,000 or less.
- Use the cash method of accounting.
- Did not have an inventory at any time during the year.
- Did not have a net loss from your business.
- Had only one business as either a sole proprietor or statutory employee.

**You May Use This Form Only If All of the Following Apply.**

- You are an employee deducting ordinary and necessary expenses attributable to your job. An ordinary expense is one that is common and accepted in your field of trade, business, or profession. A necessary expense is one that is helpful and appropriate for your business. An expense does not have to be required to be considered necessary.
- You do not get reimbursed by your employer for any expenses (amounts your employer included in box 1 of your Form W-2 are not considered reimbursements for this purpose).
- If you are claiming vehicle expenses, you are using the standard mileage rate for 2006.

**Caution:** You can use the standard mileage rate for 2006 only if (a) you owned the vehicle and used the standard mileage rate for the first year you placed the vehicle in service, or (b) you leased the vehicle and used the standard mileage rate for the portion of the lease period after 1997.

**Part II Figure Your Net Profit**

**A** Principal business or profession, including product or service: Minister

**B** Business name, if no separate business name, leave blank.

**C** Business address (including suite or room no.), address not required if same as on page 1 of your tax return:  
 1947 Main Street  
 City, town or post office, state, and ZIP code  
 Hummelton, Texas 77038

**D** File with line pages E, 6, 8, 10  
 1  2  3  4  5  6  7  8  9  0

**E** Employee ID number (EIN), if any

**Part III Information on Your Vehicle.** Complete this part only if you are claiming car or truck expenses on line 2.

|   |   |       |
|---|---|-------|
| 1 | Gross receipts. Caution: If less income was reported to you on Form W-2 and the "Statutory employee" box on that form was checked, see <b>Statutory Employees in the Instructions for Schedule C</b> , line 1, on page C-3 and check here.  | 4,668 |
| 2 | Total expenses (see instructions). If more than \$5,000, you must use Schedule C.   | 318   |
| 3 | Net profit. Subtract line 2 from line 1. If less than zero, you must use Schedule C. Enter on both Form 1040, line 12, and Schedule BE, line 2; or on Form 1040NR, line 13. (Statutory employees do not report this amount on Schedule SE, line 2. Estates and trusts, enter on Form 1041, line 3.) | 3,782 |

**Part III Information on Your Vehicle.** Complete this part only if you are claiming vehicle expense on line 1.

7 When did you place your vehicle in service for business use? (month, day, year) **07 / 15 / 01**

8 Of the total number of miles you drove your vehicle during 2006, enter the number of miles you used your vehicle for:  
 a Business 2,608 b Commuting (see instructions) 0 c Other 8,106

9 Do you (or your spouse) have another vehicle available for personal use?  Yes  No

10 Was your vehicle available for personal use during off-duty hours?  Yes  No

11a Do you have evidence to support your deduction?  Yes  No  
 b. If "Yes," is the evidence written?  Yes  No

For Paperwork Reduction Act Notice, see page 4. Cat. No. 143740 Schedule C-EZ (Form 1040) 2006

**SCHEDULES A&B (Form 1040)** **Schedule A—Itemized Deductions** (Schedule B is on back) **Self-Employment Tax** (Form 1040)

OMB No. 1545-0047 **2006** Attachment **2006** Assessment  
 Form 1040-SS (10/05) **011 | 00 | 3722** **011 | 00 | 2222**

John E. Michaels **John E. Michaels**

▶ Attach to Form 1040. ▶ See instructions for Schedule A&B (Form 1040). ▶ Attach to Form 1040. ▶ See instructions for Schedule SE (Form 1040).

▶ Attach to Form 1040. ▶ See instructions for Schedule SE (Form 1040).

**Who Must File Schedule SE**

You must file Schedule SE if:

- You had net earnings from self-employment from **other than** church-employee income (line 4 of Short Schedule SE or line 4a of Long Schedule SE) of \$400 or more, or
- You had church-employee income of \$108.28 or more, income from services you performed as a minister or a member of a religious order is **not** church-employee income (see page SE-1).

**Notes.** Even if you had a loss or a small amount of income from self-employment, it may be to your benefit to file Schedule SE and use either "optional method" in Part II of Long Schedule SE (see page SE-3).

**Exception.** If your only self-employment income was from earnings as a minister, member of a religious order, or Christian Science practitioner and you filed Form 4361 and received RPO approval not to be taxed on those earnings, do not file Schedule SE. Instead, file "Worksheet Form 4361" on Form 1040, line 5B.

**May I Use Short Schedule SE or Must I Use Long Schedule SE?**

Note. Use this flowchart only if you must file Schedule SE. If unsure, see Who Must File Schedule SE, above.

```

    graph TD
        Q1{Are you a minister, member of a religious order, or Christian Science practitioner who received RPO approval not to be taxed on those earnings, but you are self-employed on other earnings?}
        Q1 -- No --> A1[You may use Short Schedule SE below]
        Q1 -- Yes --> Q2{Did you receive wages or tips in 2005?}
        Q2 -- No --> A1
        Q2 -- Yes --> Q3{Has the total of your wages and tips subject to social security or Medicare taxes for 2005 your net earnings from self-employment from line 400?}
        Q3 -- No --> A1
        Q3 -- Yes --> Q4{Did you receive less subject to social security or Medicare tax than you did report to your employer?}
        Q4 -- No --> A1
        Q4 -- Yes --> A2[You must use Long Schedule SE on page 2]
    
```

**Section A—Short Schedule SE. Caution.** Used above to see if you can use Short Schedule SE.

|   |  |   |        |
|---|--|---|--------|
| 1 | Net farm profit or (loss) from Schedule F, line 36, and farm partnerships, Schedule K-1 (Form 1065), box 14, code A  | 1 |        |
| 2 | Net profit or (loss) from Schedule C, line 31; Schedule C-EZ, line 3; Schedule K-1 (Form 1065), box 14, code A (other than farming); and Schedule K-1 (Form 1065)-B, box 9, code J1. Ministers and members of religious orders, see page SE-1 for amounts to report on this line. See page SE-3 for other income to report | 2 | 64,133 |
| 3 | Combine lines 1 and 2  | 3 | 64,133 |
| 4 | Net earnings from self-employment. Multiply line 3 by 92.35% (0.9235). If less than \$400, do not file this schedule; you do not owe self-employment tax   | 4 | 59,227 |
| 5 | Self-employment tax. If the amount on line 4 is:   | 5 | 8,082  |
|   | • \$94,200 or less, multiply line 4 by 15.3% (0.153). Enter the result here and on Form 1040, line 5B.   |   |        |
|   | • More than \$94,200, multiply line 4 by 2.9% (0.029). Then, add \$11,660.80 to the result. Enter the total here and on Form 1040, line 5B.  |   |        |
| 6 | Deduction for one-half of self-employment tax. Multiply line 5 by 50% (.50). Enter the result here and on Form 1040, line 27   | 6 | 4,041  |

**SCHEDULES A&B (Form 1040)** **Schedule A—Itemized Deductions** (Schedule B is on back) **Self-Employment Tax** (Form 1040)

OMB No. 1545-0047 **2006** Attachment **2006** Assessment  
 Form 1040-SS (10/05) **011 | 00 | 3722** **011 | 00 | 2222**

John E. Michaels **John E. Michaels**

▶ Attach to Form 1040. ▶ See instructions for Schedule A&B (Form 1040). ▶ Attach to Form 1040. ▶ See instructions for Schedule SE (Form 1040).

**Medical and Dental Expenses**

1 Enter amount from Form 1040, line 38 **8**

2 Subtract line 2 from line 1. Enter 0 **4**

**Taxes You Paid**

3 State and local income taxes **1,750**

4 Real estate taxes (see page A-6) **1,750**

5 Personal property taxes **0**

6 Charitable taxes. List type and amount ▶

7 Add lines 3 through 6 **1,750**

**Interest You Paid**

8 Home mortgage interest and points reported to you on Form 1098 **8,810**

9 Home mortgage interest not reported to you on Form 1098. If paid to the person from whom you bought the home, see page A-3 and show that person's name, identifying no., and address ▶

10 Add lines 8 through 9 **8,810**

**Charitable Contributions**

11 Points not reported to you on Form 1098. See page A-4 for special rules **0**

12 Investment interest. Attach Form 4952 if required. (See page A-3.) **0**

13 Add lines 10 through 13 **8,810**

**Gifts to Charity**

14 Gifts by cash or check, if you made any gift of \$250 or more, see page A-6 **4,000**

15 Other than by cash or check, if any gift of \$150 or more, see page A-6. You must attach Form 8283 if over \$500 (see page A-6) **0**

16 Category from prior year **0**

17 Add lines 14 through 17 **4,000**

**Casualty and Theft Losses**

18 Casually or theft losses. Attach Form 4684. (See page A-6.) **0**

**Job Expenses and Certain Miscellaneous Deductions**

19 Unreimbursed employee expenses—job travel, union dues, job education, etc. Attach Form 2106 or 2106-EZ if required. (See page A-6.) ▶ **1,032**

20 Tax preparation fees **0**

21 Other expenses—investment, safe deposit box, etc. List type and amount ▶ **0**

22 Add lines 19 through 22 **1,032**

23 Enter amount from Form 1040, line 38 **24** **47,051**

24 Multiply line 23 by 2% (.02) **480**

25 Subtract line 24 from line 23. If line 25 is more than line 22, enter -0- **47,571**

**Other Miscellaneous Deductions**

26 Other—list on page A-7. List type and amount ▶ **0**

27 Add lines 22 through 27 **1,032**

**Total Itemized Deductions**

28 If Form 1040, line 38, over \$150,500 (over \$75,250 if married filing separately)?  No. Your deduction is not limited. Add the amounts in the far right column for lines 4 through 27. Also, enter this amount on Form 1040, line 40.  Yes. Your deduction may be limited. See page A-7 for the amount to enter. **13,834**

**Form Paperwork Reduction Act Notice, see Form 1040 instructions.** (See page 1040)

Schedule A (Form 1040) 2006

Form **1040**

Department of the Treasury—Internal Revenue Service  
**U.S. Individual Income Tax Return 2006**

(099) IRS Use Only—Do not write or staple in this space.

OMB No. 1545-0074

**Label**

(See instructions on page 16.)  
Use the IRS label. Otherwise, please print or type.

For the year Jan. 1-Dec. 31, 2006, or other tax year beginning 2006, ending 20

|  |                       |
|--|-----------------------|
| Your first name and initial<br>John E.   | Last name<br>Michaels |
| If a joint return, spouse's first name and initial<br>Susan R.   | Last name<br>Michaels |
| Home address (number and street). If you have a P.O. box, see page 16.<br>1040 Main Street                           |                       |
| City, town or post office, state, and ZIP code. If you have a foreign address, see page 16.<br>Hometown, Texas 77099 |                       |

Your social security number  
011 : 00 : 2222

Spouse's social security number  
011 : 00 : 1111

▲ You must enter your SSN(s) above. ▲

**Presidential Election Campaign**

Check here if you, or your spouse if filing jointly, want \$3 to go to this fund (see page 16)  You  Spouse

**Filing Status**

Check only one box.

- 1  Single
- 2  Married filing jointly (even if only one had income)
- 3  Married filing separately. Enter spouse's SSN above and full name here. ▶
- 4  Head of household (with qualifying person). (See page 17.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶
- 5  Qualifying widow(er) with dependent child (see page 17)

**Exemptions**

If more than four dependents, see page 19.

6a  Yourself. If someone can claim you as a dependent, do not check box 6a

b  Spouse

| (1) First name | Last name | (2) Dependent's social security number | (3) Dependent's relationship to you | (4) <input checked="" type="checkbox"/> If qualifying child for child tax credit (see page 19) |
|----------------|-----------|--|-------------------------------------|--|
| Jennifer       | Michaels  | 111 00 1113                            | Daughter                            | <input checked="" type="checkbox"/>  |
|                |           |  |                                     | <input type="checkbox"/>   |
|                |           |  |                                     | <input type="checkbox"/>   |
|                |           |  |                                     | <input type="checkbox"/>   |

d Total number of exemptions claimed **3**

Boxes checked on 6a and 6b **2**

No. of children on 6c who:

- lived with you **1**
- did not live with you due to divorce or separation (see page 20)

Dependents on 6c not entered above

Add numbers on lines above ▶ **3**

**Income**

Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.

If you did not get a W-2, see page 23.

Enclose, but do not attach, any payment. Also, please use Form 1040-V.

|     |   |                                  |                                |        |
|-----|---|----------------------------------|--------------------------------|--------|
| 7   | Wages, salaries, tips, etc. Attach Form(s) W-2  | Excess Parsonage Allowance \$240 | 7                              | 48,640 |
| 8a  | Taxable interest. Attach Schedule B if required   |                                  | 8a                             |        |
| b   | Tax-exempt interest. Do not include on line 8a  | 8b                               |                                |        |
| 9a  | Ordinary dividends. Attach Schedule B if required   |                                  | 9a                             |        |
| b   | Qualified dividends (see page 23)   | 9b                               |                                |        |
| 10  | Taxable refunds, credits, or offsets of state and local income taxes (see page 24)                            |                                  | 10                             |        |
| 11  | Alimony received  |                                  | 11                             |        |
| 12  | Business income or (loss). Attach Schedule C or C-EZ  |                                  | 12                             | 3,782  |
| 13  | Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ <input type="checkbox"/> |                                  | 13                             |        |
| 14  | Other gains or (losses). Attach Form 4797   |                                  | 14                             |        |
| 15a | IRA distributions   | 15a                              | b Taxable amount (see page 25) | 15b    |
| 16a | Pensions and annuities  | 16a                              | b Taxable amount (see page 26) | 16b    |
| 17  | Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E                   |                                  | 17                             |        |
| 18  | Farm income or (loss). Attach Schedule F  |                                  | 18                             |        |
| 19  | Unemployment compensation   |                                  | 19                             |        |
| 20a | Social security benefits  | 20a                              | b Taxable amount (see page 27) | 20b    |
| 21  | Other income. List type and amount (see page 29)  |                                  | 21                             |        |
| 22  | Add the amounts in the far right column for lines 7 through 21. This is your total income ▶                   |                                  | 22                             | 52,422 |

**Adjusted Gross Income**

|     |  |     |        |
|-----|--|-----|--------|
| 23  | Archer MSA deduction. Attach Form 8853   | 23  |        |
| 24  | Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ | 24  |        |
| 25  | Health savings account deduction. Attach Form 8889   | 25  |        |
| 26  | Moving expenses. Attach Form 3903  | 26  |        |
| 27  | One-half of self-employment tax. Attach Schedule SE  | 27  | 4,531  |
| 28  | Self-employed SEP, SIMPLE, and qualified plans   | 28  |        |
| 29  | Self-employed health insurance deduction (see page 29)   | 29  |        |
| 30  | Penalty on early withdrawal of savings   | 30  |        |
| 31a | Alimony paid b Recipient's SSN ▶   | 31a |        |
| 32  | IRA deduction (see page 31)  | 32  |        |
| 33  | Student loan interest deduction (see page 33)  | 33  |        |
| 34  | Jury duty pay you gave to your employer  | 34  |        |
| 35  | Domestic production activities deduction. Attach Form 8903   | 35  |        |
| 36  | Add lines 23 through 31a and 32 through 35   | 36  | 4,531  |
| 37  | Subtract line 36 from line 22. This is your adjusted gross income ▶  | 37  | 47,891 |

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see page 80.

Cat. No. 11320B

Form **1040** (2006)

**Tax and Credits**

**Standard Deduction for—**  
 • People who checked any box on line 39a or 39b or who can be claimed as a dependent, see page 34.  
 • All others:  
 Single or Married filing separately, \$5,150  
 Married filing jointly or Qualifying widow(er), \$10,300  
 Head of household, \$7,550

|     |   |    |        |
|-----|---|----|--------|
| 38  | Amount from line 37 (adjusted gross income)   | 38 | 47,891 |
| 39a | Check <input type="checkbox"/> You were born before January 2, 1942, <input type="checkbox"/> Blind. <input type="checkbox"/> Spouse was born before January 2, 1942, <input type="checkbox"/> Blind. Total boxes checked ▶ 39a |    |        |
| b   | If your spouse itemizes on a separate return or you were a dual-status alien, see page 34 and check here ▶ 39b <input type="checkbox"/>   |    |        |
| 40  | Itemized deductions (from Schedule A) or your standard deduction (see left margin)  | 40 | 13,434 |
| 41  | Subtract line 40 from line 38   | 41 | 34,457 |
| 42  | If line 38 is over \$112,875, or you provided housing to a person displaced by Hurricane Katrina, see page 36. Otherwise, multiply \$3,300 by the total number of exemptions claimed on line 6d                                 | 42 | 9,900  |
| 43  | Taxable income. Subtract line 42 from line 41. If line 42 is more than line 41, enter -0-   | 43 | 24,557 |
| 44  | Tax (see page 36). Check if any tax is from: a <input type="checkbox"/> Form(s) 8814 b <input type="checkbox"/> Form 4972   | 44 | 2,931  |
| 45  | Alternative minimum tax (see page 39). Attach Form 6251   | 45 |        |
| 46  | Add lines 44 and 45   | 46 | 2,931  |
| 47  | Foreign tax credit. Attach Form 1116 if required  | 47 |        |
| 48  | Credit for child and dependent care expenses. Attach Form 2441  | 48 |        |
| 49  | Credit for the elderly or the disabled. Attach Schedule R   | 49 |        |
| 50  | Education credits. Attach Form 8863   | 50 |        |
| 51  | Retirement savings contributions credit. Attach Form 8880   | 51 |        |
| 52  | Residential energy credits. Attach Form 5695  | 52 |        |
| 53  | Child tax credit (see page 42). Attach Form 8901 if required  | 53 | 1,000  |
| 54  | Credits from: a <input type="checkbox"/> Form 8396 b <input type="checkbox"/> Form 8839 c <input type="checkbox"/> Form 8859  | 54 |        |
| 55  | Other credits: a <input type="checkbox"/> Form 3800 b <input type="checkbox"/> Form 8801 c <input type="checkbox"/> Form  | 55 |        |
| 56  | Add lines 47 through 55. These are your total credits   | 56 | 1,000  |
| 57  | Subtract line 56 from line 46. If line 56 is more than line 46, enter -0-   | 57 | 1,931  |

**Other Taxes**

|    |   |    |        |
|----|---|----|--------|
| 58 | Self-employment tax. Attach Schedule SE   | 58 | 9,062  |
| 59 | Social security and Medicare tax on tip income not reported to employer. Attach Form 4137   | 59 |        |
| 60 | Additional tax on IRAs, other qualified retirement plans, etc. Attach Form 5329 if required | 60 |        |
| 61 | Advance earned income credit payments from Form(s) W-2, box 9                               | 61 |        |
| 62 | Household employment taxes. Attach Schedule H   | 62 |        |
| 63 | Add lines 57 through 62. This is your total tax   | 63 | 10,993 |

**Payments**

If you have a qualifying child, attach Schedule EIC.

|     |   |     |        |
|-----|---|-----|--------|
| 64  | Federal income tax withheld from Forms W-2 and 1099   | 64  | 272    |
| 65  | 2006 estimated tax payments and amount applied from 2005 return   | 65  | 12,000 |
| 66a | Earned income credit (EIC)  | 66a |        |
| b   | Nontaxable combat pay election ▶ 66b  |     |        |
| 67  | Excess social security and tier 1 RRTA tax withheld (see page 60)   | 67  |        |
| 68  | Additional child tax credit. Attach Form 8812   | 68  |        |
| 69  | Amount paid with request for extension to file (see page 60)  | 69  |        |
| 70  | Payments from: a <input type="checkbox"/> Form 2439 b <input type="checkbox"/> Form 4136 c <input type="checkbox"/> Form 8885 | 70  |        |
| 71  | Credit for federal telephone excise tax paid. Attach Form 8913 if required  | 71  |        |
| 72  | Add lines 64, 65, 66a, and 67 through 71. These are your total payments   | 72  | 12,272 |

**Refund**

Direct deposit? See page 61 and fill in 74b, 74c, and 74d, or Form 8888.

|     |   |     |  |
|-----|---|-----|--|
| 73  | If line 72 is more than line 63, subtract line 63 from line 72. This is the amount you overpaid             | 73  | 1,279  |
| 74a | Amount of line 73 you want refunded to you. If Form 8888 is attached, check here ▶ <input type="checkbox"/> | 74a |  |
| b   | Routing number  | c   | Type: <input type="checkbox"/> Checking <input type="checkbox"/> Savings |
| d   | Account number  |     |  |
| 75  | Amount of line 73 you want applied to your 2007 estimated tax ▶   | 75  | 1,279  |

**Amount You Owe**

|    |   |    |  |
|----|---|----|--|
| 76 | Amount you owe. Subtract line 72 from line 63. For details on how to pay, see page 62 ▶ | 76 |  |
| 77 | Estimated tax penalty (see page 62)   | 77 |  |

**Third Party Designee**

Do you want to allow another person to discuss this return with the IRS (see page 63)?  Yes. Complete the following.  No

Designee's name \_\_\_\_\_ Phone no. ( ) \_\_\_\_\_ Personal identification number (PIN) \_\_\_\_\_

**Sign Here**

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Joint return? See page 17. Keep a copy for your records.

|  |                  |                                  |  |
|--|------------------|----------------------------------|--|
| Your signature<br><i>John E. Michaels</i>  | Date<br>03/10/07 | Your occupation<br>Minister      | Daytime phone number<br>( 212 ) 444-5555 |
| Spouse's signature. If a joint return, both must sign.<br><i>Susan R. Michaels</i> | Date<br>03/10/07 | Spouse's occupation<br>Homemaker |  |

**Paid Preparer's Use Only**

Preparer's signature \_\_\_\_\_ Date \_\_\_\_\_ Check if self-employed  Preparer's SSN or PTIN \_\_\_\_\_  
 Firm's name (or yours if self-employed), address, and ZIP code \_\_\_\_\_ EIN \_\_\_\_\_ Phone no. ( ) \_\_\_\_\_

*Tax Guide for Ministers Filing 2006 Returns*

**Attachment 1. Computation of expenses, allocable to tax-free ministerial income, that are nondeductible.**

|   | Taxable          | Tax-Free         | Total            |
|---|------------------|------------------|------------------|
| Salary as a minister  | \$ 45,000        |                  | \$ 45,000        |
| Parsonage allowance:  |                  |                  |                  |
| Amount designated and paid by church (\$1,400 x 12)   | \$ 16,800        |                  |                  |
| Actual expenses   |                  |                  |                  |
| (Mortgage \$1,125 x 12, Utilities/other \$1,450, Real estate taxes \$1,750)                       | 16,700           |                  |                  |
| Fair rental value of home (including furnishings and utilities) (\$1,380 x 12)                    | 16,560           |                  |                  |
| Taxable portion of allowance  |                  |                  |                  |
| (excess of amount designated & paid over lesser of actual expenses or fair rental value)          | <u>\$ 240</u>    |                  | 240              |
| Tax-free portion of allowance (lesser of amount designated, actual expenses or fair rental value) |                  | 16,560           | 16,560           |
| Gross income from weddings, baptisms, and honoraria   | 4,000            |                  | 4,000            |
| Ministerial Income  | <u>\$ 49,240</u> | <u>\$ 16,560</u> | <u>\$ 65,800</u> |
| % of nondeductible expenses: \$16,560/\$65,800 = 25%  |                  |                  |                  |

**Schedule C-EZ Deduction Computation**

|  |               |
|--|---------------|
| Marrage and family booklets                                | \$ 87         |
| Business use of car:                                       |               |
| (459 miles driven x 44 1/2 c = \$204)                      | <u>204</u>    |
| Unadjusted Schedule C-EZ expenses                          | 291           |
| Minus:   |               |
| Nondeductible part of Schedule C-EZ expenses (25% x \$291) | <u>(73)</u>   |
| Schedule C-EZ deductions (line 2)                          | <u>\$ 218</u> |

**Form 2106-EZ - Employee Business Expense Deduction Computation**

|  |                 |
|--|-----------------|
| Car expenses for church business:                          |                 |
| (2600 miles x 44 1/2 c = \$1157)                           | \$ 1,157        |
| Publications and booklets                                  | <u>219</u>      |
| Unadjusted Form 2106-EZ expenses                           | 1,376           |
| Minus:   |                 |
| Nondeductible part of Form 2106-EZ expenses (25% x \$1376) | <u>(344)</u>    |
| Employee business expense deduction - Form 2106-EZ line 6  | <u>\$ 1,032</u> |

None of the other deductions claimed in the return are allocable to tax-free income.

**Attachment 2. Attachment to Schedule SE (Form 1040)**

|   |  |              |                  |
|---|--|--------------|------------------|
| Church wages  |  | \$ 45,000    |                  |
| Parsonage allowance                                 |  | 16,800       |                  |
| Net profit from Schedule C-EZ                       |  | <u>3,762</u> | 65,582           |
| Less:   |  |              |                  |
| Schedule C-EZ expenses allocable to tax-free income |  | \$ 73        |                  |
| Ministerial employee business expenses              |  |              |                  |
| (unadjusted Form 2106-EZ expenses)                  |  | <u>1,376</u> | <u>(1,449)</u>   |
| Net Self-Employment Income                          |  |              |                  |
| Schedule SE, Section A, line 2                      |  |              | <u>\$ 64,133</u> |

## Example Two: Retired Minister

Rev. William K. Green is a retired minister. He is 69 years old. He is married to Sarah J. Green. She is 65 years old and is also retired. For 2006, Rev. Green received \$15,000 in annuity income, all of which was designated in advance by MMBB as a housing allowance. Rev. Green had housing expenses of \$13,000. The home's fair rental value is \$1,200 per month (including furnishings and utilities). Housing allowances for retired ministers are not taxable in computing federal income tax to the extent that they do not exceed the lesser of actual housing expenses or the annual fair rental value of the home (see pages 14–18). Retirement benefits, whether or not designated in advance as a housing allowance, are not subject to self-employment taxes.

Rev. Green received \$12,000 of Social Security benefits in 2006, and his wife received \$6,000. None of this income is taxable, however, because the Green's income is not enough to expose their Social Security benefits to tax.

In 2006, Rev. Green received \$2,000 from occasional guest preaching engagements. He incurred \$506 in expenses as a result of these activities (\$356 of travel expenses, and \$150 of meal expenses). Note that Rev. Green paid self-employment tax on this income (see Schedule SE), since it represents compensation from active ministry.

### Form 1040

Rev. Green first prepares Schedule C–EZ and Schedule SE. (Attachments 1 and 2 [shown on page 49]

to Rev. Green's Form 1040 show the calculation of the amounts reported on those schedules.) Then he fills out Form 1040. He files a joint return with his wife. First he fills out the address area and completes the appropriate lines for his filing status and exemptions. Then, he fills out the rest of the form as follows:

**Line 12.** He reports his net profit of \$1,897 from Schedule C–EZ, line 3.

**Line 16a and 16b.** Rev. Green reports his total annuity income of \$15,000 on line 16a. He reports the taxable amount (\$2,000) as computed on Attachment 1 (shown on page 49) on line 16b.

**Line 20a and 20b.** Since none of Rev. Green's Social Security benefits are taxable, he does not report any amounts on line 20a or 20b.

**Line 27.** He enters \$111, one-half of his SE tax from Schedule SE, line 6.

**Line 39a.** He checks the boxes indicating that he and his wife were born before January 2, 1942 and enters "2" in the "total" box.

**Line 40.** He enters the standard deduction of \$12,300 as listed in the chart on page 35 of the Form 1040 instructions.

**Line 58.** He enters \$222, the self-employment tax from Schedule SE, line 5.

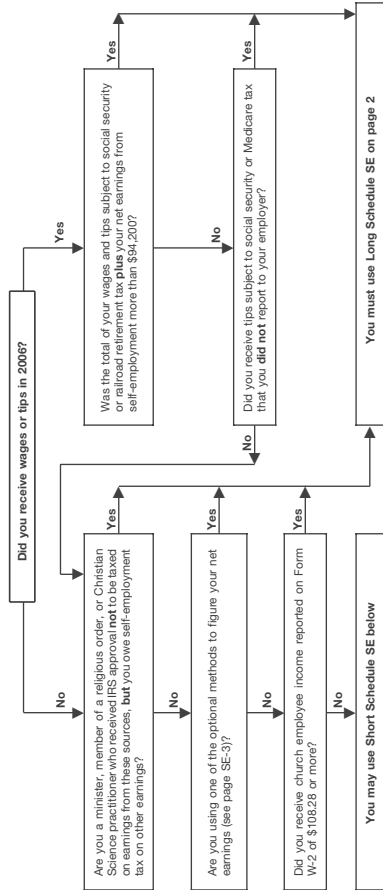
**SCHEDULE SE (Form 1040)**  
 Department of the Treasury Internal Revenue Service  
 Name of person with self-employment income (as shown on Form 1040)  
 William K. Green  
 Social security number of person with self-employment income ▶ 202 : 20 : 2002

OMB No. 1545-0074  
 2006  
 Attachment Sequence No. 17

**Self-Employment Tax**  
 ▶ Attach to Form 1040. ▶ See Instructions for Schedule SE (Form 1040).

**Who Must File Schedule SE**  
 You must file Schedule SE if:  
 • You had net earnings from self-employment from other than church employee income (line 4 of Short Schedule SE or line 4c of Long Schedule SE) of \$400 or more, or  
 • You had church employee income of \$108.28 or more. Income from services you performed as a minister or a member of a religious order is not church employee income (see page SE-1).  
**Note.** Even if you had a loss or a small amount of income from self-employment, it may be to your benefit to file Schedule SE and use either "optional method" in Part II of Long Schedule SE (see page SE-3).  
**Exception.** If your only self-employment income was from earnings as a minister, member of a religious order, or Christian Science practitioner and you filed Form 4361 and received IRS approval not to be taxed on those earnings, do not file Schedule SE. Instead, write "Exempt-Form 4361" on Form 1040, line 58.

**May I Use Short Schedule SE or Must I Use Long Schedule SE?**  
**Note.** Use this flowchart only if you must file Schedule SE. If unsure, see Who Must File Schedule SE, above.



**Section A—Short Schedule SE. Caution.** Read above to see if you can use Short Schedule SE.

|   |  |       |
|---|--|-------|
| 1 | Net farm profit or (loss) from Schedule F, line 36, and farm partnerships, Schedule K-1 (Form 1065), box 14, code A  |       |
| 2 | Net profit or (loss) from Schedule C, line 31; Schedule C-EZ, line 3; Schedule K-1 (Form 1065), box 14, code A (other than farming); and Schedule K-1 (Form 1065-B), box 9, code J1. Ministers and members of religious orders, see page SE-1 for amounts to report on this line. See page SE-3 for other income to report   | 1,569 |
| 3 | Combine lines 1 and 2  | 1,569 |
| 4 | Net earnings from self-employment. Multiply line 3 by 92.35% (.9235). If less than \$400, do not file this schedule; you do not owe self-employment tax  | 1,448 |
| 5 | Self-employment tax. If the amount on line 4 is:<br>• \$94,200 or less, multiply line 4 by 15.3% (.153). Enter the result here and on Form 1040, line 58.<br>• More than \$94,200, multiply line 4 by 2.9% (.029). Then, add \$11,680.80 to the result. Enter the total here and on Form 1040, line 58.<br>Deduction for one-half of self-employment tax. Multiply line 5 by 50% (.5). Enter the result here and on Form 1040, line 27 | 222   |
| 6 |  | 111   |

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11358Z  
 Schedule SE (Form 1040) 2006

**SCHEDULE C-EZ (Form 1040)**  
 Department of the Treasury Internal Revenue Service  
 Name of proprietor  
 William K. Green  
 Social security number (SSN)  
 202 : 20 : 2002

OMB No. 1545-0074  
 2006  
 Attachment Sequence No. 09A

**Net Profit From Business (Sole Proprietorship)**  
 ▶ Partnerships, joint ventures, etc., must file Form 1065 or 1065-B.  
 ▶ Attach to Form 1040, 1040NR, or 1041. ▶ See instructions on back.

**Part I General Information**

**You May Use Schedule C-EZ Instead of Schedule C Only if You:**

- Had business expenses of \$5,000 or less.
- Use the cash method of accounting.
- Did not have an inventory at any time during the year.
- Did not have a net loss from your business.
- Had only one business as either a sole proprietor or statutory employee.

**And You:**

- Had no employees during the year.
- Are not required to file Form 4562, Depreciation and Amortization, for this business. See the instructions for Schedule C, line 13, on page C-4 to find out if you must file.
- Do not deduct expenses for business use of your home.
- Do not have prior year unallowed passive activity losses from this business.

**A** Principal business or profession, including product or service

**C** Business name. If no separate business name, leave blank.

**E** Business address (including suite or room no.). Address not required if same as on page 1 of your tax return.

City, town or post office, state, and ZIP code

**B** Enter code from pages C-4, 9, & 10  
 ▶ 8 | 1 | 3 | 0 | 0

**D** Employer ID number (EIN), if any

**Part II Figure Your Net Profit**

**1 Gross receipts. Caution.** If this income was reported to you on Form W-2 and the "Statutory employee" box on that form was checked, see **Statutory Employees** in the instructions for Schedule C, line 1, on page C-3 and check here

**2 Total expenses (see instructions).** If more than \$5,000, you must use Schedule C.

**3 Net profit.** Subtract line 2 from line 1. If less than zero, you must use Schedule C. Enter on both Form 1040, line 12, and Schedule SE, line 2, or on Form 1040NR, line 13. (Statutory employees do not report this amount on Schedule SE, line 2. Estates and trusts, enter on Form 1041, line 3.)

|   |       |
|---|-------|
| 1 | 2,000 |
| 2 | 103   |
| 3 | 1,897 |

**Part III Information on Your Vehicle.** Complete this part only if you are claiming car or truck expenses on line 2.

4 When did you place your vehicle in service for business purposes? (month, day, year) ▶ 12 / 01 / 01

5 Of the total number of miles you drove your vehicle during 2006, enter the number of miles you used your vehicle for:

a Business 800 b Commuting (see instructions) 0 c Other 11,555

6 Do you (or your spouse) have another vehicle available for personal use?  Yes  No

7 Was your vehicle available for personal use during off-duty hours?  Yes  No

8a Do you have evidence to support your deduction?  Yes  No

b If "yes," is the evidence written?  Yes  No

For Paperwork Reduction Act Notice, see page 2. Cat. No. 14374D  
 Schedule C-EZ (Form 1040) 2006

Form **1040**

Department of the Treasury—Internal Revenue Service  
**U.S. Individual Income Tax Return 2006**

(99) IRS Use Only—Do not write or staple in this space.

**Label**

(See instructions on page 16.)  
**Use the IRS label.**  
Otherwise, please print or type.

|  |                           |  |
|--|---------------------------|--|
| For the year Jan. 1–Dec. 31, 2006, or other tax year beginning _____, 2006, ending _____, 20                                       |                           | OMB No. 1545-0074  |
| Your first name and initial<br><b>William K.</b>   | Last name<br><b>Green</b> | <b>Your social security number</b><br><b>202   20   2002</b>     |
| If a joint return, spouse's first name and initial<br><b>Sarah J.</b>  | Last name<br><b>Green</b> | <b>Spouse's social security number</b><br><b>303   30   3003</b> |
| Home address (number and street). If you have a P.O. box, see page 16.<br><b>787 Adams Street</b>                                  |                           | ▲ You must enter your SSN(s) above. ▲                            |
| City, town or post office, state, and ZIP code. If you have a foreign address, see page 16.<br><b>Springfield, New York, 10002</b> |                           |  |

**Presidential Election Campaign**

Check here if you, or your spouse if filing jointly, want \$3 to go to this fund (see page 16)  **You**  **Spouse**

**Filing Status**

Check only one box.

- 1  Single
- 2  Married filing jointly (even if only one had income)
- 3  Married filing separately. Enter spouse's SSN above and full name here. ▶
- 4  Head of household (with qualifying person). (See page 17.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶
- 5  Qualifying widow(er) with dependent child (see page 17)

**Exemptions**

If more than four dependents, see page 19.

|  |  |
|--|--|
| 6a <input checked="" type="checkbox"/> <b>Yourself.</b> If someone can claim you as a dependent, do not check box 6a | Boxes checked on 6a and 6b on 6c who:<br>• lived with you<br>• did not live with you due to divorce or separation (see page 20)<br>Dependents on 6c not entered above<br>Add numbers on lines above ▶ <b>2</b> |
| 6b <input checked="" type="checkbox"/> <b>Spouse</b>   |  |
| 6c <b>Dependents:</b>  |  |
| 6d Total number of exemptions claimed  |  |

| (1) First name | Last name | (2) Dependent's social security number | (3) Dependent's relationship to you | (4) <input checked="" type="checkbox"/> if qualifying child for child tax credit (see page 19) |
|----------------|-----------|--|-------------------------------------|--|
|                |           |  |                                     | <input type="checkbox"/>   |
|                |           |  |                                     | <input type="checkbox"/>   |
|                |           |  |                                     | <input type="checkbox"/>   |
|                |           |  |                                     | <input type="checkbox"/>   |

**Income**

Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.

If you did not get a W-2, see page 23.

Enclose, but do not attach, any payment. Also, please use Form 1040-V.

|     |   |     |        |
|-----|---|-----|--------|
| 7   | Wages, salaries, tips, etc. Attach Form(s) W-2  | 7   |        |
| 8a  | Taxable interest. Attach Schedule B if required   | 8a  |        |
| b   | Tax-exempt interest. Do not include on line 8a  | 8b  |        |
| 9a  | Ordinary dividends. Attach Schedule B if required   | 9a  |        |
| b   | Qualified dividends (see page 23)   | 9b  |        |
| 10  | Taxable refunds, credits, or offsets of state and local income taxes (see page 24)                            | 10  |        |
| 11  | Alimony received  | 11  |        |
| 12  | Business income or (loss). Attach Schedule C or C-EZ  | 12  | 1,897  |
| 13  | Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ <input type="checkbox"/> | 13  |        |
| 14  | Other gains or (losses). Attach Form 4797   | 14  |        |
| 15a | IRA distributions   | 15a |        |
| b   | Taxable amount (see page 25)  | 15b |        |
| 16a | Pensions and annuities  | 16a | 15,000 |
| b   | Taxable amount (see page 26)  | 16b | 2,000  |
| 17  | Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E                   | 17  |        |
| 18  | Farm income or (loss). Attach Schedule F  | 18  |        |
| 19  | Unemployment compensation   | 19  |        |
| 20a | Social security benefits  | 20a |        |
| b   | Taxable amount (see page 27)  | 20b |        |
| 21  | Other income. List type and amount (see page 29)  | 21  |        |
| 22  | Add the amounts in the far right column for lines 7 through 21. This is your total income ▶                   | 22  | 3,897  |

**Adjusted Gross Income**

|     |  |     |       |
|-----|--|-----|-------|
| 23  | Archer MSA deduction. Attach Form 8853   | 23  |       |
| 24  | Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ | 24  |       |
| 25  | Health savings account deduction. Attach Form 8889   | 25  |       |
| 26  | Moving expenses. Attach Form 3903  | 26  |       |
| 27  | One-half of self-employment tax. Attach Schedule SE  | 27  | 111   |
| 28  | Self-employed SEP, SIMPLE, and qualified plans   | 28  |       |
| 29  | Self-employed health insurance deduction (see page 29)   | 29  |       |
| 30  | Penalty on early withdrawal of savings   | 30  |       |
| 31a | Alimony paid   | 31a |       |
| b   | Recipient's SSN ▶  |     |       |
| 32  | IRA deduction (see page 31)  | 32  |       |
| 33  | Student loan interest deduction (see page 33)  | 33  |       |
| 34  | Jury duty pay you gave to your employer  | 34  |       |
| 35  | Domestic production activities deduction. Attach Form 8903   | 35  |       |
| 36  | Add lines 23 through 31a and 32 through 35   | 36  | 111   |
| 37  | Subtract line 36 from line 22. This is your adjusted gross income ▶  | 37  | 3,786 |

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see page 80.

Cat. No. 11320B

Form **1040** (2006)

Form 1040 continued on next page.



Tax Guide for Ministers Filing 2006 Returns

**Tax and Credits**

**Standard Deduction for—**

• People who checked any box on line 39a or 39b or who can be claimed as a dependent, see page 34.

• All others:

Single or Married filing separately, \$5,150

Married filing jointly or Qualifying widow(er), \$10,300

Head of household, \$7,550

|            |  |           |               |
|------------|--|-----------|---------------|
| <b>38</b>  | Amount from line 37 (adjusted gross income)  | <b>38</b> | <b>3,786</b>  |
| <b>39a</b> | Check <input checked="" type="checkbox"/> <b>You</b> were born before January 2, 1942, <input type="checkbox"/> <b>Blind.</b> <b>Total boxes checked</b> <b>2</b><br>if: <input checked="" type="checkbox"/> <b>Spouse</b> was born before January 2, 1942, <input type="checkbox"/> <b>Blind.</b> <b>checked</b> <b>▶ 39a</b> |           |               |
| <b>b</b>   | If your spouse itemizes on a separate return or you were a dual-status alien, see page 34 and check here <b>▶39b</b> <input type="checkbox"/>  |           |               |
| <b>40</b>  | <b>Itemized deductions</b> (from Schedule A) or your <b>standard deduction</b> (see left margin)   | <b>40</b> | <b>12,300</b> |
| <b>41</b>  | Subtract line 40 from line 38  | <b>41</b> | <b>0</b>      |
| <b>42</b>  | If line 38 is over \$112,875, or you provided housing to a person displaced by Hurricane Katrina, see page 36. Otherwise, multiply \$3,300 by the total number of exemptions claimed on line 6d  | <b>42</b> | <b>6,600</b>  |
| <b>43</b>  | <b>Taxable income.</b> Subtract line 42 from line 41. If line 42 is more than line 41, enter -0-   | <b>43</b> | <b>0</b>      |
| <b>44</b>  | <b>Tax</b> (see page 36). Check if any tax is from: <b>a</b> <input type="checkbox"/> Form(s) 8814 <b>b</b> <input type="checkbox"/> Form 4972   | <b>44</b> | <b>0</b>      |
| <b>45</b>  | <b>Alternative minimum tax</b> (see page 39). Attach Form 6251   | <b>45</b> |               |
| <b>46</b>  | Add lines 44 and 45  | <b>46</b> | <b>0</b>      |
| <b>47</b>  | Foreign tax credit. Attach Form 1116 if required   | <b>47</b> |               |
| <b>48</b>  | Credit for child and dependent care expenses. Attach Form 2441   | <b>48</b> |               |
| <b>49</b>  | Credit for the elderly or the disabled. Attach Schedule R  | <b>49</b> |               |
| <b>50</b>  | Education credits. Attach Form 8863  | <b>50</b> |               |
| <b>51</b>  | Retirement savings contributions credit. Attach Form 8880  | <b>51</b> |               |
| <b>52</b>  | Residential energy credits. Attach Form 5695   | <b>52</b> |               |
| <b>53</b>  | Child tax credit (see page 42). Attach Form 8901 if required   | <b>53</b> |               |
| <b>54</b>  | Credits from: <b>a</b> <input type="checkbox"/> Form 8396 <b>b</b> <input type="checkbox"/> Form 8839 <b>c</b> <input type="checkbox"/> Form 8859  | <b>54</b> |               |
| <b>55</b>  | Other credits: <b>a</b> <input type="checkbox"/> Form 3800 <b>b</b> <input type="checkbox"/> Form 8801 <b>c</b> <input type="checkbox"/> Form  | <b>55</b> |               |
| <b>56</b>  | Add lines 47 through 55. These are your <b>total credits</b>   | <b>56</b> |               |
| <b>57</b>  | Subtract line 56 from line 46. If line 56 is more than line 46, enter -0-  | <b>57</b> | <b>0</b>      |
| <b>58</b>  | Self-employment tax. Attach Schedule SE  | <b>58</b> | <b>222</b>    |
| <b>59</b>  | Social security and Medicare tax on tip income not reported to employer. Attach Form 4137  | <b>59</b> |               |
| <b>60</b>  | Additional tax on IRAs, other qualified retirement plans, etc. Attach Form 5329 if required  | <b>60</b> |               |
| <b>61</b>  | Advance earned income credit payments from Form(s) W-2, box 9  | <b>61</b> |               |
| <b>62</b>  | Household employment taxes. Attach Schedule H  | <b>62</b> |               |
| <b>63</b>  | Add lines 57 through 62. This is your <b>total tax</b>   | <b>63</b> | <b>222</b>    |

**Other Taxes**

**Payments**

If you have a qualifying child, attach Schedule EIC.

|            |  |            |          |
|------------|--|------------|----------|
| <b>64</b>  | Federal income tax withheld from Forms W-2 and 1099  | <b>64</b>  |          |
| <b>65</b>  | 2006 estimated tax payments and amount applied from 2005 return  | <b>65</b>  |          |
| <b>66a</b> | <b>Earned income credit (EIC)</b>  | <b>66a</b> |          |
| <b>b</b>   | Nontaxable combat pay election <b>▶ 66b</b>  |            |          |
| <b>67</b>  | Excess social security and tier 1 RRTA tax withheld (see page 60)  | <b>67</b>  |          |
| <b>68</b>  | Additional child tax credit. Attach Form 8812  | <b>68</b>  |          |
| <b>69</b>  | Amount paid with request for extension to file (see page 60)   | <b>69</b>  |          |
| <b>70</b>  | Payments from: <b>a</b> <input type="checkbox"/> Form 2439 <b>b</b> <input type="checkbox"/> Form 4136 <b>c</b> <input type="checkbox"/> Form 8885 | <b>70</b>  |          |
| <b>71</b>  | Credit for federal telephone excise tax paid. Attach Form 8913 if required   | <b>71</b>  |          |
| <b>72</b>  | Add lines 64, 65, 66a, and 67 through 71. These are your <b>total payments</b>   | <b>72</b>  | <b>0</b> |

**Refund**

Direct deposit? See page 61 and fill in 74b, 74c, and 74d, or Form 8888.

|            |   |            |  |
|------------|---|------------|--|
| <b>73</b>  | If line 72 is more than line 63, subtract line 63 from line 72. This is the amount you <b>overpaid</b>            | <b>73</b>  |  |
| <b>74a</b> | Amount of line 73 you want <b>refunded to you</b> . If Form 8888 is attached, check here <input type="checkbox"/> | <b>74a</b> |  |
| <b>b</b>   | Routing number  | <b>c</b>   | Type: <input type="checkbox"/> Checking <input type="checkbox"/> Savings |
| <b>d</b>   | Account number  |            |  |
| <b>75</b>  | Amount of line 73 you want <b>applied to your 2007 estimated tax</b>  | <b>75</b>  |  |

**Amount You Owe**

|           |  |           |            |
|-----------|--|-----------|------------|
| <b>76</b> | <b>Amount you owe.</b> Subtract line 72 from line 63. For details on how to pay, see page 62 | <b>76</b> | <b>222</b> |
| <b>77</b> | Estimated tax penalty (see page 62)  | <b>77</b> |            |

**Third Party Designee**

Do you want to allow another person to discuss this return with the IRS (see page 63)?  **Yes.** Complete the following.  **No**

|                 |           |                                      |
|-----------------|-----------|--------------------------------------|
| Designee's name | Phone no. | Personal identification number (PIN) |
|                 | ( )       |                                      |

**Sign Here**

Joint return? See page 17. Keep a copy for your records.

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

|   |                  |  |  |
|---|------------------|--|--|
| Your signature<br><i>William K Green</i>  | Date<br>03/10/07 | Your occupation<br><b>Retired Minister</b> | Daytime phone number<br>( 212 ) 333-4444 |
| Spouse's signature. If a joint return, <b>both</b> must sign.<br><i>Sarah J Green</i> | Date<br>03/10/07 | Spouse's occupation<br><b>Retired</b>      |  |

**Paid Preparer's Use Only**

|  |      |   |                        |
|--|------|---|------------------------|
| Preparer's signature   | Date | Check if self-employed <input type="checkbox"/> | Preparer's SSN or PTIN |
| Firm's name (or yours if self-employed), address, and ZIP code | EIN  | Phone no.                                       | ( )                    |

*Tax Guide for Ministers Filing 2006 Returns*

**Attachment 1. Computation of expenses, allocable to tax-free ministerial income, that are nondeductible.**

| <b><u>% of Nondeductible Expenses</u></b>  |           |                |                 |              |
|--|-----------|----------------|-----------------|--------------|
|  |           | <u>Taxable</u> | <u>Tax-Free</u> | <u>Total</u> |
| Parsonage allowance:   |           |                |                 |              |
| Ministerial retirement benefits designated as housing allowance  | \$ 15,000 |                |                 |              |
| Actual expenses  | \$ 13,000 |                |                 |              |
| Fair rental value of home (including furnishings and utilities)(\$1,200 x 12)  | \$ 14,400 |                |                 |              |
| Taxable portion of allowance<br>(excess of amount designated & paid over lesser of actual expenses or fair rental value) | \$ 2,000  | \$ 2,000       |                 | \$ 2,000     |
| Tax-free portion of allowance (lesser of amount designated, actual expenses or fair rental value)                        |           |                | \$ 13,000       | 13,000       |
| Gross income from occasional guest preaching engagements   |           | 2,000          |                 | 2,000        |
| Ministerial Income   |           | \$ 4,000       | \$ 13,000       | \$ 17,000    |
| <b>% of nondeductible expenses: \$13,000/\$17,000 = 76%</b>  |           |                |                 |              |

| <b><u>Schedule C-EZ Deduction Computation</u></b>  |        |
|--|--------|
| Business use of car<br>(800 miles driven between January 1, 2006 and December 31, 2006 x 44 1/2 ¢ = \$356)               | \$ 356 |
| Meal expenses (\$150 less 50% reduction)   | 75     |
| Unadjusted Schedule C-EZ expenses  | \$ 431 |
| Nondeductible part of expenses:<br>\$431 X 76%   | (328)  |
| Schedule C-EZ deductions, line 2<br>None of the other deductions claimed in the return are allocable to tax-free income. | \$ 103 |

**Attachment 2. Computation of Net Earnings from Self-Employment**

| <b><u>Computation for Schedule SE (Form 1040)</u></b> |          |
|---|----------|
| Gross income from Schedule C-EZ \$ 2,000              |          |
| Less:   |          |
| Unadjusted Schedule C-EZ expenses (431)               |          |
| Net Self Employment Income, Schedule SE, Line 2       | \$ 1,569 |

# RELATED TAX GUIDE RESOURCES

## 2007 Church & Clergy Tax Guide in Adobe Acrobat format on CD.



This CD features the entire *2007 Church & Clergy Tax Guide* book in Adobe Acrobat format, searchable by keyword. Includes an interactive Table of Contents and web links.

ITEM #L107C **\$29.95**

## Federal Reporting Requirements for Churches; 2007 Tax Resources Audio CD.



This audio CD covers all topics related to filing federal tax forms, including: W-2, W-3, 941, 1099 and 1096 forms. Plus it provides a review of church staff tax reporting status, help for

setting up and maintaining a business expense plan for the coming year, and an update on housing and parsonage allowances for clergy.

ITEM #L213 **\$9.95**

## Clergy Filing Procedures; 2007 Tax Resources Audio CD.



This audio CD presents a step-by-step explanation of how to complete your tax forms. It includes rules for filing both as an employee and as self-employed.

ITEM #L214 **\$9.95**



## Update for Church Treasurers; 2007 Tax Resources Audio CD.



This audio CD summarizes the key legal and tax developments of the past year, plus alerts you to other pending changes.

ITEM #L215 **\$9.95**

### SPECIAL OFFER

**2007 Church & Clergy Tax Guide** book, Adobe Acrobat format on CD, plus the three **Tax Resources Audio CDs**

ITEM #L927S

**\$79.95**

## 2007 CHURCH & CLERGY TAX GUIDE

### PRICING INFORMATION & COMBINATION OFFERS:

- ITEM #L107: **2007 Church & Clergy Tax Guide** book **\$29.95**
- ITEM #L107C: **2007 Church & Clergy Tax Guide** in Adobe Acrobat PDF format on CD **\$29.95**
- ITEM #L107S: **2007 Church & Clergy Tax Guide** book plus the Adobe Acrobat PDF format on CD **\$54.95**  
(save when you buy both)
- ITEM #L927: **2007 Church & Clergy Tax Guide** book, plus the three **Tax Resources Audio CDs** **\$54.95**  
(save when you buy all four items together!)
- ITEM #L927S: **2007 Church & Clergy Tax Guide** book, Adobe Acrobat PDF format on CD, plus the three **Tax Resources Audio CDs** **\$79.95** **SPECIAL OFFER**  
(save when you buy all tax resources together)
- ITEM #L213: **Federal Reporting Requirements for Churches; 2007 Tax Resources Audio CD** **\$9.95**
- ITEM #L214: **Clergy Filing Procedures; 2007 Tax Resources Audio CD** **\$9.95**
- ITEM #L215: **Update for Church Treasurers; 2007 Tax Resources Audio CD** **\$9.95**





**The Ministers and Missionaries Benefit Board**

475 Riverside Drive • Suite 1700  
New York, NY • 10115-0049

**Tel:** 800.986.6222

**Fax:** 800.986.6782

**[www.mmbb.org](http://www.mmbb.org)**