

III. Compensation of Priests and the Dual Tax Status of Priests: Employees for Income Tax Purposes & Self-Employed for Social Security Tax

The IRS expects that ministers, including priests, are ordinarily classified as employees for income tax purposes (but self-employed for Social security and Medicare tax purposes). No denomination has been successful in defending the self-employment status position for clergy, although certain individual clergy have successfully maintained self-employment status.

In 1995, the IRS issued its *Audit Guidelines for Ministers*, in which it states, "Only in those very limited cases . . . such as in the case of a traveling evangelist . . . a Form 1099-MISC is appropriate." This indicates that the IRS considers priests to be employees for income tax purposes, regardless of their Social Security status.

From the middle to late 1990s, when IRS audited priests who filed their tax returns as self-employed for income tax purposes, it typically reclassified them from self-employed status to employee status.

In determining the employee or independent contractor status of taxpayers, the IRS now uses the three-category approach (behavioral control, financial control and the relationship of the parties) to determine the amount of control exercised over the priest's duties, which was essentially the similar determination under Rev. Rul. 87-41. (See Chapter VI: "Compensation of Lay Employees and Deacons of the Church" for a more detailed discussion of the three categories.) An IRS analysis of the three categories as they pertain to priests would most likely result in a determination that the priest is an employee, as did the twenty-factor analysis under Rev. Rul. 87-41.

Priests who file their tax returns based on Form W-2 file as *employees*. This means that they report their business expenses on Schedule 2106 (or the simpler Schedule 2106-EZ) and then transfer those expenses to Schedule A (sometimes referred to as the "long form" or as "itemized deductions"). Generally speaking for priests, the standard deduction is greater than allowable itemized deductions. The standard deduction amount is adjusted for inflation each year and implicitly encompasses tax deductions not common to priests (e.g., real estate taxes and mortgage interest).

In very limited cases, a few priests may be permitted to file their tax returns based on Form 1099-MISC filed as bona fide *independent contractors*. This means that they report all income and related expenses on Schedule C. Under this tax status, priests receive full, dollar-for-dollar deduction offset against their income for ministry-related expenses.

Priests whose compensation is correctly reported on Form W-2 may not fully deduct their ministry-related expenses compared to priests who receive Form 1099-MISC—but there are alternatives. If a diocese adopts an accountable business expense reimbursement plan, most, if not all, of a priest's ministry-related expenses may avoid the negative tax consequences associated with the Form W-2 status. See Chapter 3 of *Income Taxes for Priests Only* (National Federation of Priests' Councils, 2011) for details; but in summary, if a diocesan entity reimburses a priest for ministry-related expenses, those reimbursements are tax-free. This has the effect of converting otherwise nondeductible expenses to tax-free reimbursements.

Other Clergy Tax Considerations:

Housing Allowance Designation

For a discussion of housing allowances for both active and retired priests, please see Chapter IV: "Compensation of Diocesan Priests: Pension and Other Post-Retirement Benefits."

Tax-free Board

Meals provided to priests are an income tax-free benefit, under the following conditions:

- 1 The meals are consumed on the parish premises.
- 2 The meals are provided for convenience of the parish, i.e., the priest is —on call.
- 3 The meals are a required part of the priest's working conditions, i.e., he is required to live in the assigned housing.

Meals that do not meet all three of the above requirements do not qualify as a tax-free benefit. If the priest is provided with food, a food allowance or reimbursement for food purchases or restaurant meals, it represents taxable income to the priest unless it qualifies as a business (Church) expense under an accountable reimbursement plan.

Stipends, Mass Fees, Allowances

The IRS considers Mass Stipends, Fees, Stole Fees and Honoraria as payments for services rendered and, thus, represent earnings subject to both federal income tax and Social Security/Self-Employment tax. Allowances paid to a priest (auto, clothing, etc) represent earnings subject to federal income tax and Social Security/Self-Employment tax. Any amounts paid to —cover a priest's self-employment or income taxes are taxable income for both taxes.

Income Tax Withholding

Priests are exempt from all federal payroll withholding requirements. However, a priest may elect to have federal income tax withheld from his pay. He may elect to have sufficient amounts withheld only as federal income tax to cover both federal income taxes and Social Security/Self-Employment tax. As discussed above, the priest is considered self-employed for Social Security purposes; therefore, Social Security (FICA) and Medicare taxes should never be withheld from his pay. State and local withholding requirements for priests may vary by state and locality.

Clergy Exemption for 403(b) or 401(k) Contributions

Contributions by priests to a Church sponsored 403(b) or 401(k) plan are excluded from net earnings for self-employment purposes. Therefore, when priests calculate their income subject to self-employment tax, they should exclude the amounts contributed to their 403(b) or 401(k) plan via payroll deduction.

IV. Compensation of Diocesan Priests: Pension and Other Post-Retirement Benefits

Introduction

Canon law stipulates that the diocesan bishop must provide suitable support and housing for all diocesan clergy upon their retirement from active service. In the United States, the USCCB has promulgated a set of norms in light of this provision of canon law. In adhering to these norms, each diocese has developed its own approach to providing for the well-being of its retired priests. Many dioceses have adopted defined benefit plans to provide pension benefits for retired priests. In some cases, dioceses sponsor tax-sheltered annuity plans or other forms of defined contribution plans.

Most retired clergy receive Medicare benefits. Currently Parts A (hospital inpatient and limited long term care), B (physician and outpatient) and D (pharmacy) programs are available. Persons need to pay close attention to enrollment requirements for these benefits, especially Part D, as timing affects the participant cost. Additionally, dioceses may provide other post-retirement benefits, such as supplemental medical and dental benefits, long-term care, and housing allowances. Although there are numerous types of benefit programs, all dioceses are obligated to provide financial support for retired priests in accord with the gospel spirit. As medical programs evolve and as federal healthcare requirements change, it is important to adjust payments to comply with the increased federal contributions.

The accounting treatment for pension and post-retirement benefit plans is specified in the Financial Accounting Standards Board Codification topic sections 712, Non-retirement Post-Employment Benefits; section 715, Compensation – Retirement Benefits; and section 958-715, Not-for-Profit Entities Compensation – Retirement Benefits.

Adherence to these pronouncements is required by generally accepted accounting principles (GAAP) for all entities, including the Catholic Church. (These pronouncements apply to lay employee plans as well as diocesan clergy plans.) Accounting guidance is periodically revised; diocesan staff should consult with professionals as changes are effective.

Accounting Treatment

Retired priests' benefits may or may not be formalized in a written plan document. In every case it is important to assure that the benefits comply with legal requirements and are not discriminatory between and among those participating in the plan. In the case of benefits provided without a written plan document, it is important to distinguish between benefits that are provided on a consistent basis over time and those benefits that are occasional and discretionary. Benefits that are provided on a case-by-case basis, without any consistency or expectation thereof, represent discretionary payments and may be accounted for on a pay-as-you go (charitable cash expense when incurred) basis. When benefits are not formalized, but provided on a consistent basis, it is necessary to set up reserves for these costs and offset the cash payments when they occur.

The regular, systematic practice of providing certain benefits to retired priests (such as monthly pension payments, payment of premiums for Medicare supplemental insurance policies, payment of

medical and dental bills, housing subsidies, etc.) is evidence of a defined benefit pension plan or a post-retirement benefit plan, whether or not a written plan document exists. The benefits may be in the form of either a reimbursement to the retiree or direct payment to a provider. Under these circumstances, benefits are viewed as deferred compensation arrangements whereby the diocese agrees to pay future benefits in exchange for current services. Therefore, the expected cost of providing pension and other post-retirement benefits to priests is to be recognized over their years of active service in the diocese. The obligation of the diocese for pension and other post-retirement benefits is to be fully accrued by the date that full eligibility for benefits is attained.

ASC 715 applies to all not-for-profit organizations with single-employer or multiple-employer defined benefit pension, health or other postretirement plans. Multi-employer defined benefit plans are excluded. ASC 715 requires that the organization (1) report the funded status of its plans, measured as the difference between the fair value of the plan assets and the benefit obligation, directly on its balance sheet (recognition provisions) and (2) align the measurement date for plan assets and benefit obligations with the organization's fiscal year-end (measurement date provisions).

ASC 715, Compensation – Retirement Benefits is a complex topic, and the circumstances of each plan need to be considered in its full implementation. Since these circumstances can vary widely from plan to plan, it would be prudent for dioceses to seek professional advice with respect to their own particular situations.

Employers are required to provide significant disclosures about the assets in postretirement benefits plans (e.g. fair value of plan assets, concentrations and categories of plan assets, etc.), (ASC 715-20-50-3; 958-715-501). The content and presentation of these disclosures changes frequently and current guidance should be reviewed when financial statements and footnotes are prepared.

An analysis of payments made to, or on behalf of, retired priests should be conducted to determine whether—despite the absence of a written plan—there is a pattern of payments that represent a systematic practice of providing benefits that should be accounted for in accordance with relevant accounting pronouncements. Additionally, consideration should be given to formalizing existing practice in a written plan document. This provides clarity to the priests and eliminates misunderstandings as to exactly what benefits they can expect. The tax treatment for benefits should be well documented and followed consistently.

Plan Funding

The method of funding these benefit plans is varied and often complex. Many dioceses rely on special assessments, special collections, fund-raising campaigns, or a combination of these and other methods. Some dioceses cover pension and other post-retirement benefits on a pay-as-you-go basis, while others pre-fund these obligations. Pre-funding can take several forms. Some dioceses set funds aside in a separate account or simply designate a portion of their unrestricted net assets. Some dioceses establish a separate trust arrangement, thereby transferring the assets off the balance sheet and legally restricting the use of the assets.

Consideration should be given to pre-funding pension and post-retirement benefit plans. Insufficient liquid assets may result in the diocese's inability to meet its obligation to retired priests. If funds are not segregated for these purposes, usually in a trust, the assets will be subject to all creditors. Trusts should not be over funded; a funding policy should be developed, approved by competent authority and followed consistently.

Only assets that are segregated and legally restricted for pension and post-retirement benefits qualify as plan assets under the provisions of GAAP. Assets that are not segregated in a trust or otherwise effectively restricted so that they cannot be used by the diocese for other purposes do not qualify as plan assets.

Health care costs are expected to increase each year. Medical costs as a percentage of GNP are also expected to continue to increase and life expectancies are continuing to increase. The issue of recognizing and funding these future obligations is more critical today than ever. Federal legislation will become effective and may change the benefits provided, as well as the method for funding such benefits. Furthermore, when pension and post-retirement plans are pre-funded, assets should be appropriately invested to generate a return on investment while maintaining the corpus of the fund and providing sufficient liquidity to reduce the amount of future funding needed.

Status of Priests' Retirement Plans

Consultation with diocesan legal counsel or pension counsel is necessary to determine whether a diocesan retirement plan (for lay employees or priests) meets the requirements of the Internal Revenue Code (IRC) either as a qualified defined benefit or defined contribution plan or as a section 403(b) tax-deferred annuity, and whether the plan qualifies as a "church plan" under section 414(e) of the Code. Although qualified church plans are not subject to ERISA (Employee Retirement Income Security Act) vesting, participation, and funding rules and are not required to file the annual Form 5500, such plans must nonetheless comply with numerous technical requirements, including certain pre-ERISA standards. Because pension legislation is amended frequently, periodic compliance reviews of all diocesan retirement plans are advisable.

Housing Allowance Designation

IRC section 107 provides an exclusion from gross income for a parsonage (housing) allowance provided to clergy (active as well as retired). This includes the rental value of a home furnished to him as part of compensation or a housing allowance, to the extent that the payment is used to rent or provide a home. In order to qualify under IRC section 107, the trustees of the priests' retirement plan, or the bishop, must designate a portion of each payment as a housing allowance excludable under IRC section 107.

The amount excludable from gross income as a housing allowance is limited to the least of the following three options:

- The amount actually used to provide a home (including rent, furnishings, repairs, insurance, taxes, utilities—but not food or entertainment)

- The amount officially designated as a housing allowance
- The fair rental value of the home, including furnishings, utilities, garage, etc.

The sum of all pension payments issued in a calendar year are to be reported as the gross distribution amount on form 1099-R. If the diocese has properly designated all, or a portion of the pension payments as a housing allowance, the taxable portion of the total payments cannot be determined by the diocese, since the amount excludable from income as a housing allowance has to be determined by the taxpayer based on the three options shown above. Therefore, the taxable amount on form 1099-R should be left blank and the box —taxable amount not determined checked.

The exclusion from income for federal income tax purposes applies to both active and retired clergy. The exclusion from income for Self-Employment tax purposes applies only to retired clergy.

Guidelines for the Retirement of Bishops

- 1 Beginning January 1, 2011, the stipend recommended for all bishops in retirement will be a minimum of \$1,900.00 per month, to be adjusted annually according to the local cost of living index.
- 2 In addition to the monthly stipend, it is also recommended that in fraternal charity and solicitude each diocese also provide the following:

Additional Basic Benefits

- i. Appropriate housing and board
- ii. Health and welfare benefits, including major medical and the full cost of medical and hospital care. This includes any applicable coverage for home health care, assisted living facilities or long-term care facilities.
- iii. An office with secretarial assistance commensurate with the retired bishop's needs.
- iv. Suitable funeral and burial.

Additional Support Benefits

- i. Transportation including an insured automobile for personal use.
- ii. Travel expenses (i.e., transportation, lodging, food, etc.) to allow the retired bishops to attend:
 - a. Provincial meetings and workshops
 - b. Regional meetings, workshops and retreats
 - c. Meetings of the USCCB
 - d. *Ad limina* visits to the Holy See
 - e. Ecumenical councils, Synods of Bishops, and meetings of the Roman Curia to which the Bishop *Emeritus* is associated.
 - f. Episcopal installations.

Housing

It is further recommended that the official residence provided by the diocese is for the use of the diocesan bishop.

- 1 If it seems advisable in order to seek some degree of uniformity, the dioceses of a given region or province, in a spirit of subsidiarity, should take upon themselves the responsibility to interpret and implement these guidelines, taking into account the local economy. Only in this way can the differing living costs in the various regions of the country be factored into the consideration of retirement benefits.
- 2 The United States Conference of Catholic Bishops will review these guidelines again in 2015 to ascertain their continuing validity.