PROVINCE POLICY ON THE REPORTING OF PRIESTS' INCOME

Approved by the Bishops, November 2, 2006

Effective Date: January 1, 2007

It is the policy of the Province of Miami that effective January 1, 2007, priests' income paid during calendar year 2007 and thereafter, should as a general rule be reported beginning January 1, 2008 on IRS Form W-2. The policy recognizes there may be exceptions for particular cases.

Diocesan priests are considered to be "employees" for Federal income tax purposes, but are considered to be "self-employed" (independent contractors) for Social Security tax purposes. As a result, FICA taxes will not be withheld. Therefore, required taxable wages must be reported on Form W-2. Although income tax withholdings are not required, they may be withheld and remitted if requested by the priest.

In addition to the salary or monthly compensation, the car allowance and all other remuneration paid by the employing unit to the priest for services of any kind should be reported on Form W-2. This includes stipends and stole fees paid to the priest by the employing unit. Not required for reporting on Form W-2 by the employing unit are reimbursements to the priest for church expenses he has incurred, as well as stipends paid by an outside organization, for which the priest has an individual duty to report.

No reporting is required for payments made to religious communities which require a vow of poverty, even though such payments may be in return for services by a priest.

It is the Responsibility of the Chancellor in each of the (arch)dioceses to assure that this policy is transmitted to pastors, parishes, schools and other employing units.

Chapter III of USCCB publication "Diocesan Financial Issues", Rev. 10/4/2006 is incorporated as an addendum to this policy.

Addendum: *Compensation of Priests and the Dual Tax Status of Priests: Employees for Income Tax Purposes, Self-Employed for Social Security Tax (Revised 10/4/2006)*

The issue of priests' employment status for Internal Revenue Service (IRS) reporting procedures has been one of considerable debate over the last twenty years. It is also the subject of an entire section of the tax manual for priests, *Income Taxes for Priests Only*, published by the National Federation of Priests' Councils.

Congress created this debate in 1937 when they introduced the Social Security system. Congress was cognizant of the doctrine of separation of church and state and did not want to impose the Social Security system upon the clergy (i.e., of all faiths). Rather than simply stating so, Congress declared clergy to be self-employed for Social Security purposes because, at that time, self-employed individuals were not covered by Social Security. They reasoned that designating clergy as self-employed would sidestep the issue of taxing the clergy.

That worked for about eighteen years, until Congress decided to include the self-employed in the Social Security system. Faced with a decision, Congress then created special laws affecting clergy. In 1955, Congress wrote laws exempting clergy from the Social Security system unless the individual clergymen opted in. In 1968, Congress changed the default so that clergy were automatically enrolled in the Social Security system unless they individually opted out based on their personal religious objection to the Social Security system. Clergy remained designated as self-employed, by congressional law, as they are today.

Since Congress declared priests self-employed for Social Security tax purposes, priests presumed they were self-employed for income tax purposes as well. Consequently, priests reported both their income and expenses on Schedule C of Form 1040. The IRS, however, disagreed. While the IRS does not debate a priest's self-employed status for Social Security tax purposes, the IRS takes issue with a self-employment status for income tax purposes. Reporting income and expenses on a self-employed basis—i.e., on Schedule C—has tax advantages for a priest. This is because the expenses are deductible whether or not the priest itemizes his deductions. The itemized deduction method also eliminates deductions equal to 2% of adjusted gross income, so that only deductions exceeding this 2% floor produce a tax benefit. The IRS reasoned, however, that priests had the characteristics of employees in most, if not all, other aspects. Priests are paid salaries; they receive employee benefits such as health insurance and pensions; and they have a boss, i.e., their bishops.

To make its point, the IRS has taken several steps. First, in 1978 it issued Publication 517, entitled *Social Security and Other Information for Members of the Clergy and Religious Workers*, in which the IRS first differentiated between the filing status for clergy as selfemployed for Social Security tax purposes, and as employees for income tax purposes. This publication explained the dual status of clergy.

Then, in 1987, the IRS issued a Revenue Ruling (Rev. Rul. 87-41) that established twenty factors to use in determining the employment status—employee or self-employed—for all workers (not just clergy). In its interpretation of the twenty factors, *Income Taxes for Priests Only* concludes that the IRS would classify most priests as employees—i.e., Form W-2—rather than as selfemployed—i.e., Form 1099-MISC.

It is important to note that the IRS has changed its approach in recent years. According to the IRS website, the common law test is determined by classifying the relevant facts into three categories:

- Behavioral control
- Financial control
- Relationship of the parties

This three-category approach tries to determine the amount of control exercised over the priest's duties, which was essentially the similar determination under Rev. Rul. 87-41. (See the section on "Compensation of Lay Employees 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.

In 1994, based on a 1988 tax filing, the IRS took a Methodist minister to court over his employment status. The Methodist minister claimed self-employed (Form 1099-MISC) status. The IRS instead claimed employee (Form W-2) status. The IRS won. In 1995, the appeals court upheld the decision, i.e., favoring the IRS.

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.

Thus, the IRS has expressed an expectation that ministers, including priests, ordinarily be classified as employees for income tax purposes rather than as self-employed. No denomination has been

successful in defending the self-employment status position for clergy, although certain individual clergy have successfully maintained self-employment status.

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"). Most priests do not qualify for use of Schedule A because the IRS allows all taxpayers a standard deduction in lieu of itemized deductions. The standard deduction amount is adjusted for inflation each year and encompasses tax deductions not common to priests (e.g., real estate taxes and mortgage interest).

Those priests who are permitted to file their tax returns based on Form 1099-MISC file 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 credit against their income for ministry-related expenses.

What this means is that priests whose compensation is reported on Form W-2 may not receive full credit for 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* 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.