

## Feature

# Demystifying the Parsonage Exclusion From Federal Income Tax

*Over the past several months, Agudath Israel of America has initiated the Dina D'Malchusa Dina series of legal seminars project. Responding to the timely need in the Orthodox Jewish community for substantive guidance regarding a range of legal and tax-related issues faced by yeshivos, shuls, gemachs, and the general public, Agudath Israel has stepped up to fill that need by coordinating this initiative. To date, Agudath Israel has presented close to ten seminars in various locations across the United States, including programs in Boro Park, Chicago, Cleveland, Flatbush, Lakewood and Los Angeles, and more are scheduled to come. The initiative has been praised by many as long overdue. It has served as a means of educating the greater Orthodox community regarding the intricacies of complicated and often misunderstood legal concepts, and has brought about a keen awareness of pertinent rules and laws vital to ensure that organizations and individuals act in compliance with state and federal law. The parsonage exclusion from income tax is one such topic. Below is an article that seeks to clarify the rules of parsonage, the limits to the exclusion and some of its nuances.*

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### Introduction

No one likes taxes. Paying them, that is. However, people's ears generally perk up at the prospect of keeping more take-home pay and giving less to Uncle Sam. Some Orthodox Jews may legitimately be able to save on their income taxes by taking advantage of the "parsonage" housing-allowance exclusion from federal income tax.

The Internal Revenue Code provides that a "minister," or one who can be classified as a minister for purposes of the tax Code, may be able to exclude a portion of his or her income earned in the exercise of performing ministerial service that has been pre-designated and actually used for the minister's housing expenses that year. This income is excluded, and will thus not be reported for purposes of federal income taxes (and most state and local taxes too) but will still be subject to social security tax.

The parsonage exclusion clearly affords a huge tax break to a group that generally doesn't bring home all that much pay to begin with and can certainly use the extra cash. Although the parsonage exclusion has faced challenges over the years on constitutional grounds and continues to be challenged (notably, as recently as a May 21, 2010 decision from a California federal court that allowed such a challenge to move forward).

At the time of this writing, the parsonage exclusion is still the law, and, as long as it continues to remain the law, those who are eligible can take advantage of it. Outlined below are some of the basic concepts and procedures for how the parsonage exclusion works. It should be noted at the outset that it is important to seek professional guidance to ensure eligibility and to ensure that its requirements are being applied correctly.

### Who is eligible?

The parsonage allowance may only be provided as payment for services that are the "duties of a minister." This includes "the ministrations of sacerdotal functions, the conduct of religious worship, and the control, conduct and maintenance of religious organizations." This defini-

tion would include most shul Rabbanim, *rebbeim* in yeshivos who teach religious subjects, as well as yeshivah administrators.

One caveat is that the person must also be "ordained, licensed or commissioned." That would not necessarily require the rabbi to have formal *semichah*, but he should have a certificate or diploma from the yeshivah he attended attesting to his qualification to act in a rabbinic capacity, and that certificate should be on file with his employer.

Female teachers conducting ministerial services (e.g. *davening* or learning with children) can likely take advantage of this provision as well. Although they may not be "ordained," it would be sufficient for the female teacher to obtain a diploma or certificate from her seminary attesting to her qualifications to teach Jewish religious subjects.

Although, generally, the employer will be a shul or

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yeshivah, there is no requirement that the employer be a religious organization. For example, a rabbi working in a rabbinic capacity (e.g. conducting *shurim*, running the shul, counseling patients on religious matters) at a nursing home or hospital would also qualify. If you are unsure whether you qualify, it is important to seek professional guidance before using the exclusion.

### What do you need to do?

The parsonage allowance, i.e. an estimate of how much of his salary the employee will use for housing expenses that year, must be designated by the employer, and that designation must happen prospectively, meaning before the income is earned, in order for an employee to take advantage of the tax break. The employee estimates his housing

expenses for the year and submits the estimate to the employer for approval. The designation must be made by "official action" of the employer. Examples of "official action" include a designation within an employment contract, in the minutes of a board of trustees meeting, in an employer resolution — but really any other appropriate document will suffice. While a verbal designation would count (so long as such designation was made by "official action"), it isn't recommended, as it can cause evidentiary issues later on.

Parsonage is a matter of tax law, and thus, like most tax laws, it follows the calendar year — January through December. Since the expenses must be pre-designated, the designation should ideally take place each December, or earlier, for the following calendar year. (If based on the school year, care should be taken that the designations for the school years involved cover the entire calendar year.) When starting a new job mid-year, the designation should occur as soon as the employee starts working, if not before.

A designation can technically be made for future years, but because pre-designation of housing expenses should be as accurate as possible, a new designation would likely be needed at the beginning of each calendar year.

### What kinds of items are considered "housing expenses"?

"Housing expenses" includes basically everything that has to do with housing. A non-exhaustive list includes various expenses in buying or owning a home such as the down payment on a home, closing costs, mortgage payments including interest and principal, home equity payments (as long as the loan proceeds were used for other housing expenses), real estate tax and property insurance. For those renting, rental payments are also considered housing expenses.

Other applicable housing expenses include the cost of utilities (e.g. electricity, heat, water, non-business telephone line, gas, sewer charges), cost of furnishings and appliances, household goods (including dishes, cookware, linens, lawn-care tools, cleaning supplies, electrical supplies), building repairs, remodel-

ing and home improvements, yard maintenance, landscaping, pest control, snow removal, local calls on the home phone, and more.

With so many everyday items included, it's important to note some items that are deemed *not* to be housing expenses. Such items are the cost of purchasing food, personal toiletries such as toothpaste and shampoo, music CDs, computer software, automobile costs, as well as the cost for services such as housekeeping and babysitting.

### Are there any limitations?

There are indeed limitations as to the amount of parsonage an employee may exclude. The employee is limited to the lesser of (a) the amount pre-designated by the employer, (b) the amount of housing expenses actually used that year, and (c) the fair rental value of a furnished home while adding the employee's actual cost of utilities incurred that year.

To illustrate how these limitations work, suppose a rabbi estimated in January that he would require \$10,000 in housing expenses for the year and the school went through the process of pre-designating by official action that amount from his salary of \$40,000. The school would pay the rabbi the entire \$40,000, but the rabbi's W-2 would only show \$30,000. (The parsonage amount of \$10,000 may be detailed in Box 14 for "other income," but there is no requirement that this be done.) When tax time comes, assuming the rabbi actually used \$10,000 on housing expenses during that calendar year, he will only report

*The parsonage exclusion merely applies to federal income tax.*

and pay federal income tax on \$30,000 of his salary.

Let's say the rabbi only used \$8,000 of the pre-designated \$10,000 for housing expenses. He would be required to report and pay federal income tax on the leftover \$2,000. Suppose the rabbi ended up using \$12,000; he is limited to the pre-designated

amount of \$10,000 — and so the additional \$2,000 of the rabbi's salary that went toward housing expenses but was not pre-designated is considered taxable income.

In this last example, should the rabbi notice during the year that his pre-designated amount will fall short, he may ask his employer to amend the designation to account for the additional amount, so long as the expenses used at that point have not yet exceeded the original pre-designated amount. To the extent they have, the amount that exceeded the pre-designated amount may not be part of parsonage as tax-free housing expenses.

To take a different example, suppose a rabbi was given the use of a home, rent-free, that was otherwise valued at \$20,000. If not for the parsonage exception, that amount likely would need to be included in the rabbi's salary as a taxable benefit gained from his employer through the course of his employment. (Note that there are certain other limited exceptions when such fringe benefits would not have to be included as taxable income, but we won't explore those in this article.)

However, given the parsonage rules afforded a rabbi by the tax Code, the \$20,000 gain will not be subject to federal income taxes. In such an instance, aside from not reporting the \$20,000 gain, the rabbi may also desire to have his employer pre-designate a portion of his salary as a housing allowance so that other housing expenses used that year would also not be included in taxable income for federal income tax purposes.

Suppose a rabbi decided in January that this year will be the year that he purchases a home. Knowing his expenses for the year will be quite significant, he designates his entire salary of \$85,000 toward his housing allowance. (As it turns out, actual housing expenses for the year may end up being even greater than his entire salary.) In this case, the fair-rental value limitation kicks in. The rabbi would need to evaluate the fair-rental value of a fully-furnished home such as his (let's say it is \$35,000), and add to that his actual cost of utilities for the year (let's say it's \$10,000), and the sum of those figures would be the maximum amount of parsonage he may take tax-free for that year, even though he pre-designated a larger amount and although he actually spent more. In our example, his parsonage amount is limited to \$45,000. The additional \$40,000 of his income (\$85,000 - \$45,000 = \$40,000) would be taxable.

As far as designating one's entire salary, that, too, is fine. Just remember that the above limitations would apply.

### Does the employee have to pay social security/Medicare tax on his income?

Here is the more troubling news. Indeed, the parsonage exclusion merely applies to federal income tax (as well as any local and state taxes that base their taxable income on the employee's federal "adjusted gross income"). Social security taxes are a different story. The employee is required to pay social security and Medicare tax on his entire income, both the parsonage as well as the non-parsonage amounts. Not only that, this burden of paying it falls completely on the employee — all 15.3% of it. If you're thinking it's strange — that's because it is.

The tax code classifies "ministers" with respect to ministerial services they perform as "dual-status employees." That means they are considered employees for all purposes (so they generally receive a W-2 at year's end from their employers), except when it comes to social security tax.

For social security purposes, ministers are considered "self-employed." The rule is that employees pay half their social security and Medicare obligations (also known as FICA, which stands for Federal Insurance Contributions Act) while employers are required to kick in the other half at their own expense, which will not be taxable to employees. Since ministers with respect to their ministerial services are exempt from FICA, there is no obligation for the employer to kick in half of the FICA. Indeed, should the employer decide to pay half regardless, such amount is considered additional taxable income to the employee.

Instead, ministers fall under the SECA system (which stands for Self-Employment Contributions Act), which requires them to pay the entire 15.3% of their entire salary themselves (parsonage and non-parsonage), just like any other self-employed person. The minister would also be required to make quarterly estimated payments towards the SECA obligation and report those payments on Schedule SE to the Form 1040. (Boxes 3 through 6 on the employee's W-2 should be left blank, as those apply only to FICA amounts, not SECA.)

One saving grace, perhaps, is that a self-employed person is allowed an adjustment on his Form 1040 of 7.65% of his entire salary (also known as an "above-the-line deduction").

If, prior to reading this, an employer had the practice of paying half of the rabbi's social security tax as though the rabbi were an ordinary employee, and now decides to no longer cover any of the rabbi's SECA obligation, to maintain the understanding between the employer and rabbi it is suggested that the employer increase the rabbi's salary by the 7.65% that the employer was previously paying, so that the rabbi is not left with a net loss.

One further thing to remember is that the social security ramifications just discussed are a by-product of a taxpayer being

deemed a "minister," and do not vary based on whether the rabbi elects to accept parsonage. So long as the rabbi is deemed a minister who is conducting ministerial services and is thus eligible for parsonage, the social security rules discussed above will apply to him — regardless of whether he actually receives parsonage.

On that note, once we've mentioned a ramification of being classified as a "minister," another important ramification is that the employer of a minister is exempt from its obligation to withhold federal income tax, whether or not the rabbi is receiving parsonage. (If receiving parsonage, this would apply only to the non-parsonage amount, as the parsonage amount is already excluded from federal income tax.) In such a case, the rabbi would be required to pay quarterly estimated federal income tax on any non-parsonage amount, just as he must do for social security tax.

The rabbi may request that his employer voluntarily withhold federal income tax on his behalf (on any non-parsonage amount) so that he need not bother arranging and filing quarterly estimated federal income taxes.

One last note about social security tax: Besides being the law and thus obligatory, as a practical matter, paying into social security serves as a sensible long-term investment, as it allows the payer to receive income after retirement. Additionally, although there is the option for certain clergy members to opt out of social security, based on their opposition to public insurance for personal religious considerations, many tax professionals have serious questions about the availability of this exemption for Orthodox Jews.

### May both a husband and wife claim parsonage?

Sure, keeping in mind that the above limitations apply: Actual (and pre-designated) housing expenses used that year that do not exceed the fair rental value of the home (including furnishings plus actual cost of utilities).

Thus, if a rabbi's entire salary won't cover all of his housing expenses, so long as the wife is also eligible to receive parsonage, her salary, too, may be pre-designated to cover the remainder of their housing expenses, keeping in mind the fair rental value limitation previously discussed.

### May one claim parsonage for a summer home?

The parsonage exclusion may only be used to exclude housing expenses incurred for one home. However, should the rabbi incur expenses for more than one home, such expenses incurred while living in that other home may be treated as housing expenses for the parsonage exclusion. The catch is that during that time, any housing expenses incurred in connection with the rabbi's primary residence are taxable. A slightly different way of structuring this arrangement is by adding the total amount of expenses

incurred for each home and multiplying each sum by the percentage of the year in which the rabbi occupied that home. Only the proportion of expenses incurred given the time spent living in that home may be considered tax-free expenses for parsonage purposes.

### For social security purposes, ministers are considered "self-employed."

### What about local and state income taxes?

Most local and state taxes base taxable income on the "adjusted gross income" reported on the employee's federal tax return. Since parsonage is an exclusion from gross income, it is not included in the employee's adjusted gross income. Thus, for most jurisdictions, the parsonage amounts would also be excluded from state and local taxes.

### Should one who is eligible always elect to accept parsonage?

Not always, as accepting par-

sonage may affect whether the employee would be entitled to other tax benefits. Thus, an employee should be sure to check with a qualified tax advisor before electing to accept parsonage, to ensure that, given the totality of the employee's specific financial circumstances, accepting parsonage would be in his best financial interest.

### Conclusion

Although parsonage amounts are not completely tax-free, they nonetheless provide a significant tax break to many families that may be eligible.

However, in actual practice, it is important to keep in mind the above principles and the need to seek guidance from a tax advisor to ensure the exclusion is applied correctly.

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