

Diocese of Covington

Policies & Procedures Manual

Section: Compliance – Payroll and Personnel

Policy: Priest Compensation and Taxation



ACTIVE (NON-RETIRED) PRIESTS

The Internal Revenue Service *Audit Guidelines for Ministries* stipulates that all ministers are to be considered employees for income tax purposes and, as such, are to receive Forms W-2 (Wage and Tax Statement) from their respective employers for each tax year.

Although priests who are not retired are considered employees for income tax purposes the IRS has ruled that they remain self-employed for purposes of Social Security taxes. Some items of income, e.g., housing, are taxable for Social Security purposes, but not for income tax.

Priests are still exempt from income tax withholding. However, as an employee, the individual priest may opt to have the employer withhold and remit a specific amount from salary checks to cover taxes. When computed properly, withholding relieves the priest of making quarterly estimated tax payments. The diocesan payroll system can provide this service for priests.

As employees, priests may take advantage of certain tax-saving measures to increase spendable income which are not available to self-employed persons.

- Employer-paid benefits, such as health insurance and pension plan contributions, are not subject to either income tax or social security when provided for employees.
- Parishes or other employing agencies should have accountable reimbursement plans, which reimburse priests for business expenses. Under such a plan, the reimbursement is not reportable as taxable income. (See the “Reimbursement of Business-Related Expenses” policy).
- Employees may take advantage of Tax Sheltered Annuity plans, which allow the employee to defer income tax on a specific amount of salary set aside in a supplemental retirement plan.
- Employees paid through the diocesan payroll system are eligible to participate in the Section 125 Cafeteria Plan. This plan allows employees to designate a portion of salary to be withheld before taxes to pay for uncovered medical expenses (e.g. deductibles, co-pays, vision, dental).
- Employees may contribute to Individual Retirement Accounts (IRA), if income maximums are not exceeded.

All parishes should have in place the following:

HOUSING ALLOWANCE PLAN

The IRS requires housing allowances, and allowances for housing-related expenses, to be designated **in advance** of payment. If a prior designation is not made, the allowances are taxable as income to the priest. The following statement establishes the points germane to housing tax benefits and should be approved by the Parish Finance Committee and placed in the parish files:

“The salary for Father _____, Pastor (Associate) of _____ Parish, is in accord with the directives of the diocesan bishop pursuant to the policy approved November 3, 1987, plus reimbursements for business expenses incurred in the exercise of his ministry. The parish provides rectory room and board with an estimated fair market value of \$_____* per day. Father is required to reside at the rectory and be on call for parish emergencies 24 hours a day.”

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*The suggested norm is \$10/day. Circumstances for each living arrangement should be considered separately and may dictate a smaller or larger amount.

ACCOUNTABLE REIMBURSEMENT PLAN

All parishes should have an accountable reimbursement plan to provide reimbursement to priests for business expenses they incur and for which they have paid. Supporting documentation for such expenses is to be submitted by the priest at the time of reimbursement. Business expenses common to priests include, but are not limited to:

- supplies, equipment and books used directly in priestly ministry
- mileage reimbursement for travel at the standard rate per mile for business travel in excess of 6,000 per year
- dues and subscriptions directly related to the performance of priestly ministry
- retreat and continuing education expenses.

NOTE: Pursuant to IRS Publication 529, work clothes and uniforms can only be deducted (i.e. reimbursed) if the following two conditions are met:

1. the clothes are required to be worn as a condition of your employment, and
2. the clothes are not suitable for everyday wear.

As clerical clothes are generally considered suitable for everyday wear, they do not meet the second condition. As the parish typically purchases (and cleans) vestments, there is no necessity for reimbursement. However, as priests typically purchase their own albs, these would be eligible for reimbursement, provided all other requirements are met (i.e. supporting documentation provided, etc.).

Each priest employed in the diocese should complete the following steps:

- A. Every priest should estimate total federal and state tax liability (Social Security Tax, Federal Income Tax, Kentucky Income Tax and any local taxes) for the year.
- B. Each priest should complete Forms W-4 (Federal withholding) and K-4 (State withholding) with a specification of the amount of taxes to be withheld, if desired (see note below). **Caution:** Because priests are self-employed for social security tax purposes, it is usually not sufficient to use only the standard withholding tables. Priests need to request additional withholding to offset their self-employed social security tax liability. **Note:** Priests can continue to make quarterly estimated tax payments as in the past. Withholding is a new option available in lieu of quarterly payments because of employee status for income tax purpose.
- C. Each priest should submit the completed tax withholding forms (W-4 and K-4) to the Diocesan Payroll Office, or to whomever prepares his salary checks.
- D. Most cities and counties have levied payroll taxes on salary earned within that city or county. The normal method of payment by employees is payroll withholding. Some locales have specifically exempted “ordained ministers” from liability for the tax. Each priest should verify his status in relation to local taxation.
- E. Each priest is to submit the ANNUAL SUMMARY OF INCOME (Form/PT2), attached, to the Finance Office by January 10 of each year so that Form W-2 can be issued by January 31 as required by law.

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The Payroll Office currently processes Tax Sheltered Annuity deductions for employees who have contracted with a variety of companies. The specified deduction is withheld on a pre-tax basis and remitted to the company. A current list of these companies is available from the Payroll Office.

RETIRED PRIESTS

In a private ruling dated September 26, 1983, the IRS informed the Covington Priests' Retirement Board that the designation of up to 75% of priests' retirement benefits as "housing allowance" has been approved. Retired priests, therefore, can deduct their actual housing costs from their gross income for income tax purposes, as long as it does not exceed 75% of the retirement benefits that they receive from the Priests' Retirement Fund. Housing expenses include both the amount paid to the landlord for "rent" plus utility costs, insurance and maintenance costs.

A retired priest receiving a pension from his diocese will receive a Form W-2P from the Pension Trust. This Form W-2P will report the total amount paid to the retired priest during the year—but not all of this money is taxable.

Retired priests may have a portion of their pension payments designated as "housing allowance." For income tax purposes, such a housing allowance is tax free for all priests.

Under ordinary circumstances, priests have to add this housing allowance into their income when computing their self-employment (Social Security) taxes. **RETIRED PRIESTS ARE NOT REQUIRED TO DO THIS** because pension payments are not subject to self-employment taxes. Therefore, the amount designated by the Pension Plan as "housing allowance" is totally tax free.

The total amount reported to the retired priest on Form W-2P should be entered on Form 1040. Then, the amount designated as "housing allowance" should be deducted and the net amount reported. This represents the taxable income to the retired priest.