

Chapter 6: Special Taxpayers

Military Personnel.....	187	Education Incentives	212
Income.....	187	Other	212
Retirement	193	Clergy	213
Life Insurance	194	Clergy Defined	213
Sale of Residence.....	196	Employment Status.....	215
Job-Related Expenses.....	196	Income.....	216
Education.....	201	Gifts.....	217
Earned Income Credit (EIC)	201	Housing Allowance	218
Foreign Earned Income Exclusion (Form 2555)	202	Expenses	219
Tax Return Due Date	202	Social Security and Medicare Taxes.....	221
Excise Tax Exemptions	203	Recent Court Case	221
Teachers.....	207	Exemptions from SE Taxes	230
Income.....	207	Retirement	231
Job-Related Expenses	210	Earned Income Credit.....	231
		Available Resources	231

Corrections were made to this workbook through January of 2006. No subsequent modifications were made.

MILITARY PERSONNEL

INCOME

Military Form W-2

Basic Pay. Most pay received by members of the armed forces is includable in gross income.¹ This includes active duty pay and back wages. It also includes amounts paid for attendance at designated service schools, drills, reserve training, and training duty, as well as regular active duty. Other types of taxable pay include:

- Special pay received by medical and dental officers, and nuclear-qualified officers;
- Special pay for services performed during foreign duty, diving duty, hostile fire, imminent danger, and special duty assignments;
- Enlistment and reenlistment bonuses;
- Accrued leave payments;
- Mustering out payments;
- Personal money allowances paid to high-ranking officers;
- Certain scholarships and student loan repayments; and
- Combat pay subject to special rules as discussed on the following page.

¹ Treas. Reg. §1.61-2(a)(1)

2005 Workbook

Basic Quarters. Subsistence provided to commissioned officers, chief warrant officers, warrant officers, and enlisted personnel of the Armed Forces is excludable from income.²

Uniform allowance to the above-named personnel is also excludable. Under this same regulation, a dislocation allowance, temporary lodging allowance, and a move-in allowance **are excluded from income.**

Payments for appointments to attend the Air Force or Naval Academy are taxable wages for cadets or midshipmen. They appear in Box 1 of Form W-2. A sample of Form W-2 is shown below.

A table of included and excluded items of gross income for military personnel not serving in the combat zone is found in IRS Pub. 3, *Armed Forces' Tax Guide*. A copy of this table is also included at the end of this section.

Note. Combat pay and pension contributions, which are discussed later, are identified in box 12 of the 2005 Form W-2. Box 1 should not include combat pay. If the taxpayer believes the Form W-2 does not show the correct income, the taxpayer should contact the appropriate service branch and request a corrected Form W-2.

a Control number		OMB No. 1545-0008		This information is being furnished to the Internal Revenue Service. If you are required to file a tax return, a negligence penalty or other sanction may be imposed on you if this income is taxable and you fail to report it.	
b Employer identification number (EIN) 35-9990000		1 Wages, tips, other compensation 17361.79		2 Federal income tax withheld 2045.96	
c Employer's name, address, and ZIP code DFAS, ATTN: DFASIN/ADIMB 8899 EAST 56TH STREET INDIANAPOLIS, IN 46249-2410		3 Social security wages 19009.11		4 Social security tax withheld 1178.56	
		5 Medicare wages and tips 19009.11		6 Medicare tax withheld 275.63	
		7 Social security tips		8 Allocated tips	
d Employee's social security number		9 Advance EIC payment		10 Dependent care benefits	
e Employee's first name and initial Last name DENNIS SBABNA0A 4841		11 Nonqualified plans		12a See instructions for box 12 Q 4747.32	
		13 Statutory employee Retirement plan Third-party sick pay <input type="checkbox"/> <input checked="" type="checkbox"/> <input type="checkbox"/>		12b	
		14 Other		12c	
				12d	
f Employee's address and ZIP code		15 State Employer's state ID number FL		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
Copy C—For EMPLOYEE'S RECORDS. (See Notice to Employee on back of Copy B.)

2005

Department of the Treasury—Internal Revenue Service

Safe, accurate,
FAST! Use



Note. The Form W-2 above shows code “Q” in box 12a. The \$4,747.32 represents nontaxable combat pay.

² Treas. Reg. §1.61-2(b)

2005 Workbook

Example 1. Samuel, a career Army soldier, served in a combat zone in 2001. After returning home, he was diagnosed as having injuries related to an accident he sustained while serving in the combat zone. Samuel entered the hospital in 2004, three years after leaving the combat zone, for treatment of those injuries. Samuel's income while in the hospital is excludable. However, if an executive order had been given in 2001 stating that combat had ended in the region where he was injured, Samuel would not have met the two-year period and the income would not have been excludable.

The amount of the combat pay exclusion depends on whether the taxpayer is enlisted or commissioned. Enlisted personnel, as well as warrant officers, may exclude the entire amount received for any month during which they served in a combat zone or certain hazardous duty areas, regardless of how many days during the month they were in the zone or area. Commissioned officers may exclude compensation not exceeding the maximum enlisted amount, which is the highest rate of basic pay at the highest pay grade that enlisted personnel may receive, plus the amount of hostile fire/imminent danger pay that the officer receives. The highest enlisted base pay for 2005 is \$6,304.20.⁴ This amount is in addition to the hostile fire/imminent danger pay of \$225.

A combat zone is any area the President of the United States designates by executive order as an area in which the U.S. armed forces are engaging or have engaged in combat. Usually, an area becomes a combat zone and ceases to be a combat zone on the dates the President designates by executive order. Following are current combat zones or hazardous duty areas:

- Kosovo area qualifies beginning March 24, 1999. It includes the Federal Republic of Yugoslavia (Serbia and Montenegro), Albania, the Adriatic Sea, and the Ionian Sea north of the 39th Parallel.⁵
- The Arabian peninsula areas have been designated as a combat zone since January 17, 1991.⁶ This includes the land and airspace of Bahrain, Iraq, Kuwait, Oman, Qatar, Saudi Arabia, the United Arab Emirates, Gulf of Aden, Gulf of Oman, Persian Gulf, Red Sea, and part of the Arabian Sea.⁷

Service in the following areas has been certified as areas in direct support of the military operations in the Afghanistan combat zone (Operation Enduring Freedom):

- Afghanistan, Pakistan, Tajikistan, and Jordan on or after September 19, 2001.
- Incirlik Air Base, Turkey, starting September 21, 2001
- Kyrgyzstan and Uzbekistan on or after October 1, 2001⁸
- Philippines on or after January 9, 2002
- Yemen on or after April 10, 2002
- Djibouti on or after July 1, 2002

Example 2. John, an enlisted person, received pay on January 5 while stationed outside the combat zone. The pay received was for the period of December 1 to 31. John served in the combat zone for one day only; December 12. Since he served at least one day in the combat zone during the December pay period, he is able to exclude the entire pay for the month of December.

⁴ Military Authorization Act, October 28, 2004

⁵ Notice 99-30, supplementing Notice 96-34, June 6, 1999

⁶ Executive Order No. 12744

⁷ Notice 2003-21, April 10, 2003

⁸ Notice 2002-17, February 11, 2002

Example 3. Jill, an enlisted person, qualified for 25 days of leave while she served in a combat zone. She used the leave in the following year when she was not serving in the combat zone. Jill is able to exclude the compensation earned for those 25 days even though she was not in the combat zone at the time she received the leave pay.

Example 4. Mark, a commissioned officer, earned 25 days of annual leave while serving in the combat zone. At the time of service in the combat zone, he received basic pay of \$7,000 per month. He was able to exclude \$6,529 per month. Mark used 25 days of annual leave the following year. He may not exclude the pay because he already excluded the maximum amount of \$6,529 per month for the month the leave was earned.

Example 5. Julie is an enlisted person. She voluntarily reenlisted in August, while she was serving in the combat zone. Julie was stationed in the combat zone for the month of August only and left there without injury. In March of the following year, Julie received a reenlistment bonus relating to the reenlistment occurring in August of the preceding year. Since Julie was serving in the combat zone at the time of reenlistment, she is able to exclude the reenlistment bonus received in the following year.

Note. The prior examples illustrate that the exclusion amount is determined by the classification as commissioned or enlisted personnel. The ability to take the exclusion is not determined by the year the money is received but rather the time the money was earned in relationship to the combat zone.

The exclusion for combat pay applies to the period of service in the zone but also to monies received while hospitalized due to the injuries. All injuries incurred in the combat zone are considered combat-related unless there is evidence to the contrary. The hospitalization period ends with the date of discharge from the hospital.

Example 6. James served in a combat zone. Three weeks after leaving the zone, he is hospitalized for a disease. Since the incubation period for the disease is two to four weeks, James' income while in the hospital is excludable since the disease is presumably contracted in the combat zone. If the incubation period began prior to the time James arrived in the combat zone, the income is not excludable.

Military personnel need not be stationed in the combat zone in order to take advantage of the exclusion if their activities are in direct support of operations in the combat zone and they qualify for hostile fire/imminent danger pay. Their duties may involve airspace or adjacent waters qualifying as a combat zone.

Example 7. Marsha is stationed in the combat zone during the month of July. For the period from August 1 to 8, her unit moves to a nearby country which is not a designated combat zone. However, her unit's service is in direct support of the military operations in the combat zone. The unit does not return to the combat zone after that time. Marsha is eligible for the exclusion for the months of July and August.

Example 8. Frank is a member of the ground crew servicing combat aircraft operating in the combat zone. Frank is not stationed in the combat zone. Even though he aids the operation by servicing the aircraft, Frank is not eligible for hostile fire/imminent danger pay, and therefore is not eligible for the exclusion.

The regulations contain certain situations in which military personnel may be present in the combat zone without being eligible for the exclusion. These situations include members of the military stationed outside the combat zone but present in the combat zone while on leave, members who pass over or through the zone going to or from two points located outside the zone, and members in the combat zone solely for their own convenience.

Example 9. Sue is stationed in a nearby country. While on leave she visits a city located in the combat zone. She is not eligible to exclude income because she is not considered to be serving in the combat zone. If Sue were eligible for hostile fire/imminent danger pay from her location, she would be eligible to exclude her income.

2005 Workbook

Death in the Combat Zone. Military members who die during combat or from injuries sustained while serving in a combat zone qualify for a special tax break. Federal income tax for the year of death is forgiven. In addition, the tax is forgiven for **any** earlier tax year ending while serving in a combat zone.⁹ Forgiven tax is tax that does not have to be paid. Any forgiven tax liability that has already been paid will be refunded if the statute of limitations is still open, and any unpaid tax liability at the date of death will be forgiven.

In addition, any unpaid taxes for prior years will be forgiven, and any prior year taxes paid after the date of death will be refunded. The forgiven tax provision also applies to a member of the armed forces serving outside the combat zone if the service:

- Was in direct support of military operations in the zone, and
- Qualified the member for special military pay for duty subject to hostile fire or imminent danger.¹⁰

Example 10. While assigned to an air unit stationed in Turkey, Bob was killed in June 2005 when his plane crashed on returning to the airbase. Bob was performing military service in direct support of the military operations in the Afghanistan combat zone at the time of his death. Bob's service also qualified for hostile fire/imminent danger pay.

Bob is deemed to have died while serving in the combat zone or as a result of wounds, disease, or injury incurred while serving in the combat zone for purposes of IRC §§692(a) and 2201 (relating to estate taxes). The result would have been the same if Bob's mission had been a supply mission rather than a combat mission.

In the case of a joint return, this forgiveness applies only to the income of the decedent and not to the spouse. The IRS provides a formula for the allocation of the decedent's income. The amount of joint liability that can be forgiven is the joint tax liability multiplied⁷ by the decedent's separate tax liability divided by the sum of the decedent and the spouse's separate tax liabilities.

Example 11. In 2004, Bill was killed while serving in Iraq. Bill was married. His wife earned \$25,000. Bill's income after the exclusion was \$35,000. Their joint tax liability for 2004 was \$5,761.

If they had filed separate returns, Bill's liability would have been \$3,704, while his wife's liability would have been \$2,204. Therefore, 62.69% ($\$3,704 \div (\$3,704 + \$2,204)$) of the tax is forgivable.

The following example explains the forgiveness provision for prior years.

Example 12. Toni failed to file income taxes for 2002, 2003, and 2004. On April 20, 2005, Toni was killed while serving in the combat zone. She was scheduled to return home on May 1, 2005, after having served in the combat zone since May 1, 2003.

IRC §692 grants forgiveness for the taxes, interest, and penalty for the 2003, 2004, and 2005 tax years. Toni's estate is still responsible for filing and paying taxes, interest, and penalty for tax year 2002 since she was not serving in the combat zone during 2002.

In addition to the forgiveness of taxes during the combat period, §692 provides for the refund of any taxes which were paid during the combat period, prior to death.

Example 13. John regularly filed his income taxes on April 15. On May 15, 2004, John was sent to Iraq. He was killed on June 12, 2005. John is not liable for income taxes in 2004 or 2005 under the provisions of §692. Since he already filed his 2004 income taxes on April 15, 2005, his estate is entitled to a refund of the amount paid.

If an individual served in **multiple** combat zones prior to being killed while serving in the combat zone, the code allows the forgiveness of taxes for **every year** from the date the individual **first** served in **any** combat zone.

⁹ IRC §692(a)

¹⁰ IRS Pub. 3, *Armed Forces' Tax Guide*

This means that an individual who served in Vietnam and in Iraq and not in a combat zone in between can be forgiven liability for the first year of service in Vietnam, the last year of service in Iraq, and all years in between. Since those years have presumably been filed, a refund may be available for any taxes paid during that period.

Letter Ruling 200447035 answers the question of how long the statute of limitations is available for the collection of refunds for those years. The general rule for claiming a refund under IRC §6511(a) indicates that a claim for refund must be filed within three years from the date the return was filed or two years from the date the tax was paid.

A suspension of the statute of limitations is provided under IRC §7508(a) for those serving in the combat zone. The suspension occurs for the period the individual was serving in the combat zone plus 180 days after the return from the combat zone. If the returns are filed within the statute of limitations, taking into consideration the suspension, the refund will be granted.

Example 14. CCA Letter Ruling 200447035 portrays a situation in which the deceased military person served in a combat zone in Year 1 and was killed while serving in a different combat zone in Year 12. The individual served in **multiple** combat zones during the intervening years. The spouse filed a claim for refund for years 2 through 10. The general rule for determining the statute of limitations applied, taking into consideration the suspension of time for each period in the combat zone plus the 180 days.

Holding of Letter Ruling. The claim for years two through six did not fall within the statute of limitations and was denied. The later claims were all within the statute of limitations and granted. See the Gross Income section of Chapter 13, “Rulings and Cases” for an analysis of this letter ruling.

Note. Any returns that are eligible for the special tax benefits available to military personnel serving in the combat zone should have the words “COMBAT ZONE” written in **red** on the top of the tax return containing the special tax relief. If the taxpayer receives any notices while serving in the combat zone, the term “COMBAT ZONE” should be written on top of the notice and on the envelope to suspend the IRS action during that period.¹¹

RETIREMENT

Military personnel are eligible to make contributions to §401(k) plans. This benefit has only been available for the past few years.

Note. While IRA contributions may be made by military personnel, the exclusion for combat pay should be taken into consideration. An individual must have taxable compensation of \$3,000 or more to make a deductible traditional IRA contribution or a Roth IRA contribution. If the combat-pay exclusion reduces the taxable income below that level and a contribution has already been made to the IRA, the individual must withdraw the excess contribution or be subject to the 6% excise tax.

Example 15. John used his 2004 tax refund to make his 2005 IRA contribution of \$3,000. The contribution was made on February 10, 2005. On February 25, 2005, John was sent to Iraq. He remained there until March 5, 2006.

As an enlisted person, his combat pay was excludable for the entire year of 2005 except the month of January. His income for January 2005 was only \$1,200. John has an excess 2005 IRA contribution of \$1,800. He must withdraw \$1,800 in order to avoid the 6% excise tax for excess contributions. John has an automatic extension period to make the required \$1,800 withdrawal. The extension period is explained later in the “Tax Return Due Date” section.

¹¹. 2004 Pub 3, page 25

Taxability of Retirement Benefits

Military retirement pay based on age or length of service is included in gross income. If the payment is reduced to provide a survivor annuity for the spouse or children of the service person, the reduction is excludable until received. This is the same tax treatment that is available to all taxpayers.

Example 16. Jenny served in the military and is entitled to collect military retirement benefits. Her benefits are \$2,000 per month for her lifetime. She has the option of collecting \$1,300 per month and having a survivor annuity paid to her spouse when she dies.

The \$700 reduction she is entitled to is not taxable to her now if she elects the survivor option. When her spouse receives the benefit in later years, the benefit will be taxable in the same manner as Jenny's benefit was taxable.

Note. In a recent case, the U.S. Bankruptcy Court ruled the IRS was not able to attach the future military retirement pay of an individual in satisfaction of a federal tax lien in bankruptcy.¹²

Divorce. Community property rules apply to military pay when the military family is domiciled in a community property state. This applies to retirement payments as well. In a community property state, income is considered to belong equally to both parties. Therefore, military benefits received by the spouse are treated as part retirement benefits and part alimony.¹³

Reminder. Community property states include Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin.

Disability Pensions. Payments received for personal injury or sickness resulting from active service in the military of any country are excluded from income.¹⁴ While this exclusion is very broad, IRC §104(b) closes the gap by adding conditions. To qualify, a person must fall into one of the following three categories:

1. **Individuals who were members of the armed forces, or who were receiving military disability benefits on or before September 24, 1975.** These are referred to as grandfathered individuals.
2. **Individuals who receive disability pensions after September 24, 1975 for combat-related injuries.** Personal injuries and sickness are combat-related if they are received as a direct result of armed conflict, while engaged in extra hazardous service, or under conditions simulating war.
3. **Individuals who qualify for military disability benefits administered by the Veterans' Administration (VA).**

Rehabilitative program payments made by the VA to hospital patients and resident veterans under the VA's therapeutic or rehabilitative programs are taxable. These payments are reported on line 21 of Form 1040.

LIFE INSURANCE

Death Benefit Gratuity Payment. The death benefit gratuity payment is different from military life insurance. It consists of a direct payment from the government and is **nontaxable** to the recipient. The death benefit gratuity payment is made to beneficiaries of members of the Armed Forces. The payment for deaths occurring prior to September 11, 2001 was \$6,000, with \$3,000 representing taxable income.

¹² *In re Herbert Alonzo Stone, Jr., Debtor*, U.S. Bankruptcy Court, So. Dist. Ala.; May 11, 2004

¹³ *Eatinger v. Commissioner*; TC Memo 1990-310, June 20, 1990

¹⁴ IRC §104(a)(4)

The death gratuity payment for deaths occurring on or after September 11, 2001 increased to \$12,240 beginning in 2005 and is totally nontaxable. It is paid to survivors in order, beginning with the spouse. The claim to request the payment is DD Form 397, *Claim for Certification and Voucher for Death Gratuity Payment*.

Note. If a survivor received the \$12,240 nontaxable payment and paid taxes on \$3,000 of it, an amended return may be filed to claim a refund. The Form 1040X should bear the heading “**Military Family Relief Act**” in red. The normal statute of limitations for refunds applies to the refund claim.

The Emergency Supplemental Appropriations Act of 2005 increased the death benefit gratuity payment to \$100,000 for survivors of those whose death is a result of hostile actions and occurred in a designated combat zone or while training for combat or performing hazardous duty. For more information, see the following web site: usmilitary.about.com/library/milinfo/casualty/blgratuity.htm.

Note. While the \$12,240 payment is made to the next of kin, the additional payment of \$87,760 is only paid to the survivors when the deceased was responsible for their support.

The Social Security Administration also provides a \$255 death benefit to the surviving spouse of a military person or veteran. This is a nontaxable life insurance payment.

Servicemembers’ Group Life Insurance (SGLI). The Emergency Supplemental Appropriations Act of 2005 increased the life insurance from \$250,000 to \$400,000 for all service members effective September 1, 2005. The Department of Defense (DoD) pays or reimburses the premiums to service members who are deployed in a designated combat zone for \$150,000 of SGLI coverage.

Until the effective date of the SGLI increase, the supplemental insurance provides for a special death gratuity of \$150,000. This is retroactive to October 7, 2001. It is paid to survivors of those whose death occurred in a designated combat operation or combat zone or whose death occurred while training for combat or performing hazardous duty.

The SGLI payment is treated the same as any other life insurance payment. However, the \$150,000 benefit for survivors of those who died between October 7, 2001 and September 1, 2005 is a direct payment from the DoD and may not be taxable. The taxability has not yet been determined.

Other Nontaxable Benefits. Benefits paid by the VA are not taxable if they are paid under any laws, regulations, or administrative practices administered by the VA. The following are examples of nontaxable veterans’ benefits:

- Education, training, and subsistence allowances
- Disability compensation and pension payments for disabilities paid either to veterans or their families
- Grants for homes designed for wheelchair living
- Grants for motor vehicles for veterans who lost their sight or the use of their limbs
- Veterans’ insurance proceeds and dividends paid either to veterans or their beneficiaries, including the proceeds of a veteran’s endowment policy paid before death
- Interest on insurance dividends on deposit with the VA
- Benefits under a dependent-care assistance program

SALE OF RESIDENCE¹⁵

The sale-of-residence rules allow an exclusion of \$250,000 (\$500,000 MFJ) of gain from the sale of a home that meets the tests provided in IRC §121. The taxpayer must meet the ownership and occupancy test. The home must be owned and occupied as the main home for two of the last five years ending on the date of sale.

Military personnel may elect to suspend the five-year period while serving on official extended duty. The five-year period may be suspended for up to 10 years. Only one property may be suspended at a time, but a suspension may be revoked. The election is made by filing a return for the tax year in which the sale occurred and not including the gain from the sale or exchange in gross income.¹⁶

To qualify as an official extended duty, the duty station must be at least 50 miles from the taxpayer's main home or the taxpayer must be living in government quarters under government orders. An individual is on extended duty when he is called or ordered to active duty for a period of more than 90 days or for an indefinite period.

Example 17. David bought and moved into a home May 1, 1996. He lived in it as his main home for 2½ years until December 1, 1998. For the next six years, he did not live in it because he was on qualified official extended duty with the Army. He sold the home at a gain in December 2, 2004.

Under the general rules for §121, David did not meet the two-out-of-five year test. However, David chose to suspend the five-year test period for the six years he was on qualifying official extended duty. This means he can disregard those six years. Therefore, David's five-year test period consists of the five years before he went on qualifying official extended duty. **He meets the ownership and use tests because he owned and lived in the home for 2½ years during this test period.**

JOB-RELATED EXPENSES

Job-related expenses generally include travel away from home while on business, meals while away from home, education expenses related to a job, professional dues, and tools related to the job.

Regular military personnel are generally reimbursed for expenses while away from their regular duty station or the expenses are paid in advance. Even if they are away from their family, the permanent duty station, whether it is out of the country or aboard ship, is considered their tax home for this purpose.

If a military person has ordinary and necessary expenses to perform the duty that are not reimbursed, the expenses are deductible in the same manner as for civilian personnel.

Uniforms costs and cleaning that are not reimbursed are deductible if the uniform is not suited for wear while off duty. This includes military battle dress uniforms and utility uniforms if they cannot be worn off duty and articles not replacing regular clothing, including insignia of rank, corps devices, epaulets, aiguillettes, and swords.

Professional dues that may be necessary for a particular rank or position are deductible. Amounts paid to officers' clubs or enlisted personnel clubs are not deductible.

Example 18. Lieutenant Margaret Allen, an electrical engineer at Maxwell Air Force Base, can deduct professional dues paid to the American Society of Electrical Engineers.

¹⁵ IRC §121(d)(9)(B)

¹⁶ Treas. Reg. §1.121-5(b)

Overnight Travel Expenses for Reservists

Unreimbursed travel expenses of military reservists can qualify for special tax treatment. The reservists must:

1. **Travel more than 100 miles** to attend Guard or Reserve meetings or camps, and
2. **Stay overnight** instead of returning to their homes.

Reservists meeting the above two tests may claim an **above-the-line deduction** for expenses related to traveling to the meetings. The deduction is limited to the federal per diem rate for the meeting site.

Observation. The U.S. government per diem rates can be found by accessing **www.gsa.gov** and selecting the “Per Diem Rate” link.

Unreimbursed expenses include:

- Meals,
- Transportation, including auto, and
- Lodging.

Note. A reservist incurring lodging, meal and incidental expenses in excess of the applicable federal government per diem rate may still be able to deduct the excess, but only if the deductions are itemized. In that event, the excess would be subject to the 2% of AGI floor.

Unreimbursed expenses for reservists’ travel is first included as an employee business expense on Form 2106 or 2106-EZ, *Employee Business Expense*. Expenses for overnight travel over 100 miles are subtracted from total expenses and are deducted as an above-the-line deduction on Form 1040. The balance of Form 2106 expenses is allowable on Schedule A as a miscellaneous itemized deduction subject to the 2% AGI floor.

How and Where the Deduction Is Claimed

The unreimbursed expenses are deducted on the 2005 Form 1040, line 24. The deduction is limited to the amount the federal government pays its employees for travel expenses. This limitation is referred to as the **federal per diem rate** for the locality where the expenses were incurred.

Example 19. Otto is a full-time auto mechanic in Decatur, IL. He and his family reside in Decatur. He is also a member of the Air National Guard unit in Springfield, IL, which is 45 miles from Decatur. In **2005**, he made 24 round trips to Springfield to attend reserve meetings. He received no mileage reimbursement and incurred no overnight lodging expenses in Springfield.

Question. Is Otto allowed to deduct auto expenses on his 2005 return?

Answer. Yes. However, since he did not incur any overnight travel expenses, he can deduct them only on Schedule A subject to the 2% AGI limitation. Otto must prepare Form 2106 (or 2106-EZ) to report the unreimbursed auto expense amount.

2005 Workbook

Example 20. Ginger is single. She is employed full-time in Chicago and resides in a Chicago suburb. She is a member of an Army National Guard unit in Rock Island, IL. In **2005**, she made 12 round trips to Rock Island to attend monthly 2-day meetings. She incurred the following unreimbursed expenses to attend the meetings.

Auto mileage

12 round trips	360 miles	4,320 miles	
Standard mileage rate		<u>× 40.5¢</u>	
Total automobile expense			\$1,750

Lodging

12 Saturday nights at the YWCA	\$15 per night		180
--------------------------------	----------------	--	-----

Meals

24 days while in overnight status	\$31	\$744	
(standard meal allowance rate)		<u>× 50% limit</u>	
			<u>372</u>

Ginger's total 2004 unreimbursed overnight travel expenses	\$2,302
---	----------------

Question A. Is Ginger allowed to deduct her travel expenses on her 2005 return?

Answer A. Yes. She met both tests.

- The Rock Island National Guard complex is more than 100 miles from her Chicago tax home.
- She incurred overnight expenses while away from home.

Question B. Where does Ginger deduct the \$2,302?

Answer B. She deducts the \$2,302 on line 24 of her 2005 Form 1040 as shown. She must complete either Form 2106 or 2106-EZ to report the \$2,302 of allowable expense. Ginger's 2005 Form 2106 and Form 1040 are shown on the following pages.

2005 Workbook

For Example 20

Form 2106 Department of the Treasury Internal Revenue Service (99)	Employee Business Expenses ▶ See separate instructions. ▶ Attach to Form 1040.	OMB No. 1545-0139 <div style="border: 1px solid black; padding: 5px; text-align: center;"> 2005 Attachment Sequence No. 54 </div>
Your name Ginger	Occupation in which you incurred expenses Army Nat'l Guard Sgt.	Social security number 999 : 99 : 9999

Part I Employee Business Expenses and Reimbursements

Step 1 Enter Your Expenses	Column A Other Than Meals and Entertainment	Column B Meals and Entertainment
1 Vehicle expense from line 22 or line 29. (Rural mail carriers: See instructions.)	1 1,750	
2 Parking fees, tolls, and transportation, including train, bus, etc., that did not involve overnight travel or commuting to and from work	2	
3 Travel expense while away from home overnight, including lodging, airplane, car rental, etc. Do not include meals and entertainment.	3 180	
4 Business expenses not included on lines 1 through 3. Do not include meals and entertainment.	4	
5 Meals and entertainment expenses (see instructions)		744
6 Total expenses. In Column A, add lines 1 through 4 and enter the result. In Column B, enter the amount from line 5	6 1,930	744

Note: If you were not reimbursed for any expenses in Step 1, skip line 7 and enter the amount from line 6 on line 8.

7 Enter reimbursements received from your employer that were not reported to you in box 1 of Form W-2. Include any reimbursements reported under code "L" in box 12 of your Form W-2 (see instructions)	7	
--	---	--

Step 3 Figure Expenses To Deduct on Schedule A (Form 1040)

8 Subtract line 7 from line 6. If zero or less, enter -0-. However, if line 7 is greater than line 6 in Column A, report the excess as income on Form 1040, line 7	8 1,930	744
Note: If both columns of line 8 are zero, you cannot deduct employee business expenses. Stop here and attach Form 2106 to your return.		
9 In Column A, enter the amount from line 8. In Column B, multiply line 8 by 50% (.50). (Employees subject to Department of Transportation (DOT) hours of service limits: Multiply meal expenses incurred while away from home on business by 70% (.70) instead of 50%. For details, see instructions.)	9 1,930	372
10 Add the amounts on line 9 of both columns and enter the total here. Also, enter the total on Schedule A (Form 1040), line 20. (Reservists, qualified performing artists, fee-basis state or local government officials, and individuals with disabilities: See the instructions for special rules on where to enter the total.) ▶	10	2,302

For Paperwork Reduction Act Notice, see instructions. Cat. No. 11700N **Form 2106** (2005)

6

Note. Military reservists include members of a reserve component of the army, navy, marine corps, air force, coast guard reserve, the army national guard of the United States, the air national guard of the United States, or the reserve corps of the Public Health Service.

Moving Expenses

Moving expenses that are paid out of pocket may be deductible. Military personnel are generally reimbursed for at least part of these costs. The reimbursement amount is based on rank. Unreimbursed moving expenses may be deductible in arriving at AGI.

EDUCATION

Educational expenses to improve job skills may be deductible. Deductibility is based on the same guidelines as used for civilians. The education must be required by the employer or the law or to improve job skills. However, the education must not lead to a new profession.

Example 21. Lieutenant James worked in the military base legal office as a legal intern. He was placed on extended leave status by his employer to attend law school. He paid all his educational expenses and was not reimbursed. After obtaining his law degree, he passed the state bar exam and worked as a judge advocate.

His educational expenses are **not** deductible because the law degree qualified him for a new trade or business, even though the education maintained and improved his skills in his work.¹⁷

Example 22. Lieutenant Colonel Martin has a degree in financial management and is in charge of base finances at her post of duty. She took an advanced finance course. She already meets the minimum qualifications for her job. By taking the course, she is improving skills in her current position. The course does not qualify her for a new trade or business. She can deduct educational expenses that are more than the educational allowance she received.

G.I. Bill

The G.I. Bill allows military personnel to receive monies to attend postsecondary schools. For purposes of the Hope and Lifetime Learning credits, this money is considered a grant or scholarship. Unlike Vietnam-era veterans, today's military personnel must contribute to the fund to be eligible for educational benefits. The contribution is equal to \$100 for each month of the first year of service for a total of \$1,200. This plan is called the Montgomery G.I. Bill.¹⁸

EARNED INCOME CREDIT (EIC)

One of the stipulations of EIC is that the principal place of abode for the taxpayer must be in the United States.¹⁹ Military personnel are treated as having a place of abode in the United States for any period during which the individual is stationed outside of the United States while serving on extended active duty in the military. "Extended active duty" means any period of active duty under a call or order in excess of 90 days or for an indefinite period of time.

Example 23. James Martin is stationed in Germany for 18 months. While on duty in Germany, his wife and two children join him. Box 1 of James' 2005 Form W-2 shows \$25,300. His wife is not employed and he has no other income. The Martins are entitled to claim the EIC for 2005 on their joint return because James is considered to have lived in the United States for purposes of the credit.

¹⁷ Rev. Rul. 72-450, January 1, 1972

¹⁸ www.gibill.va.gov

¹⁹ IRC §32(c)(3)(C)

2005 Workbook

For 2002 and later years, the definition of earned income no longer includes **nontaxable** income such as military basic quarters, living allowances, and §401(k) contributions. Depending on the circumstances, this law change may either increase or decrease the amount of allowable EIC compared to prior law results.

Example 24. Marc is married and has three children. His wife is a stay-at-home mom. Marc's 2005 Form W-2 shows taxable wages of \$32,000. He also receives excludable basic subsistence and housing allowances of \$6,400. With the omission of the \$6,400 excludable income, Marc and his wife's AGI is low enough for them to qualify for EIC.

However, military personnel may elect to treat **nontaxable combat pay** as earned income for EIC purposes. This election is available for 2004 and 2005 tax returns:²⁰

- The nontaxable combat pay is shown in the 2004 Form W-2 in Box 14, with a Code Q.
- The nontaxable combat pay will be shown in the 2005 Form W-2 in Box 12, with a Code Q.

Example 25. Shawna is a single parent with one child. Box 1 (wages) of her 2004 Form W-2 shows \$3,500. She served in a combat zone during a portion of 2004 and received combat pay of \$17,000. She had no other income during 2004.

If Shawna **did not make the election** to include her \$17,000 combat pay as earned income, her 2004 EIC based on \$3,500 would be **\$1,199**. If she **makes the election** to include the nontaxable combat pay as earned income, Shawna's EIC increases to **\$1,560**, based on \$20,500 of earned income with one qualifying child.

FOREIGN EARNED INCOME EXCLUSION (FORM 2555)

The foreign earned income exclusion is not available for military personnel serving in foreign countries since the payments are made by the U.S. government. If the military person or the spouse works in a foreign country and meets the other requirements of the earned income exclusion, they may exclude that income.

Domicile. Where a taxpayer lives may determine whether state taxes are due. In some states, the determination of domicile is made by the state where the individual lived when he entered military service. Generally, the individual must take assertive action to be considered a resident of another state. To change residency, an individual generally must have a driver's license from the state, a permanent address in the state, and be registered to vote in that state.

TAX RETURN DUE DATE²¹

The deadline for filing a tax return is automatically suspended for performing various acts required by the Code for U.S. armed forces personnel serving in a combat zone. IRC §7508 also extends the deadline for those in the U.S. armed forces deployed overseas, away from their permanent duty station in support of operations in a qualified hazardous duty area, but outside the qualified hazardous duty area.

The suspension period includes the time the individual is serving in the combat zone plus the next 180 days following the return from the combat zone. Any time remaining on the filing deadline before entering the combat zone is added to the 180 days. For example, if the taxpayer had 25 days remaining before the original filing deadline and entered a combat zone at that time, he would have 205 days (180 + 25) to file after leaving the combat zone.

The suspension of time applies to the military person as well as the spouse. However, the suspension terminates for the spouse two years after the combat activity of the individual ends.

²⁰ Working Family Tax Relief Act, October 4, 2004

²¹ IRC §7508

The suspended acts include the following:

- Filing any return for income, estate, or gift taxes (Employment and withholding taxes are not covered under this suspension.)
- Paying any income, estate or gift tax
- Filing a petition with Tax Court
- Allowing a credit or refund
- Filing a claim for credit or refund
- Bringing any suit on such claim for refund
- Assessment of any tax
- Giving or making any notice or demand for payment of tax for an IRS liability
- Collection of any IRS liability
- Bringing suit for a liability
- Making a qualified retirement contribution to an IRA
- Allowing a credit or refund of any tax by the IRS
- Any other act designated by the IRS

Power of Attorney (POA). If a military person wishes to file a return or perform tax-related acts while he is out of the country or is physically unable to perform such acts, a power of attorney (POA) is necessary to give someone else the right to perform those acts in the taxpayer's name. A spouse is not exempt from the need to have a power of attorney for military personnel. Form 2848, *Power of Attorney and Declaration of Representative*, gives an appointee the right to perform IRS functions in the name of the taxpayer. However, a durable power of attorney with tax privileges may better serve the individual. POAs relating to tax matters should be attached to the tax return.

An exception is provided in 2004 IRS Pub. 3, *Armed Forces' Tax Guide*.

Spouse in combat zone/qualified hazardous duty area. *If your spouse is unable to sign the return because he is serving in a combat zone/qualified hazardous duty area or is performing qualifying service outside of a zone/area, and you do not have a power of attorney, you can sign for your spouse. Attach a signed statement to your return that explains that your spouse is serving in a combat zone.*

Note. See page 10 of the 2004 *University of Illinois Federal Tax Workbook* for more details on this exception to the POA requirement.

EXCISE TAX EXEMPTIONS

Notice 2003-21 contains a provision which exempts phone calls from excise tax on toll telephone services when made from the Arabian peninsula areas by members of the U.S. armed forces serving there. This provision became effective January 23, 1991. A certificate of exemption must be furnished to the telephone service provider receiving payment for the call. If the payment has already been made, a refund may be obtained from the service provider or by filing Form 8849, *Claim for Refund of Excise Taxes*.²² The exemption and refund request is shown on the following page.

2005 Workbook

EXEMPTION CERTIFICATE

(Overseas Telephone Calls)

(Date)20

I certify that the toll charges of \$..... are for telephone or radio telephone messages originating at (Point of origin) within a combat zone from (Name) a member of the Armed Forces of the United States performing service in such combat zone; that the transmission facilities were furnished by (Name of carrier); and that the charges are exempt from tax under section 4253(d) of the Internal Revenue Code.

(Signature of Subscriber)

(Address)

²² IRC §4253(d)

2005 Workbook

From IRS Pub. 3, *Armed Forces' Tax Guide*.

Table A. Included Items

These items are included in gross income, unless the pay is for service in a combat zone.

Basic pay <ul style="list-style-type: none"> • Active duty • Attendance at a designated service school • Back wages • CONUS COLA • Drills • Reserve training • Training duty 	Bonuses <ul style="list-style-type: none"> • Career status • Enlistment • Officer • Overseas extension • Reenlistment
Special pay <ul style="list-style-type: none"> • Aviation career incentives • Career sea • Diving duty • Foreign duty (outside the 48 contiguous states and the District of Columbia) • Foreign language proficiency • Hardship duty • Hostile fire or imminent danger • Medical and dental officers • Nuclear-qualified officers • Optometry • Pharmacy • Special duty assignment pay • Veterinarian 	Other payments <ul style="list-style-type: none"> • Accrued leave • High deployment per diem • Personal money allowances paid to high-ranking officers • Student loan repayment from programs such as the Department of Defense Educational Loan Repayment Program when year's service (requirement) is not attributable to a combat zone
	Incentive pay <ul style="list-style-type: none"> • Submarine • Flight • Hazardous duty • High altitude/Low altitude (HALO)

Table B. Excluded Items

The exclusion for certain items applies whether the item is furnished in kind or is a reimbursement or allowance. There is no exclusion for the personal use of a government-provided vehicle.

Living allowances <ul style="list-style-type: none"> • BAH (Basic Allowance for Housing). You can deduct mortgage interest and real estate taxes on your home even if you pay these expenses with your BAH • BAS (Basic Allowance for Subsistence) • Housing and cost-of-living allowances abroad whether paid by the U.S. Government or by a foreign government • OHA (Overseas Housing Allowance) 	Combat zone pay <ul style="list-style-type: none"> • Compensation for active service while in a combat zone or a qualified hazardous duty area. Note: Limited amount for officers
Moving allowances <ul style="list-style-type: none"> • Dislocation • Military base realignment and closure benefit paid after November 11, 2003 (the exclusion is limited as described on page 5) • Move-in housing • Moving household and personal items • Moving trailers or mobile homes • Storage • Temporary lodging and temporary lodging expenses 	Family allowances <ul style="list-style-type: none"> • Certain educational expenses for dependents • Emergencies • Evacuation to a place of safety • Separation
Travel allowances <ul style="list-style-type: none"> • Annual round trip for dependent students • Leave between consecutive overseas tours • Reassignment in a dependent restricted status • Transportation for you or your dependents during ship overhaul or inactivation • Per diem 	Death allowances <ul style="list-style-type: none"> • Burial services • Death gratuity payments to eligible survivors • Travel of dependents to burial site
	Other payments <ul style="list-style-type: none"> • Defense counseling • Disability, including payments received for injuries incurred as a direct result of a terrorist or military action • Group-term life insurance • Professional education • ROTC educational and subsistence allowances • Survivor and retirement protection plan premiums • Uniform allowances • Uniforms furnished to enlisted personnel
	In-kind military benefits <ul style="list-style-type: none"> • Dependent-care assistance program • Legal assistance • Medical/dental care • Commissary/exchange discounts • Space-available travel on government aircraft

TEACHERS

Congress passed laws to recognize contributions teachers make to their students' education. The following discusses some of the benefits available to teachers and to students.

INCOME

Grants and scholarships are generally not taxable to the extent the grant or scholarship is used for tuition, books, or related fees.²³ When the amount of the scholarship or grant exceeds these expenses, the excess is included on Form 1040, line 7. If the taxable amount is not reported on a Form W-2, "SCH" is printed on the dotted line next to the taxable amount.

Grants/Scholarships

If a scholarship is in the form of a work-study program or research grant, the recipient generally receives a Form W-2. The following worksheet from IRS Pub. 970, *Tax Benefits for Education*, may be used to determine the taxable amount.

Worksheet 1-1. Taxable Scholarship and Fellowship Income

1. Enter your scholarship or fellowship income for 2004	1. _____
<ul style="list-style-type: none"> • If you are a degree candidate at an eligible educational institution, go to line 2. • If you are not a degree candidate at an eligible educational institution, stop here. The entire amount is taxable. For information on how to report this amount on your tax return, see <i>Reporting Scholarships and Fellowships</i>. 	
2. Enter the amount from line 1 that was for teaching, research, or any other services. (Do not include amounts received for these items under the National Health Service Corps Scholarship Program or the Armed Forces Health Professions Scholarship and Financial Assistance Program.)	2. _____
3. Subtract line 2 from line 1	3. _____
4. Enter the amount from line 3 that your scholarship or fellowship required you to use for other than qualified education expenses	4. _____
5. Subtract line 4 from line 3	5. _____
6. Enter the amount from line 5 that was used for qualified education expenses required for study at an eligible educational institution. This amount is the tax-free part of your scholarship or fellowship income*	6. _____
7. Subtract line 6 from line 5	7. _____
8. Taxable part. Add lines 2, 4, and 7. See <i>Reporting Scholarships and Fellowships</i> for how to report this amount on your tax return	8. _____

* If you qualify for other education benefits (see chapters 2 through 12), you may have to reduce the amount of education expenses qualifying for a specific benefit by the tax-free amount on this line.

²³ IRC §117

2005 Workbook

Caution. The following table from IRS Pub. 970 shows the taxability of scholarship and fellowship payments. However, the table should not be exclusively relied upon.

Table 1-1. **Taxability of Scholarship and Fellowship Payments¹**

Do not rely on this table alone. Refer to the text for complete details.

IF you use the payment for...	AND you are...		THEN your payment is...	
	A degree candidate	Not a degree candidate	Tax free ²	Taxable
Tuition	X		X	
		X		X
Fees	X		X ³	
		X		X
Books	X		X ³	
		X		X
Supplies	X		X ³	
		X		X
Equipment	X		X ³	
		X		X
Room	X			X
		X		X
Board	X			X
		X		X
Travel	X			X
		X		X

¹ Does not include payments received for past, present, or future services.

² Payments used for any expenses indicated in this column are tax free only if the terms of the scholarship or fellowship do not prohibit the expense.

³ If required of all students in the course.

Fulbright Grants

Fulbright grants are made to U.S. citizens and nationals of other countries for a variety of educational activities, primarily university lecturing, advanced research, graduate study, and teaching in elementary and secondary schools. A Fulbright Grant is generally treated as a scholarship or fellowship in determining how much of the grant is tax-free.²⁴

When a Fulbright scholar performs services in a foreign country, income earned is **not** considered foreign income for purposes of the foreign earned income exclusion and is not excludable. In the *Dowd* case, a lecturer was in Japan for 21 months. The court held that monies received were not eligible for the foreign earned income exclusion because the monies were paid by the United States Education Commission in Japan.²⁵

²⁴ Letter Ruling 8817010, December 30, 1987

²⁵ *L.P. Dowd*, 37 TC 399, December 4, 1961

FICA

Grants or stipends received for services provided are generally subject to FICA. However, when research does not benefit a particular group, but rather benefits society as a whole, the payment is not subject to FICA or self-employment (SE) tax. Payments received by those who are not candidates for degrees are not earnings for self-employment purposes.²⁶ In *Spiegelman*, a postdoctoral fellowship grant awarded by the university for independent research was not subject to SE tax. The taxpayer's efforts did not economically benefit the university and no services were required by the taxpayer. The taxpayer performed his research and studies primarily to further his own education and training.²⁷

Awards

Teachers may receive awards from local community groups or national organizations. The awards are generally treated as taxable income under IRC §§61 or 74, but are not wages subject to FICA since they are not paid by the employer or considered as part of the wage package. The "Golden Apple Award" is an example of an award given to a teacher who has been recognized by a local/state community as an outstanding educator. The state of Illinois has an award program that gives awards to 10 teachers state-wide. Recipients receive the following:

- A paid sabbatical at Northwestern University in Evanston, Illinois. Winners may take as many courses as they wish in any subjects they choose. As part of the sabbatical, the winners, as a group, design a seminar series to which they invite, as guests, individuals who are making significant contributions in the field of education.
- Apple personal computer
- \$2,500 stipend
- Induction into the Golden Apple Academy

The fair market value of these items is includable in income of the teacher on Form 1040, line 21.

The Golden Apple Foundation also has a program for graduating high school seniors who are entering the field of education at one of 53 Illinois schools. One hundred students are chosen for this program. Recipients of the **scholarship loans** are entitled to a \$2,500 yearly scholarship loan for each of four years. As a condition of receiving this scholarship loan, the student must be willing to teach for five years in an Illinois school of need, maintain a certain GPA, adhere to a prescribed code of conduct while in college, and participate in summer institutes. Students receive a stipend of \$2,000 for participation in the summer institutes. Since the scholarship loan must be repaid, there are no tax consequences associated with the loan and dollars spent may be used for purposes of the Hope or Lifetime Learning credits. **The stipend is taxable income and also qualifies as dollars spent toward the Hope and Lifetime Learning credits.**

Student Loans

Other types of loans may be available to teachers either to provide initial or ongoing education. Generally, if the loan is forgiven, the amount of debt forgiven must be included in income. The forgiveness of debt is included on Form 1040, line 21. If a school offers to repay the loan of a teacher as an inducement to employment, the repayment is considered wages and subject to applicable payroll taxes. Certain government loans are forgiven without additional income. These loans have to specifically allow the forgiveness under certain conditions. For example, in the early 1970s, the federal government offered loans to teachers under the Gerald Ford Direct Student Loan Program. If the student became a teacher and taught for a certain amount of time in an inner city area, the loans were forgiven without income tax consequences.

²⁶ Rev. Rul. 60-378, January 1, 1960

²⁷ *Spiegelman*, 102 TC 394, March 8, 1994

JOB-RELATED EXPENSES

Qualifying expenses for teachers are ordinary and necessary items which are not eligible for reimbursement from the school. These items may include such things as arts and craft items, decorations, food, party supplies, prizes, and awards. These expenses are deducted on the front page of Form 1040 and/or Schedule A.

Professional fees include union dues, liability insurance, job-seeking expenses, licenses, professional dues, resumes, lab coats, uniforms, and costs of attending conventions. The cost of certification in another state is also a deductible expense. This may include the cost of classes necessary to meet the specific requirements of that state after becoming a teacher in another state.²⁸ However, the cost of obtaining the initial teaching credentials is not deductible as a job-related expense.²⁹

Travel as a form of education is not deductible. Travel incurred to attend classes is deductible. Foreign travel must be reasonable. The classes must be classes that are not available within the United States.

In *Jorgensen*, an English teacher was allowed to deduct travel expenses that she incurred in connection with the university classes she took in Greece and Asia. She taught at a culturally diverse high school with a high contingency of Asian students. The courts ruled that the course content enhanced her teaching despite the IRS's contention that the travel overshadowed the classroom experience.³⁰

Computers purchased for use outside the classroom are depreciable. However, any personal use of the computer reduces the deduction. The teacher should keep a log to substantiate the business use of the computer. Other depreciable items include equipment purchased for use in the classroom. The same proof of personal versus business use is required if the equipment is not kept in the classroom.

The **home office** of a teacher rarely meets the definition required under IRC §280A. Most schools provide space for the teacher within the school setting. If a school does not provide space, a deduction on Form 2106 is allowed. In this case, the teacher should obtain a letter from the school. The letter should say space is not available and the letter kept with the tax file.

Teachers, like other professionals, are encouraged to improve their job skills by attending **continuing professional education** classes. Teachers may also be driven by the incentive of higher wages as more classes are completed. Many pay scales for teachers increase by the number of graduate credits earned. The employer or law must require education to maintain or improve job skills in order for the expense to be deductible. However, it may not prepare the teacher for a new line of work. In *Crain*, the court held that education costs paid to move a taxpayer from a licensed practical nurse to a registered nurse is not allowed because it prepares the individual for a new line of work.³¹ However, advanced degrees within the teaching community are allowed as long as they are related to the current position of the teacher. For example, in *Picknally*, a teacher with 10 years experience was allowed to seek a PhD in education administration. He was considered to be in the trade or business of being an educator.³²

Note. At the time the classes are taken, it is important to be employed in a position that is reasonably close to the new position. In *Mulherin*, the courts rejected educational expenses as business deductions when the current employment was not related to the education field. The cost of graduate school was denied to a former teacher who had resigned her position four years earlier and substantially decreased her other business activities. The court ruled she was not involved in carrying on a trade or business.³³

²⁸ Rev. Rul. 71-58, January 1, 1971

²⁹ *E.R. Marks*, CA-9, 68-1 USTC ¶9255, March 1, 1968

³⁰ *A. Jorgensen*, TC Memo 2000-138, April 13, 2000

³¹ *T.M. Crain*, TC Memo 1985-498, September 23, 1985

³² *R.J. Picknally*, TC Memo 1977-321, September 20, 1977

³³ *B.C. Mulherin*, TC Memo 1981-454, April 24, 1981

There are a number of interesting cases addressing the IRS interpretation of allowable expenses for teachers. The deductions were **disallowed** in the following three cases:

1. A second grade teacher claimed \$13,055 of miscellaneous 2% items for which she had no receipts other than a few for manicures. She also claimed an education credit for supplies purchased for her students over a course of five years, all during the year in question. She did not provide any evidence to substantiate the deduction and they were disallowed.³⁴
2. Mrs. Garcia was a high school English teacher who claimed birthday and wedding presents for graduates and former students, subscriptions to periodicals of general interest, contributions to holiday parties, toiletry items, dry cleaning, viewings of videos at home, and film used to take pictures of students. The court denied these deductions, labeling the expenses as personal in nature rather than ordinary and necessary. She also deducted the cost of European travel. The court also disallowed the travel under the restriction of travel as a form of education. Mr. Garcia, the high school golf coach, deducted his membership to the local country club because the school did not provide a facility where he could practice and maintain his golf skills. The court denied the deduction as nondeductible club dues even though the golf team was allowed to practice two to three times a week because of the membership. The court upheld the IRS assessment of the accuracy related penalty. The taxpayers, in this case, prepared their own return and did not seek professional advice.³⁵
3. A math teacher deducted comic books he purchased for an extracurricular club that he arranged. After leaving the school's employment, he kept the magazines as part of his collection. The court did not allow the expenses as an educational expense.³⁶

Not all cases before the IRS result in a disallowance of educational expenses. In the *Feinstein* case, a teacher deducted party expenses (including food).³⁷ The court, in this case, did not hold firm to the definition of ordinary. There was flexibility to accomplish the objective of learning. The *Jefferson* case reiterated the qualification of teaching supplies as professional expenses under §162.³⁸ In the *Patterson* case, the appeals court reprimanded the first court for finding the expenses nonqualifying.³⁹

Educator Expenses Allowed as an Adjustment to Income

The income adjustment for educator expenses is limited to \$250 per qualifying taxpayer.⁴⁰ The excess expenses are reported on Form 2106, *Employee Business Expenses*.

The taxpayer must be a kindergarten-through-12th-grade teacher, instructor, counselor, principal, or aide in a school for at least 900 hours during the school year. The school must be an elementary or secondary school under state law. Eligibility for home schooling individuals depends on how the home school is viewed under state law and whether the "teacher" is eligible to claim teaching expenses on Form 2106.

Qualified expenses include ordinary and necessary expenses paid in connection with books, supplies, equipment (including computer equipment, software, and services), and other materials used in the class room.

³⁴ *Renee Muhammad v. Commissioner*, TC Summary Opinion 2005-7, January 10, 2005

³⁵ *Rodolfo Garcia, Jr. and Penny A Garcia v. Commissioner*, TC Summary Opinion 2005-2, January 3, 2005

³⁶ *Kenneth Miles and Michon Snow Tesar v. Commissioner*, TC Memo 1997-207; May 5, 1997

³⁷ *Feinstein*, TC Memo 1970-288, October 8, 1970

³⁸ *Jefferson*, 74-1 USTC 9205, September 10, 1974

³⁹ *Patterson* (CA-9), 71-1 USTC 9161, January 12, 1971

⁴⁰ IRC §62(a)(2)(D)

2005 Workbook

To be deductible, the **qualified expenses** must be more than the following amounts for the tax year:

- The interest on qualified U.S. savings bonds that is excluded from income because it was used to pay qualified higher education expense
- Any distribution from a qualified tuition program that is excluded from income
- Any tax-free withdrawals from a Coverdell Education Savings Account

The adjustment to income was extended by the Working Family Tax Relief Act of 2004 through calendar year 2005.

EDUCATION INCENTIVES

The Lifetime Learning credit is also available to teachers. This credit is 20% of the first \$10,000 of eligible expenses. Eligible expenses include tuition and related fees.

As an **alternative to the education credit**, the teacher may take an adjustment to income for the tuition and fees under IRC §222. The allowable adjustment depends on the income level of the teacher. A \$4,000 adjustment is allowed when the modified adjusted gross income (MAGI) does not exceed \$65,000 (\$130,000 MFJ). For educators with MAGI not exceeding \$80,000 (\$160,000 MFJ), a \$2,000 adjustment is allowed. When the marginal tax rate is 25% or higher, this educational incentive may prove more beneficial. This is also true in situations in which the income is too high to qualify for the credit. Under current law, this incentive is gone after 2005.

A third alternative for the teacher is to use educational expenses as a Form 2106 expense. The tuition and fees are deductible as an itemized deduction even when the credit or adjustment is disallowed because of income limitations. In addition, the 2% miscellaneous deduction includes travel expenses and books.

OTHER

Social Security Coverage

In certain states, teachers are not a part of the social security system. They are included in state retirement plans.

A teacher is generally an employee for social security purposes whether it is a state plan or the federal government plan. However, Rev. Rul. 55-206 states that an individual who holds himself out to the public as a private tutor and is carrying on a business is subject to self-employment tax. However, a substitute teacher in a public school is deemed to be an employee and is not self-employed.

Retirement Coverage

Teachers may be allowed to contribute additional amounts to the retirement system to qualify for retirement. This amount is treated as additional basis in the retirement plan and reduces the taxable amount of benefits received. The reduction is considered part of the taxpayer's after-tax cost in the retirement plan and is spread over the payments received.

Certain states treat teacher retirement as nontaxable income. For federal purposes, teacher retirement is taxable.

Foreign Educators

Many educators from foreign countries come to study in the United States. They may receive a stipend from a U.S. educational institution or may have income from foreign sources. If the U.S. educational institution pays them, the income may be subject to tax when it is in excess of tuition and books. The stipend for living expenses may result in taxable income. Generally, foreign educators are admitted to the United States on a J, Q, F, or M visa. As such, their time in the United States does not qualify as days of physical presence. Therefore, these students must file a Form 1040NR, *U.S. Nonresident Alien Income Tax Return*, to report any taxable income.

It is important to consider the effect of tax treaties on foreign educators. Certain tax treaties contain benefits that may change the tax treatment of the income. For example, Article 22 of the tax treaty with India states that a teacher, professor, or research scholar who visits the U.S. for a period of not more than two years for the purpose of teaching or research at the university, and who was a resident of India immediately prior to the trip to the U.S., is exempt from income received for teaching or research in the U.S. during that two-year period.

CLERGY

The terms *minister* and *clergy* in this text include all pastors, ministers, rabbis, teachers, and others, regardless of religious denomination, as long as the individual fits the definition of *minister*. Also, the term *church* refers to the governing body of each religion, whether it has a physical building or not, and regardless of whether the denomination refers to the physical building as a *church*, *temple*, or *mosque*.

The taxation of clergy members is an issue that is complex and often controversial. There are four main parts of the Code that treat clergy differently from other occupations. These parts include:

- The treatment of clergy as employees for income tax purposes, yet as self-employed for social security purposes;⁴¹
- The exclusion of housing allowances from income for income tax purposes;⁴²
- The exemption from FICA/SECA taxes, if the minister meets certain conditions; and ⁴³
- The exemption from federal and possibly state income tax withholding. ⁴⁴

CLERGY DEFINED

Whether an individual is in fact a clergy member depends on the specific facts and circumstances of each particular religion.⁴⁵ The Regulations state that an individual is required to be a duly ordained, commissioned, or licensed minister of a church. The requirement to meet any of these terms is up to the religious denomination itself.

IRS regulations attempt to ensure a minister is indeed a minister and not an individual trying to take advantage of ministerial tax benefits while not being a true minister.

Specific services that are considered duties of clergy vary by religion. Examples of specific services include the:

- Performance of sacerdotal functions,
- Conduct of religious worship,
- Administration and maintenance of religious organizations and their integral agencies, and
- Performance of teaching and administrative duties at theological seminaries.

Also mentioned in the Regulations are services performed by a qualified minister as an employee of the United States (or a state, territory, or possession of the United States) as long as the services include services which are ordinarily the duties of a minister. The Regulations exempt from this definition chaplains in the armed forces whose service is considered that of a commissioned officer in the individual's capacity as such and not as a minister in the exercise of the ministry.⁴⁶

⁴¹. IRC §§1402 and 3121

⁴². IRC §107

⁴³. IRC §1402

⁴⁴. IRC §3401

⁴⁵. Treas. Reg. §1.1402(c)-5

⁴⁶. Treas. Reg. §1.107-1(a)

2005 Workbook

The following cases and rulings help define who qualifies as clergy:

- An ordained minister acting as president of an exempt charitable corporation that furnishes financial advice to churches, teaching chapel management and stewardship programs, was found to not be acting in the capacity of a minister. Also, the corporation did not have an affiliation with a church or religious organization.⁴⁷
- An ordained minister employed to perform services as a director of pastoral care at a public hospital was deemed to be performing ministerial duties.⁴⁸
- A “minister of music” (choir and music director) and a “minister of education” (Sunday school director) did not qualify as ministers since they were not ordained, commissioned, or licensed as ministers.⁴⁹
- A full-time cantor of the Jewish faith was held to be a minister in two cases.⁵⁰
- Unordained members of a religious organization that provides for ordination of ministers, who have been commissioned by a church and perform substantially all of the same functions within the tenets and practices of their religious denomination are treated the same as ordained ministers.⁵¹
- Individuals performing ministerial functions in a religious denomination which has no formal ordination, commission, or licensing procedure can be treated as ordained ministers.⁵²
- A minister does not have to be exercising the sacerdotal functions in the church of the faith where the minister is ordained.⁵³

Individuals who may qualify as a minister include:

- Teachers or administrators,⁵⁴
- Authors of religious books,⁵⁵
- Jewish cantors,⁵⁶
- Administrators in parochial schools,⁵⁷
- Administrators of nonprofits,⁵⁸
- Prison chaplains,⁵⁹ and
- Ministers in support of foreign missions.⁶⁰

⁴⁷ Rev. Rul. 78-172, January 1, 1978

⁴⁸ Letter Ruling 8519004, January 28, 1985

⁴⁹ Rev. Rul. 59-270, January 1, 1959

⁵⁰ *D. Silverman*, Court of Appeals, 8th Circuit, 73-2 USTC 9546, July 11, 1973, and *A.A. Salkov*, 46 TC 190, May 6, 1966

⁵¹ Rev. Rul. 65-124 (1965), modified by Rev. Rul. 78-301 (1978), Rev. Rul. 58-221 (1958), Rev. Rul. 63-90 (1963), and Rev. Rul. 70-549 (1970)

⁵² Rev. Rul. 66-90 (1966) modified by Rev. Rul. 78-301 (1978)

⁵³ Special Ruling, September 1, 1955

⁵⁴ Rev. Rul. 57-107, January 1, 1957

⁵⁵ Rev. Rul. 59-50, January 1, 1959

⁵⁶ Rev. Rul. 58-221, January 1, 1958

⁵⁷ Rev. Rul. 62-171, January 1, 1962

⁵⁸ Rev. Rul. 68-68, January 1, 1968

⁵⁹ Letter Ruling 9052001, July 17, 1990

⁶⁰ *M.A. Mosley*, 68 TCM 708, September 14, 1994

EMPLOYMENT STATUS

The proper treatment of a clergy's income and expenses depend on the "true" employment status of that person. The result of this status determines where income and expenses are reported. An employee reports income on Form 1040, line 7, while a self-employed individual reports income on Schedule C.

The independent contractor tests commonly used by the IRS to determine if a worker is an employee or an independent contractor also apply to clergy. A minister's role does not often require a great deal of actual control by the church. Only the right to control the minister needs to be shown through the supervision necessary for that occupation.⁶¹

Employee

It is important to determine if the church has the right to control enough of the activities of the clergy to be considered an employer of the clergy.

Most individual churches allow clergy to perform their ministerial duties in their own way. Every minister has a distinct way of preaching. However, most churches have the right to control how the clergy perform their work. Control can be demonstrated by the following:

- The church requires the minister to preach the church's basic teachings. For example, a Baptist church requires the minister to teach the Baptist theology and the Roman Catholic Church requires the priest to teach the Roman Catholic theology.
- The church requires the minister to conduct services during specific times. For example, a church that normally has services at 8 am and 11 am on Saturday requires the minister to perform the services at those times and may not allow the minister to change the service times to Tuesday nights at 9 pm and Fridays at noon.
- The church requires the minister to preach at the church building and does not allow the minister to permanently move the services to other locations.
- When a minister leaves, the church finds a new minister. It may contact higher levels in the church, such as a district office, to help find a new minister. Most churches do not advertise the position in the newspaper, but have specific ways to find a new minister.
- The local church may not be able to terminate a minister's employment. Some churches require that a higher administrative level individual be involved in the decision. Although the local church may not be able to terminate employment, it does have the control through its higher administrative levels.

The following case helps define employee control:

Michael Weber was a United Methodist (UM) minister. His church treated him as an independent contractor; however, the IRS ruled he should have been treated as an employee. The Tax Court took over 18 months to rule that Mr. Weber was an employee. This decision was upheld by the Court of Appeals, 4th Circuit, who pondered the matter for less than one month. The Appellate Court made special mention of a few items including the fact that the "Book of Discipline states that a 'local pastor shall be under the supervision of a district superintendent and a counseling elder who shall supervise the local pastor's work in the ministerial course of study and give counsel on matters of pastoral responsibility.'"⁶²

⁶¹ *McGuire v. United States*, 349 F2d 644, 646 (9th Cir. 1965), August 5, 1965

⁶² *Weber*, Court of Appeals, 4th Circuit, 95-2 USTC, July 31, 1995

2005 Workbook

Independent Contractor

A traveling evangelist is probably the best example of a minister who is an independent contractor. Many evangelists travel from city to city and their compensation is determined by the amounts given through an offering. They commonly preach in their own style and with their own message. They are often not affiliated with one specific religion.

Dual Status

Most clergy are employees and earn the distinction of being dual status taxpayers. They are employees for purposes of calculating income tax while they are self-employed for purposes of calculating their FICA/SECA tax.

INCOME

Clergy who are employees should receive a Form W-2 from the church. The Form W-2 should include the wages paid to the clergy member in Box 1. This income should be reported on Form 1040, line 7 as wages. Boxes 3 and 5, social security wages and Medicare wages, should be blank because a clergy member who is an employee is still considered a self-employed individual for FICA/SECA tax purposes. If the church fails to issue a Form W-2, the church is liable for the same penalties as other employers who fail to issue a Form W-2, even though they may not have payroll tax obligations.

Clergy who are employees report income on Form 1040, line 7 as wages, even if the clergy receive no statement or a Form 1099. **The status as an employee requires the reporting of the income as wages.**

Federal income tax withholding for clergy is optional. The church may withhold federal income tax only if both the clergy and the church agree. If withholding is agreed to by both parties, the amount of withholding is based on the clergy's Form W-4. There is no maximum amount of withholding except that it cannot exceed the clergy's pay. Some clergy request enough withholding to cover both the anticipated income taxes as well as the anticipated self-employment taxes.

The church **cannot** under any circumstances withhold FICA taxes from the clergy's pay.

Note. The SE tax causes the most problem for clergy. Since withholding of FICA is not allowed, having federal income taxes withheld or filing estimated tax payments may be necessary to avoid underpayment penalties.

Ministerial-related expenses paid by the minister are reported on Form 2106 and claimed as a miscellaneous 2% itemized deduction in the same manner as any other employee. If the clergy member is receiving a housing allowance, adjustments related to the tax-exempt portion of his income must be made before the expenses are reported on Form 2106. This is discussed later.

Compensation: Pay

Clergy usually receive a regular paycheck as compensation for services. Clergy members are not treated differently than other employees, except for the withholding mentioned previously.

Other Compensation

Clergy often receive other monies throughout the year. These amounts may or may not constitute compensation. These may include the following:

1. **Housing Allowance.** A housing allowance is normally considered compensation, but may be tax-free for income tax purposes. This is discussed later.
2. **Utility Allowance.** The utility allowance is treated in the same manner as a housing allowance.
3. **Various Allowances/Reimbursements.** Other types of allowances are for common business expenses and often include auto allowance/expenses and other business expense allowances which may or may not be compensation. If these amounts are paid to the clergy under an **accountable plan**, they are not income. If these amounts are **not paid** under an accountable plan, they are considered additional wages.
4. **Other Income Sources.** Other income can include gifts given to clergy to show the church's appreciation for his past and future services. Since the church (the clergy's employer) is paying these amounts, they are treated as additional compensation. Even gifts to the pastor's wife are included in this compensation unless they are outside the church relationship.⁶³
5. **FICA Adjustment or Offset.** The FICA adjustment is an additional amount paid to clergy to help cover the self-employment tax the clergy member must pay on his earnings. The church is paying the amount it would have paid if the clergy had been a FICA employee (7.65%). This is treated as additional compensation.
6. **Honorariums.** Honorariums are amounts received for speaking, officiating at religious ceremonies, counseling, and writing. The amount is reported on Schedule C if:
 - The clergy is allowed to keep the monies,
 - The money received is outside of the clergy's regular salary, and
 - The money is paid by others outside of the church.

If the church requires the clergy member to give these monies to the church, they are not income to the clergy.

GIFTS

Small or Nominal Noncash Gifts. If the small gifts are for special occasions, they are excluded from the clergy's income. This only applies if the gifts are noncash gifts of small monetary value. This is the same treatment as all employer/employee gifts.⁶⁴

Gifts from Individual Members. If a gift is made outside the congregation, is not solicited by the congregation as a whole, and is not for a service provided, the gift is nontaxable. For example, a Christmas gift given to the clergy by an individual is nontaxable.

Cash Gifts. If a gift is made by the church for holidays, anniversaries, or any other reason, it is considered compensation if given through the church or solicited by the congregation as a whole.⁶⁵

Gifts to a Retiring Clergy Member. If retirement gifts are known in advance, they are taxable. If they are unknown in advance and have no relationship to future services, they may be nontaxable. To be nontaxable, the gifts have to be made as a result of the closer relationship between the church and the clergy than that of a normal employer/employee relationship.

⁶³ *Lloyd Goodwin*, US Court of Appeals, 8th Circuit, 94-3796, October 4, 1995

⁶⁴ Rev. Rul. 59-58, January 1, 1959

⁶⁵ *Lloyd Goodwin*, US Court of Appeals, 8th Circuit, 94-3796, October 4, 1995

2005 Workbook

In *Hershman*, Mr. Hershman was a rabbi who served his congregation for almost 40 years. The congregation adopted a resolution in 1937 that Mr. Hershman would be paid an annual pension of \$5,000 upon his retirement. When Mr. Hershman retired in 1949, the congregation approved an increase in the amount to \$7,500. Since the \$5,000 was known ahead of time, it was taxable as a pension. The extra \$2,500 was a gift for past services and was nontaxable.⁶⁶

In another case, Dr. Schall worked as a pastor for the church for 18 years, receiving about \$6,000 per year. When he retired in 1939 for health reasons, the congregation accepted his resignation and gave him a gift of \$2,000 for past services. Dr. Schall did not ask for this gift, nor was there any such provision existing prior to Dr. Schall's retirement.⁶⁷

The court made the same ruling in *Mutch*⁶⁸ and the IRS has since acquiesced and now allows this treatment.⁶⁹

HOUSING ALLOWANCE

A housing allowance (or parsonage allowance) may be part of the pay package provided to clergy. It must be specifically designated in the employment agreement prior to the payment. The employing body (i.e., church) must make this designation. It can appear in the clergy's contract, the organization's minutes, the budget, voters' meeting minutes, or any other official document. Some churches make the designation "from this day forward, until changed." This avoids having to make the designation every year.

Some clergy members also receive a **utility allowance**, which is treated the same as a housing allowance. The value of housing provided **in-kind** by the church, including utilities, is treated as housing allowance.

The amount of a housing allowance which is nontaxable is the smaller of:

- The amount actually used to provide a "home,"
- The amount officially designated as a housing allowance, or
- The fair rental value of the home with all utilities and furniture furnished.

Because the housing allowance is excludable, **if properly documented**, it is an excellent tax benefit for the clergy member. Therefore, church officials should be sure they comply with all IRS regulations.

Retired clergy may also use this exclusion for housing allowances provided to them as compensation for past services if the designation has been made.⁷⁰ The national governing body of a religious organization, which has control over a clergy's pension funds, can designate a portion as housing allowance.⁷¹ This exclusion does not extend to the widow(er) of a clergy member who continues to receive the compensation or pension payment.⁷²

Note. A traveling evangelist may exclude amounts received from various churches as housing allowances by having the churches designate in advance a portion of the honorariums as housing allowance.⁷³

There is neither a specific dollar limit nor a percentage limitation on the amount that can be designated as housing allowance. Any housing allowance that exceeds the nontaxable amount as described above is taxable. This excess housing allowance must be reported as wages on the minister's Form 1040.⁷⁴

⁶⁶ United States District Court for the Eastern District of Michigan, Southern Division, No. 10,300, 120 F. Supp 956, June 29, 1953

⁶⁷ (CA-5), United States Court of Appeals for the Fifth Circuit, No. 12691, 174 F2d 893, June 3, 1949

⁶⁸ *Andrew Mutch* (CA-3), No. 11,184, 209 F2d 390, January 13, 1954

⁶⁹ Rev. Rul. 55-422, January 1, 1955

⁷⁰ Rev. Rul. 63-156, January 1, 1963

⁷¹ Rev. Rul. 62-117, January 1, 1962

⁷² Rev. Rul. 72-249, January 1, 1972

⁷³ Rev. Rul. 64-326, January 1, 1964

⁷⁴ Treas. Reg. §1.107(b)

The church is not required to report the amount of housing allowance paid to clergy.⁷⁵ Many churches report it in Box 14 of the clergy's Form W-2. Some churches report it on a separate statement given to clergy. It should not be reported on a Form 1099.

IRC §107 defines "home" as a dwelling place (including furnishings) and the appurtenances such as a garage. This includes both a purchased and rented home. It does not include a vacation home. Only the clergy's principal residence qualifies for a nontaxable housing allowance.

Qualifying expenses include expenses directly related to providing the principal home. They include, but are not limited to:

- Rent or mortgage payments (principal and interest) on a home, including the down payment;
- Real estate taxes;
- Insurance on the home and its contents;
- Remodeling expenses;⁷⁶
- Repairs and maintenance such as painting, plumbing, light bulbs, brooms, and cleaning supplies;
- Utilities such as heat, electric, water, sewer, garbage pickup, cable TV, and nonbusiness telephone;
- Home furnishings such as furniture, draperies, curtains, personal computers, rugs, knickknacks, decorations, and linens; and
- Lawn care items such as lawn mowers, fertilizers, and grass seed.

Items that **do not qualify** include:

- Mortgage interest on refinancing of the property to the extent the refinancing is for more than the principal balance immediately before the refinancing, plus amounts used to substantially improve the residence,
- The repayment of loans secured by the home for uses other than providing the home,⁷⁸ and
- Food or servants.

Note. Mortgage interest is also deductible on the clergy's Schedule A. Consequently, this can provide a double benefit.⁷⁷

EXPENSES

Clergy members are able to deduct business-related expenses for income tax purposes in the same manner as other taxpayers: A self-employed individual on Schedule C, and an employee on Form 2106. Clergy who are employees and also perform some self-employment ministerial services report direct expenses on the applicable form for the income, but allocate the indirect expenses between Form 2106 and Schedule C in a reasonable manner.

If a reimbursement is available, and the clergy member chooses not to request it, he is still considered to have received the reimbursement. Therefore, the expense is nondeductible. However, in this case the minister may have a Schedule A charitable contribution. The deemed reimbursement received is deemed given back to the employer (church) and the employer is a charitable organization.

⁷⁵ Letter Ruling 200135045, June 7, 2001

⁷⁶ Letter Ruling 8350005, August 19, 1983

⁷⁷ Rev. Rul. 87-32, 1987-1 CB 131, January 1, 1987

⁷⁸ *R.E. Rasmussen*, TC Memo 1994-311, July 6, 1994

2005 Workbook

Most clergy members are involved in visitation of congregational members and others in the community. This normally involves driving personal vehicles or taking public transportation. Expenses for business use of a vehicle may be calculated in either of the normal ways: standard mileage rate or actual expenses are used. The standard mileage rate for 2005 is 40.5¢ cents per mile. In addition, interest on the vehicle may be deductible on Schedule C, but is never deductible on Form 2106.

Note. Details on the deductions available for automobiles are located in Chapter 9, “Small Business Issues.”

The church that employs a clergy member often pays his business expenses. Reimbursements under an **accountable plan** are not income to clergy. However, the clergy member must reduce the expenses by the reimbursement. Reimbursement under a **nonaccountable plan** requires that the entire amount to be included in income and that the clergy member claim all proper expenses in their normal location (i.e., Form 2106).

Observation. Benefits of using an accountable plan to reimburse clergy for out-of-pocket expenses may include:

- Lowering the taxpayer’s AGI and therefore yielding higher credits and deductions
- Allowing the taxpayer to use the standard deduction and also exclude the reimbursements from income
- Avoidance of AMT caused by high unreimbursed employee business expenses

Other expenses paid by clergy members are also reported in the same manner as other employee’s expenses. Common expenses include:

- Travel expenses for attending church conventions, speaking engagements, performance of religious ceremonies, mission work, and youth functions.
- Educational expenses, such as tuition, books, fees, and travel expenses.
- Depreciable assets (those with an expected life of more than one year), such as office furniture.
- Newspapers, magazines, videotapes, and so on, if they are used primarily for business. The IRS tends to deny the deduction for local newspapers as most taxpayers purchase them for personal use.
- Vestments, robes, collars, and other special clothing which is not suited for general wear. An article of clothing used for business is not necessarily deductible. In order to be deductible, the clothing cannot be suitable for general wear.
- Long-distance business-related telephone calls. Local line costs are generally considered to be personal for all taxpayers. Cell phone costs are deductible based on the business/personal ratio. A printout of the phone bill should be obtained and the business-related calls should be noted along with the calculation.
- Gifts may be deductible if they are in relation to the ministry, such as music for the choir, church, or school; tracts; baptismal and wedding remembrances; and teaching aids.

Allocation of Expenses

Clergy members’ expenses must be allocated between taxable and tax-exempt income. The portion allocated to taxable income is deductible and the portion allocated to tax-exempt income (e.g., housing allowance) is nondeductible.⁷⁹

There are three cases cited in the IRS’s MSSP on Ministers regarding this position.⁸⁰

⁷⁹ IRC §265

⁸⁰ *Melvin H. Dalan*, TC Memo 1988-106, March 9, 1988; *David E Deason*, 41 TC 465, January 10, 1964; and *Robert H. McFarland*, TC Memo 1992-440, August 4, 1992

Example 26. Minister Henry has professional expenses of \$5,000 related to his work for the church. His Form W-2 from the church shows taxable wages of \$24,000. His housing allowance is \$8,000. The amount he reports on Form 2106 is \$3,750

Income from the church

1. Taxable income	1. \$24,000
2. Nontaxable income	2. <u>8,000</u>
3. Total income from clergy work for church (line 1 + line 2)	3. \$32,000

Taxable percentage of income from church

4. Taxable income (line 1)	4. \$24,000
5. Total income (line 3)	5. <u>32,000</u>
6. Taxable percentage (line 4 ÷ line 5)	6. <u>75%</u>

Expenses

7. Clerical expenses	7. \$ 5,000
8. Reimbursements, if any	8. <u>0</u>
9. Deductible expenses for Sch SE (line 7 – line 8)	9. \$ 5,000
10. Taxable % from above	10. <u>75%</u>
11. Deductible expenses for Form 2106 (line 9 × line 10)	11. \$ 3,750

SOCIAL SECURITY AND MEDICARE TAXES

FICA taxes are shared equally by the employee and the employer. SECA taxes are paid entirely by the self-employed person and are commonly referred to as SE taxes. FICA taxes are reported to the government through the Form 941 and Forms W-3/W-2. SE taxes are reported to the government through Schedule SE, which is attached to Form 1040. While the two are separate, many taxpayers consider them the same.

Social security taxes and Medicare taxes combine to make up the total FICA/SE taxes. Medicare taxes are assessed on all earned income, while social security taxes are only assessed on a limited amount of earned income (\$90,000 for 2005). All clergy, whether employees or independent contractors, are considered self-employed for these taxes. As mentioned earlier, the church **is forbidden** to withhold FICA taxes.

Clergy are subject to SE taxes on their **net** ministerial income. Under the method used in the 2004 IRS Pub. 517, *Social Security and Other Information for Members of the Clergy and Religious Workers*, this is calculated as if the clergy member had used a Schedule C to report all income (including housing allowance) and expenses. Using a Schedule C as a worksheet to show how the Schedule SE income from the ministerial work is calculated may be useful.

The clergy may also receive income from honorariums, funerals, weddings, and so on, which is properly reported on Schedule C. The net income from the employee earnings is combined with the Schedule C net income to arrive at the total Schedule SE income.

RECENT COURT CASE

In a summary opinion, the Tax Court recently agreed with the IRS. Since employee business expenses allocated to the excludable housing allowance are **not deductible for income tax purposes, the same disallowed expenses are not deductible for SE tax purposes**. This is despite the fact that the housing allowance is not excluded from SE income.⁸¹

The authority for the IRS position is Treas. Reg. §1.265-1(b) which states in general that expenses allocable to tax-exempt income are not deductible.

⁸¹ *Johnny J. and Brenda D. Young v. Commr.*, TC Summary Opinion 2005-75, June 7, 2005

2005 Workbook

Caution. Summary opinions cannot be used as precedent in other cases. However, they can be indicative of IRS positions in future audits. As of this writing, IRS publications do not reflect the position taken by the IRS in the *Young* case. Practitioners may wish to review IRS Pub. 517, IRS MSSP 17 *Ministers*, as well as the analysis of the *Young* case in the Business Expense section of Chapter 13, "Ruling and Cases." Unfortunately, neither the court case nor IRS publications constitute substantial authority.

Example 27. Reverend John Smith receives income from First Church in the form of both wages and designated parsonage allowance. He also performs weddings, funerals, and other ministry work as a self-employed person.

Reverend Smith kept records of the expenses he incurred related to his ministry services, but he did not keep track of which expenses were directly related to his role as an employee of the church versus his role as a self-employed person. Therefore, he must prorate his expenses between these sources of income. If he had documented which expenses were directly related to each source of income, he would allocate those expenses before prorating the remaining indirect expenses.

After discussing the issues and risks with his tax advisor, Reverend Smith decides to calculate his self-employment tax using the method shown in the 2004 IRS Pub 517.

The following pages show how he calculated his taxable income and deductible expenses and how he reported those amounts on his 2005 return:

	Total	Wages	Parsonage	Self-employment
Gross income from ministry services	\$99,438	\$36,000	\$42,000	\$21,438
Percent of total income by source	100%	36%	42%	22%
Expenses of ministry services (not directly related to source), prorated by source:				
Automobile	\$ 7,000	\$ 2,520	\$ 2,940	\$ 1,540
Books	3,000	1,080	1,260	660
Advertising	377	136	158	83
Office expense	5,000	1,800	2,100	1,100
Trips	9,605	3,458	4,034	2,113
Total expenses	\$24,982	\$ 8,994	\$10,492	\$ 5,496
Deductible for income tax purposes		Form 2106	No	Schedule C
Deductible for self-employment tax purposes		Sch SE	No	Sch SE
Calculation of Line 2 of Schedule SE using the 2004 Pub. 517 method:				
Gross income from ministry services			\$99,438	
Expenses deductible on Form 2106			(8,994)	
Expenses deductible on Sch C			(5,496)	
Expenses allocated to parsonage allowance			(10,492)	
Net profit for SE tax purposes			\$74,456	
Calculation of Line 2 of Schedule SE using <i>Young</i> method:				
Gross income from ministry services			\$99,438	
Expenses deductible on Form 2106			(8,994)	
Expenses deductible on Schedule C			(5,496)	
Net profit for SE tax purposes			\$84,948	
Total taxes due under Pub. 517 method			\$16,041	
Total taxes due under <i>Young</i> method (calculation not shown)			17,337	
Cost of using <i>Young</i> method			\$ 1,296	

2005 Workbook

For Example 27

a Control number		OMB No. 1545-0008		This information is being furnished to the Internal Revenue Service. If you are required to file a tax return, a negligence penalty or other sanction may be imposed on you if this income is taxable and you fail to report it.	
b Employer identification number (EIN) 00-0246810		1 Wages, tips, other compensation 36000.00		2 Federal income tax withheld	
c Employer's name, address, and ZIP code First Church 112 Main Street Anytown, WI 77777		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 011-00-2222		9 Advance EIC payment		10 Dependent care benefits	
e Employee's first name and initial Last name John Smith 113 Main Street Anytown, WI 77777		11 Nonqualified plans		12a See instructions for box 12	
		13 Statutory employee Retirement plan Third-party sick pay <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/>		12b	
		14 Other Parsonage Allowance 42000.00		12c	
				12d	
f Employee's address and ZIP code					
15 State WI	Employer's state ID number	16 State wages, tips, etc.	17 State income tax	18 Local wages, tips, etc.	19 Local income tax

Form **W-2** Wage and Tax Statement
Copy C—For EMPLOYEE'S RECORDS. (See Notice to Employee on back of Copy B.)

2005

Department of the Treasury—Internal Revenue Service

Safe, accurate,
FAST! Use



6

2005 Workbook

For Example 27

Form	1040	Department of the Treasury—Internal Revenue Service U.S. Individual Income Tax Return 2005	(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. Presidential Election Campaign		For the year Jan. 1–Dec. 31, 2005, or other tax year beginning _____, 2005, ending _____, 20	
		OMB No. 1545-0074	
		Your first name and initial John	Last name Smith
		Your social security number 011 : 00 : 2222	
Label HERE		If a joint return, spouse's first name and initial _____ Last name _____	
		Spouse's social security number _____	
Label HERE		Home address (number and street). If you have a P.O. box, see page 16. Apt. no. _____ 114 Main St	
		City, town or post office, state, and ZIP code. If you have a foreign address, see page 16. Anytown, WI 77777	
Label HERE		Checking a box below will not change your tax or refund. ▲ You must enter your SSN(s) above. ▲	
		Check here if you, or your spouse if filing jointly, want \$3 to go to this fund (see page 16) ▶ <input type="checkbox"/> You <input type="checkbox"/> Spouse	
Filing Status Check only one box.		1 <input checked="" type="checkbox"/> Single	
		2 <input type="checkbox"/> Married filing jointly (even if only one had income)	
Exemptions If more than four dependents, see page 18.		3 <input type="checkbox"/> Married filing separately. Enter spouse's SSN above and full name here. ▶	
		4 <input type="checkbox"/> 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. ▶	
Exemptions If more than four dependents, see page 18.		5 <input type="checkbox"/> Qualifying widow(er) with dependent child (see page 17)	
		6a <input checked="" type="checkbox"/> Yourself. If someone can claim you as a dependent, do not check box 6a.	
Exemptions If more than four dependents, see page 18.		b <input type="checkbox"/> Spouse	
		c Dependents:	
Exemptions If more than four dependents, see page 18.		(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 18)	
		d Total number of exemptions claimed	
Income Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.		7 Wages, salaries, tips, etc. Attach Form(s) W-2	
		8a Taxable interest. Attach Schedule B if required	
Income Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.		b Tax-exempt interest. Do not include on line 8a	
		9a Ordinary dividends. Attach Schedule B if required	
Income Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.		b Qualified dividends (see page 20)	
		10 Taxable refunds, credits, or offsets of state and local income taxes (see page 20)	
Income Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.		11 Alimony received	
		12 Business income or (loss). Attach Schedule C or C-EZ	
Income Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.		13 Capital gain or (loss). Attach Schedule D if required. If not required, check here <input type="checkbox"/>	
		14 Other gains or (losses). Attach Form 4797	
Income Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.		15a IRA distributions	
		16a Pensions and annuities	
Income Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.		17 Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E	
		18 Farm income or (loss). Attach Schedule F	
Income Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.		19 Unemployment compensation	
		20a Social security benefits	
Income Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.		21 Other income. List type and amount (see page 24)	
		22 Add the amounts in the far right column for lines 7 through 21. This is your total income ▶	
Adjusted Gross Income		23 Educator expenses (see page 26)	
		24 Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ	
Adjusted Gross Income		25 Health savings account deduction. Attach Form 8889	
		26 Moving expenses. Attach Form 3903	
Adjusted Gross Income		27 One-half of self-employment tax. Attach Schedule SE	
		28 Self-employed SEP, SIMPLE, and qualified plans	
Adjusted Gross Income		29 Self-employed health insurance deduction (see page XX)	
		30 Penalty on early withdrawal of savings	
Adjusted Gross Income		31a Alimony paid b Recipient's SSN ▶	
		32 IRA deduction (see page XX)	
Adjusted Gross Income		33 Student loan interest deduction (see page XX)	
		34 Tuition and fees deduction (see page XX)	
Adjusted Gross Income		35 Domestic production activities deduction. Attach Form 8903	
		36 Add lines 23 through 31a and 32 through 35	
Adjusted Gross Income		37 Subtract line 36 from line 22. This is your adjusted gross income ▶	
		38	

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see page 75.

Cat. No. 11320B

Form 1040 (2005)

For Example 27

Form 1040 (2005)

Page **2**

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 31.
- All others:

Single or Married filing separately, \$5,000

Married filing jointly or Qualifying widow(er), \$10,000

Head of household, \$7,300

38	Amount from line 37 (adjusted gross income)	38	46,682
39a	Check <input type="checkbox"/> You were born before January 2, 1941, <input type="checkbox"/> Blind. <input type="checkbox"/> Spouse was born before January 2, 1941, <input type="checkbox"/> Blind. Total boxes checked <input type="checkbox"/> 39a		
b	If your spouse itemizes on a separate return or you were a dual-status alien, see page 31 and check here <input type="checkbox"/> 39b		
40	Itemized deductions (from Schedule A) or your standard deduction (see left margin)	40	8,060
41	Subtract line 40 from line 38	41	38,622
42	If line 38 is \$109,475 or less, multiply \$3,200 by the total number of exemptions claimed on line 6d. If line 38 is over \$109,475, see the worksheet on page 33	42	3,200
43	Taxable income. Subtract line 42 from line 41. If line 42 is more than line 41, enter -0-	43	35,422
44	Tax (see page 33). Check if any tax is from: a <input type="checkbox"/> Form(s) 8814 b <input type="checkbox"/> Form 4972	44	5,521
45	Alternative minimum tax (see page 35). Attach Form 6251	45	
46	Add lines 44 and 45	46	5,521
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	Child tax credit (see page 37). Attach Form 8901 if required	52	
53	Adoption credit. Attach Form 8839	53	
54	Credits from: a <input type="checkbox"/> Form 8396 b <input type="checkbox"/> Form 8859	54	
55	Other credits. Check applicable box(es): a <input type="checkbox"/> Form 3800 b <input type="checkbox"/> Form 8801 c <input type="checkbox"/> Specify	55	
56	Add lines 47 through 55. These are your total credits	56	
57	Subtract line 56 from line 46. If line 56 is more than line 46, enter -0-	57	5,521
58	Self-employment tax. Attach Schedule SE	58	10,520
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	61	
62	Household employment taxes. Attach Schedule H	62	
63	Add lines 57 through 62. This is your total tax	63	16,041

Other Taxes

Payments

If you have a qualifying child, attach Schedule EIC.

64	Federal income tax withheld from Forms W-2 and 1099	64	
65	2005 estimated tax payments and amount applied from 2004 return	65	17,337
66a	Earned income credit (EIC)	66a	
b	Nontaxable combat pay election <input type="checkbox"/> 66b		
67	Excess social security and tier 1 RRTA tax withheld (see page 54)	67	
68	Additional child tax credit. Attach Form 8812	68	
69	Amount paid with request for extension to file (see page 54)	69	
70	Payments from: a <input type="checkbox"/> Form 2439 b <input type="checkbox"/> Form 4136 c <input type="checkbox"/> Form 8885	70	
71	Add lines 64, 65, 66a, and 67 through 70. These are your total payments	71	

Refund

Direct deposit? See page 54 and fill in 73b, 73c, and 73d.

72	If line 71 is more than line 63, subtract line 63 from line 71. This is the amount you overpaid	72	1,296
73a	Amount of line 72 you want refunded to you	73a	
b	Routing number	c	Type: <input type="checkbox"/> Checking <input type="checkbox"/> Savings
d	Account number		
74	Amount of line 72 you want applied to your 2006 estimated tax	74	1,296

Amount You Owe

75	Amount you owe. Subtract line 71 from line 63. For details on how to pay, see page 55	75	
76	Estimated tax penalty (see page 55)	76	

Third Party Designee

Do you want to allow another person to discuss this return with the IRS (see page 56)? ☐ 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	Date	Your occupation	Daytime phone number
Spouse's signature. If a joint return, both must sign.	Date	Spouse's occupation	

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.	

Form **1040** (2005)

Printed on recycled paper

2005 Workbook

For Example 27

SCHEDULE C (Form 1040)

Department of the Treasury
Internal Revenue Service

Profit or Loss From Business

(Sole Proprietorship)

► Partnerships, joint ventures, etc., must file Form 1065 or 1065-B.
► Attach to Form 1040 or 1041. ► See Instructions for Schedule C (Form 1040).

OMB No. 1545-0074

2005

Attachment
Sequence No. **09**

Name of proprietor John Smith		Social security number (SSN) 011 : 00 : 2222
A Principal business or profession, including product or service (see page C-2 of the instructions) Ministry Services		B Enter code from pages C-7, 8, & 9 8 1 3 0 0 0
C Business name. If no separate business name, leave blank.		D Employer ID number (EIN), if any
E Business address (including suite or room no.) ► City, town or post office, state, and ZIP code		
F Accounting method: (1) <input checked="" type="checkbox"/> Cash (2) <input type="checkbox"/> Accrual (3) <input type="checkbox"/> Other (specify) ►		
G Did you "materially participate" in the operation of this business during 2005? If "No," see page C-3 for limit on losses <input checked="" type="checkbox"/> Yes <input type="checkbox"/> No		
H If you started or acquired this business during 2005, check here <input type="checkbox"/>		

Part I Income

1 Gross receipts or sales. Caution. If this income was reported to you on Form W-2 and the "Statutory employee" box on that form was checked, see page C-3 and check here <input type="checkbox"/>	1	21,438
2 Returns and allowances	2	
3 Subtract line 2 from line 1	3	21,438
4 Cost of goods sold (from line 42 on page 2)	4	
5 Gross profit. Subtract line 4 from line 3.	5	21,438
6 Other income, including Federal and state gasoline or fuel tax credit or refund (see page C-3)	6	
7 Gross income. Add lines 5 and 6	7	21,438

Part II Expenses. Enter expenses for business use of your home **only** on line 30.

8 Advertising	8	83	18 Office expense	18	1,100
9 Car and truck expenses (see page C-3)	9	1,540	19 Pension and profit-sharing plans	19	
10 Commissions and fees	10		20 Rent or lease (see page C-5):	20a	
11 Contract labor (see page C-4)	11		a Vehicles, machinery, and equipment	20b	
12 Depletion	12		b Other business property	21	
13 Depreciation and section 179 expense deduction (not included in Part III) (see page C-4)	13		21 Repairs and maintenance	22	660
14 Employee benefit programs (other than on line 19)	14		22 Supplies (not included in Part III)	23	
15 Insurance (other than health)	15		23 Taxes and licenses	24	
16 Interest:			24 Travel, meals, and entertainment:	24a	2,113
a Mortgage (paid to banks, etc.)	16a		a Travel	24b	
b Other	16b		b Deductible meals and entertainment (see page C-5)	25	
17 Legal and professional services	17		25 Utilities	26	
			26 Wages (less employment credits)	27	
			27 Other expenses (from line 48 on page 2)		
28 Total expenses before expenses for business use of home. Add lines 8 through 27 in columns	28	5,496			
29 Tentative profit (loss). Subtract line 28 from line 7	29	15,942			
30 Expenses for business use of your home. Attach Form 8829	30				
31 Net profit or (loss). Subtract line 30 from line 29.	31	15,942			
<ul style="list-style-type: none"> • If a profit, enter on Form 1040, line 12, and also on Schedule SE, line 2 (statutory employees, see page C-6). Estates and trusts, enter on Form 1041, line 3. • If a loss, you must go to line 32. 					
32 If you have a loss, check the box that describes your investment in this activity (see page C-6).					
<ul style="list-style-type: none"> • If you checked 32a, enter the loss on Form 1040, line 12, and also on Schedule SE, line 2 (statutory employees, see page C-6). Estates and trusts, enter on Form 1041, line 3. • If you checked 32b, you must attach Form 6198. Your loss may be limited. 			32a <input type="checkbox"/> All investment is at risk.		
			32b <input type="checkbox"/> Some investment is not at risk.		

For Paperwork Reduction Act Notice, see Form 1040 instructions.

Cat. No. 11334P

Schedule C (Form 1040) 2005

For Example 27

SCHEDULE SE
(Form 1040)Department of the Treasury
Internal Revenue Service

Self-Employment Tax

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

OMB No. 1545-0074

2005

Attachment
Sequence No. 17

Name of person with self-employment income (as shown on Form 1040)

John Smith

Social security number of person
with self-employment income ▶

011 : 00 : 2222

Who Must File Schedule SE

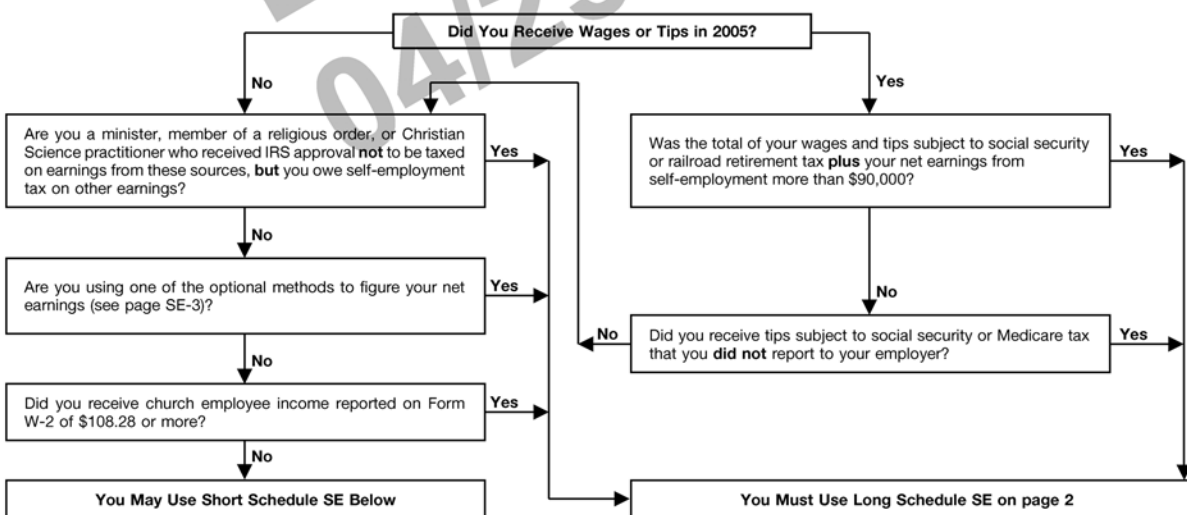
You must file Schedule SE if:

- 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?



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	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. Ministers and members of religious orders, see page SE-1 for amounts to report on this line. See page SE-2 for other income to report	2	74,456	*
3	Combine lines 1 and 2	3	74,456	
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 ▶	4	68,760	
5	Self-employment tax. If the amount on line 4 is: <div style="display: flex; align-items: center;"> <div style="margin-right: 10px;"> • \$90,000 or less, multiply line 4 by 15.3% (.153). Enter the result here and on Form 1040, line 58. • More than \$90,000, multiply line 4 by 2.9% (.029). Then, add \$11,160.00 to the result. Enter the total here and on Form 1040, line 58. </div> <div style="border-left: 1px solid black; padding-left: 10px;"> </div> </div>	5	10,520	
6	Deduction for one-half of self-employment tax. Multiply line 5 by 50% (.5). Enter the result here and on Form 1040, line 27	6	5,260	

For Paperwork Reduction Act Notice, see Form 1040 instructions.

Cat. No. 11358Z

Schedule SE (Form 1040) 2005

* See attached statement

2005 Workbook

For Example 27

Form 2106 Department of the Treasury Internal Revenue Service (99)	Employee Business Expenses ▶ See separate instructions. ▶ Attach to Form 1040.	OMB No. 1545-0139 <div style="font-size: 2em; font-weight: bold; margin: 5px 0;">2005</div> Attachment Sequence No. 54
Your name John Smith	Occupation in which you incurred expenses Minister	Social security number 011 00 2222

Part I Employee Business Expenses and Reimbursements

Step 1 Enter Your Expenses	Column A Other Than Meals and Entertainment	Column B Meals and Entertainment
1 Vehicle expense from line 22 or line 29. (Rural mail carriers: See instructions.)	1 2,520	
2 Parking fees, tolls, and transportation, including train, bus, etc., that did not involve overnight travel or commuting to and from work	2	
3 Travel expense while away from home overnight, including lodging, airplane, car rental, etc. Do not include meals and entertainment.	3 3,458	
4 Business expenses not included on lines 1 through 3. Do not include meals and entertainment.	4 3,016	
5 Meals and entertainment expenses (see instructions)	5	
6 Total expenses. In Column A, add lines 1 through 4 and enter the result. In Column B, enter the amount from line 5	6 8,994	

Note: If you were not reimbursed for any expenses in Step 1, skip line 7 and enter the amount from line 6 on line 8.

Step 2 Enter Reimbursements Received From Your Employer for Expenses Listed in Step 1

7 Enter reimbursements received from your employer that were not reported to you in box 1 of Form W-2. Include any reimbursements reported under code "L" in box 12 of your Form W-2 (see instructions)	7 0	
--	-----	--

Step 3 Figure Expenses To Deduct on Schedule A (Form 1040)

8 Subtract line 7 from line 6. If zero or less, enter -0-. However, if line 7 is greater than line 6 in Column A, report the excess as income on Form 1040, line 7	8 8,994	
Note: If both columns of line 8 are zero, you cannot deduct employee business expenses. Stop here and attach Form 2106 to your return.		
9 In Column A, enter the amount from line 8. In Column B, multiply line 8 by 50% (.50). (Employees subject to Department of Transportation (DOT) hours of service limits: Multiply meal expenses incurred while away from home on business by 70% (.70) instead of 50%. For details, see instructions.)	9	
10 Add the amounts on line 9 of both columns and enter the total here. Also, enter the total on Schedule A (Form 1040), line 20. (Reservists, qualified performing artists, fee-basis state or local government officials, and individuals with disabilities: See the instructions for special rules on where to enter the total.) ▶	10	8,994

For Paperwork Reduction Act Notice, see instructions.

Cat. No. 11700N

Form **2106** (2005)

2005 Workbook

For Example 27

SCHEDULES A&B (Form 1040)		Schedule A—Itemized Deductions (Schedule B is on back)		OMB No. 1545-0074 2005 Attachment Sequence No. 07	
Department of the Treasury Internal Revenue Service (99)		▶ Attach to Form 1040. ▶ See Instructions for Schedules A and B (Form 1040).			
Name(s) shown on Form 1040 John Smith				Your social security number 011 00 2222	
Medical and Dental Expenses	Caution. Do not include expenses reimbursed or paid by others.				
1	Medical and dental expenses (see page A-2)	1			
2	Enter amount from Form 1040, line 38 2	2			
3	Multiply line 2 by 7.5% (.075)	3			
4	Subtract line 3 from line 1. If line 3 is more than line 1, enter -0-	4			
Taxes You Paid (See page A-2.)	5 State and local (check only one box): a <input type="checkbox"/> Income taxes, or b <input type="checkbox"/> General sales taxes (see page A-2)	5			
6	Real estate taxes (see page A-3)	6			
7	Personal property taxes	7			
8	Other taxes. List type and amount ▶	8			
9	Add lines 5 through 8	9			
Interest You Paid (See page A-3.)	10 Home mortgage interest and points reported to you on Form 1098	10			
11	Home mortgage interest not reported to you on Form 1098. If paid to the person from whom you bought the home, see page A-4 and show that person's name, identifying no., and address ▶	11			
Note. Personal interest is not deductible.	12 Points not reported to you on Form 1098. See page A-4 for special rules	12			
13	Investment interest. Attach Form 4952 if required. (See page A-4.)	13			
14	Add lines 10 through 13	14			
Gifts to Charity If you made a gift and got a benefit for it, see page A-4.	15 Gifts by cash or check. If you made any gift of \$250 or more, see page A-4	15			
16	Other than by cash or check. If any gift of \$250 or more, see page A-4. You must attach Form 8283 if over \$500	16			
17	Carryover from prior year	17			
18	Add lines 15 through 17	18			
Casualty and Theft Losses	19 Casualty or theft loss(es). Attach Form 4684. (See page A-5.)	19			
Job Expenses and Most Other Miscellaneous Deductions (See page A-5.)	20 Unreimbursed employee expenses—job travel, union dues, job education, etc. Attach Form 2106 or 2106-EZ if required. (See page A-6.) ▶ Form 2106	20		8,994	
21	Tax preparation fees	21			
22	Other expenses—investment, safe deposit box, etc. List type and amount ▶	22			
23	Add lines 20 through 22	23		8,994	
24	Enter amount from Form 1040, line 38 24 46,682	24			
25	Multiply line 24 by 2% (.02)	25		934	
26	Subtract line 25 from line 23. If line 25 is more than line 23, enter -0-	26			8,060
Other Miscellaneous Deductions	27 Other—from list on page A-6. List type and amount ▶	27			
Total Itemized Deductions	28 Is Form 1040, line 38, over \$145,950 (over \$72,975 if married filing separately)? <input type="checkbox"/> 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. <input type="checkbox"/> Yes. Your deduction may be limited. See page A-6 for the amount to enter.	28			8,060
29	If you elect to itemize deductions even though they are less than your standard deduction, check here <input type="checkbox"/>	29			

For Paperwork Reduction Act Notice, see Form 1040 instructions.

Cat. No. 11330X

Schedule A (Form 1040) 2005

EXEMPTIONS FROM SE TAXES

Any member of a religious organization that takes a vow of poverty is automatically exempt from self-employment tax on ministerial income.

Clergy members not belonging to such a religious organization may elect out of the SECA system for ministerial income based on religious opposition to the acceptance of any public insurance that makes payments because of death, disability, old age, or retirement, or makes payments toward, or provides services for, medical care (including social security and Medicare).

To elect out of SECA coverage, a clergy member must file Form 4361, *Application for Exemption from Self-Employment Tax for Use by Ministers, Members of Religious Orders, and Christian Science Practitioners*.

This form must be filed in triplicate by the due date (including extensions) for filing the clergy member's income tax return for the **second** year in which there is \$400 or more of net earnings from ministerial services.⁸²

Note. Rev. Proc. 92-35 grants a six-month extension from the original unextended due date to make this election. This makes the due date for Form 4361 six months after the normal unextended due date for the clergy's Form 1040. The filing of Form 4361 after the due date should have the statement "FILED PURSUANT TO REVENUE PROCEDURE 92-35" written at the top of the form.

Example 28. Pastor Sam begins his ministry in July 2003. His net earnings for 2003 are \$15,000. In 2004, his net earnings from clergy activities amount to \$25,000. Pastor Sam must make the election by April 15, 2005, unless an extension was filed or he is taking advantage of the special six-month extension. If Pastor Sam waits until 2006, he will not be eligible to elect out of SECA coverage.

The clergy member must inform the church he is conscientiously opposed to, or because of religious principles is opposed to, the acceptance of public insurance benefits based on ministerial services.

Upon receipt of Form 4361, the IRS mails a statement to the clergy member outlining the grounds for receiving the exemption. The clergy member must sign, certify, and return the statement to the IRS within 90 days after its receipt. When the IRS receives the signed and certified statement, it will return a copy of Form 4361 marked "approved." This should be retained in the clergy member's permanent records.

Once the approval is granted by the IRS, it is **irrevocable** and is applicable to all open years and all future years. Therefore, if a clergy member has paid SE tax on ministerial income in any prior year still open by the normal statute of limitations, he can obtain a refund of such taxes.

Note. There have been two short periods of time in which Congress has permitted ministers to elect back into the SECA system, with the most recent period ending April 15, 2002.

This exemption out of SECA is only applicable to ministerial income. Other services provided by clergy, whether as an employee or a self-employed person, are not exempt, such as working in a grocery store or preparing income tax returns.

After receiving approval, the clergy member no longer has to file Schedule SE for the ministerial income. If this is the only self-employment income the minister has, the notation "Exempt-4361" is made to the left of the SE tax line on Form 1040. If the clergy member has other self-employment income, Box A is checked on Part 1 of Schedule SE and the SE tax is computed on the other self-employment income.

⁸² Treas. Reg. §1.1402(e)-3

Note. The issue of electing out of SECA is a controversial one. It is not an election to avoid paying the tax, but an election based on an opposition to the acceptance of public insurance. If a clergy member makes this election and was previously employed long enough to qualify for benefits based on that employment, should the minister apply for Social Security or Medicare benefits?

As with any self-employed individual, clergy who are eligible for the foreign earned income exclusion due to ministerial services performed outside the United States calculate SE tax without regard to the exclusion.

RETIREMENT

Saving for retirement is just as important for a clergy member as for any other individual. In fact, if the clergy member has an accepted Form 4361, this may be the only income he will have in retirement.

An employed clergy member is eligible to participate in a qualified pension plan through the church.⁸³ Many churches have §403(b) plans set up through the national office of the denomination.

All ministers are eligible to make contributions to a traditional or a Roth IRA. The deductibility of a traditional IRA contributions may be limited if the clergy member is covered by a qualified plan through the church, such as a §403(b) plan. Clergy who are self-employed for income tax purposes may set up their own retirement plan such as a SEP, Keogh, or SIMPLE. (These limit the deductibility of IRA contributions.)

The taxability of pension income is generally the same for clergy as for other employees. One common difference can exist. Pension distributions designated as “housing allowance” are considered to be housing allowances and are tax-exempt. The taxable portion is reportable as pension income. The gross pension is included on Form 1040, line 16a, while the taxable portion after the reduction for the housing allowance is shown on line 16b.

This designation must come from the former employing church or denomination (whichever is paying the retirement) prior to the payment to the clergy member. It is not a designation that clergy can choose on their own.⁸⁴

Even if a pension is designated as a housing allowance, the pension is not subject to SE taxes.

EARNED INCOME CREDIT

The earned income credit (EIC) is available to clergy in almost the same manner as other employees and self-employed individuals.

A clergy member’s “earnings” are the amounts that come from Schedule SE. Therefore, a clergy member’s housing allowance is part of his earnings for purposes of EIC, even though the housing allowance may not be subject to income tax. Although this is contrary to the normal rule that nontaxable income is not taken into account for EIC purposes, the wording of IRC §32 **requires** this inclusion for clergy.

The EIC is also available to clergy who elect out of social security taxes.⁸⁵

AVAILABLE RESOURCES

The following sources offer more information relating to tax issues for clergy:

- Market Segment Specialization Program for Ministers
- IRS Pub. 517, *Social Security for Members of the Clergy and Religious Workers*

⁸³ Rev. Rul. 73-258 and 73-381, January 1, 1973

⁸⁴ Rev. Rul. 63-156, January 1, 1963, and Rev. Rul. 62-117, January 1, 1962

⁸⁵ Rev. Rul. 79-78, January 1, 1979

2005 Workbook