

## **Pension and Disability Benefits as a Housing Allowance Exclusion**

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Throughout their active ministry, most clergy take advantage of a section of the Internal Revenue Code (Code) which allows a “minister of the gospel” to exclude a “housing allowance” from his or her gross income when paying federal income taxes.<sup>1</sup> Retired or disabled clergy are also entitled to take advantage of this exclusion.<sup>2</sup> (Please note that for purposes of the housing allowance, “retired” is not limited to how that term is defined under the UMC’s Book of Discipline. A clergy person who is considered “terminated” under the Book of Discipline, but is receiving retirement benefits, may be considered “retired” for purposes of the housing allowance depending on all relevant facts and circumstances (including, e.g., whether he or she is engaged in other employment). A clergy person should discuss this issue with his or her tax advisor. This publication discusses how the pension benefits a clergy person receives from Wespath Benefits and Investments (Wespath) are excludable from his or her gross income as a “housing allowance.” This document also discusses how the disability benefits a clergy person receives from Wespath may be excludable from his or her gross income as a “housing allowance.”

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- 1. Eligibility for housing allowance.** The housing allowance exclusion comes from Code section 107. This provision was first included in the tax code in 1921. It was revised in 1954 and again in 2002. It currently provides:

“In the case of a minister of the gospel, gross income does not include:

- a) the rental value of a home furnished to him as part of his compensation; or
- b) the rental allowance paid to him as part of his compensation, to the extent used by him to rent or provide a home and to the extent such allowance does not exceed the fair rental value of the home, including furnishings and appurtenances such as a garage, plus the cost of utilities.”<sup>3</sup>

These few words have caused the Internal Revenue Service (IRS) over the years to issue more than 200 Private Letter Rulings, Revenue Rulings and Regulations interpreting this subject. Even though Code section 107 does not mention clergy, the IRS has stated that they also may exclude a housing allowance up to the rental value of a home furnished to him or her by a church.<sup>4</sup>

- 2. Designation of housing allowance.** The housing allowance must be designated by an appropriate body or organization of the church.<sup>5</sup> For retired or disabled clergy, the annual conference is the appropriate body to make the designation.<sup>6</sup> The designation must be made prior to the time the designation is to be effective.<sup>7</sup> Accordingly, most annual conferences annually pass a housing allowance resolution at the conference session, characterizing the amount of the housing allowance for the next calendar year. The resolution is normally published in the conference journal.
- 3. Amount to be excluded from income.** One aspect of the housing allowance issue is often misunderstood: the amount designated by the conference is not necessarily the amount that may be excluded by the clergy person. The amount designated is only one of three factors that must be considered. The amount that may be excluded is the least of:
  - a) the amount designated as the housing allowance exclusion,<sup>8</sup>
  - b) the amount actually expended by the clergy person for housing,<sup>9</sup> or

c) the fair rental value of the residential property occupied by the clergy person.<sup>10</sup>

For example, if the conference designates 100% of the pension as a housing allowance and the clergy person receives \$6,000 in pension, but spends only \$5,000 on housing which has a fair rental value of \$8,000, the amount that may be excluded may not exceed \$5,000.

**a. Amount designated.** During the early 1980s, Wespath helped each existing annual conference obtain a Private Letter Ruling from the IRS. Each Private Letter Ruling stated that the annual conference is the appropriate body to designate a housing allowance for its clergy, and that the annual conference may designate up to and including 100% of pension as a housing allowance. Wespath understands that annual conferences generally take advantage of this legal authority by passing an annual resolution normally characterizing 100% of pension as a housing allowance.

Clergy often ask what constitutes pension income for the purpose of claiming the housing allowance exclusion. In general, a housing allowance exclusion may be claimed only from the taxable portion of pension payments. Taxable pension benefits include payments from conference/employer sources as well as payments from the clergy person's before-tax account and earnings on after-tax contributions.

**b. Amount expended.** The second factor controlling the amount which may be excluded from gross income is the amount actually expended by the clergy person for housing. Expenses for food and servants are not considered for this purpose to be directly related to providing housing.<sup>11</sup>

Many Private Letter Rulings, Revenue Rulings and Regulations have been issued describing which expense items may be considered in determining expenditures. For a clergy person who rents housing, actual expenses may include rental payments, utilities and furnishings.<sup>12</sup> For a clergy person who owns his or her own home, actual expenses include mortgage and related interest payments, real estate taxes, maintenance, utilities and furnishings.<sup>13</sup> (The Tax Reform Act of 1986 grants the full deduction for mortgage interest and real estate taxes even if a housing allowance exclusion is taken by the taxpayer.<sup>14</sup> Payments for an equity line of credit may not be included as a housing allowance expense unless the money was used for actual housing-related expenses.<sup>15</sup>)

The expenses must occur in the tax year in which the clergy person is to exclude those expenses from his or her gross income. In one instance the IRS ruled a clergy person could not exclude as housing allowance an amount equal to the amortization of his advance payment for lifetime rental of his retirement home. The clergy person paid a flat fee in advance for the lifetime rental. Utilities, maintenance and insurance payments were due yearly. The clergy person excluded as housing allowance the maintenance, utilities, insurance and one-fifteenth of the advance rental. The IRS ruled the housing allowance was limited to the utilities, maintenance and insurance.<sup>16</sup>

**c. Fair rental value.** In 1971, the IRS issued a Revenue Ruling which imposed a third factor upon clergy who own their own home: the amount excluded from gross income cannot exceed the fair rental value of the housing.<sup>17</sup> This rule was added to Code section 107(2) itself in 2002. According to the above-referenced Revenue Ruling and current publications issued by the IRS, the "fair rental value" of a clergy person's housing includes, in addition to the fair rental value of the housing (with furnishings), the fair rental value of appurtenances such as a garage and the cost of utilities.<sup>18</sup>

The fair rental value of a clergy person's housing would likely become an issue only in the event of an IRS audit. In determining the amount of the exclusion, however, the clergy person should make a bona fide, even if informal, calculation so that, if ever challenged, he or she would be able to substantiate the amount of the exclusion. If the clergy person actually rents the house, the amount of the rent would be persuasive evidence as to the fair rental value (unless there is some family connection or the clergy person is otherwise paying a non-market rate). Sometimes a clergy person will have rented the house to others before retirement and thus will have a good idea of the actual rent that the house could command. There are other, equally obvious methods of calculating a fair rental value: an appraisal from a local realtor, examination of listings with local realtors, verification of actual rents paid for any comparable housing in the neighborhood or community (as adjusted for special advantages or disadvantages of the specific property) or a survey of newspaper ads of houses for rent in the community.

**4. Exclusion of pension received from plans not administered by Wespath.** Some United Methodist clergy, while serving appointments beyond the local church, may have participated in pension programs that are not administered by

Wespath. Based on IRS materials related to the housing allowance exclusion, it appears clergy may use the conference housing allowance resolution to claim a housing allowance exclusion from pension payments received from these other pension programs. However, the exclusion may be claimed only if the clergyperson was entitled to use the Code section 107 housing allowance exclusion during the time he or she actively served the appointment beyond the local church to which these pension payments are related.

**Warning:** *The IRS has ruled inconsistently on this matter. There are instances where the IRS has disallowed the housing allowance exclusion from pension payments received from non-Wespath sources.*

5. **Rollovers from other plans may not be excluded from income.** It is possible that a clergyperson who has participated in a pension plan that is not administered by Wespath might, under some circumstances, roll over these other pension funds to his or her rollover account with Wespath. However, even when the clergyperson begins to receive benefits from the rollover account, these benefits may not be excluded from taxation as a housing allowance.
6. **Procedural aspects of the exclusion.** Most local churches or other employing units of The United Methodist Church do not include the amount of housing allowance (e.g., the fair rental value of a parsonage or a cash payment characterized as a housing allowance in lieu of a parsonage) on informational returns such as *IRS Form W-2s, 1099s*, etc. Therefore, most active clergy never need to show the exclusion of the housing allowance when filing their federal income tax returns.

The retired or disabled clergyperson faces a different situation. Because distributions from pension programs must be reported to the IRS, Wespath reports the full amount distributed to the clergyperson during the year. The clergyperson must take the responsibility of actually excluding the housing allowance from his or her reported gross income.

The clergyperson will receive from Wespath an *IRS Form 1099-R* or *IRS Form W-2* respectively. A copy of the form should be attached to the federal income tax return (and likewise, to any state or local return) filed by the clergyperson. This form reflects the amount of money received from Wespath. When calculating total (gross) income, the clergyperson must report all pension payments on line 5a "Pensions and Annuities" (*IRS Form 1040*). The clergyperson should then report on line 5b (*IRS Form 1040*) the taxable amount of his or her retirement income; i.e., the total amount of the retirement income minus the sum of: 1) the portion of the retirement income attributable to the after-tax contributions (if any), and 2) the portion being excluded in accordance with Code section 107.

The clergyperson who is claiming a housing allowance exclusion should also add an explanatory note. Next to line 5b (*IRS Form 1040*), the clergyperson should write "See note," and, on a separate sheet of paper, should designate a "Note to line 5b." The note should include language similar to the following: "I received \$xxx from the UMC Benefit Board, Inc., as reported by the attached *1099-R* or *W-2*. I did not include \$yyy of this amount on line 5b because it has been excluded under the provisions of section 107 of the Internal Revenue Code as a housing allowance exclusion. As a United Methodist clergyperson, I am entitled to take this housing allowance exclusion." An explanation of this type should be sufficient in most situations. Disabled clergypersons could substitute the following language in their explanation for the last sentence in the earlier quoted text: "As a disabled United Methodist clergyperson, I may take this housing allowance exclusion according to IRS guidance."

7. **Surviving spouses not eligible for housing allowance.** The housing allowance exclusion is available only to ordained clergy—not to surviving spouses.<sup>19</sup> The tax return for the year in which a clergyperson dies may include, as an exclusion from the gross income of the clergyperson, a housing allowance exclusion for the full period of time the clergyperson was alive. That is, the death of a clergyperson during the year does not invalidate the housing allowance exclusion for the entire year. The exclusion is still available with respect to the income of the clergyperson during the time he or she was alive.
8. **Pension benefits taken as a housing allowance are not self-employment income.** A provision contained in the Small Business Job Protection Act of 1996 amends the definition of net earnings from self-employment to specifically exclude from Self-Employment Compensation Act (SECA) tax "the rental value of any parsonage or any housing allowance (whether or not excludable under Code section 107) provided after the individual retires, or any other retirement

benefit received by such individual from a church plan [as defined in Code section 414(e)] after the individual retires.”<sup>20</sup>

Some clergy continue to work in retirement and have self-employment income. The fact that these clergy have self-employment income does not alter the fact their pension payments are not subject to SECA tax, even if excluded from income under Code section 107.

- 9. Summary.** When computing his or her federal income taxes, a clergyperson should carefully calculate the amount of the housing allowance exclusion to which he or she is entitled, always keeping in mind that the amount will be limited to the least of the three limits discussed above. The clergyperson should make sure to attach a note to the federal income tax return to explain the difference between the amount of pension reported by Wespeth and the amount reported by the clergyperson as taxable.

**Endnotes:**

1. Code §107.
2. For more than 10 years the IRS has stopped issuing rulings about the availability of the housing allowance exclusion to retirees while the issue is “under study.” It is not known whether or when the IRS might issue further guidance on the subject.
3. Code §107.
4. Rev. Rul. 63-156.
5. Treas. Reg. §1.107-1(b).
6. See, e.g., IRS Technical Advice Memorandum 8039007. For retired bishops of The United Methodist Church, the General Council on Finance and Administration would be the appropriate organization to designate their housing allowance. Bishops must follow the same rules and procedures as set forth herein. For the sake of simplicity, no further mention of bishops will be made.
7. Treas. Reg. §1.107-1(c).
8. Ibid.
9. Ibid.
10. Code §107(2); Rev. Rul. 71-280.
11. Treas. Reg. §1.107-1(c).
12. Ibid., Rev. Rul. 72-588.
13. Ibid.
14. Code §265(a)(6), Rev. Rul. 87-32.
15. IRS Letter Ruling 9115051.
16. Technical Advice Memorandum 8039007.
17. Rev. Rul. 71-280.