

SELF-STUDY CONTINUING PROFESSIONAL EDUCATION

Individuals: Special Tax Situations

Fort Worth, Texas
(800) 231-1860
cl.thomsonreuters.com/Q



THOMSON REUTERS

Copyright 2010 Thomson Reuters/Gear Up
All Rights Reserved

This material, or parts thereof, may not be reproduced in another document or manuscript in any form without the permission of the publisher.

This publication is designed to provide accurate and authoritative information in regard to the subject matter covered. It is sold with the understanding that the publisher is not engaged in rendering legal, accounting, or other professional service. If legal advice or other expert assistance is required, the services of a competent professional person should be sought.—*From a Declaration of Principles jointly adopted by a Committee of the American Bar Association and a Committee of Publishers and Associations.*




Gear Up is registered with the National Association of State Boards of Accountancy (NASBA) as a sponsor of continuing professional education on the National Registry of CPE Sponsors. State boards of accountancy have final authority on the acceptance of individual courses for CPE credit. Complaints regarding registered sponsors may be addressed to the National Registry of CPE Sponsors, 150 Fourth Avenue North, Suite 700, Nashville, TN 37219-2417. Website: www.nasba.org.



Gear Up is registered with the National Association of State Boards of Accountancy (NASBA) as a Quality Assurance Service (QAS) sponsor of continuing professional education. State boards of accountancy have final authority on acceptance of individual courses for CPE credit. Complaints regarding QAS program sponsors may be addressed to NASBA, 150 Fourth Avenue North, Suite 700, Nashville, TN 37219-2417. Website: www.nasba.org.



CFP®, CERTIFIED FINANCIAL PLANNER®, and  are certification marks owned by the Certified Financial Planner Board of Standards, Inc. These marks are awarded to individuals who successfully complete CFP® Board's initial and ongoing certification requirements.

Registration Numbers

New York	00505
Texas	000941
NASBA Registry	103024
NASBA QAS	017

INTRODUCTION

Individuals: Special Tax Situations is an interactive self-study CPE course designed to enhance your understanding of the latest issues in the field. To obtain credit, you must log on to our Online Grading System at **OnlineGrading.Thomson.com** to complete the Examination for CPE Credit by **November 30, 2011**. Complete instructions are included below and in the Testing Instructions on page 141.

Taking the Course

You are asked to read the material and, during the course, to test your comprehension of each of the learning objectives by answering self-study quiz questions. After completing each quiz, you can evaluate your progress by comparing your answers to both the correct and incorrect answers and the reason for each. References are also cited so you can go back to the text where the topic is discussed in detail. Once you are satisfied you understand the material, **answer the examination questions which follow each lesson** and record your answer choices by logging on to our Online Grading System.

Qualifying Credit Hours—QAS or Registry

Gear Up is registered with the National Association of State Boards of Accountancy as a sponsor of continuing professional education on the National Registry of CPE Sponsors (Registry) and as a Quality Assurance Service (QAS) sponsor. Part of the requirements for both Registry and QAS membership include conforming to the *Statement on Standards of Continuing Professional Education (CPE) Programs* (the standards). The standards were developed jointly by NASBA and the AICPA. As of this date, not all boards of public accountancy have adopted the standards. This course is designed to comply with the standards. For states adopting the standards, recognizing QAS hours or Registry hours, credit hours are measured in 50-minute contact hours. Some states, however, require 100-minute contact hours for self-study. Your state licensing board has final authority on accepting Registry hours, QAS hours, or hours under the standards. Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self-study. You may also visit the NASBA website at **www.nasba.org** for a listing of states that accept QAS hours. Credit hours for CPE courses vary in length. Credit hours for this course are listed on the “Overview” page.

CPE requirements are established by each state. You should check with your state board of accountancy to determine the acceptability of this course. We have been informed by the North Carolina State Board of Certified Public Accountant Examiners and the Mississippi State Board of Public Accountancy that they will not allow credit for courses included in books or periodicals.

Obtaining CPE Credit

Log on to our Online Grading Center at **OnlineGrading.Thomson.com** to receive instant CPE credit. Click the purchase link and a list of exams will appear. You may search for the exam by selecting Gear Up/Quickfinder in the drop-down box under Brand. Payment of **\$27** for the exam is accepted over a secure site using your credit card. For further instructions regarding the Online Grading Center, please refer to the Testing Instructions located at the beginning of the examination. A certificate documenting the CPE credits will be issued for each examination score of 70% or higher.

Obtaining CFP® Credit

To receive CFP® credit, please provide your name and CFP license number to Thomson Reuters within the Online Grading Center. Upon successful completion of the course, we will submit the credit hours you've earned directly to the CFP Board. The CFP Board will then send you a confirmation email that includes the number of credits you have been awarded and the category in which they were earned. If we do not receive your name and license number within 30 days of completion, the CFP Board will **not** award you credit.

Retaining CPE Records

For all scores of 70% or higher, you will receive a *Certificate of Completion*. You should retain it and a copy of these materials for at least five years.

PPC In-House Training

A number of in-house training classes are available that provide up to eight hours of CPE credit. Please call our Sales Department at (800) 387-1120 for more information.

Individuals: Special Tax Situations (DSSTG10)

OVERVIEW

COURSE DESCRIPTION:	This interactive self-study course discusses the unique tax rules that apply to licensed professionals, ministers, and athletes and entertainers.
PUBLICATION/REVISION DATE:	November 2010
RECOMMENDED FOR:	Users of the Individuals—Special Tax Situations <i>Quickfinder</i> ® Handbook
PREREQUISITE/ADVANCE PREPARATION:	None
CPE CREDIT:	8 QAS Hours, 8 Registry Hours
CTEC CREDIT:	8 Federal CTEC Hours, 0 California Hours
	Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self-study. You may also visit the NASBA website at www.nasba.org for a listing of states that accept QAS hours.
	Enrolled Agents: This CPE course is designed to enhance professional knowledge for Enrolled Agents. Gear Up is a qualified CPE Sponsor for Enrolled Agents as required by Circular 230 Section 10.6(g)(2)(ii).
CFP® CREDIT:	4 CE Hours – CFP® Credit hours are half the number of CPE credit hours.
FIELD OF STUDY:	Taxes
EXPIRATION DATE:	November 30, 2011
KNOWLEDGE LEVEL:	Basic

LEARNING OBJECTIVES

Lesson 1: Licensed Professionals

Completion of this lesson will enable you to:

- Define what constitutes a licensed professional and characteristics common to professional practices.
- Describe specific tax issues that apply to many licensed professionals.

Lesson 2: Ministers

Completion of this lesson will enable you to:

- Determine the qualifications of a minister and a religious organization.
- Identify self-employment tax issues.
- Compute net earnings from self-employment subject to self-employment tax.
- Determine excludable housing allowance.
- Identify allowable tax deductions.
- Describe retirement plans available to ministers.
- Summarize IRS audit activity and potential issues faced by ministers.

Lesson 3: Athletes and Entertainers

Completion of this lesson will enable you to:

- Identify unique characteristics and tax issues relevant to athletes.
- Describe deferred compensation plans.
- Classify compensation and other income earned by an athlete.
- Determine how to maximize an athlete's deductible expenses.
- Describe characteristics of and sources of income generated by professional entertainers.

ADMINISTRATIVE POLICIES

For information regarding refunds and complaint resolutions, dial (800) 323-8724, select the option for Customer Service and your questions and concerns will be promptly addressed.

CPE & Training Solutions *Powered by Checkpoint Learning!*

800.231.1860 | cl.thomsonreuters.com

Online Courses and Learning Management

Checkpoint Learning *New!*

Checkpoint Learning...a dream come true for CPE decision makers. With the combined power of MicroMash, PASS Online, PPC and Required, we are pleased to introduce you to the next level in online learning! Checkpoint Learning provides reporting, learning reminders and prompts, CPE compliance tracking, and much more. You can purchase and complete courses directly from Checkpoint Learning, either individually or as part of a subscription package. Select from hundreds of online and downloadable courses on auditing, tax, management, yellow book, and staff training topics. Contact us today to discuss your training needs and begin building a learning plan that's right for you.

MicroMash

A trusted provider of technology-based CPE and training for over 20 years. Choose from more than 130 courses on hot topics that will help you stay on top of your field—now available through Checkpoint Learning!

PASS Online

A CPE provider since 1990, PASS Online offers more than 180 courses covering a variety of accounting and tax topics, including industry-leading state ethics training courses for accountants. Now available through Checkpoint Learning!

Live Seminars & Conferences

Gear Up Seminars, Workshops and Conferences

A leading provider of tax and accounting education for 39 years, Gear Up offers nationwide events designed for you! *Seminars:* Half-day to two-day seminars in states nationwide! Select from our 1040 and Business Entities seminars, plus specialty titles—including the new *Assisting Small Business from A to Z*.

Conferences: Our week-long CPE conferences are held at exciting vacation destinations! In 2010, join us at Royal Flush in Las Vegas (November 29–December 4), and Magic Week in Orlando (December 14–18), and looking ahead to 2011 join us at Jackpot in Las Vegas (May 16-21), Citrus Week in Orlando (June 13-16), and Windy City Week in Chicago (August 1-6).

Workshops: Our 8-hour workshop format provides a streamlined learning experience at an affordable price! Accounting and tax titles available this year in Alabama, Florida, Illinois, North Carolina, and Texas.

PPC and AuditWatch Conferences

Practical guidance you need at locations you'll love! PPC and AuditWatch offer in-depth learning at conferences created to meet the needs of professionals nationwide. We gather field experts who bring attendees the most up-to-date, relevant information regarding a variety of important topics. Registration cost includes continental breakfast, luncheon and refreshment breaks, and all sessions, conference materials, and reception.

Details about our 2011 PPC and AuditWatch Conferences will be online soon! Check back for early bird registration discounts and terrific room rates for attendees at our hotel locations.

AuditWatch Live Seminars

AuditWatch, the audit profession's premier training and consulting firm and recognized leader in audit productivity, offers specialized auditing seminars in locations nationwide. These live seminars include:

AuditWatch University—an integrated development curriculum that provides your firm five levels of audit staff training

AuditWatch University—Yellow Book—a three-day series. Choose to attend all or just the sessions most important to you.

Day 1: Auditing Nonprofit Organizations, Day 2: Performing Efficient and Effective Single Audits, Day 3: Auditing State and Local Governments/Government Update.

TaxWatch University—core tax staff training covering: individual, corporate, pass-through, partnership, and more.

In-House Training

PPC In-House Seminars

PPC offers on-site customized training on over 50 accounting and auditing, management, staff training, tax and Yellow Book topics. This learning experience is custom-tailored to meet your needs, taught by highly rated instructors, features current, relevant course content—and at approximately \$15 per credit hour, In-House training is very affordable!

Practitioners Monthly Video Digest

This monthly CPE product is a convenient and cost-effective way for firms to provide timely, leading-edge in-house training. Every month (excluding February and March) your firm will receive a training module that contains a high-quality instructional DVD and related course materials including an instructor's guide and participant materials. Members of your firm will meet monthly, view a DVD featuring leading experts addressing new and emerging issues, and participate in related discussions.

Webinar Learning Network

You'll find webinars and webcasts (with live streaming video) on the latest developments in tax, accounting, auditing, finance and more—all you need is a high-speed internet connection and a phone!

AuditWatch

AuditWatch has an intense focus on serving the audit and accounting profession with leading experts to train and consult with firms that provide auditing services. Our integrated development curriculum for audit professionals and CPA firms, audit process consulting, and audit technology services make AuditWatch the recognized leader in audit productivity.

Self-Study Courses

Gear Up Self-Study

A leading provider of tax and accounting education for 39 years, Gear Up offers print-based self-study courses based on our popular live seminars plus additional standalone specialty topics. Most live seminar topics can be supplemented with video and audio materials to provide you with the feel of an instructor-led seminar in your home or office—learn on your schedule!

PPC Self-Study

Learn with the company that provides the industry-leading PPC Guides—convenient self-study courses are available on a variety of accounting & auditing and tax topics. Easily access many print-based self-study courses as downloadable PDFs and complete your CPE exams online for immediate results, now directly through the new Checkpoint Learning platform!

Quickfinder | Gear Up Self-Study CPE

Quickfinder's trusted content combined with Gear Up's history as a leader in tax & accounting professional education—a winning combination for your training needs!

RIA Self-Study CPE

RIA and PPC's Complete Analysis of the Tax and Benefits Provisions of the American Recovery and Reinvestment Act, and RIA's 2010 Federal Tax Review. Download PDF at no cost from Checkpoint Learning!



Table of Contents

Lesson 1: Licensed Professionals	1
Tax Issues Applicable to Specific Licensed Professions	2
Lesson 2: Ministers	27
Qualifying as a Minister	28
Employment Tax Issues	34
Income Tax Issues	46
IRS Audit Issues	63
Comprehensive Illustration	66
Lesson 3: Athletes and Entertainers	89
Professional Athletes	90
Minimizing Taxes on Personal Services Income	91
Planning for Other Income Earned by an Athlete	105
Maximizing an Athlete’s Deductible Expenses	108
Planning an Athlete’s Estimated Tax Payments	113
Representing Professional Entertainers	114
Identifying the Sources of Income Generated by Entertainers	115
Will a Loan-out Corporation Save an Entertainer Taxes?	121
Glossary	137
Index	139
<p>To enhance your learning experience, the final examination questions are located throughout the course reading materials. Please look for the exam questions following each lesson.</p>	
Testing Instructions for Examination for CPE Credit	141

Lesson 1: Licensed Professionals

Learning Objectives

Completion of this lesson will enable you to:

- Define what constitutes a licensed professional and characteristics common to professional practices.
- Describe specific tax issues that apply to many licensed professionals.

The characteristics distinguishing licensed professional practices from other businesses are:

- a. *State Licensure.* Most professional practitioners have one or more licenses to practice granted by a licensing authority. The authority is usually a regulatory body either operated within a state government or officially sanctioned by a state. Professional practice businesses generally may only be owned by individuals holding a state-approved license.

In addition to an ownership requirement, the state licensure laws typically restrict certain procedures or professional acts to those who have current state licenses. Thus, while professional practices typically employ both licensed and unlicensed individuals, only licensed practitioners may perform certain services (e.g., only a licensed physician may perform surgical procedures and prescribe drugs, only a licensed attorney may draft legal documents, etc.).

State licensure is required because of the underlying premise that the services involved require a recognized set of skills. Accordingly, a condition of receiving a state license in a professional field typically involves an entry level education requirement, attaining a certain score or grade on a standardized examination, and an ongoing continuing education requirement. These requirements are intended to protect the public by assuring that only individuals who are credentialed and who possess up-to-date skills render the applicable professional services.

- b. *Unlimited Personal Liability.* In granting licensure, the state generally will also require that licensed professionals bear the personal responsibility for their own malpractice. Thus, a second hallmark of a licensed occupation is that practitioners cannot shield their personal assets from liability created by their own professional actions by operating within a corporate or other limited liability entity. However, it is possible to limit personal liability from the professional errors of colleagues who operate within the same business entity.
- c. *Professional Goodwill.* The value of a professional practice is generally dependent on goodwill and other intangible assets. While businesses in many industries build goodwill in the form of an established customer base, a recognized name and location, and similar attributes, a professional practice may have much of its goodwill attributable to the skills, reputation and efforts of one or more individuals. This professional goodwill may have little value to a buyer and may expire with the death, disability or retirement of the individual. This characteristic can create problems in valuing professional practices.

The licensed occupations that typically meet the criteria discussed above and are the topic of this lesson can generally be grouped into six fields: (1) doctors, dentists and similar health care professionals; (2) attorneys; (3) certified public accountants (CPAs) and other state-licensed accounting practitioners; (4) engineers; (5) architects; and (6) actuaries.

The definition of licensed professional services could certainly be expanded beyond the six occupations identified above. However, from a tax standpoint, the Internal Revenue Code has characterized the above six professions, along with consultants and performing artists, as the groups to which the personal service corporation restrictions apply.

Licensed professional practices tend to have the following three tax characteristics:

1. *PSC Restrictions.* Licensed professional practices which operate as C corporations typically meet the various definitions within the tax law applicable to personal service corporations (PSCs).
2. *Cash Method of Accounting.* As businesses that recognize revenue from the collection of fees in exchange for the rendering of services, as opposed to recognizing revenue from the sale of goods, licensed professional practices are generally eligible to use the cash method of accounting. This not only creates tax deferral opportunities but allows some flexibility in timing expense deductions.
3. *High Compensation.* While not universally true, licensed professionals tend to have above average income levels within their Form 1040. While professionals' earned income may be subject to higher ordinary income tax rates, it is also eligible for exclusion or tax deferral strategies that either converts the income to nontaxable fringe benefits or use the income to fund tax-qualified retirement plans. Accordingly, maximizing the use of fringe benefit plans as well as the funding of qualified retirement plans represent important issues for licensed professionals.

Tax Issues Applicable to Specific Licensed Professions

While there are a number of similarities among the licensed professions, there are many unique tax issues within specific professions. These tax issues have often arisen as a result of IRS initiatives, either through published positions or significant and widespread examination activity. Some of the more important issues are discussed in the following paragraphs.

Law Firms

Trust Accounts. An account that is peculiar to practicing attorneys is the trust fund or escrow account. The law firm will deposit into this account funds it receives from a client that are to be disbursed to various third parties, and sometimes to the law firm for fees earned. Typically, these funds represent proceeds from the settlement of cases and deposits received from real estate closings. The trust fund may also contain a specific retainer, which represents an agreed fee for a particular case that has been received in advance. Cases involving criminal work, bankruptcy, and divorce often involve the collection of a retainer.

Law firms may have many separate trust accounts. Typically, IRS examiners will review trust accounts to determine if any trust account funds have been diverted to a personal account or disbursed for personal purposes, or to determine if the trust account is holding and deferring fees that should be transferred to the general law firm account and recognized as taxable income. Once a case is settled, the attorney's fee is determinable and should be included in income. This position has been supported by the courts. IRS examiners determine whether any funds in the trust account represent fees that have been earned on settled cases but not yet recognized as income because the fees are retained within the trust account.

IRS examiners also scrutinize checks issued from the trust account to verify that any fees due to the attorney have been properly deposited in the attorney's general operating account. Checks disbursed from the account should be examined to ensure they represent proper transfers of fees to the attorney or expense reimbursements to third parties, rather than personal benefit expenditures for the attorney.

Trust accounts may also be used to collect contingent fees. A law firm will often accept a personal injury case under a contingent fee arrangement, which provides that the firm receives a share, generally one-third, of the ultimate recovery upon litigation or settlement. When the settlement is received, it is deposited to the attorney's trust account, any expenses that have been advanced by the law firm are reimbursed, and the remaining proceeds, after the attorney's fee, are distributed to the client.

A retainer is generally thought of as an agreed-upon fee received in advance. Retainers typically are deposited into a trust or escrow account and then transferred to the law firm's general account as the retainer is earned through the rendering of services by the attorney. The IRS's position is that a law firm on the cash method of accounting that has free access to client retainer funds is taxable on the funds when received.

Client Expense Advances. Law firms commonly pay litigation expenses on behalf of their clients. These costs are then recovered by the professional practice when the settlement or court award is received. This practice is typically applied by firms that accept cases on a contingency basis, such as in the litigation of personal injury claims. In some cases, it may take several years to resolve a case. Meanwhile, a law firm may have advanced substantial costs in anticipation of collecting a percentage share of the settlement or court award at some future time.

The use of the cash method of accounting can distort income because advanced funds and expenses may be incurred by the law firm several years ahead of settling the case and receiving the offsetting revenue or reimbursement. Accordingly, the courts have held that litigation costs and other expenses advanced by an attorney, where the client is unconditionally responsible to reimburse the attorney, do not represent deductible business expenses when incurred but rather must be treated as loans to the client. If the law firm is not successful in receiving reimbursement from its client, it can deduct the expenses incurred as a bad debt when it determines that worthlessness of the loan has occurred.

If a law firm incurs expenses on behalf of a client that it initially treats as a loan but later decides that it will not bill the client and will not seek reimbursement, and assuming that there is a valid business purpose for not billing the client, the unreimbursed costs may be deductible as a business expense (Ltr. Rul. 9432002). This ruling mentions several situations when a valid business purpose may exist for not billing a client, such as when the client has received insufficient benefit for the out-of-pocket expense incurred or when the amount is small in relation to other billings to the client.

A 9th Circuit case provided a solution allowing law firms to currently deduct client expenses if the firm arranges its contracts with clients under what is known as a gross fee basis. According to the contractual arrangements with its clients, the firm paid all expenses and litigation costs but was not reimbursed by the client if there was no settlement or award. The court concluded that the expenses incurred by the law firm could not be characterized as loans because the client had no obligation to repay the expenses. In addition, the court costs, fees, expert witness charges and similar expenditures could be categorized by the firm as ordinary and necessary business expenses.

Firms that advance client expenses under a net fee arrangement (as opposed to the gross fee arrangement discussed in the preceding paragraph where current deductibility is allowable) should treat the client expense advances as loans until recovery occurs, either at settlement or via reimbursement from the client. Law firms incorrectly handling these expenses are to submit a Form 3115 (Application for Change in Accounting Method) to accomplish an automatic accounting method change. The advantage of submitting an accounting method change under Rev. Proc. 2002-9 is the ability to spread the income impact (the so-called Section 481 adjustment) over four tax years. If the accounting method change is imposed by the IRS, the adjustment will be made in a single tax year, typically the earliest open year.

Passive Losses of Real Estate Professionals. Some real estate professionals can treat otherwise passive rental real estate activities as nonpassive activities, which means that the losses from such activities can be used to offset wages, interest, and other nonpassive income. This treatment is only available to eligible real estate professionals who materially participate in the real estate activity.

To be eligible for these special rules, the taxpayer must materially participate in real property trades or businesses rather than participate in business activities involving real estate transactions. This suggests that the benefits of these rules may be unavailable to individuals, such as many lawyers, who are only peripherally involved in real property trades and businesses. For example, a lawyer who spends 85% of her time working on real estate legal matters, and who has several rental properties that have substantial losses for the year, probably cannot treat the rental losses as nonpassive. This is so even though she spends a substantial amount of time dealing with real property issues.

Payments to “Of Counsel” Attorneys. In response to an inquiry from the field, the IRS Chief Counsel’s office has issued a private letter ruling discussing the classification of “Of Counsel” attorneys for employment tax purposes. In the situation under examination, the law firm paid a fixed monthly amount to of counsel attorneys in exchange for legal services, reporting the amounts as guaranteed payments on the partnership Schedule K-1. The individuals were not otherwise partners in the law firm, as they had no interest in firm profits or capital, nor any managerial rights or ability to bind the partnership. For these reasons, the IRS concluded that the “of counsel” attorneys were not partners and the partnership payments were not guaranteed payments. The letter left open the possibility that the payments could be classified as compensation to an employee or as self-employment income to an independent contractor. The letter also contained a lengthy discussion of IRS procedural requirements in making adjustments to partnership items that may involve either employment (FICA) or self-employment (SE) tax.

Reporting Payments to Attorneys

Anyone engaged in a trade or business who, in the course of that activity, makes payments totaling at least \$600 for rent, salaries, wages, or other fixed or determinable gains, profits, and income, has to report the payments on an information return. Form 1099-MISC is used to report the payments, unless another form (such as Form W-2 for wages) applies. Reg. 1.6041-1(d)(2) makes it clear that this rule applies to payments made to attorneys. IRC Sec. 6045(f) requires any payments for legal services to be reported on an information return, regardless of whether the payment is made to a legal practice operating as a sole proprietorship, partnership, LLC, or corporation, and regardless of whether the payer knows how much of the payment ultimately belongs to the attorney (as opposed to the attorney’s client).

Basic Reporting Requirements. In general, every payer engaged in a trade or business who, in the course of that activity, makes payments aggregating \$600 or more during a calendar year to an attorney in connection with legal services (even if the services are not performed for the payer) must file an information return related to such payment(s). Businesses are required to report payments to attorneys in box 7 or 14 of Form 1099-MISC. Because law firms often issue payments to other attorneys in shared litigation arrangements, these regulations have application to law firms as both payers and recipients. The regulations define the following terms for reporting purposes:

- A payer is a person who makes a payment to an attorney if that person is an obligor on the payment, or the obligor's insurer or guarantor.
- An attorney is a person engaged in the practice of law, whether as a sole proprietor, partnership, corporation, or joint venture.
- Legal services are all services related to, or supportive of, the practice of law performed by, or under the supervision of, an attorney.

If more than one attorney is listed as a payee on a check, the information return must be filed with respect to the payee attorney to whom the check is delivered. If someone other than one of the payee attorneys receives the check (i.e., either a non-attorney who is a payee, or anyone who is not a payee), the information return must be filed with respect to the first-listed payee attorney on the check.

Example 1-1: Multiple attorneys listed as payee.

Fellows Corporation settles a suit brought by Matt Grayson by paying a check for \$1 million to Matt's three attorneys, Adam, Zeke, and Charles. The check is delivered to Zeke, who deposits the check into a trust account and makes payments by separate checks to Adam for \$100,000 and to Charles for \$50,000 for their share of the attorney fees. Zeke also makes a payment of \$550,000 to Matt.

Fellows must file an information return (Form 1099-MISC, box 14) for \$1 million with respect to Zeke, who in turn must file a Form 1099-MISC with respect to Adam (for \$100,000) and Charles (for \$50,000). Zeke should report the amounts paid to Adam and Charles in box 7 of Form 1099-MISC (assuming they were working for him as outside legal consultants).

Now assume that Fellows makes the check payable to Matt, but still delivers it to Zeke. Here, Fellows is not required to file an information return with respect to Zeke because there was no payment to an attorney as defined in IRC Sec. 6045(f). Depending on the nature of the lawsuit, Fellows presumably would need to file a Form 1099-MISC with respect to Matt.

Example 1-2: Settlement taxable to claimant.

Sam sued his former employer, Petersen Industries, for back wages. Petersen settled the suit for \$300,000. (The full amount is taxable to Sam as wages.) A \$200,000 check (\$300,000 less income and FICA tax withholding), payable jointly to Sam and his attorney, Taylor McBride, is given to Taylor. Taylor keeps \$75,000 of the payment and disburses the remaining \$125,000 to Sam.

Petersen must issue an information return to Taylor for \$200,000 (reported in box 14 of Form 1099-MISC). In addition, under IRC Sec. 6051, Petersen must report \$300,000 on a Form W-2 for Sam.

Example 1-3: Settlement not taxable to claimant.

Joyce sues BigMart for damages resulting from personal injuries suffered while in a BigMart store. BigMart settles the suit with a \$600,000 damage payment that is excludable from Joyce's income under IRC Sec. 104(a)(2). BigMart writes the settlement check payable jointly to Joyce and her attorney, Clark. The check is delivered to Clark, who retains \$240,000 as attorney fees and remits the remaining amount (\$360,000) to Joyce. BigMart must file an information return with respect to Clark for \$600,000 (reported in box 14 of Form 1099-MISC).

Exceptions to Reporting Requirements. The regulations contain the following exceptions for when reporting is not required by IRC Sec. 6045(f) (although as noted, reporting may be required under another provision):

- Wages or other compensation paid to an attorney by the attorney's employer. (A Form W-2 is required instead.)
- Compensation or profits paid or distributed to partners by a partnership or LLC engaged in providing legal services. (Instead, the partners or members should receive a Schedule K-1 from the entity.)
- Dividends or corporate earnings and profits paid to shareholders by a corporation engaged in providing legal services. (A Form 1099-DIV will be required if the annual total is at least \$10.)
- Payments to an attorney reportable under IRC Sec. 6041(a) (or payments that would be reportable if they totaled at least \$600 for the year) for rents, premiums, annuities, or other fixed or determinable amounts. In other words, payments for an attorney's services that are reportable in box 7 of Form 1099-MISC are not reportable in box 14 of Form 1099-MISC.
- Payments made to foreign attorneys who are not engaged in a U.S. trade or business and do not perform any labor or personal services in the U.S.
- Payments made to an attorney as the settlement agent in a real estate transaction.
- Payments made to an attorney in the attorney's capacity as a trustee in bankruptcy.

To summarize, almost any payment made to an attorney in the course of the payer's trade or business is reportable if total payments to a single payee are \$600 or more during the year. Payments for services belong in box 7 of Form 1099-MISC, while other payments (such as in settlement of a lawsuit) belong in box 14. When a payment belongs in box 14, the regulations provide guidance on the applicable reporting requirements.

Health Care Professionals

Prohibited Private Inurement or Private Benefit. More than in any other profession, the health care industry often involves for-profit individuals (e.g., physicians) engaging in business arrangements with not-for-profit hospitals or charities. But charitable organizations operate under numerous restrictions, including one that requires that their income not inure (or accrue) to the benefit of a private shareholder or individual. Private inurement can include excessive compensation paid to physicians. If compensation is "reasonable," there is no private benefit to the individual for Section 501(c)(3) purposes. In determining whether compensation is reasonable or excessive, the IRS looks at whether comparable services would cost as much if obtained from an outside source in an arm's-length transaction. In an "integrated delivery

system” involving a tax-exempt hospital, physicians cannot vote on compensation issues related to their practices. In general, an integrated delivery system is a combination of hospitals, physicians, and other medical service providers that provide coordinated, continuing medical care to a defined population or group of enrollees. To prevent private inurement and private benefit, tax-exempt organizations should pay FMV for all assets and services.

Another key issue is whether there was payment for the goodwill or other intangibles associated with the practice. Any goodwill payment should be based on the value of the goodwill to the selling physician, not what the practice would be worth to the organization. (That methodology is known as the “business enterprise value.”) The IRS has cautioned that the purchase price the tax-exempt organization may be willing to pay is not necessarily the value that will be allowed upon audit for tax purposes.

In addition to the payment of compensation and the purchase of assets, inurement may occur if the tax-exempt entity pays excessive rent, provides physicians with interest-free or low-interest loans, or sells assets at less than FMV.

Although the requirements for finding inurement or private benefit are similar, the two are different. A minimal amount of inurement results in a violation, whereas private benefit must be more than quantitatively or qualitatively incidental to be a violation. Inurement only applies to “insiders,” while a private benefit may accrue to anyone.

The qualitative test recognizes that a tax-exempt organization’s purpose is to provide substantial benefits to the community. The organization cannot achieve its purpose without others incidentally benefiting. For example, there is a private benefit in a relationship between a hospital and a physician, but the benefit does not create a problem if incidental to the public benefits involved. The quantitative test requires that the benefits received by others must be insubstantial when compared to the public benefit.

In the past, the IRS has been reluctant to revoke a 501(c)(3) organization’s tax-exempt status because of private inurement. This is based on the idea that the harm to innocent persons (e.g., holders of the organization’s tax-exempt bonds or members of the community served by the organization) that revocation would cause may outweigh any “determent” that revocation may accomplish. IRC Sec. 4958 (the so called “intermediate sanctions” provisions) was enacted to provide the IRS with the means to punish private inurement by potentially revoking an organization’s tax-exempt status.

The Section 4958 intermediate sanction rules impose a three-tier excise tax on individuals who benefit from or participate in excess benefit transactions:

- A first-tier tax equal to 25% of the excess benefit is assessed against a disqualified person involved in an excess benefit transaction.
- A second-tier tax equal to 200% of the excess benefit is imposed on the disqualified person if the excess benefit transaction is not corrected by the earlier of when the first-tier tax is assessed or when a deficiency notice regarding the tax is mailed.
- An additional tax equal to 10% of the excess benefit, but not to exceed \$20,000, can be imposed on any organization manager who knowingly participated in the excess benefit transaction.

In certain situations, the rules against inurement and private benefit can conflict with other (nontax) fraud and abuse statutes. A hospital incentive program to improve the cost-efficient use of services may pass IRS scrutiny but run afoul of other federal laws.

Physician Compensation Arrangements. As noted earlier, a 501(c)(3) organization's compensation arrangement with an employee or an independent contractor must not result in private inurement if that person is an insider, and must not confer impermissible private benefit whether or not that person is an insider. This requires that any compensation or incentive payments to physicians must be reasonable. The Tax Court has held that an arrangement involving a tax-exempt clinic and a group of employee physicians violated the requirement against inurement of net earnings. Under the compensation arrangement, substantially all of the clinic's net receipts, after other expenses, were set aside and distributed to the physicians. The controlling physicians received the bulk of the distributions, and the court found private inurement occurred. Similarly, a hospital was found to be operated to a considerable extent for the private benefit of two founding doctors, rather than exclusively as a charitable organization. The two doctors shared in the fees from a privately owned laboratory and X-ray department within the hospital, even though they personally performed no associated services.

The IRS has ruled that a fixed percentage compensation plan of an exempt hospital does not result in prohibited private inurement if the compensation plan meets the following three tests: (a) the plan must not be merely a device to distribute profits to persons in control or to transform the organization's principal activity into a joint venture, (b) the compensation plan must be the result of arms-length bargaining, and (c) the compensation must be reasonable in comparison to amounts received by physicians at similar hospitals with comparable responsibilities and patient volume. Whether these criteria are met depends on the facts and circumstances of each case.

There is no rule preventing health care organizations from making incentive compensation payments to physicians. In an IRS information letter concerning tax-exempt hospitals making incentive payments to physicians, the IRS indicated that it considers the following factors in determining whether an arrangement violates the rules against private inurement and impermissible private benefit:

- Was the compensation arrangement established by an independent board or compensation committee?
- Does the compensation arrangement with the physician result in total compensation that is reasonable?
- Is there an arms-length relationship between the health care organization and the physician?
- Does the compensation arrangement include a ceiling or reasonable maximum to protect against projection errors or substantial windfall benefits?
- Does the compensation arrangement have the potential for reducing the charitable services or benefits that the organization would otherwise provide?
- Does the compensation arrangement take into account data that measures quality of care and patient satisfaction?
- If the amount under the compensation arrangement depends on net revenues, does the arrangement accomplish the organization's charitable purposes?
- Does the compensation arrangement transform the organization into a joint venture with the physician?
- Is the compensation arrangement merely a device to distribute all or a portion of the health care organization's profits?

- Does the compensation arrangement serve a real and discernable business purpose of the exempt entity?
- As a result of the compensation arrangement, do the prices and operating costs of the entity compare favorably with similar organizations?
- Does the compensation arrangement reward the physician based on services actually performed?

Physician Recruitment and Retention. Hospitals go to great lengths to attract and retain physicians because physicians control the majority of admissions to hospitals. For hospitals with low occupancy or located in areas with heavy competition, aggressive recruitment may be the only means of survival. Among others, hospitals often offer the following inducements: (a) reduced office rent, (b) joint ventures, (c) low-interest financing, (d) income guarantees, (e) reimbursement of relocation expenses, (f) salaried administrative positions, and (g) reduced practice management service fees.

These items will be scrutinized by the IRS for violations of the private inurement rules if the hospital is tax-exempt. The fact that any of the benefits may be present will not, in itself, create a problem for the nonprofit hospital. However, the nonprofit hospital needs to be able to show that the benefit to the physician is incidental to the benefit of the community.

Retention incentives by a hospital to a physician already on the hospital's medical staff are not permissible. Incentives may only be given to recent graduates of residency or fellowship programs or to a physician that has not previously practiced in the hospital's community.

The following are permissible financial incentives for the recruitment of physicians:

- A signing bonus.
- The payment of malpractice premiums for a limited period of time.
- Reimbursement for professional liability insurance tail coverage.
- Offering below-market rent in a hospital-owned building for a limited period of time.
- The guarantee of a personal home mortgage for a residence in the hospital's service area.
- The extension by the hospital of a written loan at commercially reasonable terms.
- Reimbursement of moving expenses as defined by IRC Sec. 217(b).
- The provision of a compensation guarantee for a limited number of years.

In Rev. Rul. 97-21, the IRS looked at whether a Section 501(c)(3) hospital's tax-exempt status is jeopardized when it provides recruitment incentives to physicians. The common denominator in each scenario presented is the need for physicians. Three of the scenarios involve a rural community or economically depressed inner-city area that has a critical shortage of the type of physician the hospital is trying to recruit. In the fourth situation, the hospital is recruiting to fill a position on its own staff so it can effectively serve the community. In all four situations, the recruitment incentives were not a problem. However, the hospital in the fifth scenario had been found guilty of violating Medicare and Medicaid anti-kickback statutes for providing incentives that amounted to the payment for referrals. Therefore, the hospital did not qualify as tax-exempt because its recruitment activities were found to be inconsistent with its charitable purpose.

Physician Anti-referral and Anti-kickback Rules. Physician recruitment and incentive arrangements also must avoid the impact of the federal anti-referral statutes and the Medicare/Medicaid anti-kickback statute. The anti-kickback statutes address knowingly and willfully paying any remuneration in return for a referral. The statutes do not address intent, but rather strictly prohibit referrals between physicians and entities with which the referring physicians have a financial relationship, and apply to designated services such as hospital care and services for which payment occurs under Medicare Part B.

The anti-referral rules apply when the recruiting arrangement involves a financial relationship to the entity. A financial relationship can involve ownership attributes, such as an equity or debt item, or a compensation arrangement involving either the physician or a family member. Despite this broad language, there are a number of significant exceptions similar to those allowed by the IRS for recruitment incentives. Compensation arrangements designed to induce a physician to relocate to the geographic area served by the hospital are permitted if the (a) physician is not required to refer patients to the hospital, (b) arrangement is not based on the volume or value of referrals by the physician, (c) arrangement and its terms are established in writing, and (d) physician is not precluded from establishing privileges at another entity.

The federal anti-kickback statute prevents the knowing or willful solicitation or receipt of any remuneration in return for referring an individual to a party who furnishes any item or medical service reimbursed under Medicare or state Medicaid programs. The statute is worded broadly and the courts have interpreted its language in an expansive manner, finding arrangements in violation if even one of the purposes involved is to induce referrals. The Office of the Inspector General (OIG) of the Department of Health and Human Services (HHS) has issued safe harbor regulations, identifying 23 specific arrangements that are not considered to violate the federal anti-kickback statute. These safe harbors include arrangements involving the leasing of office and practice space, equipment rental, and compensation for services. In all cases, the agreements must be in writing and reflect market value terms. There are also safe harbor provisions to assist recruitment in health professional shortage areas and to allow hospitals to assist in the payment of obstetrical malpractice insurance premiums.

Physician's Gainsharing Arrangements. Over the past several years there has been increasing discussion within the health care industry on so-called gainsharing (or value sharing) arrangements between hospitals and physicians or groups of physicians. Under such arrangements, the hospital agrees to share a percentage or portion of its cost savings that are attributable to the physicians delivering care in a more cost-effective manner. In an unreleased private letter ruling, the IRS concluded that a gainsharing arrangement under which a hospital agreed to financially reward physicians who improve services while still saving the hospital money would not adversely affect the hospital's tax-exempt status. (While the IRS did not release the ruling because it pertains to tax-exemption issues, the taxpayer gave its attorneys permission to release the ruling.)

The IRS found that the terms of the participation agreement between the hospital and physician group were arrived at during arm's-length negotiations and were intended to provide reasonable, FMV compensation to the physician group. It therefore concluded that the program would not adversely affect the hospital's Section 501(c)(3) status because the incentive pool would not be funded unless the physician group provided quality health care to the satisfaction of the hospital's patients and the hospital realized tangible cost savings.

The last two lines of the IRS ruling are telling. They state that: "This ruling does not render any opinion as to the reasonableness of physician benefits resulting from the [a]greement. It also assumes that such benefits constitute a lawful activity." On July 8, 1999, the Office of

Inspector General of the U.S. Dept. of Health and Human Services issued a special advisory bulletin that gainsharing arrangements are prohibited by federal law. While acknowledging that hospitals have a legitimate interest in enlisting physicians to eliminate unnecessary costs, the Inspector General announced that federal law prohibits hospitals from paying physicians “to reduce or limit” care to fee-for-service Medicare and Medicaid patients.

Physician Joint Ventures with Nonprofits. As noted earlier, it is common in the health care industry to have financial arrangements between for-profit physician groups and nonprofit hospitals and other health care facilities. In 1998, the IRS issued a ruling that provided guidelines on a partnership arrangement between a nonprofit hospital and a for-profit corporate group. This ruling examined two situations, one of which was permitted and one of which caused the hospital to lose its exempt status. Under the principles of this ruling, the partnership or joint venture arrangement would only be permissible for the exempt entity if the arrangement furthered the charitable or exempt purpose of the nonprofit entity, and the partnership agreement resulted in only incidental benefit to the for-profit partners. For examples of joint ventures that have received favorable rulings based on Rev. Rul. 98-15, see Ltr. Ruls. 200304042 and 200436022.

In 1999, the Tax Court held that the IRS properly denied the tax-exempt status of an organization that had “ceded control” to a for-profit partner, meaning that it was not operated exclusively for charitable purposes. Redlands Surgical Services (RSS) was a subsidiary of a tax-exempt public benefit corporation that (through RSS) became general partner with a for-profit corporation in a partnership formed to acquire a majority interest in an outpatient surgical center. Based on its conclusion that RSS was operated for substantial nonexempt purposes because its operations benefited private interests (in more than an incidental way), the IRS denied RSS’s application for tax exempt status.

The Tax Court agreed with the IRS that RSS was not entitled to exempt status under IRC Sec. 501(c)(3) because it had ceded effective control over its sole activity to its for-profit partners and their affiliated for-profit management company. The court rejected RSS’s argument that control was not the issue, finding in part that the partnership was not bound to put charitable purposes ahead of its economic objectives, and RSS lacked formal and informal control over the surgery center. Instead, the court accepted the IRS’s reasoning that a nonprofit’s ability to control a partnership with a for-profit is key to obtaining or retaining tax exempt status. This Tax Court opinion was subsequently affirmed by the 9th Circuit.

Physician Employment Status. Physicians are increasingly relinquishing ownership of independent medical practices and taking nonownership positions with large corporate health care organizations. Under the common law control rules, the physician’s work status with the organization generally is that of an employee. The IRS discounts the lack of control by the corporation over the physician’s delivery of medical services, and instead emphasizes the economic dependency normally exhibited by the physician in these arrangements: minimal investment by the physician, little acceptance of risk, and a commitment to work solely for the health care organization. The IRS believes these factors clearly indicate the physician is an employee who is dependent on the health care organization for his livelihood.

The IRS has developed a proposed Coordinated Issue Paper (CIP) entitled “Proposed Coordinated Issue Paper: Employee Status of Hospital-Based Physicians” to guide its agents in examining the employment status of hospital-based physicians (i.e., physicians who practice medicine in a hospital setting). Depending on the facts, the hospital-based physician may be an employee of his own professional corporation, an employee of the hospital, an employee of

both, or an independent contractor (IC). Before the analysis can be properly completed, it is necessary to identify all parties to the transaction and understand how they interrelate. The following discussion explains common relationships that exist and illustrates how the physician's work status is classified in each instance.

A physician may be the sole shareholder, director, and officer of a professional medical service corporation that operates a medical practice either in the corporation's clinic, at a hospital, or both. Here, the physician's relationship to the corporation generally is that of an employee. Payments for medical services rendered to patients (either in the corporation's clinic or at a hospital) by the physician usually are the property of the corporation. Payments by the corporation to the physician for services rendered usually are wages for employment tax purposes.

Conversely, a physician may practice medicine as an employee of the hospital in which he delivers medical services. (While this arrangement typically is found in hospitals owned or operated by governments or medical colleges or universities, it may also arise when the hospital contracts with a physician to chair a hospital department.) The hospital may be the employer in a variety of hospital/physician relationships. The following relationships commonly arise:

- a. Physician who is a member of the staff of the hospital generally is an employee if the physician (a) is a faculty member of the governmental or educational institution that owns the hospital, (b) works exclusively for the hospital and does not maintain a separate office, (c) receives traditional employee benefits from the educational institution, and (d) receives a fixed salary without reference to fees collected for services rendered.
- b. Residents (physicians who are participating in post-graduate medical training programs to obtain board certification in a medical specialty) are generally employees and not ICs. However, since a resident may have a relationship with more than one entity, it can be difficult to determine which entity is the resident's employer. For example, the sponsoring institution may be a medical school, but all clinical aspects of the residency may be performed at participating institutions whose only affiliation with the medical school is by contract.

A hospital-based physician can qualify as self-employed if the physician has bona fide control over the business aspects of the delivery of her medical services despite the need for performing such services in a hospital setting. The mere fact that a physician performs medical services using only hospital facilities does not in itself cause her to be an employee of the hospital. The physician may be able to demonstrate enough independence to establish an IC relationship with the hospital, especially where the physician holds herself out to perform services for patients in other hospitals or facilities.

Physicians may establish medical practice relationships with a hospital that cause them to be an employee of the hospital for some services but not for others. For example, a physician may chair a hospital department, while providing medical services to patients in the hospital as a sole practitioner or through his own corporation. Organizations that operate hospitals may form a complex structure of professional corporations that complicate the determination of employee status for physicians who function both as officer of the corporation and as an officer or trustee of the hospital. For example, such an arrangement may be created to segregate each medical department by specialty or to incorporate faculty practice clinics.

Dental Supply Costs. In discussing the examination of professional practices, the IRS's Internal Revenue Manual suggests that the costs of supplies in a dental practice will be higher than in other medical professions due to the use of gold, silver, and the providing of crowns, bridges and dentures. In a private letter ruling, the IRS examiner attacked the taxpayer's use of the cash method due to the possibility that *merchandise* sold to dental patients, such as drugs, prosthetics, crowns, bridges, and dentures, were a material income producing item. The IRS National Office, however, ultimately determined that these merchandise or supply items were not sufficiently substantial to require use of the accrual method.

Optometrist's Inventory. Similar to the IRS concern with dental supplies discussed above, the IRS has also attempted to impose the accrual method of accounting on practices of optometrists and ophthalmologists, where the doctor maintained a supply of eyeglasses and frames for sale. However, in this situation the amount of merchandise involved was considered to be a material income producing amount, and the IRS required the use of the accrual method. However, with the adoption of cash method relief procedures for small businesses that average under \$10 million in gross receipts, most optometrical and ophthalmology practices will no longer face this attack.

Optometrist's Disabled Access Credit. An optometrist was allowed to claim a \$5,000 disabled access credit for his purchase of an automatic refractor and stand. The fact that he also used the refractor to treat nondisabled patients was "not fatal" to his entitlement to the credit. By way of analogy, the court noted that the use of a restaurant's wheelchair ramp by nondisabled customers would not "deprive the restaurant owner of the disabled access tax credit with regard thereto."

Architects

The IRS Market Segment Specialization Program guide on architects states that architects will be paid about 10% of the project cost for small jobs, while for larger jobs, the percentage may drop to 4%–5% of the project cost. Unless the job is small, the architect will generally have progress billings rather than lump-sum payments. They often will be tied to the completion of various phases of the service provided by the architect (e.g., schematic design, design development, construction documents, bidding or negotiation, and construction). The plans represent the only real leverage the architect has to secure the payment of fees. Therefore, they will normally have billed 80%–90% of their fee by the start of the construction phase.

The MSSP guide notes that the architect may have problems collecting the last amounts billed to the client. The client may be running low on funds, disagreements may arise on the pricing for changes or any number of other problems. Some architects may choose to walk away rather than create ill will with their clients. Nevertheless, amounts not collected should only be a small percentage of the contract price. If it is a large amount or percentage, there may be the possibility that the architect is receiving noncash payments for their services.

Veterinarians

As with other health care professionals, most veterinarians prefer to use the cash method of accounting for tax purposes because it facilitates year-end planning and tax deferral. In the IRS Audit Techniques Guide (ATG) on veterinary medicine (released in April 2005), examiners are told that: "If the production, purchase, or sale of merchandise is an income producing factor in the veterinarian's business, propose that the taxpayer change from cash to an accrual method of accounting. If the taxpayer keeps its books in such a way that the sale of merchandise is severable from the sale of services, propose a change to a hybrid method...."

However, in view of the rules allowing small businesses with average annual gross receipts of \$10 million or less to use the cash method of accounting, this IRS guidance does not apply to all veterinary practices. A veterinary practice whose principal activity is veterinary services is eligible to use the cash method for all its activities (both veterinary services and retail sales of pet supplies and other merchandise), subject only to the requirement that the merchandise and supplies for resale may not be deducted until actually sold.

The ATG also notes that some customers pay in cash and some write checks payable to the veterinarian personally. Such revenue can easily be diverted without being reported on any tax returns. To uncover such unreported income, examiners are told to analyze the:

- a. *Duplicate Deposit Slips*—generally there should be frequent and significant cash deposits.
- b. *Day Sheets*—the total collections per the day sheets should equal the gross receipts per the tax return.
- c. *Customer Account Ledger Cards*—by selecting a sample and tracing the entries on the customer account ledger cards to the day sheets.
- d. *Charge Slips*—since it is possible for the veterinarian to pull the customer account ledger cards that he or she does not want the examiner to see.
- e. *Appointment Book and/or Sign-in Sheet*—if these books show that X number of customers came in on a certain day, there should be X revenue entries on the taxpayer's day sheets.
- f. *Business Cash Payouts*—to verify that the income was reported before it was paid out for business expenses.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. All of the following are characteristics distinguishing licensed professional practices from other businesses, **except**:
 - a. Flow-through structure.
 - b. Professional licensure.
 - c. Personal responsibility for malpractice.
 - d. Professional goodwill.

2. A licensed professional practice has much of its professional goodwill attributable to which of the following?
 - a. Recognized name.
 - b. Skills, reputation and efforts of one or more individuals.
 - c. Established customer base.
 - d. Specific, recognizable location.

3. The Internal Revenue Code has characterized six professions, along with consultants and performing artists, as the groups to which the personal service corporation restrictions apply. Which of the following professions is included in the list?
 - a. Handyman.
 - b. Pharmaceutical representatives.
 - c. Painters.
 - d. Engineers.

4. All of the following are important issues facing licensed professionals, **except**:
 - a. Funding of qualified retirement plans.
 - b. Converting nontaxable income to taxable income.
 - c. Maximizing the use of fringe benefits.
 - d. Tax deferral strategies.

5. Law firms have many unique tax issues including the use of trust accounts. The IRS closely scrutinizes trust accounts for all of the following reasons, **except**:
 - a. To determine if trust funds have been diverted to personal accounts.
 - b. To calculate an estimated amount due under a contingent fee arrangement and verify appropriate capitalization.
 - c. To determine if the trust account is holding or deferring fees that should be transferred to the general account and recognized as income.
 - d. To verify that any fees due to the attorney have been properly deposited in the attorney's general operating account.

6. Which of the following individuals is required to file Form 1099-MISC to report payments to attorneys?
 - a. Ava Smith updated her estate plan and paid an attorney \$1,500 for preparation of new estate planning documents.
 - b. Robert Newman operates a chain of convenience stores. He paid an attorney \$550 for zoning assistance.
 - c. Betty Sue runs a rental property business and paid an attorney \$750 to prepare contracts and lease agreements.
 - d. Sam Rogers purchased a vacation home and paid an attorney \$650 to prepare the closing documents.

7. Which of the following statements is an exception to the information reporting requirements for payments made to an attorney?
- a. Profits distributed to partners by a partnership engaged in providing legal services.
 - b. Payments made to a corporation.
 - c. Check jointly payable to the attorney and claimant.
 - d. Payments to foreign attorneys who perform personal services in the U.S. for 10 days or less.
8. To prevent private inurement and private benefit, tax-exempt health care organizations should do which of the following?
- a. Isolate activities with physicians to the performance of services.
 - b. Avoid making loans to physicians or shareholders.
 - c. The purchase price for a practice should be set based on what the practice would be worth to the health care organization.
 - d. Pay fair market value for all assets and services.
9. Which of the following statements regarding physician compensation arrangements would violate the rules against private inurement and impermissible private benefit?
- a. A compensation arrangement that rewards the physician based on services actually performed.
 - b. A compensation arrangement where the health care organization and physician jointly benefit from net profits.
 - c. A compensation arrangement established by an independent board or compensation committee.
 - d. Comparable compensation arrangements are in place at health care organizations that are similar sized and serve a similar market and volume.

10. Physician recruitment and incentive arrangements must comply with the anti-kickback statutes. Which of the following arrangements designed to induce a physician to relocate to the geographic area served by a hospital would violate these statutes?
- a. A portion of the compensation agreement is based on the volume or value of referrals by the physician.
 - b. The agreement is silent as to whether a physician may establish privileges at another entity.
 - c. The physician is allowed, but not required, to refer patients to the hospital.
 - d. The arrangement between the physician and hospital was agreed upon orally but later established in writing.
11. Ronald Smith is an internist and is the sole shareholder of a professional medical service corporation that operates a medical practice in the ambulatory care center of a local hospital. For employment purposes, he is classified as a(an):
- a. Sole-proprietor.
 - b. Self-employed.
 - c. Employee of the hospital.
 - d. Employee of the professional corporation.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

1. All of the following are characteristics distinguishing licensed professional practices from other businesses, **except: (Page 1)**
 - a. **Flow-through structure. [This answer is correct. Many licensed professional practices are created as a flow-through entity such as an S corporation or limited liability partnership (“LLP”). However, this characteristic is not unique to professional practices. Many businesses decide to utilize these types of structures in order to eliminate a second level of tax as seen with a C corporation.]**
 - b. Professional licensure. [This answer is incorrect. Most professional practitioners have one or more licenses to practice granted by a licensing authority. The license authority may be a regulatory body operated with a state government or an organization sanctioned by the government.]
 - c. Personal responsibility for malpractice. [This answer is incorrect. Licensed professionals have personal responsibility for their own malpractice. They cannot organize in such as way as to limit or eliminate their personal liability.]
 - d. Professional goodwill. [This answer is incorrect. The value of a practice is generally dependent on the goodwill and other intangible assets. Professional practices generally are not capital intensive enterprises, but rather rely on the knowledge and experience of the licensed professionals.]
2. A licensed professional practice has much of its professional goodwill attributable to which of the following? **(Page 1)**
 - a. Recognized name. [This answer is incorrect. The majority of professional practices take their name from the owners of the practice. The name of the practice generally does not have name recognition beyond their local market.]
 - b. **Skills, reputation and efforts of one or more individuals. [This answer is correct. A licensed professional practice may have much of its goodwill attributable to the skills, reputation and efforts of one or more individuals. It is the individual providing the service who creates the goodwill. This characteristic can make it difficult to value professional practices.]**
 - c. Established customer base. [This answer is incorrect. Unlike a paper supply company or beverage distribution company, a licensed professional’s customer base does not generally establish goodwill. Once the individual performing services for the client ceases to perform services, most clients will look towards other resources to obtain similar services.]
 - d. Specific, recognizable location. [This answer is incorrect. Most professional practices do not operate in a national market or in a specific, recognizable location. Clients of professional practices generally tend to do business within their local area.]

3. The Internal Revenue Code has characterized six professions, along with consultants and performing artists, as the groups to which the personal service corporation restrictions apply. Which of the following professions is included in the list? **(Page 1)**
- a. Handyman. [This answer is incorrect. Handymen complete odd jobs at a personal residence generally in the context of fixing items the homeowner cannot or does not have time to complete. Although these individuals provide a valuable service, they do not require a special education. This profession is not one governed by a licensing board within a state or specifically listed in the Internal Revenue Code subject to the personal service corporation rules.]
 - b. Pharmaceutical representatives. [This answer is incorrect. Doctors, dentists and similar health care professionals are included in the Internal Revenue Code list; however, a pharmaceutical representative does not work for a practice that provides services directly to the public but rather a pharmaceutical company.]
 - c. Painters. [This answer is incorrect. Although painters do provide personal services, they are not specifically included in the Internal Revenue Code as subject to the personal service corporation restrictions. A painter does not have to be licensed in the state where he or she conducts business.]
 - d. **Engineers. [This answer is correct. Engineers are specifically included in the Internal Revenue Code as subject to the personal service corporation rules. The other six professions include attorneys; doctors, dentists and similar health care professionals; certified public accountants (CPAs) and other state-licensed accounting practitioners; architects; and actuaries.]**
4. All of the following are important issues facing licensed professionals, **except: (Page 2)**
- a. Funding of qualified retirement plans. [This answer is incorrect. Licensed professionals tend to have above average income levels; therefore, using the income to fund tax-qualified retirement plans in order to defer recognition on the income is very important to these professionals.]
 - b. **Converting nontaxable income to taxable income. [This answer is correct. Licensed professionals generally have above average earnings so it is very beneficial if they convert a portion of their taxable income into nontaxable income. Individuals in these professions tend to participate in eligible qualified plans to the fullest, maximize itemized deductions, utilize fringe benefits and implement other tax deferral strategies where appropriate.]**
 - c. Maximizing the use of fringe benefits. [This answer is incorrect. The level of income earned by licensed professionals is generally higher than other professions; therefore, licensed professional practices try to maximize their owner's income through non-taxed areas such as fringe benefits.]
 - d. Tax deferral strategies. [This answer is incorrect. Due to the level of income earned by licensed professionals, these individuals are eager to shelter a portion of their income with tax deferral strategies. These strategies can be as simple as prepaying state income taxes, to more complicated investment strategies with oil and gas investments or other tax-favored investments.]

5. Law firms have many unique tax issues including the use of trust accounts. The IRS closely scrutinizes trust accounts for all of the following reasons, **except: (Page 2)**
- a. To determine if trust funds have been diverted to personal accounts. [This answer is incorrect. The IRS is very interested as to whether trust funds have been diverted to personal accounts or disbursed for personal purposes to determine the taxability of the amounts distributed. Once an individual has constructive receipt of the proceeds, if not earlier, taxation of the amount is required.]
 - b. To calculate an estimated amount due under a contingent fee arrangement and verify appropriate capitalization. [This answer is correct. The IRS does not scrutinize estimated amounts due under a contingent fee arrangement and verify that they are appropriately capitalized. The law firm should be interested in calculating their potential fee. The IRS is more concerned with the determination of income recognition and making sure taxable income is reported correctly.]**
 - c. To determine if the trust account is holding or deferring fees that should be transferred to the general account and recognized as income. [This answer is incorrect. The IRS is concerned with the proper recognition of income. Once a case is settled, the attorney's fee is determinable and included in income.]
 - d. To verify that any fees due to the attorney have been properly deposited in the attorney's general operating account. [This answer is incorrect. The IRS does scrutinize checks issued from the trust account to ensure proper transfer of fees to the attorney or expense reimbursements to third parties.]
6. Which of the following individuals is required to file Form 1099-MISC to report payments to attorneys? **(Page 4)**
- a. Ava Smith updated her estate plan and paid an attorney \$1,500 for preparation of new estate planning documents. [This answer is incorrect. Ava Smith is not engaged in a trade or business and therefore is not required to prepare Form 1099-MISC for payments to her attorney.]
 - b. Robert Newman operates a chain of convenience stores. He paid an attorney \$550 for zoning assistance. [This answer is incorrect. Only payments in excess of \$600 are required to be reported on Form 1099-MISC.]
 - c. Betty Sue runs a rental property business and paid an attorney \$750 to prepare contracts and lease agreements. [This answer is correct. Betty Sue is required to report the payment of \$750 on Form 1099-MISC to the attorney. She is engaged in a trade or business and in the course of that activity she made a payment in excess of \$600 to an attorney.]**
 - d. Sam Rogers purchased a vacation home and paid an attorney \$650 to prepare the closing documents. [This answer is incorrect. Even though the payment is in excess of \$600, Sam is not engaged in a trade or business activity. Therefore, he is not required to prepare Form 1099-MISC.]

7. Which of the following statements is an exception to the information reporting requirements for payments made to an attorney? **(Page 6)**
- a. **Profits distributed to partners by a partnership engaged in providing legal services. [This answer is correct. Compensation or profits paid or distributed to partners by a partnership or LLC engaged in providing legal services would not be subject to information reporting requirements. Instead, partners or members should receive a Schedule K-1 from the entity.]**
 - b. Payments made to a corporation. [This answer is incorrect. If the payment exceeds \$600, an information return is required regardless of whether the payment is made to a legal practice operating as a corporation, sole proprietorship, limited liability partnership, or limited liability company.]
 - c. Check jointly payable to the attorney and claimant. [This answer is incorrect. If the settlement claim is taxable to the claimant, both the attorney and claimant will receive information returns. If the settlement claim is not taxable to the claimant, only the attorney will receive an information return. An information return is required even if the payer does not know how much of the payment will ultimately belong to the attorney.]
 - d. Payments to foreign attorneys who perform personal services in the U.S. for 10 days or less. [This answer is incorrect. Payments made to foreign attorneys who are not engaged in a U.S. trade or business and do not perform any labor or personal services in the U.S. are an exception to the reporting requirements. There are not a *de minimis* number of days for activity in the U.S.]
8. To prevent private inurement and private benefit, tax-exempt health care organizations should do which of the following? **(Page 7)**
- a. Isolate activities with physicians to the performance of services. [This answer is incorrect. Tax-exempt health care organizations may have many relationships with their physicians. The physicians may be employees, independent contractors, the organization may purchase assets from the physician practice or purchase the entire business, or rent space from the physician.]
 - b. Avoid making loans to physicians or shareholders. [This answer is incorrect. The tax-exempt health care organization should avoid making interest-free or low-interest loans. Loans that include competitive market rates are not considered inurement or private benefit.]
 - c. The purchase price for a practice should be set based on what the practice would be worth to the health care organization. [This answer is incorrect. Goodwill payments should follow the “business enterprise value” methodology which reflects a value of the goodwill to the selling physician, not what the practice would be worth to the health care organization.]
 - d. **Pay fair market value for all assets and services. [This answer is correct. To prevent private benefit and inurement, a tax-exempt health care organization should pay fair market value for all assets and services. The IRS looks at whether comparable services would cost as much if obtained from an outside source in an arm’s-length transaction.]**

9. Which of the following statements regarding physician compensation arrangements would violate the rules against private inurement and impermissible private benefit? **(Page 8)**
- a. A compensation arrangement that rewards the physician based on services actually performed. [This answer is incorrect. Compensation arrangements that reward the physician based on services actually performed is an acceptable arrangement under the IRS provisions as long as the compensation is reasonably computed.]
 - b. A compensation arrangement where the health care organization and physician jointly benefit from net profits. [This answer is correct. A compensation plan that transforms the health care organization's principal activity into a joint venture would violate the rules against private inurement and impermissible private benefit. The plan cannot merely be a mechanism to distribute profits to persons in control.]**
 - c. A compensation arrangement established by an independent board or compensation committee. [This answer is incorrect. One of the three tests a compensation plan must meet is that the plan must be the result of arm's-length bargaining. One indication of an arm's-length transaction is where a compensation committee or independent board establishes the compensation plan.]
 - d. Comparable compensation arrangements are in place at health care organizations that are similar sized and serve a similar market and volume. [This answer is incorrect. One factor the IRS considers is whether as a result of the compensation arrangement, the prices and operating costs of the entity compare favorably with similar organizations. Similar sized organizations with similar compensation and operating costs would be indicative of an acceptable plan.]
10. Physician recruitment and incentive arrangements must comply with the anti-kickback statutes. Which of the following arrangements designed to induce a physician to relocate to the geographic area served by a hospital would violate these statutes? **(Page 10)**
- a. A portion of the compensation agreement is based on the volume or value of referrals by the physician. [This answer is correct. If the arrangement's purpose is to induce referrals, it will be in violation of the anti-kickback statutes.]**
 - b. The agreement is silent as to whether a physician may establish privileges at another entity. [This answer is incorrect. As long as the compensation agreement does not preclude the physician from establishing privileges at another entity, it meets one of the four conditions for compliance with the anti-kickback statutes.]
 - c. The physician is allowed, but not required, to refer patients to the hospital. [This answer is incorrect. This provision is not in violation of the anti-kickback statutes. As long as the physician is not required to refer patients to the hospital, the compensation agreement complies with one of the required conditions.]
 - d. The arrangement between the physician and hospital was agreed upon orally but later established in writing. [This answer is incorrect. The compensation agreement must be established in writing to avoid violation of the anti-kickback statutes. Even though it was originally agreed upon orally, as long as it was established in writing it does not come afoul of the rules.]

11. Ronald Smith is an internist and is the sole shareholder of a professional medical service corporation that operates a medical practice in the ambulatory care center of a local hospital. For employment purposes, he is classified as a(an): **(Page 12)**
- a. Sole-proprietor. [This answer is incorrect. Since Ronald established his medical practice in the corporate form, he cannot be a sole-proprietor. A sole-proprietor is someone that operates a trade or business in an unincorporated structure.]
 - b. Self-employed. [This answer is incorrect. The facts and circumstances of this service arrangement do not indicate Ronald is self-employed. He does not provide the capital to perform his services, set his own hours or carry the business risk since he is the shareholder of a professional corporation.]
 - c. Employee of the hospital. [This answer is incorrect. The hospital does not possess sufficient control over the delivery of services by Ronald to classify him as an employee.]
 - d. **Employee of the professional corporation. [This answer is correct. Ronald is considered an employee of the professional corporation. Payments for medical services rendered to patients are the property of the professional corporation. Payments by the corporation to Ronald Smith for services rendered are wages for employment tax purposes.]**

EXAMINATION FOR CPE CREDIT

Lesson 1

Determine the best answer for each question below. Then log onto our Online Grading Center at **OnlineGrading.Thomson.com** to record your answers.

1. Which of the following is **not** a condition of receiving a state license in a professional field?
 - a. Prior experience in the specific professional field.
 - b. Entry-level educational requirement.
 - c. Attaining a certain score or grade on a standardized examination.
 - d. Ongoing continuing education.

2. Licensed professionals tend to have all of the following tax characteristics, **except**:
 - a. High compensation.
 - b. Personal service corporation (PSC) restrictions.
 - c. Accrual method of accounting.
 - d. Cash method of accounting.

3. When an attorney advances the client the costs of litigation and the client is unconditionally responsible for reimbursing the attorney, how are these advance payments reported?
 - a. Deductible business expenses.
 - b. Trust account advances.
 - c. Deferred revenue.
 - d. Loans.

4. Nancy Ballard is a paralegal who works with Tom Smith, an attorney licensed to practice in the state. Nancy settled an insurance case for \$10,000 for Mr. and Mrs. Macon who were injured in a traffic accident. Nancy worked under the direction of Tom Smith. If the check was delivered to Nancy and made payable to Nancy Ballard and Tom Smith, who should receive the information return?
 - a. Mr. and Mrs. Macon since they received the settlement.
 - b. Nancy Ballard since she received the check.
 - c. Tom Smith, as the first-listed payee attorney on the check.
 - d. Nancy Ballard and Tom Smith since they were both included on the check.

5. Which of the following items is **not** an exception to the information reporting requirements for payments made to an attorney?
 - a. Dividends paid to shareholders by a corporation engaged in providing legal services.
 - b. Contingent fee arrangement paid to an attorney at the settlement of a class action lawsuit.
 - c. Payment made to an attorney as the settlement agent in a real estate transaction.
 - d. Payment made to an attorney in the attorney's capacity as a trustee in bankruptcy.
6. Charitable and tax-exempt health care organizations must safeguard that their income does not inure (accrue) to the benefit of a private shareholder or individual. Which of the following items would constitute inurement?
 - a. Compensation paid to physicians.
 - b. Below market rate loans.
 - c. Competitive market place rental payments.
 - d. Assets sold at fair market value.
7. A _____ second-tier excise tax is imposed on individuals who benefit from or participate in excess benefit transactions if not corrected by the earlier of when the first-tier tax is assessed or when a deficiency notice regarding the tax is mailed.
 - a. 25%.
 - b. 50%.
 - c. 100%.
 - d. 200%.
8. All of the following items are permissible financial incentives for the recruitment of physicians, **except**:
 - a. Reimbursement of moving expenses.
 - b. Offering below-market rent in a hospital-owned building for a limited period of time.
 - c. Payment of malpractice premiums for the duration of employment.
 - d. The guarantee of a personal home mortgage for a residence in the hospital's service area.
9. Physicians who maintain an inventory of merchandise such as eyeglasses and frames, may face an attack from the IRS concerning:
 - a. Deductibility of merchandise.
 - b. Inventory valuation method.
 - c. Characterization of income.
 - d. Use of the cash basis of accounting.

Lesson 2: Ministers

Learning Objectives

Completion of this lesson will enable you to:

- Determine the qualifications of a minister and a religious organization.
- Identify self-employment tax issues.
- Compute net earnings from self-employment subject to self-employment tax.
- Determine excludable housing allowance.
- Identify allowable tax deductions.
- Describe retirement plans available to ministers.
- Summarize IRS audit activity and potential issues faced by ministers.

Ministers represent a truly unique group of taxpayers. Taxpayers performing services in the exercise of ministry are subject to a dual-status tax treatment: as employees for income tax purposes under the common law rules, but as self-employed taxpayers for social security purposes. This lesson discusses not only the dual-status tax treatment of ministers, but other unique tax considerations associated with ministers.

Tax Considerations Unique to Ministers

Some of the unique tax provisions that apply to ministers include:

- a. The exemption of some ministers from self-employment tax.
- b. The treatment of ministers not exempt from self-employment tax as self-employed for social security tax purposes, even though wages are reported on Form W-2.
- c. The exemption of ministerial wages from federal income tax withholding.
- d. The exclusion from income tax of a parsonage allowance provided to the minister.

The proper representation of ministers is approached best by first defining who qualifies as a minister. This issue is extremely important because the unique ministerial payroll tax and income tax rules only apply to qualifying individuals.

Employment tax considerations associated with ministers are addressed later in this lesson. Besides being afforded the opportunity to elect out of self-employment taxation, the employee/self-employed rules for ministers differ under the payroll tax and income tax rules.

The pertinent income tax considerations associated with ministers are discussed later in this lesson. The question of taxable income versus parishioner gifts arises often, and ministers typically receive stipends and other income over and above agreed upon salary amounts from the parish. Additionally, the rules associated with the exclusion of a parsonage allowance from the taxable income of a minister create both opportunities and potential pitfalls.

The Audit Technique Guide (ATG) issued by the IRS for ministers, and some of the areas the IRS may scrutinize during an income or payroll tax examination will also be discussed.

This lesson concludes with a comprehensive illustration summarizing many of the income and payroll tax considerations discussed throughout this lesson.

Tax Return Filing Requirements

Although ministers may not otherwise be required to file a Form 1040, one must be filed if the minister:

- a. Is not exempt from self-employment tax and has net earnings from self-employment of \$400 or more in the taxable year,
- b. Is exempt from self-employment tax on earnings from qualified ministerial services but has \$400 or more of other earnings subject to self-employment tax, or
- c. Had wages of \$108.28 or more from a church or church-controlled organization that has elected to exclude employees from FICA coverage.

Ministers who are liable for self-employment tax must file Schedule SE with their Form 1040.

Qualifying as a Minister

Definition of Church and Religious Order

While the term *church* is not specifically defined in the Code or the regulations, guidance on such definition can be found in case law. In the *Foundation of Human Understanding* decision, the court listed a number of (nonexclusive) factors to be considered, including the following:

- A distinct legal existence, and a distinct religious history.
- A recognized creed and form of worship.
- A definite and distinct ecclesiastical government.
- A formal code of doctrine or discipline.
- A membership not associated with any church or denomination.
- A complete organization of ordained ministers who are selected after completing prescribed courses of study.
- A literature of its own.
- Established places of worship with Sunday schools for the religious instruction of the young.
- Regular congregations and regular religious services.
- Schools for the preparation of its ministers.

Additionally, in Rev. Proc. 91-20, the IRS provided a list of characteristics to be used in determining whether an organization qualifies as a religious order. In general, the presence of all of the stated characteristics (see the following list) indicates that the organization is a religious order. Alternatively, the absence of the first characteristic [that the organization is described in IRC Sec. 501(c)(3)] indicates that the organization is not a religious order. If one or more of the other characteristics is absent, the determination is based on the relevant facts and circumstances. The characteristics are as follows:

- a. The organization is described in IRC Sec. 501(c)(3).
- b. The members of the organization vow to live under a strict set of rules requiring moral and spiritual self-sacrifice and dedication to the goals of the organization at the expense of their material well-being.

- c. The members of the organization, after successful completion of the organization's training program and probationary period, make a long-term commitment to the organization (normally more than two years).
- d. The organization is, directly or indirectly, under the control and supervision of a church or convention or association of churches, or is significantly funded by a church or convention or association of churches.
- e. The members of the organization normally live together as part of a community and are held to a substantially stricter level of moral and religious discipline than that required of lay church members.
- f. The members of the organization work or serve full-time on behalf of the religious, educational, or charitable goals of the organization.
- g. The members of the organization participate regularly in activities such as public or private prayer, religious study, teaching, care of the aging, missionary work, or church reform or renewal.

In two private letter rulings, the IRS determined that organizations met the requirements of a religious order, even though all seven characteristics did not exist. In both situations, the organizations possessed all of the characteristics other than the fourth characteristic, despite the fact that churches independently provided the organizations with financial support and had some influence over the policies of the organization. Nevertheless, both organizations were found to meet the definition of a religious order. Similarly, in a case dealing with the excludability of parsonage allowances, the IRS argued that such amounts were taxable because the evangelical organization involved was not a church. However, the Tax Court classified the organization as a church, looking to its religious purposes and the means by which its religious purposes were accomplished.

Definition of a Minister

The Internal Revenue Code requires a taxpayer to perform services in the exercise of his ministry in order to meet the definition of a minister. Reg. 1.107-1(a), dealing with the rental value of parsonages, references Reg. 1.1402(c)-5(b)(2), which concerns self-employment income, in defining the term *in the exercise of his ministry*.

Under Reg. 1.1402(c)-5, a duly ordained, commissioned, or licensed minister of a church or a member of a religious order (other than a member of an order who has taken a vow of poverty) is "engaged in carrying on a trade or business with respect to service performed by him in the exercise of his ministry or in the exercise of duties required by such order." The 10th Circuit noted that "We interpret Congress' language providing . . . for any individual who is 'a duly ordained, commissioned or licensed minister of a church' to mean that the triggering event is the assumption of the duties and functions of a minister." So, the date of hire clearly takes on significance in determining when the unique tax considerations become effective. If a church or denomination ordains some ministers and licenses or commissions others, those who are licensed or commissioned must be able to perform substantially all the religious functions of an ordained minister to be treated as a minister for social security purposes. Services performed by a minister in the exercise of his ministry include the following:

- a. The conduct of religious worship or the ministration of sacerdotal functions, which depends on the tenets and practices of the particular religious body constituting the minister's church or church denomination.

- b. The control, conduct, and maintenance of a religious organization, which is associated with the direction, management, or promotion of the activities of the organization. A religious organization is deemed to be under the authority of a religious body constituting a church or church denomination if it is organized and dedicated to carrying out the tenets and principles of a faith in accordance with either the requirements or sanctions governing the creation of institutions of the faith.
- c. The conduct of religious worship or the ministration of sacerdotal functions, whether or not performed for a religious organization.
- d. Service for an organization which is operated as an integral agency of a religious organization under the authority of a religious body constituting a church or church denomination, where the service is in the conduct of religious worship, the ministration of sacerdotal functions, or in the control, conduct, and maintenance of the organization.
- e. Service performed pursuant to an assignment or designation by a religious body constituting the minister's church for an organization which is neither a religious organization nor operated as an integral agency of a religious organization, even though the service may not involve the conduct of religious worship or the ministration of sacerdotal functions.

Example 2-1: Ministerial services not performed for a religious organization.

Stan, a duly ordained minister, currently serves as chaplain at Minnesota State University. Some of Stan's duties as chaplain include conducting religious worship services, offering spiritual counsel to university students, and teaching a religion class at the university. Stan devotes his entire time to performing these duties, and is accordingly deemed to be performing service in the exercise of his ministry.

Example 2-2: Services performed directly for religious organization.

Betty, a duly ordained minister, serves as a director of one of the departments of a religious board. Betty performs no other services other than acting as a director, but the religious board is an integral agency of a religious organization operating under the authority of a religious body constituting a church denomination. Betty is considered to be performing service in the exercise of her ministry.

Example 2-3: Promotion of activities of a religious organization.

Leo, a duly ordained minister, is assigned by the religious body constituting his church to perform advisory services to Liturgical Publishing Company in connection with the publication of a book dealing with the history of Leo's church denomination. Liturgical Publishing Company is neither a religious organization nor operated as an integral agency of a religious organization. Leo performs no other services for the religious body or Liturgical Publishing Company. However, Leo is deemed to be performing service in the exercise of his ministry.

Reg. 1.1402(c)-5(c) also describes services that are *not* in the exercise of ministry. If a minister is performing service for an organization which is neither a religious organization nor operated as an integral agency of a religious organization and the service is not performed pursuant to an assignment or designation by the minister's ecclesiastical superiors, only the service performed by the minister in the conduct of religious worship or the ministration of sacerdotal functions is in the exercise of ministry.

Example 2-4: Service not in the exercise of ministry.

Stan, a duly ordained minister, is engaged by Minnesota State University to teach history and mathematics. From time to time he also performs marriages and conducts funerals for relatives and friends. The university is neither a religious organization nor operates as an integral agency of a religious organization. Stan is not performing the service for the university pursuant to an assignment or designation by his ecclesiastical superiors. Accordingly, the service performed by Stan for the university is not in the exercise of his ministry. However, service performed by Stan in performing marriages and conducting funerals is in the exercise of his ministry.

Service performed by a minister as an employee of the U.S., or a state, territory or possession of the U.S., or the District of Columbia, or a foreign government or political subdivision of any of the foregoing, is not considered to be in the exercise of ministry for purposes of self-employment income, even if it involves the ministration of sacerdotal functions or the conduct of religious worship.

Example 2-5: Services as an Armed Forces chaplain.

Service performed by Tony as a chaplain in the Armed Forces of the U.S. is considered to be performed by a commissioned officer, and not by a minister in the exercise of his ministry. Similarly, if Tony was a chaplain in a state prison, the service would be considered to be performed by a civil servant of the state and not by a minister in the exercise of his ministry.

Members of Religious Orders

Members of religious orders who have not taken a vow of poverty are generally afforded the same treatment as ministers for tax purposes. Organizations and individuals unsure of whether they qualify as a religious order or member of a religious order may request a ruling from the IRS, following the general procedures for a ruling request (which are usually published annually in the first IRS revenue procedure of the year).

Christian Science Practitioners and Readers

Christian Science practitioners and readers are generally afforded the same treatment as ministers for tax purposes. Christian Science practitioners are defined as members in good standing of the Mother Church, The First Church of Christ Scientist, in Boston, Massachusetts. These church members practice healing according to the teachings of Christian Science and are also specifically exempted from licensing by state laws.

Some Christian Science practitioners also function as Christian Science teachers or lecturers, with income from these activities considered the same as income from work as a Christian Science practitioner.

Christian Science readers are considered the same as ordained, commissioned, or licensed ministers.

Theological Students

Theological students serving a required internship as a part-time or assistant pastor do not meet the definition of a minister, unless they are formally ordained, commissioned, or licensed.

While not intended just for theological students, IRC Sec. 3121(b)(10) exempts from FICA tax services performed for a school, college, university, or certain affiliated organizations described in IRC Sec. 509(a)(3) by a student enrolled and regularly attending classes at the institution. Under Rev. Proc. 2005-11, full-time employees are not eligible for the student FICA exception. Whether an employee is full-time is based on the institution's standards and practices, except that an employee whose normal work schedule is 40 or more hours per week is always considered full-time. Additionally, under Rev. Proc. 2005-11, an individual is probably not a student, and, therefore, not exempt from FICA if he or she (a) is eligible for employment benefits, (b) has the status of a professional employee, or (c) is required to be licensed under state or local law in order to perform the services provided. A half-time undergraduate or a half-time graduate or professional student who does not meet the above requirements qualifies for the student FICA exception with respect to services performed for an institution of higher education (as defined in Rev. Proc. 2005-11) where the employee is enrolled or for an affiliated Section 509(a)(3) organization with respect to the institution of higher education. A half-time undergraduate or half-time graduate or professional student is an undergraduate or graduate student who is in the last semester, trimester, or quarter of a course of study requiring at least two semesters, trimesters, or quarters to complete and is enrolled in the number of credit or unit hours needed to complete the requirements for obtaining a degree, certificate, or other recognized educational credential offered by that institution of higher education, even if enrolled in less than half the number required of full-time students.

Similarly, services performed by a student at a public or private school, college, or university at which he or she is enrolled and regularly attending classes are exempt from unemployment (FUTA) tax. This includes service performed by a full-time student for academic credit and combining instruction with work experience if the program was not established by or on behalf of an employer or group of employers. However, services performed by student employees, including those enrolled in work-study programs, are generally subject to income tax withholding.

Members of Recognized Religious Sect

Some taxpayers, while not qualifying as a minister or a member of a religious order, work for a religious sect or division that is opposed to social security and Medicare. Individuals who are members of such a recognized religious sect, who adhere to the established tenets or teachings of the sect, and who are also individually conscientiously opposed to social security and Medicare, can choose to be exempt from social security and Medicare coverage.

Court and IRS Interpretations

Because Reg. 1.1402(c)-5 requires a minister to be *duly ordained, commissioned, or licensed*, numerous rulings and case law have further defined these terms. In *Salkov*, the Tax Court determined that a Jewish cantor who officiated at weddings, funerals, and at houses of mourning clearly fell within the phrase *sacerdotal functions* as applied to the liturgical practices of the Jewish faith. The taxpayer conducted weekly religious ceremonies, festivals, and high holidays with a Jewish rabbi, trained young men, directed the musical program, and supervised the youth chorus of his congregation. The IRS argued that he did not meet the ministerial definition because he was not fully ordained as a Jewish rabbi. However, the Tax Court determined that the phrase *duly ordained, commissioned, or licensed* was disjunctive, rather than conjunctive, and that the taxpayer met the test of being a qualified minister. In doing so, the court concluded that the purpose of the requirement was to exclude self-appointed ministers, not to limit benefits only to the ordained. A similar finding occurred in *Silverman*.

Following the decisions in *Salkov* and *Silverman*, the IRS issued Rev. Rul. 78-301, ruling that a Jewish cantor who was not ordained but was employed by a congregation on a full-time basis to perform religious functions met the requirements of being a minister. Rev. Rul. 78-301 also revoked a previous ruling and modified two other rulings, which had previously required full ordination of a minister to meet the ministerial definition. Accordingly, Jewish cantors with a bona fide commission who are employed full-time by the congregation to perform substantially all the religious functions of the Jewish faith qualify under the definition of a minister.

Taxpayers sometimes argue that they do not meet the test for being a qualified minister. In *Knight*, a Presbyterian church licentiate argued that he was not formally ordained as a minister and could not administer church sacraments or participate in church government, and thus was an employee of the church not subject to self-employment tax under IRC Sec. 1402. However, the Tax Court ruled that because he was a licensed minister, conducted worship services for the church, and was considered by the church to be a spiritual leader, he qualified under the definition of a minister for self-employment tax purposes.

In *Wingo*, an ordained deacon in the United Methodist Church met the definition of a minister because he was allowed to conduct sacraments of the church (baptism and the Lord's Supper) and because he performed the services of marriages, confirmations, and burials. He also conducted religious worship services. The court determined that the deacon performed services "in control, conduct, and maintenance of the church," thus fulfilling the necessary requirements of being *ordained, commissioned, or licensed*. In its ruling, the court relied heavily on its prior rulings in *Salkov* and *Silverman*.

The Tax Court also ruled in *Brannon* that an individual met the ministerial definition because he "presided over the ministrations of sacerdotal functions, conducted religious worship, and served in the control, conduct, and maintenance of his charge within the church." Because he met the ministerial definition and had net earnings of at least \$400 derived from the performance of services as a minister in previous years, his Form 4361 was deemed to have been filed late and was ineffective, allowing the IRS to collect self-employment tax for the tax years in question.

In *Lawrence*, the Tax Court determined that a minister of education in a Baptist church did not meet the definition of a minister. Although the taxpayer held a Masters Degree in Religious Education, he was not formally ordained. The court interpreted the *commissioning* of the individual by the church to be for tax purposes only, as no change in duties resulted from the commissioning, which occurred only after he assumed his position. Additionally, the court strongly considered duties the taxpayer did not perform, including his inability to officiate at baptisms and the Lord's Supper, and his inability to preside over or preach at worship services. In ruling against the taxpayer, the court concluded that the duties of a minister of education were not equivalent to the duties of a full Baptist minister.

In a 1999 private letter ruling, the IRS determined that three deacons met the ministerial definition and so were entitled to the exclusion for parsonage allowances. While the deacons did not lead worship services, they did participate with the pastor in the weekly worship services and performed other duties at the local church (including confirmation preparation). The IRS found the deacons met the ministerial definition by applying the analysis previously established in *Wingo*.

IRS Warning on Sham Religious Schemes

The IRS is continually watchful for abusive, sham situations involving nonprofit religious organizations. In a ruling on an abusive situation, the Tax Court disallowed charitable contributions claimed by a taxpayer, finding the contributions were made to a nonexempt organization. The court found no evidence that the pastor of the organization performed marriages, burials, baptisms, or other sacerdotal functions, also determining the pastor was not a licensed or ordained minister. The court noted that no other members belonged to the church organization and that no one else had made contributions to the organization.

Employment Tax Issues

Although ministers may be deemed to be employees for income tax purposes, they are normally considered to be self-employed for payroll tax purposes. Special rules apply to the computation of self-employment income, including the deductibility of business expenses against Form W-2 wage income. Special rules also apply in determining the self-employment tax liability on retirement benefits paid to ministers, as well as the federal withholding tax and federal unemployment tax on wages paid to a minister.

Electing Out of Self-employment Tax and FICA Coverage

Ministers and religious workers must pay self-employment tax on their ministerial earnings unless:

- a. They have taken a vow of poverty as a member of a religious order, or
- b. They file for an exemption from self-employment tax under IRC Sec. 1402(e).

Ministers and religious workers may elect out of self-employment tax because of conscientious or religious opposition to social security and Medicare. Individuals and religious organizations use different forms, depending on whether the individual is a minister, religious worker, Christian Science practitioner, or a member of a recognized religious group. Additionally, church employers may make a general election to exclude employees from FICA coverage if the organization is opposed to social security and Medicare.

A summary of the forms used by different individuals and church organizations to elect out of self-employment tax and FICA coverage is as follows:

- a. *Form 4361*—used by ministers, religious workers, and Christian Science practitioners to elect exemption from self-employment tax.
- b. *Form 8274*—used by church organizations to elect exemption from payment of the employer's share of social security and Medicare taxes.
- c. *Form 4029*—used by members of recognized religious sects to apply for exemption from social security and Medicare taxes and waiver of benefits.

Vow of Poverty

Members of a religious order who have taken a vow of poverty are exempt from paying self-employment tax on their earnings. The earnings are considered tax free to the individual; rather, the earnings are considered the income of the religious order.

If services performed by a member of a religious order are not considered directed or required by the order, the member is considered to be an employee of the outside party.

Example 2-6: Vow of poverty with outside job.

Cheryl White is a member of a religious order and has taken a vow of poverty. Cheryl is a CPA and the superiors of her order instructed her to get a job with a public accounting firm. Cheryl joined a firm as an employee, and as requested by Cheryl, the firm made the salary payments directly to the religious order. Cheryl's services are not duties required by the order and accordingly her earnings are subject to social security and Medicare tax.

Example 2-7: Vow of poverty with related responsibilities.

Lisa Taylor is a member of a religious order and has taken a vow of poverty. Lisa is a secretary and the superiors of the order instructed her to accept a job with the business office of the church that supervises the order. Lisa accepted the job and gave all of her earnings to her order.

Lisa's services are considered duties required by the order as she is acting as an agent of the order and not an employee of a third party. She does not need to include her earnings in gross income and these earnings are not subject to income tax withholding, social security and Medicare (FICA) tax, or self-employment tax.

Filing Form SS-16. Religious orders whose members have taken a vow of poverty are allowed to elect social security and Medicare coverage for their current and future members. This is done by filing Form SS-16 (Certificate of Election of Coverage), which is available at www.irs.gov. Form SS-16 must be filed in triplicate with one copy returned to the filer after the form is accepted by the IRS.

For purposes of the payment of these taxes, the term wages includes the individual's remuneration for the fair market value of board, lodging, clothing, and other perquisites furnished by the order, where the value of these items is at least \$100 per month.

The election can be retroactive up to 20 calendar quarters as discussed in the following paragraph. A retroactive election only applies to services performed during the retroactive period by persons who were active members when the services were performed and who are alive on the first day of the quarter the certificate is filed. The taxes owed for the retroactive period are reported on Form 941 (Employer's Quarterly Federal Tax Return), which must be filed by the last day of the month following the calendar quarter in which the certificate is filed.

The election is irrevocable and, depending on the date entered on Form SS-16 by the applicant, becomes effective for the period beginning on the first day of:

- a. The calendar quarter in which the certificate is filed,
- b. The calendar quarter after the quarter in which the certificate is filed, or
- c. Any one of the 20 calendar quarters before the quarter in which the certificate is filed.

Ministers, Religious Workers and Christian Science Practitioners—Form 4361

Ministers, religious workers, and Christian Science practitioners who are conscientiously opposed to, or because of religious principles opposed to, the acceptance of any public insurance that makes payments (a) in the event of death, disability, old age, or retirement; or (b) toward the cost of or provides services for medical care, are entitled to an exemption from self-employment tax. This privilege does not apply to members of a recognized religious sect.

Ministers electing this exemption must properly notify the ordaining, commissioning or licensing body of the church or order that the minister is opposed to such insurance and must file Form 4361 (Application for Exemption from Self-Employment Tax for Use by Ministers, Members of Religious Orders and Christian Scientists Practitioners) with the IRS. Ministers granted such an exemption are deemed to not be involved in a trade or business for self-employment tax purposes.

A minister, member of a religious order, or Christian Science practitioner must meet one of two alternative tests to file Form 4361:

1. A religious principles test, which refers to the institutional principles and discipline of the particular religious denomination to which the individual belongs; or
2. A conscientious opposition test, which refers to opposition because of religious considerations of the individual (rather than opposition based on the general conscience of the individual).

Ministers claiming an exemption from self-employment tax must meet all of the following conditions:

- a. File Form 4361 with the IRS. Form 4361 is available at www.irs.gov.
- b. Be conscientiously opposed to public insurance because of the minister's individual religious considerations (not because of the minister's general conscience), or be opposed because of the principles of the religious denomination.
- c. File the exemption for other than economic reasons.
- d. Inform the ordaining, commissioning, or licensing body of the church or order that he or she is opposed to public insurance as a minister or member (other than a vow-of-poverty member). This provision does not apply to Christian Science practitioners.
- e. Establish that the religious organization that ordained, commissioned, or licensed him or her is a tax-exempt religious organization.
- f. Establish that the religious organization is a church, convention, or association of churches.
- g. Sign and return the statement the IRS mails to him or her certifying that the minister requested the exemption based on the grounds listed on the statement. The statement must be signed and returned to the IRS Service Center that issued the statement no later than 90 days after the date the statement was mailed to the minister. This requirement also extends to Christian Science practitioners. If not mailed within 90 days, the exemption is not effective until the date the signed copy of the statement is received at the IRS Service Center.

Example 2-8: Acceptance of benefits for nonministerial services.

Leo, an ordained minister, is not opposed to the acceptance of benefits under the Social Security Act with respect to services performed by him, which are not in the exercise of his ministry. Nevertheless, Leo is eligible to file an application for exemption from self-employment tax on Form 4361 with respect to services performed by him in the exercise of his ministry.

Filing Form 4361. Form 4361 must be filed in triplicate (original and two copies) and must include a statement certifying that the minister opposes, for the services as a member of the clergy, government insurance for death, disability, old age, or retirement because of the minister's religious principles or conscience. This includes public insurance such as Medicare and Medicaid, along with social security benefits.

The IRS will return a copy of the Form 4361 that the minister filed indicating whether the exemption request has been approved. If approved, the minister must keep an approved copy of the exemption request with his or her permanent records. The Tax Court, in a Small Tax Case Division Opinion, ruled that a minister was exempt from self-employment tax where the record established that he had filed Form 4361. While the taxpayer was unable to provide a copy of the approved Form 4361, the court concluded the IRS must have approved the application because the taxpayer had not paid self-employment tax, without dispute, for 21 years.

Form 4361 must be filed by the due date, including extensions, of the tax return for the second tax year in which the minister has net earnings from self-employment of at least \$400. This rule applies if any part of net earnings for each of the two years came from services as a minister, member of a religious order, or Christian Science practitioner. The two years do not have to be consecutive tax years.

Example 2-9: Due date for filing Form 4361.

Reverend Smith is a minister ordained in 2009 with net earnings of \$450 in 2009 and \$500 in 2010. Reverend Smith must file his Form 4361 by the due date, including extensions, for his 2010 income tax return. However, if Reverend Smith does not receive his approved Form 4361 by April 15, 2011, his self-employment tax for 2010 is due by that date (or the extended due date if the return is extended). If he later receives the approved Form 4361, he is eligible to amend his 2010 return.

Example 2-10: Earnings years for exemption purposes need not be consecutive.

Reverend Smith has \$300 of net earnings in 2009, but earned more than \$400 in both 2008 and 2010. Reverend Smith must file his application for exemption by the due date, including extensions, for his 2010 income tax return. However, if he did not receive the exemption by April 15, 2011 (or the extended due date of the return), his self-employment tax for 2010 would be due by that date. Reverend Smith can file an amended tax return for 2010 if the approved Form 4361 is later received.

Example 2-11: Effective date of exemption.

Reverend Smith, ordained in 2009, has \$8,000 of net earnings as a minister in 2009 and 2010. He files Form 4361 on March 8, 2011. If the exemption is granted, it is effective for 2009 and later years.

Example 2-12: Self-employment tax on nonministerial income.

Reverend Smith, an ordained minister, applied for and previously received an exemption from self-employment tax for his ministerial services. In 2010, Reverend Smith has ministerial income of \$10,000 and income from a data processing consulting service, a sole proprietorship, of \$14,000. He must pay self-employment tax on the \$14,000, but not on the \$10,000 of ministerial income.

Example 2-13: Due date with negative net ministerial income.

Reverend Smith was ordained in 2008 and had \$700 of net earnings as a minister that year. In 2009, he was paid \$1,000 as a minister, but had related expenses exceeding this amount, resulting in no net self-employment income as a minister in 2009. Also in 2009, he opened a restaurant and had \$10,000 in net self-employment earnings from the restaurant. In 2010, he had net earnings of \$1,500 as a minister and \$12,000 net self-employment earnings from the restaurant.

Because Reverend Smith had net earnings from self-employment in 2008 and 2010 of \$400 or more each year, and because part of the earnings in each of those years was for services as a minister, he must file his Form 4361 by the due date, including extensions, for his 2010 income tax return.

The right to file the Form 4361 ends with an individual's death. A surviving spouse, executor, or administrator cannot file an exemption application for a deceased clergy member.

Once received, an approved exemption is effective for all tax years after 1967 in which the minister has \$400 or more of net earnings from self-employment, and any part of the earnings is for services as a member of the clergy. Once an exemption is granted, it is irrevocable.

Because of the availability of the election out of social security coverage, the issue of who qualifies for the election is often determined by the courts. The Tax Court places emphasis on whether the individual performs the duties of a minister and not on whether the person is ordained. For IRS guidance on filing Form 4361 in three specific instances, including one where a minister has a change of faith and is ordained by a different church.

Form 1040 Reporting. Taxpayers who received IRS approval of Form 4361 and do not have any other income subject to self-employment tax do not need to file Schedule SE. Instead, they should write "Exempt-Form 4361" on the line for self-employment tax on page 2 of Form 1040.

Election to Exclude Employees from FICA Coverage—Form 8274

Churches and church-controlled organizations can elect not to pay the employer's portion of social security and Medicare tax by certifying to the IRS that, for religious reasons, the church or organization is opposed to paying these taxes. This election applies to all current and future employees of the church or organization.

An employee of a church or church organization which has made the election to exclude employees from FICA coverage is required to pay self-employment tax on wages which equal or exceed \$108.28 [\$108.28 reduced by the one-half of self-employment tax deduction of IRC Sec. 164(f) = \$8.28; results in \$100 net]. This is because IRC Sec. 1402(j) requires the payment of self-employment tax on self-employment income for church employees with income of \$100 net or more. The amount subject to self-employment tax is the wage income without any reduction for deductions associated with the wages. The individuals are also treated as employees for all other tax purposes, including federal income tax withholding. The electing organization must therefore continue to withhold federal income tax on the individual's wages and report this income and the tax withheld on Forms W-2 and 941 (or 944).

Churches and church organizations make the election to exclude employees from FICA coverage by filing two copies of Form 8274 (Certification by Churches and Qualified Church-Controlled Organizations Electing Exemption from Employer Social Security and Medicare Taxes). The form is filed after employees are hired, but before the first date on which a quarterly or annual employment tax return is due or would be due except for the election. Form 8274 is available at www.irs.gov. Organizations should retain a copy of Form 8274 with their permanent records.

The church or church organization is allowed to revoke the election, but any revocation cannot later be reversed. The IRS also has the authority to revoke the election if certain filing requirements for Forms W-2 are not met.

Church organizations meeting both of the following criteria are *not* eligible to make the election:

- a. The organization offers goods, services, or facilities for sale to the general public, other than on an incidental basis for a nominal charge; and
- b. The organization normally receives more than 25% of its support from governmental sources and/or receipts from admissions, sales of merchandise, services, or facilities in related trade or business activities.

Members of a Recognized Religious Sect—Form 4029

Members of a recognized religious sect may also choose to be exempt from social security and Medicare taxes. An individual is given this opportunity only if he or she is a member of a religious sect or division opposed to social security and Medicare. The exemption does not apply to any services of the individual as a minister of a church or as a member of a religious order.

The Tax Court ruled against a taxpayer who argued that he was conscientiously opposed to the social security system, and therefore fell under the exemption of IRC Sec. 1402(g) as a member of a religious sect. The court determined the taxpayer was not a minister, was not a member of any religious order, sect, or division thereof, was not a Christian Science practitioner, and therefore the taxpayer's belief did not represent those of a member of any religion or sect. The court determined the exemption provided under IRC Sec. 1402(g) only applies to individuals who are members of a recognized religious sect and who file an application for exemption from self-employment tax. While the court sympathized with the taxpayer's personal convictions, the court found the convictions did not serve as a substitute for the strict requirements of the statute.

All of the following requirements must be met in order for a member to claim this exemption:

- a. The member must:
 - (1) File Form 4029 (Application for Exemption from Social Security and Medicare Taxes and Waiver of Benefits) with the IRS.
 - (2) Be conscientiously opposed as a follower of the established teaching of the sect or division to accepting benefits of any private or public insurance which makes payments for death, disability, old age, retirement, medical care, or provides services for medical care.
 - (3) Waive all rights to receive any social security payment or benefit and agree that no benefits or payments will be made to anyone else based on the member's income.

- b. The Social Security Commissioner must determine that:
- (1) The member's sect or division is conscientiously opposed to accepting benefits of any private or public insurance for the reasons specified in point a.(2) listed above;
 - (2) It is the practice, and has been the practice for a substantial period of time, for members of the sect or division to provide for their dependent members in a manner that is reasonable in view of the member's general level of living; and
 - (3) *The* sect or division has existed at all times since December 31, 1950.

Filing Form 4029. To request the exemption, Form 4029 must be filed in triplicate with the Social Security Administration at the address shown on the form. The sect or division must also complete a portion of the form. If approved, a copy of the Form 4029 is returned to the taxpayer. This copy should be retained by the taxpayer with other permanent records.

Form 4029 can be filed at any time, but once approved, terminates if the taxpayer fails to meet the eligibility requirements or if the Social Security Commissioner determines the sect or division fails to meet the requirements. The election is generally irrevocable, but taxpayers are required to notify the IRS within 60 days if they are no longer a member of the religious group or if they no longer follow the established teachings of the group. The exemption terminates on the date the IRS is notified.

An approved exemption is effective on the first day of the first calendar quarter after the quarter in which the Form 4029 is filed. The exemption ends on the last day of the calendar quarter before the quarter in which the employer, employee, sect or division fails to meet the exemption requirements.

Both the employee and employer, if the eligibility requirements are met, can apply to be exempt from their share of social security and Medicare taxes on wages paid. However, an employer's approved exemption applies to social security and Medicare taxes paid on wages only to employees who also received an approved exemption.

Form W-2 Reporting. Forms W-2 for employees holding an approved Form 4029 should have the text "Form 4029" entered in the box marked "Other." There should be no entries in boxes 3 (social security wages), 4 (social security tax withheld), 5 (Medicare wages and tips), or 6 (Medicare tax withheld) of the Form W-2.

Payroll Tax Reports. Employers holding an approved Form 4029 should not include the exempt wages on Form 941 (Employer's Quarterly Federal Tax Return), Form 943 (Employer's Annual Tax Return for Agriculture Employees), or Form 944 (Employer's Annual Federal Tax Return). Employers should check the box on line 4 of Form 941 (line 3 of Form 944) and write "Form 4029" in the empty space below the checked box to signify the wages are not subject to these taxes. If Form 943 is filed, write "Form 4029" to the right of the wage entry spaces on lines 2 and 4.

Form 1040 Reporting. Taxpayers who have received IRS approval of Form 4029 and do not have any other income subject to self-employment tax do not need to file Schedule SE. Instead, they should write "Form 4029" on the line for self-employment tax on page 2 of Form 1040.

Calculation of Self-employment Tax

If an exemption from self-employment tax was not applied for or was not granted, earnings of a minister are subject to self-employment tax. However, ministers are generally considered to be employees under the common law rules for income tax purposes. Accordingly, ministers receive a Form W-2 for wages paid under the common law rules with no FICA withholding on the Form W-2 wages (because ministers are deemed to be self-employed for employment tax purposes).

Net earnings from self-employment are generally computed by totaling gross income for services performed as a minister, as a member of a religious order who has not taken a vow of poverty, or as a Christian Science practitioner. Allowable business deductions are subtracted from this amount. Expenses allocable to tax-free income, which are nondeductible for income tax purposes, are also nondeductible in computing net earnings from self-employment. Schedule SE is used to compute the self-employment tax.

In calculating the net earnings from self-employment on Schedule SE of Form 1040, ministers must include the following amounts:

- a. Salaries and fees received for qualified services (normally reported on Form W-2);
- b. Offerings received for marriages, baptisms, funerals, masses, etc.;
- c. The value of meals and lodging provided to the minister, the minister's spouse, and the minister's dependents under IRC Sec. 119;
- d. The fair rental value of a parsonage provided to the minister (including the cost of utilities furnished with the property), and any rental allowance paid to the minister under IRC Sec. 107 (including any amount for payment of utilities); and
- e. Any amounts which the church paid towards the income tax or self-employment tax of the minister, other than federal withholding amounts on the minister's salary. Amounts paid by the church towards the income tax or self-employment tax of the minister are also subject to income tax.

Example 2-14: Reporting church wages and fair rental value of parsonage on Form 1040 and Schedule SE.

Reverend Charles Long, pastor of Harmony Church, is treated as an employee under the common-law rules. He has not applied for an exemption from SE tax. The church did not withhold federal income tax or social security tax because he did not request withholding. The church provides a parsonage and pays him a utilities allowance that is less than his actual utilities expense.

For 2010, Reverend Charles received \$40,500 income and allowances, as follows:

Form W-2 wage income:	
Harmony Church	\$29,600
Hilldale College (teaching—FICA tax was withheld)	2,400
Schedule C income (weddings and speaking engagements)	2,500
Utility allowance	1,200
Parsonage—fair rental value	4,800

On his 2010 Form 1040, Reverend Charles will report wages of \$32,000 (\$29,600 from the church plus \$2,400 from the college) and Schedule C income of \$2,500. He does not have to report the fair rental value of the parsonage or the utility allowance as income on Form 1040.

On his 2010 Schedule SE, Reverend Charles will include church wages of \$29,600 (treated as earnings from self-employment for SE tax purposes), the \$4,800 fair rental value of the parsonage, the \$1,200 utility allowance, and his Schedule C income of \$2,500 for a total of \$38,100. Reverend Charles should attach a supplemental schedule of SE income to Schedule SE. He will complete the short Schedule SE (i.e., Section A) because his wages subject to social security tax and SE earnings (\$40,500) are less than the 2010 social security tax ceiling of \$106,800.

Effective in 2013, the 2010 Health Care Act imposes an additional 0.9% Medicare tax on taxpayers with compensation in excess of \$125,000 for married taxpayers filing separately, \$250,000 for married taxpayers filing jointly, and \$200,000 for all other taxpayers.

A discussion of ministers who are employed by governmental agencies, including ministers acting as U.S. Armed Forces chaplains and prison chaplains was presented earlier in this lesson. Although amounts earned while working in a foreign country may be excluded from income tax, such amounts must be included in the computation of self-employment tax if the minister is a U.S. citizen or resident alien serving abroad and living in a foreign country.

Ministers should not include the following amounts in self-employment income when calculating net earnings from self-employment:

- a. Offerings made to the church by other parties.
- b. Contributions by the church to an annuity plan set up for the minister, including salary reductions which are not included in the minister's gross income.
- c. Pension payments or retirement allowances paid to the minister for past qualified services.
- d. The rental value of a parsonage or a parsonage allowance provided after the minister retires.

As shown in Example 2-15, to compute self-employment tax on a minister's earnings, allowable business expenses are subtracted from the gross earnings of the minister.

Some adjustments may be required to compute the self-employment tax of a minister. For example, any cash housing allowance or utility allowance must be added to self-employment income, and so must the fair rental value of a parsonage, if provided, including the cost of utilities and furnishings.

Example 2-15: Addback of parsonage allowance.

Reverend Clay, who receives a \$25,000 salary from his church and a parsonage allowance of \$1,000 per month (\$12,000 annually), has unreimbursed employee business expenses of \$5,000. His net earnings from self-employment are \$32,000, computed as follows:

Form W-2 salary	\$ 25,000
Parsonage allowance	12,000
Unreimbursed employee business expenses	<u>(5,000)</u>
Total	<u>\$ 32,000</u>

IRC Sec. 265 (associated with the allocation of business expenses to exempt income) requires a reduction of the unreimbursed business expense deduction for income tax purposes. Such a computation is also required for self-employment tax purposes.

Example 2-16: Deducting business expenses related to exempt income.

Reverend Clay receives a salary of \$15,000, a housing allowance of \$10,000, and earns \$5,000 from other ministerial engagements, including conference presentations, weddings, and funerals. Reverend Clay reports his salary as wages on page 1 of the Form 1040, but reports the \$5,000 of other ministerial earnings on a Schedule C. Assume that Reverend Clay’s actual housing cost is \$5,000 for the year, which is less than the housing allowance and the fair rental value of the home for the year. Accordingly, Reverend Clay must include \$5,000 of the housing allowance as other income for income tax purposes.

Reverend Clay’s total business expenses are \$6,000. The computation of deductible expenses for income tax purposes, described in detail above, is as follows:

$$\frac{\$5,000 \text{ housing allowance exempt from income tax}}{\$30,000 (\$15,000 \text{ salary} + \$10,000 \text{ housing} + \$5,000 \text{ fee})} = 16.67\% \text{ nontaxable income}$$

Of the total expenses, $\$6,000 \times 16.67\% = \$1,000$ are nondeductible expenses.

Of the total expenses, $\$6,000 - \$1,000 = \$5,000$ are deductible expenses.

For income and SE tax purposes, only \$5,000 of the \$6,000 of business expenses are deductible. Reverend Clay’s self-employment income would be computed as follows:

Salary	\$15,000
Housing allowance	10,000
Schedule C other ministerial earnings	5,000
Business expenses	<u>(5,000)</u>
Self-employment income	<u>\$25,000</u>

Ministers drawing social security benefits but still actively employed may receive erroneous notices from the Social Security Administration that their social security benefits will be reduced because they are over the earnings limit. The problem arises because the Social Security Administration may include the Form W-2 amount from Form 1040 and also add the self-employment income from the Schedule SE, effectively doubling up the earned income.

Submitting the minister's tax return, with appropriate explanation, to the local Social Security office normally clarifies the matter.

Example 2-17: Potential erroneous Social Security Administration computation.

Reverend Gee receives a salary of \$30,000, which is properly reported on a Form W-2. He is age 63 and is currently drawing social security benefits. His Schedule SE shows total self-employment income of \$35,000, after considering additions for his tax-free housing allowance.

The Social Security Administration could possibly include the \$30,000 of wages reported on page 1 of Form 1040 and add this to the \$35,000 of Schedule SE earnings, calculating \$65,000 of total earned income for Reverend Gee. Accordingly, the Social Security Administration may attempt to reduce his social security benefits.

If Reverend Gee receives a notice from the Social Security Administration, he should take a copy of his tax return to the local Social Security office and explain that the wage income is reported on page 1 of the Form 1040 and also included in the Schedule SE amount. However, attaching a supplemental schedule of SE income to Schedule SE in the filed return may avoid this problem.

The Senior Citizens' Freedom to Work Act of 2000 eliminated the social security retirement earnings test in the calendar year in which a person attains the full benefit retirement age (currently age 66 for individuals born in 1943–1954, but differs depending on when the taxpayer was born). Previously, the earnings test determined whether social security benefits received by a person under age 70 (rather than age 65) would be reduced if the individual continued to work. Special rules apply for the year in which the individual reaches the full benefit retirement age. Further information can be obtained at www.ssa.gov.

Optional Methods for Calculating Self-employment Earnings. Similar to other taxpayers, ministers are allowed to use the optional method for determining net earnings from self-employment. The farm and nonfarm optional methods of computing self-employment tax allow continued coverage for social security and Medicare purposes when a taxpayer has low self-employment income for a year. While ministers would normally use the nonfarm optional method, ministers who are also involved in a farming business may qualify for both the farm and nonfarm optional methods in the same year.

The nonfarm optional method may be used if a taxpayer meets all of the following requirements:

- a. Nonfarm net profits for the year are less than \$4,721 (for 2009).
- b. Nonfarm net profits for the year are less than 72.189% of the taxpayer's total gross income from nonfarm self-employment.
- c. The taxpayer is self-employed or a partner on a regular basis, meaning that actual net earnings from self-employment are \$400 or more in at least two of the three tax years before the tax year the optional method is used.
- d. The taxpayer has not previously used the nonfarm optional method for more than four years (i.e., the nonfarm optional method is limited to a maximum of five years during a taxpayer's lifetime). However, the five years do not have to be consecutive.

Taxpayers who qualify for the nonfarm optional method can report the smaller of two-thirds of the gross income from the taxpayer's nonfarm business, or \$4,360 (for 2009), as the net earnings from self-employment. But they cannot report less than their actual net earnings from nonfarm self-employment.

Self-employment Tax on Retirement Benefits of Ministers

Retirement benefits received from a church plan, as well as the rental value or parsonage allowance (including utilities) furnished to a minister after retirement, are not subject to self-employment tax.

The IRS has announced that it will not issue advance rulings on whether amounts distributed to a retired minister from a pension or annuity plan can be excluded as a parsonage allowance.

Federal Income Tax Withholding (FITW)

Salary earned for qualified services performed by a minister is subject to federal income tax, but is generally not subject to federal income tax withholding. Ministers may want to make estimated tax payments to avoid underpayment penalties when earnings are not subject to withholding.

Example 2-18: Voluntary withholding to cover income and SE tax.

Reverend George is a minister whose total income tax shown on his Form 1040 is \$400 and total self-employment tax is \$2,200. Reverend George expects the following year's income to be approximately the same, and gets paid by the church every two weeks. Accordingly, Reverend George voluntarily requests that the church withhold \$100 of federal income tax from each paycheck. In this manner, the total tax of \$2,600 withheld during the year and included on Reverend George's Form W-2 should come close to covering Reverend George's income tax and self-employment tax liability for that year. This allows Reverend George to avoid paying quarterly tax estimates during the year.

Ministers who elect to pay estimated tax amounts during the year to cover income and self-employment tax should use Form 1040-ES and include payment with a Form 1040-ES payment voucher.

Federal Unemployment Tax (FUTA)

Ministerial services performed by a minister are excluded from the definition of covered employment for FUTA purposes through the exemption granted for services in the employ of religious organizations and other nonprofit organizations described in IRC Sec. 501(c)(3).

Example 2-19: FUTA exemption on salary payment.

Reverend George receives a \$30,000 church salary, which is exempt from federal income tax withholding and FICA withholding. The church must report the \$30,000 as taxable wages for federal income tax purposes on Form W-2. However, the church is exempt from any FUTA tax on the salary payment.

Income Tax Issues

In addition to salary amounts, ministers must include amounts from offerings and fees received for marriages, baptisms, funerals, masses, and so forth in taxable income. However, if the offering is made directly to the religious institution, it is not taxable income to the minister. Special rules apply for outside earnings paid to the minister and then transferred to the religious organization. According to IRS Pub. 517, "Social Security and Other Information for Members of the Clergy and Religious Workers," the minister must include the outside earnings as income, but may be entitled to a charitable contribution for the amount given to the religious organization if the minister itemizes deductions.

Example 2-20: Offering transferred to religious organization.

Reverend Ahern is paid a fee of \$500 for a presentation at a religious conference on church governance. Reverend Ahern transfers the amount directly to his church. Because the amount is paid directly to Reverend Ahern, the \$500 constitutes taxable income to him and is also subject to self-employment tax. Reverend Ahern is entitled to a \$500 charitable contribution deduction for contributing the money to his church, but this may be of no benefit if he does not itemize his deductions.

Alternatively, Reverend Ahern could arrange for his conference presentation to be on behalf of his church and have the \$500 amount paid directly to the church. Such an arrangement could be easily structured and justified between the church and the conference coordinator under the premise that the speaking fee displaces salary expense paid when he is absent from his normal church duties.

Employee versus Independent Contractor

The question of whether a minister is an employee or an independent contractor is primarily a question of fact. This factual determination involves the classic test of whether an employer has control over the manner in which work is performed, including the right to control the worker when appropriate and necessary. In *James*, the Tax Court determined that the extent of control required for a professional worker such as Dr. James, a pathologist, is less than what would be required for a nonprofessional worker performing routine duties. Similar rules should apply to a professional worker such as a minister.

In a case involving United Methodist ministers, an ordained minister of the church was found to be an employee, rather than a self-employed taxpayer, because of the control the church exercised over the minister. This resulted in business expenses for the taxpayer being deductible as miscellaneous itemized deductions on Schedule A, rather than deductible in full on Schedule C.

Ministers are generally considered employees under the common law rules, yet payment for services as a minister is considered self-employment income, subject to self-employment tax. Even as an employee, payment for services to a minister is not subject to FICA tax or income tax withholding, although the minister can optionally elect to have federal income tax withheld.

Taxable Income versus Gifts

Common examples of situations where individuals give money directly to ministers, even though no fee is charged, include (a) special occasions, such as ordination anniversaries, religious holidays, etc.; (b) weddings, funerals, and baptisms; and (c) special pastor offerings. Because of the labels given to such payments (e.g., love gifts or pastor's offering), many ministers assume that these payments are nontaxable. But regardless of how labeled, payments for services performed are taxable income. For a gift to be tax free, it must be given with true donative intent, which means that the donor does not expect to receive anything in return.

Church members may feel that they have a personal relationship with a minister, but in reality, most members (other than close personal friends) do not have a relationship with the minister outside of the church and related functions. However, this does not mean that ministers can never receive a nontaxable gift. For example, a gift given by a personal friend in celebration of a minister's birthday presumably would be a nontaxable gift as long as it is given outside of the church environment, even if the friend is a member of the church's congregation. But if the friend gives the minister cash after the minister performs a wedding, the money would be taxable income because it was given in return for services rendered during the wedding ceremony.

Several court cases over the years have dealt with the taxable versus nontaxable nature of receipt of monies by a minister. As an example, in *Goodwin*, a special collection was taken in the parish for the benefit of the minister on a regular basis (three separate occasions per year). The 8th Circuit affirmed the Tax Court in determining that the amounts represented taxable income to the minister because the payments occurred on a regular basis. The amounts were intended to supplement regular salary amounts, and thus needed to be included in the taxable income of the recipient.

To the contrary, in Rev. Rul. 55-422, the IRS ruled that payments by a congregation to a retiring minister qualified as excludable gifts because, among other factors, "there was a far closer personal relationship between the recipient and the congregation than is found in lay employment relationships." Accordingly, payments made by a congregation to a retiring minister who is not expected to perform any further services often represent nontaxable gifts to the recipient.

Example 2-21: Anniversary recognition of a minister.

Reverend Rae is celebrating the 25th anniversary of his ordination into the ministry. In recognition of this accomplishment, an open house is held in the social hall of Reverend Rae's parish. Many parishioners attend to congratulate and socialize with Reverend Rae. Most parishioners drop a card of congratulations in a basket, often with money included. Many parishioners unable to attend mail Reverend Rae a card of congratulations, often with money enclosed.

Because Reverend Rae performed no direct services in receipt of the funds, and because the clear intent of the parishioners was that the cards and money were to be a gift to Reverend Rae, receipt of the monies by Reverend Rae should represent a nontaxable event. Parishioners would not be allowed a charitable contribution deduction for the payments.

Example 2-22: Annual recognition party for minister.

Assume the same facts as in Example 2-21, except the parish annually holds a recognition party for Reverend Rae, suggesting to parishioners that this event is an opportunity for them to supplement the rather modest salary paid to Reverend Rae. Based on the *Goodwin* case, these payments would probably represent taxable income to Reverend Rae, subject to both income tax and self-employment tax, because the events occur on a regular basis and are intended to supplement his salary.

Although not directly addressed in the *Goodwin* case, parishioners would likely be allowed a charitable contribution for the payments, as they would be deemed to be contributions to the parish, followed by a deemed payment of additional wages by the parish to Reverend Rae. Again, although not directly addressed in the *Goodwin* case, the parish would likely be required to issue a Form 1099 information return to Reverend Rae, or even to include these amounts in his Form W-2 wages.

Amounts paid by a church to a minister in addition to salary intended to cover the income tax and self-employment tax of the minister represent additional taxable income.

Amounts for weddings, funerals, etc. given directly to the church do not represent taxable compensation to the minister, but the IRS has ruled that amounts paid for the support of individual missionaries represent taxable income to the missionaries. In this ruling, contributions designated for specific missionaries were paid to the main office of the mission and then distributed directly to the individual missionaries in the field.

Parsonage or Housing Allowance

While compensation for services is generally included in gross income for federal income tax purposes, IRC Sec. 107 provides that in the case of a minister of the gospel, the value of a parsonage allowance is excludable in computing taxable income and should not be included in Form W-2 wages. However, the parsonage allowance is subject to self-employment tax. A minister can receive a parsonage allowance for only one home. The term *home* means a dwelling place, including furnishings, and the appurtenances thereto (e.g., garage).

In TAM 200318002, the IRS concluded that parsonage allowances provided to teachers and staff members of a school for preschoolers through eighth graders did not qualify under IRC Sec. 107. Although the school represented that these employees were “commissioned as ministers of the gospel and the commissioning took place the date each employee began his or her duties at [the school],” the IRS concluded that none of the prescribed duties of the teachers and administrative staff were equivalent to services performed by a church minister. Rather, their duties and responsibilities were “typical [of those] found in secular schools.”

Church-provided Parsonage. Ministers can exclude from gross income the fair rental value of a house or parsonage, including utilities, furnished as part of the minister’s pay. However, the exclusion cannot be more than the reasonable pay for the minister’s services. If the minister pays for the utilities, he or she can exclude any allowance designated for utility costs, up to the minister’s actual cost.

If a church-owned parsonage is provided to the minister instead of a parsonage allowance, the fair rental value of the housing must be determined. This is based on all facts and circumstances of the local market, but often the church and minister agree on an amount and can provide documentary evidence.

Example 2-23: Determining excludable amount for church-provided parsonage.

Reverend Joanna Baker is a full-time minister at the Central Mission Church. The church allows her to live in its parsonage, which has an annual fair rental value of \$7,200. Her annual salary is \$20,000, of which \$1,200 is designated for utility costs. Her utility costs during the year were \$1,000.

For income tax purposes, Reverend Baker excludes \$8,200 from gross income (the fair rental value of the parsonage plus \$1,000 from the allowance for utility costs). She will report \$19,000, comprised of her \$18,800 salary plus the \$200 of unused utility allowance.

Rental Allowance. If the minister receives an amount officially designated as a rental allowance, that amount can be excluded from gross income if it is (a) used to provide or rent a home, and (b) not more than reasonable pay for the minister's services. The term rental allowance includes an amount to pay utility costs. The IRS has ruled that a minister's rental allowance was not excludable to the extent it exceeded reasonable compensation for the minister's services. In this ruling, the minister had a full-time outside job, performed only occasional, insubstantial services for a small church, and all of his compensation from the church was designated as a rental allowance. Under these facts, the IRS concluded that only one-fifteenth of the compensation was reasonable for the services performed.

Regulations add that the term *rental allowance* means an amount paid to a minister to rent or otherwise provide a home if such amount is designated as rental allowance pursuant to official action taken in advance of payment by the employing church or other qualified organization. The designation can be evidenced in (a) an employment contract; (b) a budget, minutes, or resolution by a church or other qualified organization; or (c) any other appropriate instrument evidencing such official action. A rental allowance must be included in the minister's taxable income in the year received to the extent it is not used during the year to rent or otherwise provide a home.

Home Ownership. If a minister owns a home and receives a housing or rental allowance, he or she can exclude from gross income the smallest of (a) the amount actually used to provide a home; (b) the amount officially designated as a rental allowance; or (c) the fair rental value of the home, including furnishings, utilities, garage, etc. The minister must include in gross income the amount of his or her rental allowance that exceeds the smallest of the minister's reasonable salary, item a in the previous sentence, or item c in the previous sentence. Pub. 517 adds that the minister can still deduct home mortgage interest and real estate taxes even though part or all of the mortgage is paid with funds received through a tax-free parsonage allowance. Restrictions on the exclusion of parsonage allowance amounts when home equity loans are used are discussed later in this lesson.

Example 2-24: Determining excludable housing allowance.

Bea is an ordained minister who is Vice President of Admissions at a church college. Her compensation package includes a salary of \$70,000 per year and a \$25,000 housing allowance. Bea's housing costs for the year include mortgage payments of \$12,000, utilities of \$3,000, and another \$3,000 for home maintenance and new furniture. The fair rental value of the home is \$20,000 per year. In computing her excludable housing allowance, the three amounts for comparison are as follows:

1. Actual expenses of \$18,000 (\$12,000 mortgage + \$3,000 utilities + \$3,000 other costs).

2. Designated housing allowance of \$25,000.
3. Fair rental value plus utilities of \$23,000 (\$20,000 + \$3,000 utilities).

Bea may exclude \$18,000 from gross income but must include the other \$7,000 of the housing allowance in taxable income. However, the entire \$25,000 housing allowance must be included in computing self-employment income.

Variation: Now assume Bea's actual expenses equal \$28,000 (\$22,000 mortgage + \$3,000 utilities + \$3,000 other costs). According to the Clergy Housing Allowance Clarification Act of 2002, Bea's rental allowance exclusion cannot exceed the fair rental value of her home plus the cost of utilities. This means that she can exclude \$23,000 from gross income but must include the other \$2,000 of the housing allowance in taxable income.

Example 2-25: Excludable amount when mortgage previously satisfied.

Charlie is an ordained minister who is salaried at \$30,000 per year and receives a designated parsonage allowance of \$12,000 per year. Charlie's mortgage was paid off several years ago and during the current year, Charlie spent \$1,500 on utilities, \$1,200 on real estate taxes, and \$300 on house insurance. The fair rental value of his home, as furnished, is \$500 per month (\$6,000 per year). In computing his excludable housing allowance, the three amounts for comparison are as follows:

1. Actual housing costs of \$3,000 (\$1,500 utilities + \$1,200 taxes + \$300 insurance).
2. Designated housing allowance of \$12,000.
3. Fair rental value plus utilities of \$7,500 (\$6,000 fair rental value + \$1,500 utilities).

Charlie may only exclude the actual expenses of \$3,000 for income tax purposes. He is not able to exclude the fair rental value of his house even though he paid for it in previous years.

Charlie must include in taxable income the difference between the housing allowance he received (\$12,000) and the allowable exclusion (\$3,000). The amount of excess rental allowance should be reported on line 7 of his Form 1040.

Example 2-26: Designated housing allowance lower than actual expenses.

Dee is an ordained minister who receives a \$30,000 salary plus a \$12,000 designated parsonage allowance. Dee spent \$12,000 on mortgage payments, \$3,000 on utilities, and \$3,000 on new furniture. The fair rental value of Dee's home, as furnished, is \$18,000. In computing her excludable housing allowance, the three amounts for comparison are as follows:

1. Actual expenses of \$18,000 (\$12,000 mortgage + \$3,000 utilities + \$3,000 other costs).
2. Designated housing allowance of \$12,000.
3. Fair rental value plus utilities of \$21,000 (\$18,000 + \$3,000 utilities).

Dee's exclusion is limited to the \$12,000 designated amount, even though the actual costs (\$18,000) and fair rental value and utilities (\$21,000) are greater than the designated housing allowance. Dee is unable to deduct any housing costs in excess of the designated allowance amount.

The designated housing allowance amount of \$12,000 should be formalized in a written document between the congregation's governing body and the minister.

Example 2-27: Parsonage allowance associated with duplex.

Ed's designated housing allowance is \$12,000 for the year. Ed and his family live in half of a duplex which they own, with the other half of the duplex rented to an unrelated party for \$800 per month. Mortgage payments for Ed's part of the duplex are \$900 per month and utilities run \$1,500 per year. The renter pays their portion of the utilities based on the readings of a separate meter. During the year, Ed paints the entire structure at a cost of \$3,000 and did other minor repairs at a total cost of \$500.

Ed must allocate the mortgage costs, painting, and repairs between Ed's own unit and the rental unit in determining the amount of the excludable parsonage allowance. Any amounts allocable to the rental portion for interest, taxes, etc., are reported on Schedule E.

Ed's actual costs to provide a home were \$14,050 (\$10,800 mortgage payment + \$1,500 utilities + \$1,750 for half the painting and repair).

The fair rental value for the unit should be the same as the rent charged for the other half, which is \$800 per month, unless Ed can prove a different fair rental value with convincing evidence. Ed estimates that his furnishings add another \$150 per month to the fair rental value. Ed's fair rental value plus utilities is \$12,900 (\$9,600 fair rental value + \$1,500 utilities + \$1,800 furnishings). Ed may exclude \$12,000 for income tax purposes, which is the lesser of the designated housing allowance (\$12,000), actual costs to provide the home (\$14,050), or fair rental value (\$12,900).

As previously discussed, parsonage allowances must be included in the self-employment income of a minister, even though excluded from income for income tax purposes.

Example 2-28: Calculation of parsonage allowance for SE tax purposes.

Ann is an ordained minister receiving an annual salary of \$25,000 and is provided with the use of a parsonage, which has a fair rental value of \$700 per month, including utilities. Ann is covered under an accountable plan for other business expenses such as travel and transportation. Ann's gross income for income tax purposes is \$25,000, but for self-employment tax purposes is \$33,400 (\$25,000 salary + \$8,400 fair rental value of parsonage for the year).

Amounts reported in Box 1 of a Form W-2 as taxable income should not include parsonage allowance amounts. Rather, these amounts should be reported in Box 14 (Other) of Form W-2.

Retired ministers can exclude from their gross income the rental value of a home (plus utilities) furnished by a church as a part of their pay for past services, or the part of their pension that was designated as a rental allowance. (The IRS will not rule on whether amounts distributed to

a retired minister from a pension or annuity plan can be excluded as a parsonage allowance.) However, a minister's surviving spouse cannot exclude the rental value unless the rental value is for ministerial services the spouse performs or performed. Retired ministers may claim the amount as excludable for both income tax purposes under IRC Sec. 107 and for self-employment tax purposes under IRC Sec. 1402(a)(8).

The courts have issued a number of rulings concluding that ministers with excludable housing allowances who also incur and deduct unreimbursed employee business expenses cannot deduct the portion of the expenses allocated to the tax-exempt housing allowance. The court opinions are based on IRC Sec. 265, which disallows deductions associated with tax-exempt income.

Example 2-29: Computation of excludable housing allowance.

Reverend Baker is an ordained minister who receives a \$30,000 salary from his church plus a designated housing allowance of \$10,000. Box 1 of Reverend Baker's Form W-2 shows the \$30,000 of taxable wages, while the \$10,000 housing allowance amount is shown in Box 14. During the year, Reverend Baker spent the following amounts for housing:

Mortgage payments	\$ 8,000	Furnishings	\$ 600
Taxes and insurance	2,000	Repairs and maintenance	500
Utilities	1,400		

Reverend Baker estimates that the house, as currently furnished, could be rented for approximately \$1,000 a month. Reverend Baker's excludable housing allowance is determined as follows:

(1) Designated amount per ministerial agreement	<u>\$ 10,000</u>
(2) Fair rental value of housing plus actual utilities:	
Annual rental value of house	\$ 12,000
Actual utilities expenses	<u>1,400</u>
Total fair rental value and utilities	<u>13,400</u>
(3) Actual expenditures for tax year:	
Utilities	1,400
Furnishings	600
Mortgage payment	8,000
Taxes and insurance	2,000
Repairs and maintenance	<u>500</u>
Total expenses	<u>12,500</u>
Allowable exclusion (Lesser of 1, 2, or 3)	<u>\$ 10,000</u>

Reverend Baker is allowed to exclude the full designated amount of \$10,000 from gross income as a nontaxable parsonage allowance. This amount is less than the fair rental value (including utilities) and the actual expenditures he incurred. Accordingly, Reverend Baker need only report the \$30,000 of wages shown on his Form W-2 as taxable income.

Reverend Baker would need to allocate any employee business expenses based on the \$30,000 taxable salary and the \$10,000 nontaxable parsonage allowance for income tax deductibility purposes.

Although ministers use mortgage interest and real estate taxes to determine the nontaxable housing allowance exclusion, they are still allowed to deduct the mortgage interest and real estate taxes as itemized deductions on Schedule A of their Form 1040. Effectively, they obtain a double benefit for these amounts.

Mortgage proceeds must be used to provide the minister a home in order to qualify these amounts for the housing allowance exclusion. In *Rasmussen*, the exclusion was not allowed where the home mortgage was comprised of a home equity loan, the proceeds of which were used other than for acquisition or construction of the home.

Example 2-30: Home equity loan versus mortgage.

Reverend Lacey, an ordained minister, acquires a home equity loan and uses the proceeds to take the family on an around-the-world cruise. Payments on the home equity loan are \$500 per month. Although he has a loan secured by his residence, the money was not used to provide a home and so cannot be used to compute the excludable portion of his parsonage allowance.

Traveling evangelists are able to exclude a designated rental allowance from out-of-town churches if they meet all of the following requirements:

- a. They are ordained ministers.
- b. They perform qualified services at churches located away from their home communities.
- c. They actually use the rental allowance to maintain a permanent home.

Foreign Earned Income

Ministers, like other taxpayers, are eligible for the foreign earned income exclusion of IRC Sec. 911 for work in a foreign country or a specified U.S. possession. Assuming the requirements of IRC Sec. 911 are met, up to \$91,500 (for 2010) of foreign earned income can be excluded. But a minister's self-employment earnings are determined without regard to the foreign earned income exclusion or foreign housing exclusion or deduction otherwise available to a taxpayer who is a U.S. citizen or resident alien serving abroad and living in a foreign country.

Reimbursement Arrangements

Like other taxpayers, ministers report business-related expense reimbursements (including advances and allowances) differently, depending upon whether the reimbursements are paid under an accountable plan or a nonaccountable plan.

Accountable Plan. In order to qualify as an accountable plan, the employer's reimbursement arrangement must meet all three of the following requirements:

- a. The minister must have incurred the expenses while performing services as an employee and the expenses must have a business connection.

- b. The minister must make an adequate accounting of the expenses to the employer within a reasonable period of time. The determination of a reasonable period of time depends on facts and circumstances, although two safe harbors are described in Reg. 1.62-2(g)(2).
- c. The minister must return any excess allowance or reimbursement to the employer within a reasonable period of time.

The IRS has provided guidance on an employer-implemented electronic reimbursement arrangement for travel and entertainment expenses that eliminates the need for paper documents. A credit card company provides electronic receipts for all expenses billed to an employee's business credit card on a daily basis. The employer transfers the electronic receipts to a database, which employees access to create an electronic expense report to accompany the receipts. This arrangement qualifies as an accountable plan because the three preceding requirements are met.

Under an accountable plan, if a minister's expenses equal the reimbursement, the reimbursement is not reported on the Form W-2 and the minister is not allowed to deduct the expenses. However, if expenses exceed the reimbursement amount, the minister can deduct the excess expenses for self-employment tax purposes, and also for income tax purposes on Schedule A as miscellaneous itemized deductions.

Nonaccountable Plans. A nonaccountable plan is a reimbursement arrangement that fails one or more of the three requirements of an accountable plan. Even if the employer maintains an accountable plan, any excess reimbursements which a minister fails to return to the employer are treated as paid under a nonaccountable plan. Additionally, if the employer reimburses any expenses which are nondeductible as business expenses, these reimbursements are deemed to have been paid under a nonaccountable plan.

Reimbursements paid under a nonaccountable plan are added to the Form W-2 wages of the minister. Business expenses associated with amounts paid under a nonaccountable plan, which are included in a minister's Form W-2 can be deducted for both income tax and self-employment tax purposes, although the income tax deduction is only available on Schedule A of the Form 1040.

Example 2-31: Importance of accountable plan.

Reverend Lewis is paid a base salary of \$25,000 and also receives a mileage allowance of \$2,000 per year. The business mileage of Reverend Lewis, which has been properly documented, exactly equals the mileage allowance amount for the year using the standard business mileage rate. However, Reverend Lewis does not adequately account for his mileage to his employer, requiring the employer to add the \$2,000 allowance into the Form W-2 wages (which then total \$27,000).

Although Reverend Lewis will still be able to deduct the \$2,000 of business expenses in computing his self-employment tax because he has proper substantiation for the mileage, the deductibility of this mileage expense for income tax purposes only occurs on Schedule A of Form 1040 (subject to the 2% of AGI phase-out for miscellaneous itemized deductions and the base standard deduction amount). Accordingly, he would likely receive no income tax benefit for the mileage.

Variation: Assume that Reverend Lewis makes a proper accounting of the business mileage to his church, such that the accountable plan requirements are met. The gross wages reported on the Form W-2 of Reverend Lewis now total \$25,000, as opposed to \$27,000 above. Although the self-employment tax computation is unchanged (because no expenses are deducted against the Form W-2 wages in computing self-employment tax), income is \$2,000 less for income tax purposes.

Ministerial Business Expenses as an Employee

Ministers who are employees may deduct ministerial business expenses on Schedule A as miscellaneous itemized deductions subject to the 2% of AGI floor. Expenses to be deducted include employee business expenses which are not reimbursed under an accountable plan and other *nonaccountable* reimbursed business expenses.

Ministers incur different types of deductible business expenses, including the following:

- a. *Transportation Costs.* These include costs for trips for hospital and nursing home visits, attendance at conferences, and other church business.
- b. *Travel Costs.* Travel costs away from home for special conferences or other duties out of the area are deductible. The same rules regarding deductibility of meals, entertainment, and lodging apply to ministers as apply to other taxpayers. The Tax Court disallowed travel expenses for a licensed Pentecostal evangelist, finding that the individual did not have a church or a fixed base of operation for the conduct of his ministry and thus fell under itinerant status.
- c. *Business Use of Home.*
- d. *Supplies and Publications.* Office supplies and job-related books and periodicals associated with ministerial duties are deductible as business expenses. However, ministers using personal computers for writing sermons, correspondence, and recordkeeping may have their business-related usage challenged by the IRS.
- e. *Professional Dues.* Dues paid by ministers for professional organizations and to maintain their credentials are deductible as business expenses.
- f. *Educational Expenses.* Expenses paid by ministers for continuing education related to their ministerial duties are deductible as business expenses.
- g. *Other Expenses.* In general, taxpayers can deduct the cost of purchasing and upkeep of work-related clothing if it is required as a condition of employment and is not usable or adaptable for general (nonbusiness) use. Ministers often incur expenses for special vestments and other work-related clothing. In one case, the Tax Court disallowed the taxpayer's deduction for clothing worn on the job because the taxpayer testified that he was not required to wear particular types of clothing, although it was customary to do so. Other examples of deductible business expenses can include unreimbursed long distance phone calls and office supplies. Contributions made to the minister's church are not deductible as business expenses, but rather (as with any other taxpayer) as charitable contributions on Schedule A.

Ministers who receive no compensation for services are only allowed to deduct out-of-pocket business expenses as charitable contributions.

Ministers who incur ministerial employee business expenses must reduce the deductible amount by the portion allocable to tax-free income (as described in the following paragraphs) before reducing the expenses by the 2%-of-AGI limitation.

Expenses Allocable to Tax-free Income

Ministers who receive a parsonage allowance that is exempt from income tax must allocate a portion of their ministerial expenses to the tax-free income. Consequently, the portion of expenses allocated to the tax-free rental or parsonage allowance cannot be deducted. Additionally, the court has ruled that the portion of expenses allocated to the tax-free rental or parsonage allowance, which cannot be deducted for income tax purposes, also cannot be deducted in computing net earnings from self-employment. Nevertheless, no allocation is required for home mortgage interest and real estate taxes on a residence, since these amounts are otherwise fully deductible.

To calculate the portion of the otherwise deductible expenses that are allocable to the tax-free income and thus are nondeductible, the expenses should be multiplied by the following fraction:

$$\frac{\text{Tax-free rental or parsonage allowance or other tax-free income}}{\text{All income taxable and tax-free earned from the ministry}}$$

When calculating the allocation, include the income and expenses related to the ministerial duties performed both as an employee and as a self-employed person.

Example 2-32: Reduction of expenses for tax-free income.

Reverend Gene Alnes received a total of \$40,000 in ministerial earnings, consisting of a \$28,000 salary, \$2,000 for weddings and baptisms, and a \$10,000 tax-free housing allowance. Reverend Gene incurred \$4,000 of unreimbursed expenses connected with his ministerial earnings, with \$3,500 of the \$4,000 related to his ministerial salary and the remaining \$500 of expenses related to the weddings and baptisms performed as a self-employed person.

The nondeductible portion of expenses related to his ministerial salary is calculated as follows:

$$\frac{\$10,000}{\$40,000} \times \$3,500 = \$875$$

The nondeductible portion of expenses related to his wedding and baptism income is as follows:

$$\frac{\$10,000}{\$40,000} \times \$500 = \$125$$

Example 2-33: Allocation of expenses to exempt income.

Gwen, an ordained minister, receives a salary of \$18,000, an exempt housing allowance of \$9,000, and an auto expense allowance of \$3,000. Gwen incurs business expenses as follows:

Auto	\$ 3,575
Vestments	175
Dues	60
Publications and supplies	<u>150</u>
Total	<u>\$ 3,960</u>

Gwen's total ministerial income equals \$30,000 (\$18,000 salary + \$9,000 housing allowance + \$3,000 car allowance). Her nondeductible expenses are computed as follows:

$$\frac{\$9,000 \text{ housing allowance}}{\$30,000 \text{ total ministerial income}} = 30\%$$

Total business expenses	\$ 3,960
Nontaxable income percentage	<u>× 30%</u>
Nondeductible expenses	<u>\$ 1,188</u>
Total business expenses	\$ 3,960
Nondeductible expenses	<u>(1,188)</u>
Deductible expenses	<u>\$ 2,772</u>

Gwen's deductible expenses are reported as Schedule A miscellaneous itemized deductions because her church considers her an employee and issues a Form W-2. These expenses, along with any other miscellaneous itemized deductions, are subject to the 2%-of-AGI limitation and are nondeductible for alternative minimum tax (AMT) purposes.

Ministers receiving a tax-free rental or parsonage allowance who incur ministerial expenses should attach a statement to their tax return containing the following information:

- a. Each item of taxable ministerial income by source (salary, weddings, baptisms, etc.) and amount.
- b. Each item of tax-free ministerial income by source (e.g., parsonage allowance) and amount.
- c. Each item of otherwise deductible ministerial expenses, including the amount.
- d. Calculations illustrating the nondeductible portion of the otherwise deductible expenses.
- e. A statement that the other deductions on the tax return are not allocable to tax-free income.

Office-in-home Expenses

Employees and self-employed persons can claim deductions for the business use of their home if certain conditions are met; the most common of which is that the office space must be used exclusively and regularly as their *principal place of business*. The definition of principal place of business includes a home office that is used exclusively and regularly to conduct administrative or management activities and is the only fixed location where the taxpayer conducts such activities. While employees can claim home office deductions, the business use must be for the convenience of the employer, and the space must be used exclusively and regularly for job-related activities. As most employers provide ministers with an office and do not require them to work at home, many ministers cannot claim a deduction for the business use of their home.

The Tax Court disallowed a home office deduction for an insurance agent and part-time minister. Although the residence was used regularly and exclusively in both activities, the taxpayer did not meet the principal place of business test for the year in question (1994). While for tax years beginning after 1998, IRC Sec. 280A(c)(1) allows a deduction if the office is used for substantial administrative or management activities and there is no other fixed location where the taxpayer can conduct these activities, each activity must separately meet the requirements to sustain the deduction. This can present a problem for a taxpayer who, for example, uses the home office for employment-related duties and for a self-employment business.

Fringe Benefits

Ministers properly treated as employees under the common law rules are eligible to receive qualified fringe benefits (e.g., accident and health insurance, group term life insurance) on a tax-free basis, similar to other employees. Accordingly, a church or religious organization is able to provide such tax-free fringe benefits to a minister employed by the organization. Other examples of qualified fringe benefits include self-insured medical reimbursement plans, disability insurance, Section 125 cafeteria plans, qualified moving reimbursements, and educational assistance programs. Ministers are also able to voluntarily contribute to IRAs and tax-sheltered retirement plans.

Deductibility of Health Insurance Costs

Effective March 30, 2010, self-employed taxpayers are allowed to deduct 100% of the medical insurance costs paid for themselves, their spouse, their dependents, and any nondependent child under age 27 at the end of the year. Prior to this date, nondependent children were not eligible for this deduction. This deduction is allowed (on page 1 of Form 1040) even if the taxpayer does not itemize deductions on Schedule A. While ministers are normally considered self-employed for employment tax purposes, IRC Sec. 401(c)(2)(A)(ii) specifically excludes earnings on which a minister pays self-employment tax from the definition of earned income for purposes of the deduction of health insurance costs for self-employed taxpayers. [IRC Sec. 162(l)(2) limits the self-employed health insurance deduction based on the definition of earned income under IRC Sec. 401(c).] This precludes many ministers from qualifying for the 100% self-employed health insurance deduction.

Example 2-34: Deductibility of minister's health insurance costs.

Reverend Porter is treated as an employee under the common-law rules, but pays self-employment tax on his wage income. Reverend Porter is paid a base salary of \$20,000 and also receives a \$5,000 parsonage allowance, resulting in total self-employment income for purposes of calculating self-employment tax of \$25,000.

Although Reverend Porter must pay self-employment tax on the \$25,000 amount, it is excluded from the definition of earned income for purposes of deducting health insurance costs of self-employed individuals. This means that Reverend Porter's only opportunity to deduct his health insurance costs is on Schedule A of Form 1040 as a medical expense subject to the 7.5%-of-AGI limitation.

Note: The floor on medical expense deductions increases from 7.5% to 10% of AGI for years beginning after 2012. However, for 2013-2016, the floor will remain at 7.5% if the taxpayer or his or her spouse has reached age 65 before the end of the tax year.

Ministers who are properly treated as independent contractors and are not employees under the common-law rules are allowed the deduction for health insurance costs paid for themselves and their families, similar to other self-employed taxpayers, as follows:

- a. Any amounts used for the self-employed health insurance deduction are not available for deductibility as medical expenses on Schedule A of the Form 1040.
- b. The deduction is not allowed for any month in which the minister is eligible to participate in a subsidized plan of either the minister's or the minister's spouse's employer.
- c. The deduction cannot be used to reduce net earnings for self-employment tax purposes, nor can it exceed the minister's net earnings from the organization that established the insurance plan. The IRS has clarified that health insurance purchased in the name of an individual sole proprietor rather than in the name of the proprietor's business qualifies for the self-employed health insurance deduction. However, a self-employed taxpayer cannot aggregate profits and losses from separate businesses in applying the net earnings ceiling on the deductible amount.

Retirement Plans and IRAs

Retirement Plans. Although ministers are considered self-employed for self-employment tax purposes, they are normally considered employees for income tax purposes, which qualifies them for employer retirement plans. However, some ministerial income may be considered self-employment income while other ministerial income may be considered wage income.

The common law rules determine whether a minister is an employee or a self-employed taxpayer. Ministers treated as employees under the common-law rules are not eligible to establish a qualified retirement plan, even though they are treated as self-employed for social security tax purposes. If self-employed, a minister may establish a qualified retirement plan such as a Keogh plan, a Simplified Employee Pension (SEP) plan, or a SIMPLE plan. The IRS has ruled that for purposes of determining the Section 415 contribution limits to a retirement plan, amounts treated as a parsonage allowance are not treated as compensation.

Example 2-35: Ineligible for qualified retirement plan.

Reverend Ellis is paid an annual salary by her church for performing qualified ministerial services. Reverend Ellis is subject to the control of the congregation, resulting in treatment as an employee under the common-law rules. While Reverend Ellis is required to pay self-employment tax on her wage income, she is not considered a self-employed person for qualified retirement plan purposes.

Alternatively, monies Reverend Ellis receives directly from members of the congregation (such as fees for performing marriages, baptisms, etc.) which are reported on Schedule C of Form 1040 are deemed to be earnings from self-employment for all federal tax purposes. Therefore, Reverend Ellis is eligible to establish a qualified retirement plan on her Schedule C net income amounts.

Earned income for retirement plan purposes includes amounts received for services by self-employed individual members of certain religious sects conscientiously opposed to social security benefits who receive exemptions from self-employment tax. Similarly, for purposes of the SIMPLE plan rules, compensation of self-employed individuals is now defined to include services by self-employed individual members of certain religious sects conscientiously opposed to social security benefits who receive exemptions from self-employment tax. Therefore, self-employed ministers exempt from self-employment tax will qualify for Keogh, SEP, and SIMPLE plans.

IRAs. Ministers are allowed to use both traditional IRAs and Roth IRAs to save for retirement, subject to the overall limit on IRA contributions. The general rules associated with IRA contributions also apply to ministers, generally allowing them to make contributions to either a traditional IRA or a Roth IRA of up to \$5,000 (for 2010), plus an additional \$1,000 if age 50 or over, or the amount of their earned income, whichever is less. Contributions to a traditional IRA may or may not be deductible, depending on the earnings level of the minister, when the minister is covered by an employer retirement plan. But because of their relatively low earnings, many ministers can use a deductible IRA in addition to being covered under an employer retirement plan.

If a minister is an active participant in an employer-sponsored retirement plan, the \$5,000 (for 2010) deduction limit is phased out when modified adjusted gross income (AGI) reaches certain levels for the tax year (\$89,000–\$109,000 for 2010 on a joint tax return). Generally, a taxpayer is not considered an active participant in an employer-sponsored retirement plan just because his or her spouse is an active participant. If only one spouse is a participant in an employer's plan, the spouse who is not a participant can generally contribute and deduct up to \$5,000 (for 2010) to an IRA. However, the ability to deduct such a contribution begins to phase out when a couple's modified AGI reaches \$167,000 (for 2010) and is totally phased out (i.e., no IRA deduction is allowed) once modified AGI reaches \$177,000 (for 2010).

Example 2-36: Deductible IRA with qualified retirement plan.

Reverend Ellis receives Form W-2 wages of \$20,000 from her church. The church sponsors a qualified retirement plan, and pays 25% of her earnings (\$5,000) into the plan. Reverend Ellis also reports Schedule C income totaling \$4,000 on her tax return. Although covered under a qualified retirement plan of the church, Reverend Ellis is still eligible to establish another qualified retirement plan (Keogh, SEP, or SIMPLE) based on her Schedule C net income.

Additionally, because Reverend Ellis is below the AGI threshold established by IRC Sec. 219 for using a deductible IRA, she is also eligible to make a \$5,000 traditional (deductible) IRA contribution (or alternatively a \$5,000 Roth IRA contribution) for 2010.

Since many ministers (because of their relatively low level of earnings) will be eligible to deduct a contribution to a traditional IRA, the issue of whether it is better to make contributions to a Roth IRA or a traditional deductible IRA is a common one. The decision depends on the

minister's tax and financial situation, and should be made only after considering such factors as his or her age, current income tax situation, net worth, and expected post-retirement tax situation. As with most tax planning alternatives, the practitioner should run the numbers for all alternatives before deciding on a particular planning strategy.

Generally speaking, Roth IRAs and traditional IRAs are mirror images. Contributions to a traditional IRA can be deductible, but the funds (contributions and earnings) are taxable when withdrawn. Roth IRA contributions are nondeductible, but qualifying distributions of contributions and earnings can be withdrawn tax free. Thus, the tax benefits of deductible IRAs are frontloaded while the tax benefits of Roth IRAs are *backloaded*.

A Roth IRA's biggest advantages are the ability to receive tax-free distributions (if the requirements are satisfied), no mandatory distribution rules at age 70½, and the ability to continue contributions past age 70½, assuming the client (or spouse) has earned income. Roth IRA distributions are taxable only in limited circumstances. Qualified distributions are completely free of tax and are not subject to the 10% early distribution penalty. A qualified distribution is one that is received (a) after the five-tax-year period beginning with the first tax year for which a contribution is made to a Roth IRA, and (b) after the individual is age 59½ .

Even if the taxpayer receives a nonqualified distribution from a Roth IRA, only the earnings are taxed. Furthermore, contributions are deemed to be distributed before earnings. Therefore, taxpayers can withdraw any amount up to the cumulative contributions at any time, tax free and penalty free. However, earnings included in nonqualified distributions are subject to the 10% early distribution penalty unless the withdrawal qualifies for an exception to the 10% penalty.

The following factors can be considered when advising a client on when a Roth IRA contribution may be preferable to a traditional deductible IRA contribution:

- a. Generally, the longer the period the funds will be invested, the more beneficial the deferral and tax-free distribution advantages of the Roth IRA. In the long term, a taxpayer will accumulate more after-tax income under a Roth IRA than a traditional IRA. The shorter the period the funds will be invested, the more beneficial the immediate tax savings advantage of the deductible IRA.
- b. A taxpayer who expects to be in a higher tax bracket at retirement than today would favor a Roth IRA with its tax-free withdrawals at retirement, while an individual who expects to be in a lower tax bracket at retirement would favor a traditional IRA with its current deduction at today's higher tax rate.
- c. A Roth IRA generally is preferable for taxpayers currently in a low tax bracket and who anticipate remaining so in the future. They will realize little or no immediate tax savings from contributing to a deductible IRA.
- d. Because Roth IRA withdrawals come first from contributions (which are not taxed and not subject to the 10% early distribution penalty when withdrawn), taxpayers can withdraw contributions from a Roth IRA tax free and penalty free at any time, regardless of how the funds are used. This is true even if the five-year waiting period has not expired and the taxpayer is not yet age 59½. Thus, Roth IRAs can be a useful vehicle for taxpayers who may need to access their original contributions (for whatever purpose) before retirement.

Tax-sheltered Annuities. A tax-sheltered annuity plan [also referred to as a 403(b) plan or a TSA plan] is a retirement plan that, if operated properly by a qualified employer, is tax-exempt. The most common way to contribute to TSA plans is through a salary reduction agreement under which an employee agrees to take a reduction in salary or to forego a salary increase, and the employer contributes that amount to a TSA plan for that employee. (These employer contributions are called *elective deferrals*.) A TSA plan can also be funded through nonelective employer contributions or after-tax employee contributions.

According to IRS Pub. 571, "Tax-Sheltered Annuity Plans (403(b) Plans) For Employees of Public Schools and Certain Tax-Exempt Organizations" the following ministers are eligible employees for whom a 403(b) account can be established:

- a. Ministers employed by Section 501(c)(3) organizations.
- b. Self-employed ministers. A self-employed minister is treated as employed by a tax-exempt organization that is a qualified employer. In regulations dealing with deemed IRAs, the IRS notes that "the only circumstance under which a self-employed individual may participate in a section 403(b) plan is when a self-employed minister . . . participates."
- c. Ministers (chaplains) who (1) are employed by organizations that are not Section 501(c)(3) organizations and (2) function as ministers in their day-to-day professional responsibilities with their employers.

Catch-up Contributions. Section 403(b) plans can allow participants who have attained age 50 by year-end to defer an additional amount [i.e., to defer more than the 2010 \$16,500 limit]. These additional amounts are referred to as catch-up contributions. Such catch-up contributions are not subject to any other contribution limits and are not considered in applying other contribution limits. In addition, they are not subject to applicable nondiscrimination rules. However, they must be available to all age 50 and over participants on an equal basis. The allowable catch-up contribution to a 403(b) plan for 2010 is \$5,000. Additionally, employees of certain types of nonprofit organizations, including schools, health care organizations, and churches, may be eligible for a special Section 403(b) catch-up limit. To qualify for the special catch-up limit, the participant must have at least 15 years of service. Participants who qualify can make as much as an additional \$3,000 contribution per year for up to five years. Any catch-up contribution for an employee who is eligible for both an age 50 catch-up contribution and the special 403(b) catch-up contribution is treated first as a special 403(b) catch-up contribution to the extent a special 403(b) catch-up contribution is allowed, and then as an amount contributed as an age 50 catch-up contribution.

In 2007, the IRS issued final regulations that provide comprehensive guidance on the many statutory and administrative changes that have occurred in the Section 403(b) annuity area in the last 40 years, as well as answers to questions that have not been addressed in formal guidance. The final regulations generally apply to tax years beginning after 2008 and contain significant new requirements [e.g., a rule that 403(b) plans must in writing] that may require changes to current Section 403(b) arrangements.

Earned Income Credit

A refundable earned income credit is available under IRC Sec. 32 for taxpayers with earned income who meet certain adjusted gross income (AGI)—or if greater, earned income—thresholds. The earned income credit (EIC) is computed using the earned income table and worksheet. The credit is available to taxpayers whether or not they have a qualifying child. If a taxpayer has a qualifying child, Schedule EIC must be attached to the Form 1040. As a refundable credit, the earned income credit can produce a refund even when no tax is owed.

Earned income includes wages, salaries, tips and other pay, along with net earnings from self-employment (less the deduction claimed for one-half of self-employment tax on page 1 of Form 1040). Ministers whose ministerial services income is exempt from self-employment tax by reason of an approved Form 4361 include amounts received for performing ministerial duties *as an employee* in the earned income amount. However, amounts received by these ministers for performing nonemployee ministerial duties (e.g., weddings and baptisms) are not earned income. Nevertheless, net earnings from self-employment, less the one-half of SE tax deduction, from any *nonministerial duties* performed by these ministers is earned income.

Ministers whose income from qualified services is not exempt from self-employment tax calculate earned income by including all net earnings from self-employment, plus any amounts received for nonministerial duties, less the one half self-employment tax deduction from page 1 of Form 1040.

Ministers holding an approved Form 4029 as a member of a recognized religious sect include all wages, salaries, tips, and other taxable employee compensation as earned income. However, amounts received as a self-employed individual are not earned income and any losses from Schedule C, C-EZ, or F cannot be subtracted from wages on page 1 of Form 1040.

Outstanding Tax Liabilities

The Tax Court ruled in favor of the IRS (*Pixley*) regarding a taxpayer who claimed to be an ordained Baptist minister and who had filed an offer-in-compromise with the IRS related to outstanding tax liabilities. In filing the offer-in-compromise, the taxpayer had included a \$520 monthly living expense amount titled “tithe to church.” The court determined that tithing would be an allowable expense in determining the ability to pay outstanding tax liabilities if the tithing was a condition of employment. However, the court determined the tithing was not a requirement of employment in this case, finding that the taxpayer had failed to substantiate he was employed as a Baptist minister in the years in question.

IRS Audit Issues

IRS audit activity among ministers is fairly high because of their unique income tax and employment tax issues. The reclassification of items such as parsonage allowances and reimbursements under a nonaccountable plan can have a significant impact on the income tax liability of the minister, so IRS agents often take a fairly aggressive stance in these areas. Accordingly, adherence to the rules in these areas is critical and proper documentation should be retained by both the employer and the minister.

Minister Audit Technique Guide (ATG)

The IRS posted a revised ATG on its website in April 2009. The ATG can be found at www.irs.gov, select Businesses, then Audit Techniques Guides (ATGs), then Minister Audit Technique Guide.

The ATG for ministers summarizes for IRS examiners many unique income tax and payroll tax matters of ministers, and it also highlights areas that the IRS is likely to examine during an audit of a minister's tax return.

The ATG identifies several potential issues that can be prevalent on ministers' tax returns:

- a. The issue of employee versus independent contractor. (The ATG indicates this is primarily a factual question that must be determined on common law grounds.)
- b. The issue of monies received and whether they should be classified as gifts or compensation for services.
- c. The issue of being exempt from self-employment tax either as a member of a religious order who has taken a vow of poverty or by seeking an exemption based on opposition to receiving social security benefits due to religious principles.
- d. The issue of parsonage or housing allowance, including the determination of the fair rental value of the housing or parsonage allowance and the assurance that this amount is included in the computation of self-employment tax.

Political Activity by Religious Leaders

One area in which the IRS has taken particular interest involves individual political activity by ministers and other religious leaders. While numerous restrictions prohibit political campaign activity by religious organizations, these restrictions are not intended to restrict free expression on political matters by leaders of churches or religious organizations speaking for themselves, *as individuals*. However, religious leaders jeopardize the IRC Sec. 501(c)(3) status of their organization if they make partisan political comments in official organization publications or at official church functions. IRS Pub. 1828, "Tax Guide for Churches and Religious Organizations," cautions ministers that "to avoid potential attribution of their comments outside of church functions and publications, religious leaders who speak or write in their individual capacity are encouraged to clearly indicate that their comments are personal and not intended to represent the views of the organization."

Example 2-37: Endorsement by minister in a personal capacity.

Minister Adam is the minister of Church J and is well known in the community. With the permission of the individuals involved, Candidate Tom publishes a full-page ad in the local newspaper listing five prominent ministers who have personally endorsed Candidate Tom, including Minister Adam. Minister Adam is identified in the ad as the minister of Church J.

The ad states, "Titles and affiliations of each individual are provided for identification purposes only." The ad was paid for by Candidate Tom's campaign committee.

Because the ad was not paid for by Church J, the ad is not otherwise in an official publication of Church J, and the endorsement is made by Minister Adam in a personal capacity, the ad does not constitute campaign intervention by Church J.

Example 2-38: Campaign intervention attributed to church.

Minister Bea is the minister of Church K. Church K publishes a monthly church newsletter that is distributed to all church members. In each issue, Minister Bea has a column titled “My Views.” The month before the election, Minister Bea states in the “My Views” column, “It is my personal opinion that Candidate Ursula should be reelected.” For that one issue, Minister Bea pays from her personal funds the portion of the cost of the newsletter attributable to the “My Views” column.

Even though she paid part of the cost of the newsletter personally, the newsletter is an official publication of the church. Because the endorsement appeared in an official publication of Church K, it constitutes prohibited campaign intervention attributed to Church K.

Example 2-39: No attribution of campaign intervention.

Minister Cal is the minister of Church L and is well known in the community. Three weeks before the election Minister Cal attends a press conference at Candidate Vin’s campaign headquarters and states that “Candidate Vin should be reelected.” Minister Cal does not say he is speaking on behalf of his church. His endorsement is reported on the front page of the local newspaper and Minister Cal is identified in the article as the minister of Church L.

Because Minister Cal did not make the endorsement at an official church function, in an official church publication or otherwise use the church’s assets, and did not state that he was speaking as a representative of Church L, Minister Cal’s actions do not constitute campaign intervention attributable to Church L.

Example 2-40: Political campaign intervention attributable to church.

Minister Dee is the minister of Church M. During regular services of Church M shortly before the election, Minister Dee preaches on a number of issues, including the importance of voting in the upcoming election, and concludes by stating “It is important that you all do your duty in the election and vote for Candidate Warren.”

Because Minister Dee’s remarks indicating support for Candidate Warren were made during an official church service, they constitute prohibited political campaign intervention attributable to Church M.

The prohibition on political campaign activity does not prohibit churches from having general contact with individuals who are candidates for public office. The guidance makes it clear that a church may invite political candidates to speak at its events without jeopardizing its tax-exempt status. However, a church can invite political candidates to speak in their capacity as candidates only if the church has taken steps to ensure that:

- a. It provides an equal opportunity to other political candidates seeking the same office,

- b. It does not indicate any support of or opposition to any candidate, and
- c. No political fund-raising occurs.

Similarly, the IRS guidance indicates that a church can invite a political candidate to speak in his or her individual (noncandidate) capacity as long as the church takes steps to ensure that:

- a. The candidate speaks only in a noncandidate capacity,
- b. Neither the candidate nor any representative of the church makes any mention of the election or candidacy of the individual, and
- c. No campaign activity occurs in connection with the candidate's attendance.

This continues to be a hot topic in the tax-exempt community. The IRS has stated that tax exemption is a privilege, not a right, and has prohibited churches or any other tax-exempt groups from interfering in political campaigns by endorsing or opposing candidates or by talking about issues that are slanted towards a particular candidate. Ministers have argued that their First Amendment rights are violated by not having a right to speak on the moral qualifications of candidates for office. For further guidance on the political campaign prohibition as it applies to churches, see IRS Pub. 1828.

In 2009, the IRS issued guidance under IRC Sec. 7611 indicating that the Director of Exempt Organizations was the "appropriate high level Treasury official" authorized to begin an inquiry into whether a church no longer qualifies for its tax exemption.

Comprehensive Illustration

The following example is intended to illustrate many of the topics discussed throughout this lesson.

Example 2-41: Comprehensive illustration of tax treatment of ministers.

During 2010, Reverend Paul serves as a minister for the First Comprehensive Church. Reverend Paul is married, files a joint Form 1040 with Mrs. Paul, has two children (both of whom qualify for dependent exemptions and the IRC Sec. 24 child tax credit), and has not applied for exemption from self-employment tax. Because the church exercises sufficient control over the manner in which Reverend Paul performs his ministerial duties, he is considered a common-law employee of the church, and is salaried at \$30,000 per year. Additionally, Reverend Paul performs weddings, baptisms, and other ministerial functions for which he receives \$6,000 per year. He reports this amount as self-employment income on Schedule C of his Form 1040; as described in the following discussion of "Schedule C," he incurs \$220 of business expenses against this income.

Reverend Paul previously purchased a residence within walking distance of the church, on which he pays \$1,000 per month as a mortgage payment. The First Comprehensive Church pays Reverend Paul \$1,000 per month as his parsonage allowance, excluding utilities, with the fair rental value of the home deemed to be \$1,200 per month. Utility bills for the year total \$1,000 and the church paid him an additional \$100 per month as an allowance for utility costs.

Reverend Paul has not requested any withholding of federal income tax from his wages, so his gross salary of \$30,000 is reported in box 1 of Form W-2, with the boxes for social security wages and Medicare wages left blank. He makes total estimated tax payments of \$8,000 during the year.

Reverend Paul also acted as an instructor for a series of seminars sponsored by a local college, for which he was paid \$4,000, reported to him on a Form W-2. There was federal income tax of \$300 withheld on these wages, and because Reverend Paul is treated as an employee of the college, he was subject to social security and Medicare tax withholding on the wages. Accordingly, his Form W-2 shows \$248 withheld for social security taxes and \$58 withheld for Medicare taxes.

Form 1040. In computing his excludable housing allowance, the three amounts for comparison are as follows:

1. Actual expenses of \$13,000 (\$12,000 for mortgage + \$1,000 for utilities).
2. Designated allowance of \$13,200 (parsonage allowance of \$12,000 + \$1,200 for utilities).
3. Fair rental value of \$15,400 (including actual utilities expense of \$1,000).

Reverend Paul must include in taxable income the difference between the housing allowance he received (\$13,200) and the allowable exclusion (\$13,000). The difference of \$200 should be included with wages for a total income of \$34,200 that Reverend Paul reports on line 7 of his Form 1040. This is comprised of \$34,000 of wages (the \$30,000 church salary and \$4,000 college salary) and \$200 of other income (the excess of his utility allowance over actual utilities costs). He should also write "Excess Utility Allowance \$200" in the space to the left of box 7. On page 1 of the Form 1040 he reports his net profit of \$5,838 (see computation in the following paragraph) from Schedule C.

Schedule C. On Schedule C, Reverend Paul reports the \$6,000 of fees he received from weddings, baptisms, and miscellaneous honoraria. Reverend Paul incurred \$220 of business mileage expense associated with these fees during the year, computed at the standard mileage rate. However, Reverend Paul cannot deduct the portion of his business expenses allocable to his tax-free income. Accordingly, his practitioner performs the following calculation and attaches a schedule to his tax return:

(1) Amount of tax-exempt income:	
Parsonage allowance	\$ 12,000
Utility allowance	<u>1,000</u>
Total	<u>\$ 13,000</u>
(2) Total income from ministry:	
Salary	\$ 30,000
Fees	6,000
Taxable part of utility allowance	200
Amount from line 1, above	<u>13,000</u>
Total	<u>\$ 49,200</u>
(3) Divide line 1 by line 2 (\$13,000 ÷ \$49,200)	<u>26.42%</u>
(4) Total business (auto) expenses substantiated	<u>\$ 220</u>
(5) Multiply line 4 total by line 3 percentage to compute nondeductible expenses allocable to tax-exempt income	<u>58</u>
(6) Subtract line 5 amount from line 4 amount, calculating the deductible expenses for Schedule C purposes	<u>\$ 162</u>

Reverend Paul's practitioner then subtracts the \$162 from the \$6,000 of fees, calculating net Schedule C income of \$5,838. This net profit from Schedule C is then carried to page 1 of his Form 1040.

Schedule SE. Reverend Paul's practitioner calculates his self-employment income as follows:

Church salary	\$ 30,000
Parsonage allowance	12,000
Utility allowance	1,200
Schedule C net income	5,838
Less: employee business expenses (see the following discussion of Form 2106) reduced by allocable amount to tax exempt income ($650 \times 73.58\%$)	<u>(478)</u>
Total	<u>\$ 48,560</u>

His self-employment tax liability of \$6,861 ($\$48,560 \times .9235 \times .153$) is then entered on the appropriate line of page 2 of Form 1040, and Reverend Paul is entitled to deduct one-half of this self-employment tax on page 1 of the Form 1040 in the amount of \$3,431.

Form 2106. Reverend Paul's practitioner completes Form 2106 (or Form 2106 EZ) to report any unreimbursed business expenses he encountered as a common-law employee of First Comprehensive Church. Reverend Paul must first complete Part II related to the business mileage that he is able to substantiate. Reverend Paul's business mileage, at the standard mileage rate, amounted to \$472 for the year. Reverend Paul also can substantiate \$178 of business expenses for professional publications and books.

However, Reverend Paul must reduce these total business expenses of \$650 ($\$472 + \178) by the amount allocable to the tax-free parsonage allowance in a manner similar to that shown for the deductibility of expenses on the Schedule C. Once the reduced amount of deductible employee business expenses has been calculated, it is entered in the miscellaneous itemized deduction area of Schedule A. These allowable employee business expenses, including a reduction for the allocable portion to tax-free income, are allowed for self-employment tax purposes.

Schedule A. Reverend Paul's practitioner deducts \$1,900 of real estate taxes on Schedule A and \$6,250 of home mortgage interest. During the year, Reverend Paul contributed \$4,300 in cash to various qualifying charities, which is deducted as charitable contributions on his Schedule A. In the miscellaneous itemized deduction area, Reverend Paul claims his unreimbursed employee business expenses, but because this amount is less than 2% of his adjusted gross income, his total deductible miscellaneous itemized deductions are zero. The total of all of his itemized deductions ($\$1,900 + \$6,250 + \$4,300$) is \$12,450, which is entered on the total line of Schedule A and carried to page 2 of his Form 1040.

Overall Results. Reverend Paul pays income tax on approximately \$9,550 of taxable income (computation not shown), resulting in only about \$955 of federal income tax. However, the \$6,861 of self-employment tax increases the total income tax and self-employment tax liability to approximately \$7,800, resulting in a refund of about \$2,500 to Reverend Paul (based on the available child tax credit—both refundable and nonrefundable—of \$1,000 per child, \$8,000 of estimated tax paid, and \$300 of federal withholding on the wages paid by the college).

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

12. The absence of which characteristic would indicate the organization is not a religious order?
- a. The organization is described under IRC Sec. 501(c)(3).
 - b. The organization is, directly or indirectly, under the control and supervision of a church or convention.
 - c. The members of the organization vow to live under a strict set of rules requiring moral and spiritual self-sacrifice.
 - d. The members of the organization work or serve full-time on behalf of the religious, educational, or charitable goals of the organization.
13. Which of the following individuals would be considered performing services *in the exercise of his ministry*?
- a. Service performed by Larry, a chaplain in the Armed Forces of the U.S. stationed in Afghanistan.
 - b. Service performed by Steve, a chaplain in the Armed Forces of the U.S. stationed at Fort Bragg, NC.
 - c. Andrew, a duly ordained minister, is engaged by the University of Florida as their chaplain.
 - d. Mark, a duly ordained minister, is engaged by the University of North Carolina to teach political science.
14. Which of the following statements is true regarding a church or church-controlled organization's election to exclude employees from FICA coverage?
- a. The church may elect not to pay the employer's portion of FICA tax by certifying to the IRS that it is opposed to paying the taxes for religious reasons.
 - b. If the church elects to not pay FICA taxes, the election also qualifies the employee for exemption on their portion of FICA taxes.
 - c. If an election is made by the church or church-controlled organization, it is irrevocable.
 - d. A church organization that receives more than 25% of its support from governmental sources may make the election.

15. Members of a recognized religious sect may also choose to be exempt from social security and Medicare taxes. Which of the following statements is correct with respect to this election?
- a. The employer's approved exemption applies to all members of the religious sect.
 - b. The election is revocable, either by the religious sect or the employee.
 - c. The member must waive all rights to receive any social security payments in the future.
 - d. Members of the religious sect need not apply for the exemption separately.
16. Which of the following amounts is considered self-employment income for a minister?
- a. Amounts paid by the church toward the income tax of the minister.
 - b. Offerings made to the church by other parties.
 - c. Salary reductions from a minister's income contributed to an annuity plan set up by the church.
 - d. The rental value of a parsonage provided to a minister after he retires.
17. Reverend Ayers receives a salary of \$25,000, a housing allowance of \$10,000, and earns \$7,500 from other ministerial engagements. His housing cost is \$8,500 per year. Reverend Ayers' earnings from self-employment equal _____.
- a. \$32,500.
 - b. \$34,000.
 - c. \$35,000.
 - d. \$42,500.
18. Reverend Ayers receives a salary of \$25,000, a housing allowance of \$10,000, and earns \$7,500 from other ministerial engagements. His housing cost is \$8,500 per year and his total business expenses equal \$5,000. Reverend Ayers' deductible expenses from gross self-employment income equal _____.
- a. \$5,000.
 - b. \$4,000.
 - c. \$3,825.
 - d. \$3,785.

19. The All Saints Episcopal Church collects a love offering every December to provide Christmas bonuses to their pastors. How is the love offering characterized?
- a. Treated as a nontaxable gift from the parishioners to the pastor.
 - b. Exempt from self-employment tax since it is supplemental payments outside of the pastor's compensation package.
 - c. Subject to federal income tax withholding on the amount reported by the church.
 - d. Treated as other income subject to federal income tax.
20. Which of the following statements is correct with regards to a housing allowance?
- a. If the housing allowance is paid under a nonaccountable plan, it is subject to federal income tax.
 - b. A minister can receive a housing allowance for multiple homes.
 - c. If the minister owns a home and receives a housing allowance, he can still deduct home mortgage interest and real estate taxes.
 - d. Additional payments made to a minister for a reimbursement of utilities used in the parsonage are subject to federal income tax.
21. Reverend Banks owns a home and also receives a housing allowance from his church. The housing allowance equals \$20,000. His actual housing cost for the year includes mortgage payments of \$14,500, utilities of \$3,000 and another \$2,000 for home maintenance and new furniture. The fair rental value of the home is \$18,000 per year, as furnished. How much of the housing allowance may Reverend Banks exclude from gross income?
- a. \$14,500.
 - b. \$18,000.
 - c. \$19,500.
 - d. \$20,000.

22. Business expenses reimbursed under an accountable plan are not taxable to the minister. Which of the following statements would fail the accountable plan requirements and make the reimbursements taxable?
- a. The minister need not account for the expenses to the employer.
 - b. Amounts received by the minister in excess of the actual expenses incurred, must be returned to the employer.
 - c. The minister incurs expenses while performing services as an employee.
 - d. In order to qualify under the plan, the expenses must have a business connection.
23. All of the following are examples of deductible business expenses incurred by a minister, **except**:
- a. The cost of transportation for hospital visits.
 - b. A copy of the *Da Vinci Code*, as research for upcoming sermons.
 - c. A subscription to *Theology Today*, an ecumenical journal of theology.
 - d. Dues paid to Gold's Gym that maintains a location beside the church.
24. Which of the following statements is true with regards to retirement plans for a minister?
- a. Ministers treated as common-law employees are able to establish a qualified retirement plan because they are treated as self-employed for social security purposes.
 - b. A special exception available to the minister is that they are not subject to the active participation rules related to traditional IRAs.
 - c. Self-employed ministers exempt from self-employment tax qualify to establish a Keogh, SEP, or SIMPLE plan.
 - d. A minister is allowed the maximum catch-up contribution of \$5,000 available for all plans, including qualified plans, IRAs, and tax-sheltered annuities.

25. In which of the following situations would a Roth IRA be preferable to a traditional IRA?
- a. A taxpayer currently in a high tax bracket anticipates owing a large amount of tax on April 15.
 - b. A taxpayer that may need access to the funds before retirement.
 - c. A taxpayer who expects to be in a lower tax bracket at retirement than today.
 - d. A short time horizon for investment of the funds.
26. All of the following items have been identified by the IRS as potential issues prevalent on minister's returns, **except**:
- a. Employee versus independent contractor.
 - b. Determination of parsonage allowance.
 - c. Exemptions from self-employment tax.
 - d. Categorization of deductions on tax return.
27. When a minister is involved in a political activity, the primary concern is that the activity may:
- a. Jeopardize the IRC Sec. 501(c)(3) status of the organization.
 - b. Restrict the minister's freedom of expression.
 - c. Change status from self-employed for self-employment tax purposes to employee.
 - d. Subject minister to FUTA tax, FICA and federal income tax withholding.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

12. The absence of which characteristic would indicate the organization is not a religious order? **(Page 28)**
- a. **The organization is described under IRC Sec. 501(c)(3). [This answer is correct. In Rev. Proc. 91-20, the IRS provides a list of characteristics to be used in determining whether an organization qualifies as a religious order. Any organization not described under IRC 501(c)(3), would immediately be disqualified from consideration as a religious order.]**
 - b. The organization is, directly or indirectly, under the control and supervision of a church or convention. [This answer is incorrect. One of the factors that should be considered when determining whether an organization is a religious organization includes whether the organization is, directly or indirectly, under the control and supervision of a church or convention or association of churches, or is significantly funded by a church or convention or association of churches. The absence of this factor does not preclude the organization from being a religious order.]
 - c. The members of the organization vow to live under a strict set of rules requiring moral and spiritual self-sacrifice. [This answer is incorrect. One of the characteristics of a religious order is whether the members of the organization vow to live under a strict set of rules requiring moral and spiritual self-sacrifice and dedication to the goals of the organization at the expense of their material well-being. However, the absence of this characteristic does not prohibit the organization from being considered a religious order.]
 - d. The members of the organization work or serve full-time on behalf of the religious, educational, or charitable goals of the organization. [This answer is incorrect. Rev. Proc. 91-20 includes this characteristic as one of the relevant facts and circumstances that can determine if an organization is a religious order. However, the revenue procedure does provide one fact of which the absence would disqualify the organization.]
13. Which of the following individuals would be considered performing services *in the exercise of his ministry*? **(Page 30)**
- a. Service performed by Larry, a chaplain in the Armed Forces of the U.S. stationed in Afghanistan. [This answer is incorrect. Service performed by a minister as an employee of the U.S., or a state, territory or possession of the U.S. is not considered to be in the exercise of ministry regardless of where the individual is located.]
 - b. Service performed by Steve, a chaplain in the Armed Forces of the U.S. stationed at Fort Bragg, NC. [This answer is incorrect. Although Steve performs the ministrations of sacerdotal functions and conducts religious worship, he does not qualify as in the exercise of ministry because he is an employee of the U.S.]

- c. **Andrew, a duly ordained minister, is engaged by the University of Florida as their chaplain. [This answer is correct. Andrew's services do qualify as in the exercise of his ministry. He devotes his entire time to performing duties as chaplain, such as offering spiritual counsel, teaching a religion class, and conducting religious worship.]**
- d. Mark, a duly ordained minister, is engaged by the University of North Carolina to teach political science. [This answer is incorrect. Although Mark is a duly ordained minister, his duties are not classified as in the exercise of his ministry. His primary duties for the school are unrelated to his being an ordained minister and his employer is not considered a religious institution.]
14. Which of the following statements is true regarding a church or church-controlled organization's election to exclude employees from FICA coverage? **(Page 38)**
- a. **The church may elect not to pay the employer's portion of FICA tax by certifying to the IRS that it is opposed to paying the taxes for religious reasons. [This answer is correct. A church or church-controlled organization can elect not to pay the employer's portion of FICA taxes if it is religiously opposed to such taxes and makes a certification with the IRS. The election applies to all current and future employees of the church or organization.]**
- b. If the church elects to not pay FICA taxes, the election also qualifies the employee for exemption on their portion of FICA taxes. [This answer is incorrect. An employee of a church or church organization which has made the election to exclude employees from FICA coverage is required to pay self-employment tax on wages which equal or exceed \$108.28. The election made by the church does not extend to the employee.]
- c. If an election is made by the church or church-controlled organization, it is irrevocable. [This answer is incorrect. The election is revocable by the church or organization but any revocation cannot later be reversed.]
- d. A church organization that receives more than 25% of its support from governmental sources may make the election. [This answer is incorrect. If a church organization normally receives more than 25% of its support from governmental sources and/or receipts from admissions, sales of merchandise, services, or facilities in related trade or businesses activities, then it cannot make the FICA tax election.]
15. Members of a recognized religious sect may also choose to be exempt from social security and Medicare taxes. Which of the following statements is correct with respect to this election? **(Page 39)**
- a. The employer's approved exemption applies to all members of the religious sect. [This answer is incorrect. The employer's approved exemption applies to social security and Medicare taxes paid on wages only to employees who also received an approved exemption.]
- b. The election is revocable, either by the religious sect or the employee. [This answer is incorrect. The election is generally irrevocable. If a taxpayer is no longer a member of the sect or no longer follows the established teachings of the group, he is required to notify the IRS within 60 days from such date.]

- c. **The member must waive all rights to receive any social security payments in the future. [This answer is correct. The member must be conscientiously opposed to accepting benefits of public insurance and waive all rights to receive any social security payments or benefit and agree that no benefits or payments will be made to anyone else based on the member's income.]**
- d. Members of the religious sect need not apply for the exemption separately. [This answer is incorrect. Members of the sect must file Form 4029, Application for Exemption from Social Security and Medicare Taxes and Waive Benefits, with the Social Security Administration.]
16. Which of the following amounts is considered self-employment income for a minister? **(Page 41)**
- a. **Amounts paid by the church toward the income tax of the minister. [This answer is correct. Amounts paid by the church toward the income tax or self-employment tax of the minister are considered self-employment income. In addition, such payments are subject to income tax.]**
- b. Offerings made to the church by other parties. [This answer is incorrect. Offerings made to the church by other parties for general church operations or a building fund is not income to the minister.]
- c. Salary reductions from a minister's income contributed to an annuity plan set up by the church. [This answer is incorrect. Unlike common law employees, salary reductions from a minister's gross income are not subject to self-employment tax when contributed to an annuity plan established by the church for the benefit of the minister.]
- d. The rental value of a parsonage provided to a minister after he retires. [This answer is incorrect. The church organization may provide a parsonage allowance or a parsonage for the benefit of a minister after he retires and it is not subject to self-employment tax. However, such benefits are included as self-employment income for the minister for periods up to retirement.]
17. Reverend Ayers receives a salary of \$25,000, a housing allowance of \$10,000, and earns \$7,500 from other ministerial engagements. His housing cost is \$8,500 per year. Reverend Ayers earnings from self-employment equal _____. **(Page 43)**
- a. \$32,500. [This answer is incorrect. Although the housing allowance, limited to the amount of housing cost in this example, is not subject to federal income tax it is subject to self-employment tax.]
- b. \$34,000. [This answer is incorrect. You have calculated the amount subject to federal income tax, not self-employment tax.]
- c. \$35,000. [This answer is incorrect. Don't forget that other ministerial activities are subject to self-employment tax.]
- d. **\$42,500. [This answer is correct. Reverend Ayers' earnings from self-employment equal \$42,500, calculated as follows:**

Salary	\$25,000
Housing allowance	\$10,000
Other ministerial work	\$7,500
Total	\$42,500]

18. Reverend Ayers receives a salary of \$25,000, a housing allowance of \$10,000, and earns \$7,500 from other ministerial engagements. His housing cost is \$8,500 per year and his total business expenses equal \$5,000. Reverend Ayers' deductible expenses from gross self-employment income equal _____. **(Page 43)**
- \$5,000. [This answer is incorrect. A reduction of the unreimbursed business expense deduction associated with tax-exempt income is required for self-employment tax purposes. The entire amount is not deductible.]
 - \$4,000. [This answer is correct. Reverend Ayers may deduct \$4,000 of business deductions against his self-employment income. This amount is calculated as follows:**

\$8,500 (housing allowance exempt from tax/\$42,500 self-employment income (\$25,000 salary + \$10,000 housing allowance + \$7,500 fee) = 20.00% nontaxable income.

Of the total expenses, \$5,000 × 20% = \$1,000 are nondeductible expenses.

Of the total expenses, \$5,000 – \$1,000 = \$4,000 are deductible expenses.]
 - \$3,825. [This answer is incorrect. You have calculated the deductible expenses by excluding the entire \$10,000 housing allowance from federal income tax. Remember, the amount excludible from federal income tax for the housing allowance in this example is limited to the lesser of the housing allowance or the actual housing costs.]
 - \$3,785. [This answer is incorrect. The other ministerial work of \$7,500 should be included in the denominator as self-employment income.]
19. The All Saints Episcopal Church collects a love offering every December to provide Christmas bonuses to their pastors. How is the love offering characterized? **(Page 47)**
- Treated as a nontaxable gift from the parishioners to the pastor. [This answer is incorrect. In order for the love offering to be considered a gift, there must be donative intent on behalf of the parishioners. Payments for events such as ordinations, marriages, baptisms, anniversaries and special pastor offerings are not considered gifts.]
 - Exempt from self-employment tax since it is supplemental payments outside of the pastor's compensation package. [This answer is incorrect. Although the pastor's compensation agreement with the church does not include this bonus, it is still considered compensation for self-employment tax purposes. The love offering is given for services rendered as a current pastor of the church. Therefore, the amount is subject to self-employment tax.]
 - Subject to federal income tax withholding on the amount reported by the church. [This answer is incorrect. There is a special exception to the federal income tax withholding requirements for ministers. Amounts earned by a minister are not subject to federal income tax withholding. Ministers may want to make estimated tax payments to avoid an underpayment penalty.]

- d. **Treated as other income subject to federal income tax. [This answer is correct. Love offerings are considered special offerings for the pastor, similar to payments received for the performance of services for special occasions (baptism, marriage, and ordination.) These offerings are considered payments for services rendered and are compensation for federal income tax as well as self-employment tax purposes. There is not a donative intent on the part of the parishioners for these types of offerings. The parishioners generally take a tax deduction for the contribution and the minister recognizes taxable income.]**
20. Which of the following statements is correct with regards to a housing allowance?
(Page 49)
- a. If the housing allowance is paid under a nonaccountable plan, it is subject to federal income tax. [This answer is incorrect. A minister does not have to substantiate the use of the housing allowance proceeds. The allowance must be reasonable based on the minister's pay for services. It is irrelevant whether the allowance is paid under an accountable or nonaccountable plan. However, an allowance in excess of actual costs or fair rental value may be taxable for federal income tax purposes.]
- b. A minister can receive a housing allowance for multiple homes. [This answer is incorrect. A minister can receive a parsonage allowance for only one home.]
- c. **If the minister owns a home and receives a housing allowance, he can still deduct home mortgage interest and real estate taxes. [This answer is correct. A parsonage or housing allowance is not subject to federal income tax unless the payments exceed certain amounts. However, even though the payment is exempt from tax, the minister may still deduct home mortgage payments and real estate taxes if he owns the home. Certain rules apply to home equity payments.]**
- d. Additional payments made to a minister for a reimbursement of utilities used in the parsonage are subject to federal income tax. [This answer is incorrect. A utility cost allowance or reimbursement of utility costs is not taxable income to the minister unless the amount paid exceeds the minister's actual cost.]
21. Reverend Banks owns a home and also receives a housing allowance from his church. The housing allowance equals \$20,000. His actual housing cost for the year includes mortgage payments of \$14,500, utilities of \$3,000 and another \$2,000 for home maintenance and new furniture. The fair rental value of the home is \$18,000 per year, as furnished. How much of the housing allowance may Reverend Banks exclude from gross income? **(Page 49)**
- a. \$14,500. [This answer is incorrect. When determining the amount excludible from tax for a housing allowance, for the actual costs computation you may also include the cost of utilities and other costs for home maintenance and new furniture. Remember, the excludible amount is subject to a three prong test.]
- b. \$18,000. [This answer is incorrect. Although the fair rental value is \$18,000 per year, when determining the amount excludible under the three prong test, you add utility costs to the fair rental value for that component of the test.]

- c. **\$19,500. [This answer is correct. Reverend Banks may exclude \$19,500 of the \$20,000 from gross income. The amount excludible is limited to the lesser of (a) the amount actually used to provide a home, including furnishings and utilities which equals \$19,500; (b) the amount officially designated as a rental allowance or \$20,000; or (c) the fair rental value of the home, plus the cost of utilities which equals \$21,000.]**
- d. \$20,000. [This answer is incorrect. Even though the housing allowance equals \$20,000, it does not always equate to the excludible portion. The amount excludible is limited to the lesser of three variables: (a) the amount actually used to provide a home, including certain expenses; (b) the amount officially designated as a rental allowance; or (c) the fair rental value of the home, plus certain expenses.]
22. Business expenses reimbursed under an accountable plan are not taxable to the minister. Which of the following statements would fail the accountable plan requirements and make the reimbursements taxable? **(Page 53)**
- a. **The minister need not account for the expenses to the employer. [This answer is correct. Under an accountable plan, the minister must make an adequate accounting of the expenses to the employer within a reasonable period of time.]**
- b. Amounts received by the minister in excess of the actual expenses incurred, must be returned to the employer. [This answer is incorrect. One of the characteristics of an accountable plan is that the employee is required to return excess payments to the employer within a reasonable period of time. If the employee can keep any excess monies, the entire amount provided to the employee would be taxable.]
- c. The minister incurs expenses while performing services as an employee. [This answer is incorrect. Only expenses incurred by employees can be reimbursed or paid under an accountable plan. If the minister is classified as an independent contractor for federal income tax purposes, the expenses cannot be reimbursed under an accountable plan but rather are business deductions incurred directly by the independent contractor and reportable against self-employment income on Schedule C.]
- d. In order to qualify under the plan, the expenses must have a business connection. [This answer is incorrect. Qualified business expenses must be incurred in connection with a business, be ordinary and necessary expenses as well as reasonable in amount.]
23. All of the following are examples of deductible business expenses incurred by a minister, **except: (Page 55)**
- a. The cost of transportation for hospital visits. [This answer is incorrect. Unreimbursed transportation costs including costs associated with trips to the hospital or nursing home visits, attendance at conferences, and other church business are considered deductible business expenses for the minister.]

- b. A copy of the *Da Vinci Code*, as research for upcoming sermons. [This answer is incorrect. Job-related books and office supplies associated with ministerial duties are deductible business expenses.]
 - c. A subscription to *Theology Today*, an ecumenical journal of theology. [This answer is incorrect. Ministers may deduct the cost of periodicals and subscriptions to job-related publications as business expenses.]
 - d. **Dues paid to Gold's Gym that maintains a location beside the church. [This answer is correct. Club dues, including athletic, civic organization and social club dues are nondeductible business expenses regardless of the taxpayer's occupation or business.]**
24. Which of the following statements is true with regards to retirement plans for a minister?
(Page 59)
- a. Ministers treated as common-law employees are able to establish a qualified retirement plan because they are treated as self-employed for social security purposes. [This answer is incorrect. Ministers treated as common-law employees are not able to establish a qualified retirement plan unless they have other self-employment income. Even though ministerial income is treated as self-employment income, it is not treated as such with regards to eligibility for establishing a qualified plan.]
 - b. A special exception available to the minister is that they are not subject to the active participation rules related to traditional IRAs. [This answer is incorrect. There is not a special exception from the active participation rules for ministers. If a minister is an active participant in an employer-sponsored retirement plan, the deduction available for a traditional IRA phases out based on the modified adjusted income level for their filing status.]
 - c. **Self-employed ministers exempt from self-employment tax qualify to establish a Keogh, SEP, or SIMPLE plan. [This answer is correct. In general, ministers are considered common-law employees. If a minister does qualify as self-employed under the common-law tests, then the minister may establish a qualified plan to shelter a portion of his/her income.]**
 - d. A minister is allowed the maximum catch-up contribution of \$5,000 available for all plans, including qualified plans, IRAs, and tax-sheltered annuities. [This answer is incorrect. Ministers are allowed to make catch-up contributions if they meet the age requirements; however, the maximum amount allowed under the various plans is different. For an IRA, the catch-up contribution equals \$1,000. For qualified plans including Sec. 401(k) and Sec. 403(b) plans, the catch-up contribution amount is \$5,000.]

25. In which of the following situations would a Roth IRA be preferable to a traditional IRA? **(Page 61)**
- a. A taxpayer currently in a high tax bracket anticipates owing a large amount of tax on April 15. [This answer is incorrect. If a taxpayer is currently in a high tax bracket and anticipates owing a large amount of tax on April 15, it would be advantageous for the taxpayer to establish a traditional (deductible) IRA, in order to get the tax deduction at the high tax bracket.]
 - b. **A taxpayer that may need access to the funds before retirement. [This answer is correct. A Roth IRA would be preferable for a taxpayer who may need access to the funds before retirement because Roth IRA withdrawals come first from contributions that are not taxed and not subject to the 10% early distribution penalty. Early distributions from a traditional IRA would be taxable and subject to the 10% penalty unless one of the exceptions to the penalty applies.]**
 - c. A taxpayer who expects to be in a lower tax bracket at retirement than today. [This answer is incorrect. It would be more beneficial for a taxpayer who expects to be in a lower tax bracket at retirement than today to establish a traditional (deductible) IRA. The taxpayer would get the income deduction currently at the higher tax rate and be subject to income tax at a lower rate when the funds are distributed.]
 - d. A short time horizon for investment of the funds. [This answer is incorrect. Generally, a Roth IRA is more advantageous if there is a long time horizon for investment of the funds. In a longer period, a taxpayer will accumulate more after-tax income under a Roth IRA than a traditional IRA. Generally, a shorter time horizon for investment favors a traditional IRA due to the immediate tax deduction.]
26. All of the following items have been identified by the IRS as potential issues prevalent on minister's returns, **except: (Page 64)**
- a. Employee versus independent contractor. [This answer is incorrect. The IRS has indicated that the designation of employee versus independent contractor is a potential issue on minister's returns. The status is primarily based on facts and circumstances and must be determined on common law grounds.]
 - b. Determination of parsonage allowance. [This answer is incorrect. The issue of parsonage allowance is a primary concern of the IRS. The IRS is concerned with the determination of the fair rental value of the housing or parsonage allowance and whether the amount is included in the computation of self-employment income subject to self-employment tax.]
 - c. Exemptions from self-employment tax. [This answer is incorrect. The IRS and Social Security Administration are undoubtedly concerned as to whether the individuals claiming an exemption from tax actually qualify. Members of a religious order who have taken a vow of poverty or those individuals seeking an exemption based on opposition to receiving social security benefits due to religious principles would qualify for the exemption.]
 - d. **Categorization of deductions on tax return. [This answer is correct. The IRS is always concerned with the categorization and amount of deductions taken on a tax return. This potential issue is common to all taxpayer returns, and has not been identified as a prevalent issue on minister's returns.]**

27. When a minister is involved in a political activity, the primary concern is that the activity may: **(Page 64)**
- a. **Jeopardize the IRC Sec. 501(c)(3) status of the organization. [This answer is correct. A religious leader can jeopardize their organization's IRC Sec. 501(c)(3) status if they make partisan political comments in official publications or at official church functions. What this means is the church or organization may lose their tax-exempt status and become a taxable entity for tax purposes. Furthermore, individual contributions to the organization would become nondeductible.]**
 - b. Restrict the minister's freedom of expression. [This answer is incorrect. Although there are many restrictions imposed on religious leaders, these restrictions are not intended to restrict free expression on political matters by the leaders of the church speaking for themselves, as individuals.]
 - c. Change status from self-employed for self-employment tax purposes to employee. [This answer is incorrect. The classification of the minister as independent contractor versus employee is determined based on the facts and circumstances of the situation. The primary concern is the control over the activity of the minister. Although the IRS is very interested in the classification because of the ability to deduct business expenses directly against self-employment income of an independent contractor, it is not the primary concern for engaging in political activity.]
 - d. Subject minister to FUTA tax, FICA and federal income tax withholding. [This answer is incorrect. A minister is not subject to FUTA tax or federal income tax withholding on their ministerial income. They are considered self-employed for FICA purposes unless they can substantiate independent contractor status. This is an issue prevalent with ministers; however, it is not the primary concern of engaging in political activity.]

EXAMINATION FOR CPE CREDIT

Lesson 2

Determine the best answer for each question below. Then log onto our Online Grading Center at **OnlineGrading.Thomson.com** to record your answers.

10. Which of the following tax characteristics does **not** apply to ministers?
 - a. A parsonage allowance is exempt from federal income tax.
 - b. All ministerial wages are subject to self-employment tax.
 - c. Ministerial wages are exempt from federal income tax.
 - d. A minister may elect out of self-employment tax in certain situations.

11. A minister who may not otherwise be required to file a Form 1040, would be required to do so under which of the following situations?
 - a. A minister is not exempt from self-employment tax and has net earnings from self-employment of \$300 in the taxable year.
 - b. A minister is exempt from self-employment tax on earnings from qualified ministerial services but has \$300 of other earnings subject to self-employment tax.
 - c. A minister had wages of \$100 from a church that has elected to exclude employees from FICA coverage and \$300 from self-employment income.
 - d. A minister had wages of \$200 from a church or church-controlled organization that has elected to exclude employees from FICA coverage.

12. Ministers and religious workers may elect out of self-employment tax because of conscientious or religious opposition to social security and Medicare tax. Which of the following forms is used by a Christian Science practitioner to elect out of self-employment tax?
 - a. Form 4029.
 - b. Form 4361.
 - c. Form 8274.
 - d. Form SS-16.

13. Earnings by members of a religious order who have taken a vow of poverty are treated as:
 - a. Taxable income of the member.
 - b. Charitable contribution by the member to the religious order.
 - c. Contribution to capital of the religious order.
 - d. Gross income of the religious order.

14. Which of the following amounts is excluded from self-employment income for a minister?
 - a. Pension payments paid to a minister for past qualified services.
 - b. The fair rental value of a parsonage provided to the minister.
 - c. Amounts paid by the church towards the income tax of the minister.
 - d. Offerings received for marriages.

15. Reverend Jim Elliott, minister for the First Presbyterian Church, earns a gross salary of \$50,000 and a \$15,000 housing allowance. He has a \$6,000 salary reduction contribution to a TSA plan. Rev. Elliott also earns \$4,000 from other ministerial work. How much is Rev. Elliott's self-employment income?
 - a. \$54,000.
 - b. \$63,000.
 - c. \$65,000.
 - d. \$69,000.

16. Reverend Jim Elliott, minister for the First Presbyterian Church, earns a gross salary of \$50,000 and a \$15,000 housing allowance. He has a \$6,000 salary reduction contribution to a TSA plan. His actual housing costs equal \$13,000. In addition, Rev. Elliott earns \$4,000 from other ministerial work and incurs unreimbursed business expenses of \$5,000. How much may Rev. Elliott deduct as business expenses?
 - a. \$5,000.
 - b. \$4,060.
 - c. \$3,970.
 - d. \$3,810.

17. In a year when the minister has low self-employment income, he may use the nonfarm optional method to compute his earnings from self-employment. To be eligible, the minister must meet several requirements including:
- a. The taxpayer has not previously used the nonfarm optional method for more than five consecutive years.
 - b. Nonfarm net profits for the year are greater than \$1,733.
 - c. The taxpayer has reported self-employment income of at least \$400 or more in three of the five years before the tax year the optional method is used.
 - d. Nonfarm net profits for the year are less than 72.189% of the taxpayer's total gross income from nonfarm self-employment.
18. In which of the following situations is the minister subject to federal income tax and self-employment tax on the amount received?
- a. Payment made by a congregation to a retiring minister.
 - b. Amounts paid for a funeral given directly to the church.
 - c. Amounts paid to a minister for a wedding that he transferred to the church.
 - d. A birthday gift given to a minister from the church staff.
19. Veronica is an ordained minister who is a Vice President of Admissions at a seminary located in New Jersey. Her compensation package includes a salary of \$65,000 per year and a \$27,000 housing allowance. Veronica spent \$18,000 on mortgage payments, \$3,500 on utilities, and \$4,000 on new furniture. The fair rental value of Veronica's home, as furnished, is \$21,000. How much of the housing allowance may Veronica exclude from gross income?
- a. \$21,500.
 - b. \$24,500.
 - c. \$25,500.
 - d. \$27,000.

20. Scott is an ordained minister who receives an annual salary of \$55,000 and a designated parsonage allowance of \$15,500. Scott's mortgage was paid off several years ago and during the current year, Scott paid \$2,200 on utilities, \$1,600 real estate taxes, and \$450 home insurance. The fair rental value of his home is \$12,000 plus an additional \$3,000 for furnishings. How much of the housing allowance may Scott exclude from gross income?
- \$4,250.
 - \$12,000.
 - \$15,000.
 - \$15,500.
21. Reverend John has an office at his church but also maintains an office at home. He is a night owl and writes most of his sermons from home where it is peaceful and quiet. Which of the following expenses would be deductible for Rev. John, without an adjustment for personal use?
- Personal computer.
 - Recliner.
 - Desk.
 - Theological periodicals.
22. A minister who is properly treated as an independent contractor (as opposed to an employee) should deduct health insurance costs as:
- Deductible on page 1 of Form 1040.
 - A medical expense subject to the 7.5% of AGI limitation on Schedule A.
 - A self-employed business deduction on Schedule C.
 - Do not select this answer choice.
23. Reverend Marks pays self-employment tax on her wage income although she is treated as an employee under the common-law rules. She is paid a base salary and receives a parsonage allowance. Where does Rev. Marks deduct her health insurance costs?
- Page 1 of Form 1040.
 - Schedule A of Form 1040.
 - Schedule C of Form 1040.
 - Do not select this answer choice.

24. Which of the following retirement plans may provide a tax deduction to the minister?
- Roth IRA.
 - Traditional IRA.
 - TSA plan.
 - Sec. 403(b) plan.
25. If a minister's income is below certain threshold amounts, which of the following statements is true?
- The minister has the ability to fund a deductible IRA in addition to being covered under a qualified employer retirement plan.
 - The minister can make regular IRA contributions plus catch-up contributions if participant's age is below 70½.
 - The minister has the ability to contribute the maximum amount of \$5,000 to both a traditional and Roth IRA.
 - The minister can avoid taxation and early withdrawal penalties on nonqualified distributions.
26. Pastor Laurin is the minister of White Memorial Church. White Memorial Church publishes a quarterly newsletter that is distributed to all church members. Pastor Laurin writes a letter to the church members which is included in the newsletter. This quarter's letter was related to the upcoming presidential election and expresses a view as to which candidate should be elected. Which of the following statements is correct?
- Pastor Laurin's actions do not constitute campaign intervention attributable to the church because he did not say he was speaking as a representative of the church.
 - The endorsement made by Pastor Laurin was done in a personal capacity in his personal letter written to the church members.
 - The endorsement appeared in an official church publication of White Memorial Church, which constitutes prohibited campaign intervention attributable to the church.
 - Pastor Laurin is allowed to express his personal views and it not be attributable to the church as long as he paid for the printing of his portion of the newsletter out of his personal funds.

Lesson 3: Athletes and Entertainers

Learning Objectives

Completion of this lesson will enable you to:

- Identify unique characteristics and tax issues relevant to athletes.
- Describe deferred compensation plans.
- Classify compensation and other income earned by an athlete.
- Determine how to maximize an athlete's deductible expenses.
- Describe characteristics of and sources of income generated by professional entertainers.

Professional athletes and entertainers provide us with many of the most recognizable names in our society, as well as many of the most highly compensated individuals. Let's drop a few names: Kobe Bryant, LeBron James, Alex Rodriguez, Serena Williams, Peyton Manning, Joe Maurer, Shaquille O'Neal, Tom Brady, Beyonce, Kenny Chesney, Carrie Underwood, and Tom Hanks. As these and many other well-known celebrities have demonstrated the path to fame and fortune, thousands more have followed. For every Peyton Manning or Tom Hanks, there are tens of thousands of aspiring athletes or entertainers attempting to reach a similar lofty status. Many quickly give up the chase, while others stay with it and achieve more modest levels of success. This much larger group of athletes and entertainers realizes artistic satisfaction while generating enough revenue to support themselves and their families.

Over the years, sports has become a bigger and bigger business. It is now abundantly clear that professional athletics have become a form of entertainment and the athletes have increasingly become entertainers. Professional leagues of all kinds as well as individual teams within the leagues seek to identify and promote stars in order to increase their revenue. At the same time, many entertainers aspire to be jocks, and athletic themes are increasingly common on stage, screen, and video and audio discs. The commonality between the two professions is mirrored in the number of key federal and state tax concepts that apply to both professions.

This lesson deals with individual participants, not the teams, stadiums, clubs, theatres, etc., that allow the individual to ply his or her trade. Specifically, it focuses (a) in the athletic field, on the competing athletes involved in team sports; and (b) in the entertainment area, on the actors, actresses, vocalists, musicians, comedians, dancers, etc., who "put on the show." While this lesson is primarily concerned with the important and distinctive tax considerations of athletes and entertainers who are full-time professionals, many of the principles have application to part-time participants as well.

The federal, state, and local income tax planning techniques and pitfalls that are most vital to the professional athlete or entertainer are the focus of this lesson. Both professions can experience revenue flows that are volatile and relatively short-term in duration. Planning to maximize the current and long-term after-tax benefits of this revenue flow is discussed extensively. Most athletes and entertainers must deal with vexing, expensive, and often bewildering imposition of income tax by a multiplicity of states and this is analyzed extensively. Both professions may be entitled to substantial income tax deductions arising from some very unique and sometimes exotic categories of expenses. Planning to assist these professionals in obtaining all possible deductions and utilizing them in the most effective manner is discussed. Finally, the estimated tax process which can be a challenge for both professions is discussed.

Athletes and entertainers can be very interesting and rewarding clients, from both a business and personal perspective. They are involved in a profession where many struggle financially, but if they succeed, the financial results can vary from comfortable to beyond comprehension. While today's Carrie Underwood or Josh Hamilton may not be a feasible target to add to a practitioner's client list, tomorrow's Carrie Underwood or Josh Hamilton, singing in local clubs or playing college baseball, may be an attainable client. The practitioner should consider the risk-reward potential of this type of client. This can involve lower fees in earlier years with the possibility of a very substantial revenue source in the future. Even if the entertainer or athlete falls considerably short of attaining superstar status (which most, of course, will), many will remain very attractive clients. Aside from the revenue potential of the client itself, collateral benefits in the areas of recruiting other clients and new staff can result from associating with such high profile individuals.

The practitioner who has a professional athlete or entertainer as a client must consider other unique challenges beyond the technical tax rules:

- a. *The Glamour Factor.* A client engaged in either of these fields may generally be considered a celebrity, at least on a local basis. The practitioner must guard against being swept away with the glamour of the client. Maintaining the highest standards of professional responsibility and due care must remain the practitioner's primary goal.
- b. *Lack of Record-keeping.* Only rarely will an athlete or entertainer have much affinity for or interest in maintaining the supporting documentation necessary for tax compliance. The individual's attention generally is totally absorbed in performing his or her very demanding and competitive profession. While the very successful ones may have business managers to expedite the process, most will not. This puts additional pressure on the practitioner to develop approaches to gathering information to ensure the preparation of accurate tax returns, and to enable the practitioner to design and implement successful tax planning strategies.
- c. *The Rumor Mill.* Athletes and entertainers generally have an extensive network of peers who excel at spreading myths and misinformation about federal and state tax rules. Often the fellow performer's tax return may be incorrectly prepared, but it simply has not been caught through an audit. In other instances, the fellow performer may completely misunderstand how his or her return is being prepared. This underground information network can put pressure on the practitioner to thoroughly research the law and communicate to the client the correct tax treatment.

Professional Athletes

The focus of this lesson will be on team athletes, since that is the client most likely encountered by practitioners. Athletes involved in individual professional sports such as golf, tennis, boxing, auto racing, bowling, skiing, track, cycling, etc., are less plentiful and are often represented by "full service" agents or business managers. As a practical matter, many of the key income tax concepts applicable to athletes engaged in individual sports are more similar to freelance entertainers.

While team athletes have the potential for extraordinary levels of income, those levels can generally only be achieved for a relatively short period. In most cases, this period will be less than ten years. This increases the desire to "make hay while the sun shines" by minimizing the taxes that will be imposed on that income. The practitioner can obviously play a key role in planning and executing strategies to help make that hay. This lesson discusses the key areas in which this planning and execution may be possible.

An understanding of state and local income tax concepts is necessary for effective representation of professional team athletes. State and local taxes can have a much more significant impact on athletes than on most types of clients. The athlete may be a permanent resident of one state, the athlete's team may be based in a second state, and the athlete may be traded (or transferred) during the year to a team in a third state. Furthermore, the team will play many of its games in several other states. It may conduct its preseason training in still another state. Therefore, the athlete may find that many states and cities are attempting to extract tax from the athlete's earnings.

Minimizing Taxes on Personal Services Income

This section examines ways to minimize the income taxation of signing bonuses and salary income, including the use of deferred compensation arrangements. A significant portion of the tax planning can revolve around minimizing the client's state income tax burden.

Signing Bonuses

All major team sports regulate the signing of amateur talent through an annual draft procedure. The team selecting a player in the draft will possess exclusive negotiating rights to that player, generally for one year. (Players who are not selected in the draft are free to sign with any team.) An amateur player who signs an initial contract is generally bound to that team for a period of years (anywhere from two or three years to as long as 10 years), depending on the sport and the particular circumstances. Thus, signing an initial contract involves relinquishing substantial future negotiating rights. A bonus is, therefore, generally paid by the team to the amateur player for relinquishing these potentially valuable rights. These bonuses can be in seven figures for the most highly sought amateur players.

The athlete will generally be represented by an agent who is experienced in negotiating the terms of an initial signing. It should not be assumed, however, that the agent has an in-depth knowledge of federal, state, and local income tax laws. It is incumbent on the practitioner to work closely with the agent to produce the best income tax results for the athlete.

Key planning issues revolve around the proper characterization of the signing bonus. Although the team's payroll department obviously works in this area, the practitioner should not view the department as the ultimate authority in this relatively complex area of tax law. Rather, the practitioner should develop an understanding of the key concepts and should form an amicable relationship with the team's payroll department, which will greatly aid in working through many of the athlete's tax issues.

Federal Tax Withholding on Signing Bonuses

The first issue to consider is whether the signing bonus constitutes "wages subject to withholding" for federal tax purposes. *Withholding* includes not only federal income tax, but also social security tax consisting of a 6.2% component [for old age, survivors and disability insurance (OASDI)] and a 1.45% component for hospital insurance (Medicare). The OASDI and Medicare taxes are collectively known as the FICA tax.

The prevailing authority on withholding on signing bonuses for many years was Rev. Rul. 58-145, which concerned a baseball player. This ruling stated that if the bonus received on the signing of an athlete's first professional contract was not predicated on the athlete rendering future services (i.e., was given solely for signing and was not dependent on

any future performance of services by him for the club), the bonus was not subject to withholding. (Conversely, if payment of the bonus was predicated on continuing employment, it was subject to withholding.) Most initial signing bonuses qualified under these rules and were not subject to any withholding. If the bonus was \$100,000, that was the amount on the check that was received without any reduction for withholding.

The longstanding IRS rules applicable to signing bonuses changed for any bonus payments made under contracts entered into after January 11, 2005. Rev. Rul. 2004-109 now provides that federal income tax and FICA must be withheld from signing bonuses. Specifically, it holds that, "Amounts an employer pays as bonuses for signing or ratifying a contract in connection with the establishment of the employer-employee relationship are wages for purposes of FICA, FUTA, and Federal income tax withholding." Rev. Rul. 58-145 was revoked by Rev. Rul. 2004-109.

If an athlete encounters a team that does not withhold in accordance with Rev. Rul. 2004-109, this may appear to be a windfall, but the revenue ruling would still require that the bonus be treated as income subject to FICA and should be reported that way on the athlete's income tax return.

Strategies for Paying Tax on Signing Bonuses

Based on current withholding tax regulations, the federal income tax withheld from the bonus will generally be 25% (35% for payments exceeding \$1 million). This will often be lower than the eventual tax rate. Therefore, the practitioner should carefully plan tax payments with the client. Particular attention should be given to IRC Sec. 6654(d), which describes exceptions to the underpayment of estimated tax penalty. The athlete signing his or her first contract will generally have a relatively small amount of taxable income and tax in the year prior to signing, which means that only a small amount of tax need be withheld or paid in the current year to avoid a penalty. As a result, the tax withheld on the signing bonus will generally be sufficient to satisfy the estimated tax exception, and no estimated tax payments will be necessary for the year of the bonus.

The practitioner should verify that the athlete actually filed a return in the prior year, since that is a prerequisite to the application of the "100% of the preceding year's tax" exception to the penalty. If a return was not filed, one should be filed, even though taxable income may have been less than the minimum requirement, to provide a basis for the estimated tax exception.

When using strategies that minimize tax withholding and estimated tax payments during the year, the practitioner should make it very clear to the athlete that income tax will be due, but that it is more beneficial to pay it later instead of now. If the amount of income tax withheld and paid during the year will be less than the amount of tax for the year, care should be exercised that the eventual payment is budgeted and funds are set aside to meet the obligation. In the interim, the funds should be invested to earn a fair rate of return. Bonds maturing shortly before April 15 of the following year can be an effective investment since they generate interest income, tax on that interest income can be deferred for still another year, and the bonds provide a secure and liquid source for eventual payment.

Assigning Portions of the Bonus to a Family Member

If the bonus is large, there may be a temptation to reduce the income tax by assigning portions of it to parents or other family members and thus spread more income to lower tax brackets. This approach generally will be unsuccessful unless a valid assignment is in place well in advance of receipt of the bonus. A successful assignment was made in the *Hundley* case, which involved former baseball player Randy Hundley. In this case, a high school ballplayer's agreement to pay his father 50% of any future bonus for signing a professional contract was reasonable because the pay was compensation for his father's coaching to make him a better baseball player and acting as his agent in negotiating the best possible contract. This should be contrasted with the unsuccessful attempted income assignment in the subsequent *Richard A. Allen* case, which involved the colorful "Richie" or "Dick" Allen. Here, a professional baseball contract stating that \$40,000 of a \$70,000 bonus would be paid to the ballplayer's mother was not reasonable because the player's mother knew nothing about professional baseball or finance, and instead, relied on an older son's advice when negotiating. Furthermore, there was no preexisting agreement to pay her anything.

A comparison of the cases suggests that income assignment can only be sustained when there is an agreement before the actual contract signing and the party to whom the income is assigned actually brings time and talent to the deal. An assignment will not be successful simply because of an agreement to arbitrarily split compensation without substantial involvement by the nonathlete participant.

Using Deferred Compensation Techniques to Reduce Tax on a Signing Bonus

While the ability to reduce taxes through assigning portions of a bonus to family members is limited, use of deferred compensation techniques can apply to many situations. A signing bonus can be structured to utilize the benefits of deferred compensation (a cash payment made in one period for service performed in an earlier period). Particularly in baseball and hockey, where players may receive a substantial signing bonus when they sign their first professional contract, but then are relegated to several years in the minor leagues at low wages, the deferral of a portion of the bonus can substantially reduce the client's overall income tax burden.

Example 3-1: Income tax benefits of deferring the receipt of a signing bonus.

Sammy Slapshot is an 18-year-old amateur hockey player from Minnesota who is drafted by the Dallas Stars and offered a signing bonus of \$400,000. Sammy has no other hockey income in 2009, the year that he is offered the contract. He will be assigned to the team's minor league club for 2010 and will be paid a \$20,000 salary. Sammy is single. If he receives the signing bonus in 2009 and the regular salary in 2010 (and assuming for simplicity that other income in those years equals his standard deductions plus personal exemption), his tax would be \$117,683 in 2009 and \$2,581 in 2010, a total of \$120,264.

But, if the signing bonus is structured so that he defers \$200,000 of the signing bonus until 2010, Sammy's tax would be \$51,142 in 2009 and \$57,716 in 2010 for a total of \$108,858. Income tax savings of \$11,406 would be achieved.

If it appears that Sammy will continue to have a low salary through 2010 and 2012, the bonus might be spread through those years as well, thereby achieving additional savings. This planning should especially be considered with younger athletes when longer minor league development is anticipated. Generally, an interest factor will be negotiated in a deferral agreement to compensate the athlete for the loss of earnings on the bonus during the deferral period.

Note: In 2010, the top tax rate for individuals is 35%. However, absent congressional action, beginning in 2011, the top tax rate for individuals will increase to 39.6%. This potential increase should be considered before suggesting that an athlete defer some of his or her current salary or bonus. It has been reported that several free agent baseball players are currently seeking large signing bonuses to avoid paying higher taxes if the top tax rate increases.

The deferred compensation plans negotiated for athletes fall within the category of “nonqualified” plans for income tax purposes. These types of plans are not designed to meet the detailed Internal Revenue Code requirements for “qualified” plans such as pension, profit sharing, Keogh, 401(k), etc. Instead, the nonqualified plan is an individually negotiated arrangement between an athlete and team that provides for spreading the payment of compensation to the athlete into years after the compensation was actually earned. Nonqualified plans are relatively easy to structure to produce the desired tax planning results while satisfying the less restrictive IRS requirements that are imposed on nonqualified plans. Terms will often be negotiated whereby the team credits interest to the athlete’s account throughout the deferral period. The plan must specify the period over which payment is to be made and who will receive the payments if the athlete dies. Nonqualified plans defer the athlete’s income and the team’s deduction until the receipt of cash, but they are not subject to the numerous Internal Revenue Code (and in some cases, ERISA) restrictions covering qualified plans.

While nonqualified deferred compensation is not required to satisfy the detailed framework for qualified plans set forth in IRC Sec. 401, they must satisfy a number of tests. These tests have largely developed from cases and rulings until the addition of IRC Sec. 409A, which establishes rules that, although not as extensive as those applied to qualified plans, must be considered if the desired deferred tax is going to be achieved with a nonqualified deferred compensation plan. The requirements for successfully implementing nonqualified deferred compensation plans (both before and after the adoption of IRC Sec. 409A) are discussed later in this lesson.

State Income Tax Considerations with Signing Bonuses

State income tax considerations can be very important in planning for a signing bonus, particularly if the athlete is signing with a team located in a state with a high individual income tax rate. Here, the goal is to exclude as much of the bonus as possible from the home team state’s high tax rate. Substantial tax can be saved on the signing bonus as well as regular salary if the athlete is a resident of a state with no or low income tax. The fact that the athlete is a resident of that state at the time the contract is signed should be well documented.

Seven states (Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming) do not have individual income tax. New Hampshire and Tennessee tax individuals only on interest and dividend income. An understanding of the rules that determine residence is very important

to planning to minimize an athlete's state income tax burden, both on the initial signing bonus and on the subsequent salary. The practitioner may be able to assist the athlete in establishing a desired state of residence by documenting the factors indicating the state of domicile noted below.

Nearly every state treats a person domiciled in the state as a resident. In general, a domicile is the person's true, fixed, and permanent home. It is the place to which a person has the intention of returning, even if absent for periods of time. The state of domicile is question of fact and is usually the state where the person has the most ties. Factors indicating a person's domicile can include:

- a. Owning a home, or leasing a home or apartment, in that state.
- b. Maintaining a mailing address, driver's license, auto license tags, and bank accounts in that state.
- c. Having a portion or all compensation wired or deposited to a bank account in that state.
- d. Filing income tax returns with an address in that state.
- e. Having church or club memberships or civic involvement in that state.
- f. Drafting a will as a resident of that state.
- g. Enrolling children in schools or other activities in that state.
- h. Returning to that state whenever possible.
- i. Registering to vote in that state.

If the athlete is not a resident of the state in which the team is located, the bonus should not be subject to tax in that state. The facts of residence should be communicated to the team's payroll department prior to signing so that proper withholding occurs. It is generally preferable for the contract to be physically signed in the athlete's resident state and the bonus amount wired to a bank account in the resident state to further support this treatment. If a favorable structure is not possible due to team or league restrictions, the practitioner should become familiar with the "duty days" concept in order to minimize the percentage of duty days in the home team's state in the year the bonus is received.

This planning technique is not limited to new players coming to the league. A veteran player receiving a signing bonus late in his or her career may wish to consider the possible favorable state income tax results of a deferral until after retirement.

Minimizing Tax on Regular Salary

One does not need to be a sports fan to realize that the annual salary paid to virtually any team athlete in the major leagues is substantial by most people's standards. The salary received, including bonuses for individual or team performance, is reportable as ordinary income. Planning opportunities focus upon deferred compensation arrangements and the minimization of state income tax.

Deferred Compensation Arrangements

The basic concept of deferred compensation arrangements is to defer the payment and reporting of a portion of the salary to a specified time in the future. Since the individual athlete reports taxable income on a cash basis, taxation of the compensation may be deferred until

received, if properly structured. Assuming the compensation is deferred until after retirement, when the athlete has a smaller income base, and, therefore, a lower tax rate, absolute income tax savings may be achieved. Deferred compensation can also reduce the aggregate payroll (FICA) tax burden of the athlete in certain situations. If the athlete retires to a state with no or low individual income tax, significant state income tax savings can result, assuming the deferred compensation is structured to produce qualifying payments (i.e., payments made over a period based on life expectancy or for at least ten years). This is because federal law prohibits a nonresident state from taxing any qualifying payments received by an individual.

Because the typical deferred compensation agreement extends for a fairly lengthy period, interest-type provisions should be considered. (The ability to earn interest is particularly beneficial because it is earned on pre-tax dollars; i.e., the taxation is deferred until the interest is actually received.) The rate of interest, which should be a fair market rate, is a matter for negotiation with the team. The presence of interest does not cause any portion of the deferred compensation to be currently taxable, and the interest itself is not taxable until received.

In addition to the potential income tax benefits, deferred compensation arrangements are also often sought by the athlete and/or practitioner as a means of automatic savings. While the athlete may enjoy years with high compensation levels, these high earning years may be limited, particularly if the athlete suffers an injury. His or her athletic career may be over at age 30 or younger. A deferred compensation agreement restricts the athlete from receiving as much during the peak earning years, when there is great temptation to spend it on automobiles, entertainment, elaborate homes, jewelry, expensive toys, and so forth. Deferred compensation provides for the financial rainy days that can occur after the cheering stops.

Example 3-2: Benefits of long-term deferred compensation.

Dante Dunkster is a basketball player for the San Antonio Spurs. His contract, signed in 2009, calls for a \$1 million salary for 2010, but allows him to elect, by the end of 2009, to defer any portion of his 2010 salary until his employment with the Spurs ends. An interest rate of 1% over prime, compounded annually, has been negotiated on any amount he elects to defer. When he signs the contract in 2009, Dante elects to defer \$250,000 of his 2010 salary.

Dante has a fantastic 2010 season, signs a multi-year deal with the Spurs, and plays for them until an injury forces him to retire in January of 2021, at which time he receives the \$250,000 plus interest he deferred from 2010. His intention is to not be gainfully employed in any fashion whatsoever after retirement.

For purposes of the illustration, it is assumed that a 5% prime interest rate applies through the 11-year deferral period, that Dante's other income will equal his deductions in the year he retires, and that the income tax rate structure in 2021 (the year he retires) will be the same as the current one.

The results of Dante's one-time deferral can be estimated as follows:

Amount deferred	\$ 250,000
Interest on \$250,000 compounded for 11 years @ 6% (prime of 5% + 1% per the contract)	<u>224,575</u>
Total to be received	474,575
Less: tax on \$474,575 in 2021 (joint rates)	<u>(136,409)</u>
Net after-tax proceeds	<u>\$ 338,166</u>

Variation: This result can be compared to the projected result if Dante does not defer any of his salary. Assume that a 35% income tax rate applies to the \$250,000 in 2010 (for simplicity, it is assumed that the salary is all received in one year, although the basketball season overlaps two years), and an after-tax earnings rate of 4% for the 11-year period applies to the amount left after Dante pays tax on the \$250,000. The results would be as follows:

Amount of compensation	\$ 250,000
Less: income tax	<u>(87,500)</u>
Amount to invest	162,500
Earnings on investment amount compounded for 11 years @ 4%	<u>87,661</u>
Net after-tax proceeds	<u>\$ 250,161</u>

The foregoing analysis suggests that Dante would enjoy an after-tax benefit of over \$88,000 from the one-time deferral. Since Dante has the habit of spending virtually all of his current take-home pay, there is a possibility that little money would be available for his retirement if he did not elect the deferral. Additionally, if Dante's multi-year contract has a deferral option that he takes advantage of, he will have even more money available for retirement.

The Spurs may also welcome the deferred compensation agreement, particularly if an interest rate lower than its bank financing rate is negotiated. Since the team cannot deduct either the compensation or the interest until the player includes it in income (generally upon payment), even though the team reports on an accrual basis, it may use this as an agreement for a lower interest rate. Both the compensation deferred and the interest thereon, would be reported to Dante as wages when paid and appropriate federal income tax is withheld thereon.

Federal Taxation of Deferred Compensation

In Example 3-2, Dante utilized the type of deferred compensation arrangement classified as *nonqualified*. The term nonqualified does not have negative connotations—it simply distinguishes these arrangements from those meeting the rigorous, statutory requirements applicable to qualified plans [such as the traditional retirement plans, profit sharing plans, 401(k) plans, etc.] under the Internal Revenue Code.

Nonqualified deferred compensation arrangements have been very commonly used in a multitude of situations for many years. The arrangements are certainly not limited to professional sports. According to the ERISA Industry Committee, approximately 92% of Fortune 1000 companies use nonqualified deferred compensation plans. Virtually none of the rules that apply to the plans, however, have been derived directly from the Code. Most of the tax law on deferred compensation has evolved from cases and rulings.

This reliance on cases and rulings will be significantly shifted for amounts that are deferred after December 31, 2004 by the adoption of IRC Sec. 409A as part of the American Jobs Creation Act of 2004. IRC Sec. 409A now spells out specific requirements that a nonqualified deferred compensation plan must satisfy if it is to achieve the desired results. IRC Sec. 409A, while placing more restrictions on deferred compensation plans, creates a more certain environment while still allowing nonqualified plans more flexibility than is available with qualified retirement plans.

Although the Code itself now contains specific requirements, amounts deferred prior to January 1, 2005 generally will continue to be governed by the somewhat less restrictive requirements of the law developed from cases and rulings. Many of the concepts and principles continue. Therefore, the existing law prior to January 1, 2005 will first be discussed, followed by an analysis of new IRC Sec. 409A.

Deferred Compensation Rules Prior to 2005

Prior Case and Ruling Law. Many of the fundamental deferred compensation principles can be found in Rev. Rul. 60-31. To achieve deferral of reporting compensation for income tax purposes, an agreement must be executed before the services are rendered. The Ruling also sets forth the requirement that the employer's obligation must be an unsecured and unfunded promise to make payments of the deferred compensation to the athlete in the future. As illustrated in Example 3-2, interest is frequently incorporated into the agreement and enjoys the same deferral from taxation as the compensation itself.

The IRS has expanded somewhat on the requirement that any deferred compensation agreement be executed before the services are actually rendered for the deferral to be allowed under the constructive receipt doctrine in Rev. Proc. 92-65 and Ltr. Rul. 8632003. Although the courts have not been as restrictive, it has certainly been more prudent to have the deferral agreement in place before the services are rendered. In the case of professional team athletes, this meant that a deferral agreement was in place before the beginning of training camp. A good planning approach was to negotiate a provision in any long-term contract that up to a certain amount of compensation could be deferred annually at the player's election. The timing of this election would be prior to the time the player reported to training camp for a particular year. This provided maximum flexibility in structuring deferred compensation levels to respond to a player's changing financial circumstances. (Note that specific "deadlines" for electing deferral have now been provided in IRC Sec. 409A, as discussed later in this lesson).

Unsecured Promise to Pay. The requirement that the team's obligation to pay deferred compensation be an unsecured promise of the employer is critical in planning potential deferred compensation. This requirement is based upon the economic benefit theory that an employee can be taxed at the time he or she receives property that has a determinable, present economic value. The economic benefit theory often must be considered in situations involving deferred compensation plans funded by trust, escrow, or insurance arrangements. However, a team's unsecured promise to make compensation payments in the future has been determined to not have such value and so allows deferral treatment.

The athlete should understand that he or she is foregoing current receipt of compensation in exchange for the unsecured promise of future payments, and so is assuming some financial risk. Owning a team's unsecured promise to pay is certainly not the equivalent of owning a U.S. Treasury Bond. Sports franchises and entire leagues have been known to fail financially. The extension of an agreement over a substantial number of years increases this risk. In the event of a team bankruptcy, the deferred compensation obligation to the player will be on par with all other unsecured obligations and, as a result, will (unfortunately) have a relatively low priority on the order-of-payment totem pole. While the league itself may step in to see that obligations are fulfilled, there is no assurance that the league will do so or that it will have the financial capability to do so. The level of potential financial risk, and the athlete's ability to tolerate such risk, must be considered in evaluating and structuring a deferred compensation agreement.

Attempts to structure some form of additional security for a deferred compensation obligation have been the subject of many cases and rulings. The payment of a football player's bonus to an escrow agent with provisions that the amount plus interest be paid over five years was found to be immediately taxable in Rev. Rul. 60-31. In that ruling, the IRS quoted the following from a 1951 case: "The question then becomes . . . was any economic or financial benefit conferred on the employee as compensation in the taxable year. If so, it was taxable to him that year. This question we must answer in the affirmative. The employer's part of the transaction terminated in 1945. It was then that the amount of the compensation was fixed at \$10,500 and irrevocably paid out for [the taxpayer's] sole benefit."

However, the IRS later concluded that the purchase of an annuity in a player's name did not accelerate deferred income as long as the employer actually owned the contract and it was an asset subject to the claims of its creditors. When ownership of an annuity is actually transferred to an employee, however, immediate taxation can result. The impact on deferral of a guarantee of the obligation by an individual owner is not totally clear. In the Berry case (involving a bankrupt professional basketball player who was employed by the Carolina Cougars), the court found that the guarantee of the team's obligation by the principal owners did not cause the compensation to be immediately reported.

Irrevocable Trust Arrangements. The continuing quest to eliminate as much of the employee's financial risk as possible has led to using various irrevocable trust arrangements. Deferred compensation plans in which the team places money into an irrevocable trust are considered funded, resulting in current taxation unless a forfeiture risk exists or the amounts are accessible by the employer's general creditors. This is true even if the employee has no opportunity to currently receive the deferred amount from the trust. The following trusts are commonly used:

- a. *Rabbi Trust.* A rabbi trust (so named because the first ruling dealing with such a trust involved retirement obligations payable to a rabbi) is established and funded by the employer but has an independent trustee. Trust assets can only be used to pay deferred compensation or claims of the employer's creditors. This arrangement provides the employee with one level of security (protection against the employer later refusing to pay) but not from the risk that the employer's assets will not be sufficient to satisfy all creditors. The employee does not receive an economic benefit since the trust assets remain accessible to the employer's creditors.
- b. *Secular Trust.* In this type of irrevocable trust arrangement, the athlete would again be the beneficiary, but neither the employer *nor* its creditors can have access to the trust funds. This arrangement fully insulates the employee against all risk but also results in current taxation of deferred amounts. The employee has received an economic benefit because the funded amounts are secured from both the employer and its creditors and therefore subject to immediate income tax. The player might consider such an arrangement from the standpoint of forced savings, but if deferral of tax is a primary objective, the secular trust will not provide this benefit.

Deferred Compensation Rules after 2004

In the American Jobs Creation Act of 2004, Congress finally provided some specific statutory rules for nonqualified deferred compensation. The primary provision setting forth these rules is IRC Sec. 409A. Pursuant to IRC Sec. 409A, the basic principles of deferred compensation must still be met (i.e., the written agreement must be executed before services are rendered

and must constitute an unsecured and unfunded promise to make payments to the athlete in the future). However, IRC Sec. 409A added specific tests as to the time of the election to defer compensation, the time that the deferred compensation must be paid, the ability to change the time that the compensation is to be paid, and the use of rabbi trusts.

Time of Election to Defer Compensation. The athlete employee must now elect to defer compensation by the end of the employee's tax year preceding the year in which the services are performed. Thus, if Peyton Manning wishes to defer a portion of his 2010 salary, he must elect to do so by December 31, 2009, even though he will not report to the Indianapolis Colts training camp until July 2010. In the first year that an athlete would be contractually entitled to defer compensation, the initial deferral election can be made, for services performed after the election, within 30 days after the athlete becomes eligible to make the election. For any performance-based compensation (e.g., bonuses) based on services performed over a period of at least 12 months, the initial deferral election must be made no later than six months before the end of the period.

Generally, the timing of the election to defer is based on the employee's tax year. However, if the employer's and the employee's tax year are not the same, the plan may provide that fiscal year compensation (e.g., a bonus for services performed during the employer's fiscal year) may be deferred at the employee's election only if the election to defer such compensation is made no later than the close of the employer's tax year immediately preceding the employer's first tax year in which any compensable services are performed and payable. Thus, in the above example, if the Colts had a February 28 year-end and Peyton's bonus was for services performed during the Colts' fiscal year ending February 28, 2012, if the plan so provided, his election would be valid if made no later than February 28, 2011.

Time of Distribution of Deferred Compensation. The amount distributed under the plan may not be distributed earlier than:

- a. A time or times specified at the date of deferral,
- b. Separation from service,
- c. Death or disability of the athlete,
- d. Certain changes in the team ownership structure, or
- e. The occurrence of an unforeseen financial emergency.

Generally, this will mean that a definite schedule for payments of the deferred compensation must be established. A schedule using specific future dates for payment should clearly qualify. Often, however, the athlete prefers to base the time of payment on a future event such as retirement or death. Final regulations provide guidance on what it means for a payment to be made upon one of these events. If the time of payment is based upon the occurrence of a specified event, the plan must provide that the date of the event is the payment date or must designate a date that is objectively determinable and nondiscretionary at the time the event occurs. For example, a plan could designate the payment date as 30 days following a separation from service, or the first calendar year following an athlete's death.

Change of Time That Deferred Compensation Is to Be Paid. Generally, no acceleration of payments earlier than the originally agreed schedule is allowed. The payments can be further delayed only if the plan requires that:

- a. The later election may not take effect for at least 12 months;
- b. Except in the case of elections relating to distributions on account of death, disability, or unforeseeable emergency, the first payment must be deferred for at least five years from the date such payment would otherwise have been made; and
- c. A later election related to a distribution to be made at a specified time may not be made less than 12 months before the date of the first scheduled payment.

Although the new law does not totally eliminate flexibility in structuring deferred compensation terms, it substantially restricts it.

Use of Rabbi Trusts. Generally, rabbi trusts can still be used. The assets of the trust, however, cannot be located outside of the United States. This rule is designed to prevent a situation in which deferred compensation is effectively fully secured through use of the restrictive laws of a foreign jurisdiction. The use of rabbi trusts is also not allowed in instances where assets are transferred to a rabbi trust upon a change in the employer's financial health. For example, if a deferred compensation plan provides that, upon a change in the financial health of the employer, the deferred assets will be put in a rabbi trust for the athlete, all the assets set aside are taxable to the athlete as soon as they are set aside.

Consequences of Not Satisfying Deferred Compensation Rules. If a deferred compensation agreement fails to satisfy the tests, all compensation deferred under the agreement (including amounts deferred in years prior to the year the agreement failed to satisfy the tests) must be reported as taxable income immediately. IRC Sec. 409A also provides for a penalty-type tax equal to 20% of the incorrectly deferred amount as well as interest (at the underpayment rate plus 1%) from the time the income should have been reported. Thus, the penalty for attempting to defer compensation and failing is relatively severe.

Planning with the New Rules. Viewed positively, the new rules provide a degree of certainty that previously did not exist. Viewed negatively, the rules provide penalties for the unaware or over-aggressive. Under the effective date provisions, the new rules apply to amounts deferred after 2004. Therefore, even though long-term contracts that provide future election to defer compensation may have been in place before 2005, they must be reviewed, and possibly very carefully modified to conform to the new rules, or the future deferrals may not be effective for tax purposes. Any amounts already deferred prior to 2005, as well as the increase in these amounts from interest, are not subject to the new rules unless the plan under which the deferral is made is materially modified after October 3, 2004. An amount will be treated as deferred before 2005 only if the employer has a binding legal obligation to pay an amount in a future year, and the athlete's right to the amount is earned and vested as of December 31, 2004. For arrangements developed after 2004, the practitioner needs to thoroughly understand the rules of IRC Sec. 409A in assisting the athlete and the athlete's agents or attorneys with the development of deferred compensation plans. Not only must the plan be drafted according to the rules, it must also be executed according to the rules. The benefits can be substantial, but the structure and execution must be correct.

The American Jobs Creation Act of 2004 also provides that deferred compensation amounts must now be reported on an individual's Form W-2 (or Form 1099) for the year deferred. This does not mean that these amounts will be reported as currently taxable wages, but it does mean that the amount will be reported as information that the IRS can use in attempting to enforce the deferred compensation provisions.

FICA Withholding on Deferred Compensation

Amounts deferred under nonqualified plans are subject to FICA withholding at the time the services are performed (assuming there is not a substantial risk of forfeiture). But once this amount is treated as wages, IRC Sec. 3121(v) specifically states that it is not treated as wages again. While this rule can accelerate the withholding of FICA tax, it can also produce an absolute reduction of taxes that otherwise might be payable. This is because the player's compensation actually received during the current year will almost assuredly exceed the maximum of the OASDI portion of FICA tax (\$106,800 for 2010). Thus, adding the deferred compensation on top of other compensation received in the current year will not increase the OASDI tax due. This deferred amount will *not* be treated as wages when actually received in later years, so the OASDI taxes otherwise payable in the later year will not apply.

Example 3-3: Impact of compensation deferral on social security tax withholding.

Continuing with Example 3-2, since Dante Dunkster's \$250,000 deferral is not subject to a substantial risk of forfeiture, it will be subject to FICA tax in 2010, the year services are performed. FICA tax withheld on his \$1,000,000 salary for 2010 (\$750,000 received currently and \$250,000 deferred) will be as follows:

OASDI—6.20%	\$162,800 (maximum)	\$ 6,622
Medicare—1.45%	\$1,000,000	<u>14,500</u>
Total		<u>\$ 21,122</u>

Because the \$106,800 maximum for the OASDI has been reached and surpassed by the current portion of Dante's salary (\$750,000), no OASDI tax has been applied to the deferred portion. When the deferred salary is ultimately paid in 2021, it will be free of any FICA tax withholding whatsoever because FICA tax has been calculated on Dante's compensation in the year it was earned and deferred. Since he plans to be unemployed when the deferred compensation is received, he will have saved \$6,622 of tax (assuming the same OASDI rate and limit apply in the year the compensation is received).

State Income Taxation of Deferred Compensation

Deferred compensation arrangements can also produce favorable state income tax consequences as a result of the Pension Income Tax Limits Act. This law prohibits a state from taxing certain retirement income of individuals who are not a resident of that state when the income is actually received. Payments under nonqualified deferred compensation plans will fall within this rule if part of a series of substantially equal annual payments for the life expectancy of the recipient or for at least 10 years.

If a player performs for a team located in a state with a high rate of income tax but plans to retire to a state with low or no tax (such as Florida or Texas), a deferred compensation arrangement can produce significant state tax savings. For example, assume a quarterback for the San Diego Chargers defers \$500,000 of salary when he was a California resident and

has it paid to him at a rate of \$50,000 (plus interest) annually for ten years after he retires and establishes a Texas residence (which has no state income tax). If the effective California tax rate is 11%, he would enjoy a savings of \$55,000 (11% of \$500,000). For simplicity, this example does not include an interest element—interest should be negotiated and would have the same exclusion from nonresident state tax as the base compensation.

State Income Taxation of Regular Compensation

State income tax can represent a substantial burden to the professional team athlete. Most states (and many cities) where professional teams perform have individual income tax laws and are well attuned to extracting income tax from the athlete. In fact, doing so is relatively easy. The athlete is highly visible, the performance in the state is well known, and the athlete often is highly compensated, all of which make athletes a prime target for state income tax departments. Most states with major league sports teams have a state income tax on compensation (exceptions are Florida, Texas, Tennessee, and Washington). Most of the income tax states now require the team to report the portion of an athlete's salary earned in that state and/or require state income tax withholding. Many cities also require income tax reporting and/or withholding as well. If the athlete is not a resident of that state, the income subject to tax should be limited to compensation actually earned in that state.

Some clarification of the amount of compensation earned in a particular state has been provided with the adoption by most states of the "Uniform State Regulation to Apportion Income of Nonresidential Professional Athletes." Under these rules, the athlete's salary is prorated to each state where he or she performs on a "duty day" basis. The compensation apportioned to a particular state is based upon a fraction. The numerator is the number of days the athlete performed in the state and the denominator is generally the total number of days from the beginning of the team's official pre-season training through the last game in which the team competes. The denominator also includes days in which the athlete is required to perform related services falling outside this period, such as instructional leagues, post-season all star games, and promotional events. Off-season training activities are also included if part of a team-imposed program is conducted at the team's facilities.

These rules are particularly important to athletes who maintain their residence in a state that has no income tax or a low tax structure. A key concept to understand is that the state where the athlete's team is located is not necessarily the state of the athlete's residence. As long as the overall facts and circumstances indicate that the athlete's off-season home is the true state of residence, the athlete should file state income tax returns on that basis.

If the athlete's state of residence has an income tax, all income earned by the athlete will be subject to tax (although a credit for taxes paid to other states on that income will generally be available). If the state of residence has no income tax, only the compensation earned by the athlete that is allocable to states with income tax (based on the duty day concept) will be subject to state income tax. Thus, establishing and maintaining residence in a state with no income tax can be very beneficial to the athlete.

Example 3-4: Application of the duty day concept for apportioning wages.

Sally Swoopes is a Nevada resident and star player for the Los Angeles Swishers professional basketball team. Her compensation for the year is \$1 million.

During the past year, she participated in the team’s seven day mini-camp in April before reporting to the regular pre-season training camp in Long Beach, California on May 10. Her team was eliminated from the playoffs on September 29. Between May 10 and September 29, she spent 83 days in California either practicing or playing, including three days playing road games in Sacramento.

She was in New York, North Carolina, Minnesota, Michigan, Texas, and Florida for six days each and in other states the remainder of the time.

Under the duty day rules, her \$1 million compensation is apportioned as follows:

Total duty days (143 days from May 10–Sept. 29 + 7-day mini-camp)	150
Duty days in California (7 day mini-camp + 83 days)	90
Ratio of California duty days ($90 \div 150$)	60%
Multiplied by her compensation for year	\$1,000,000
Compensation taxable in California	<u>\$ 600,000</u>
Ratio of duty days in each of the other named states ($6 \div 150$)	4%
Multiplied by her compensation for year	<u>\$1,000,000</u>
Compensation allocable to each of the other named states	<u>\$ 40,000</u>

Sally is clearly subject to California income tax and would have tax withheld on her compensation allocated to California. The Swishers will report income that Sally earned in New York, North Carolina, Minnesota, and Michigan to those states as part of Sally’s W-2. Sally would file income tax returns in California, Michigan, Minnesota, New York, and North Carolina. She is not subject to tax in either Texas or Florida, since neither state has an individual income tax.

Because she resides in Nevada (a state with no individual income tax), any compensation allocated to Texas, Florida, or any other state with no income tax is free from state income tax. Conversely, if she was a California resident, all of her compensation would be subject to tax in some state, with a credit calculation being performed in California to prevent her from being taxed twice (although Sally generally will pay the highest rate of the two states).

The duty day concept can present practitioners with the following planning opportunities:

- Many major league baseball teams conduct training camp in Florida, a state without income tax. This can be beneficial to a player who is a resident of Florida or another state with no income tax.
- Days the athlete spends on the disabled list or the injured reserve are presumed not to be duty days when figuring the numerator, but are duty days for purposes of the denominator. Therefore, it is very important to identify such days, particularly for residents of states that do not tax compensation.
- Days a player neither practices, plays, nor attends team meetings also are not included in the numerator, but are part of the denominator. These include any travel days, if no game, practice, or meeting occurs on that day. Although these days are relatively rare in most team sports, they do occasionally occur and should be properly identified.

- If a player switches teams, separate duty day calculations must be made for the time spent with each team and applied to the compensation paid by each team.
- The duty day calculation for teams in sports that span two years (e.g., hockey, men's basketball and possibly football) can be particularly challenging.

The team will report income the athlete earned in various states based upon the team's interpretation of the duty day concept. This may not be consistent with the calculation performed by the athlete's practitioner. If the practitioner's calculation of income earned in a particular state is materially different from the team's calculation, the practitioner should consider reconciling the difference with the team's payroll department as part of the tax return preparation process. If the athlete's reporting will vary from the team's reporting, a detailed duty day calculation should generally be included with the state income tax return.

The same need for apportionment exists with other employees who travel with the team, such as managers and coaches. The nature of their jobs are such, however, that the position can often be taken that they perform services year-round, so the denominator of their fraction should be 365. Maintaining a residence in a nonincome tax state can be even more beneficial for these individuals. Trainers and clubhouse managers also present interesting situations for apportionment purposes.

The difference in income tax rates among the states and the absence of an individual income tax in some states makes it particularly important for the practitioner to work with the client to develop a system to accurately identify all duty days during the year. A team's schedule, including pre-season training and off-season activities, should be maintained identifying the duty days and nonduty days. A relatively small amount of attention and effort can produce significant tax savings.

Despite the need for uniformity in applying state income tax rules to athletes to produce fairness and equity, states sometimes stray from these concepts. For example, Arizona does not include preseason training in duty days. Several states seek to apportion wages based on the proportionate number of games actually played in the state (i.e., do not consider training and practice days) instead of utilizing the more prevalent duty day concept.

Illinois has been the state which has most significantly deviated from the uniform *duty day* concept. For many years, the Illinois Department of Revenue had taken the position that the entire salary of athletes employed by Chicago-based teams should be taxable by Illinois, regardless of the athlete's state of residence. This approach completely ignored the duty day concept. In addition, Illinois resident athletes were not allowed a credit for taxes paid to other states on wages earned in those other states. These extreme positions resulted in hundreds of unresolved cases and controversies with professional athletes. Illinois' position with respect to nonresident athletes was rejected by an Illinois Circuit Court in the Radinsky case, but its position on resident athletes was upheld in the Sosa case. The players' associations of all four major team sports became involved, and legislation was introduced that was designed to conform Illinois to the duty day concept and allow its resident athletes to claim credit for tax paid to other states. This legislation was enacted into law on June 19, 2005.

Planning for Other Income Earned by an Athlete

Professional athletes typically have opportunities to generate income from a variety of sources aside from compensation received from the athlete's team. These income opportunities can be

grouped into income arising from the athlete's (a) occupation and reputation, and (b) investment of earnings and/or net worth (which for some athletes is quite substantial). Income from the first area often involves capitalizing upon the team's and/or athlete's name and notoriety, such as through product endorsements or appearance fees.

Successful athletes find that their notoriety and earning potential attract all sorts of investment "opportunities." A unique situation faced by many athletes and their advisors is responding to sales pitches by promoters of exotic (and often highly speculative) ventures who are looking for prospects with a high net worth and little or no business sense. Here, the practitioner can often act as a shield for the client. While this often requires an extraordinary level of patience and tact, it can represent one of the more valuable services a practitioner can provide the athlete/client.

Endorsements and Appearance Fees

Pure endorsements involve the athlete receiving compensation for allowing his or her name to be associated with a product without performing any personal services. Most of the players' unions market the use of player likeness and/or names on a group basis to trading card manufacturers and others and evenly distribute the resulting revenue to the members. This may be characterized as licensing revenue. This revenue is reported to the player as royalty income on Form 1099-MISC, and should be reported on Schedule E of the player's federal income tax return. Income received directly by the athlete from a trading card company should be similarly reported.

Reporting the income as a royalty is advantageous because royalties are not subject to payroll taxes (because they do not arise from the performance of services). Since the athlete is not rendering services, royalty income would be subject to tax only in the state of the athlete's residence. Conversely, reporting the income as a royalty may be disadvantageous to the extent the athlete wants to maximize contributions to a qualified retirement plan.

Professional athletes generally will have other income opportunities that involve rendering services. These can include (a) making personal appearances or speeches, (b) participating in commercials or advertisements, (c) appearing on pre-game or post-game radio or television shows, (d) attending coaching clinics, and (e) participating in fantasy camps or cruises. The income from these "trade or business" activities should be reported on Schedule C and subjected to self-employment (SE) tax.

A threshold question in dealing with this "outside" income is whether the athlete is rendering services as an independent contractor or an employee. Worker classification is inherently a facts and circumstances issue, and as a practical matter tends to be more prevalent with entertainers than with athletes.

A threshold challenge facing the practitioner with respect to this "outside" income is to be sure that all income is reported. Athletes tend to be poor recordkeepers, and unfortunately the athletic "underground" can foster the notion that if payment is received in cash, it is not reportable. This, of course, is not true, as a number of athletes have learned to their dismay. (Several prominent athletes have been criminally prosecuted for failing to report cash revenue received from autograph activities.) While strong emphasis should be placed on the athlete getting all Forms 1099 and W-2 into the practitioner's hands, a workable approach should be developed for also identifying amounts that are not reported on such forms.

A form of team athletes' income that has largely gone unreported in past years is the value of complimentary tickets to games that the athlete is allowed to distribute to family and friends. Essentially, all professional teams allow team members, coaches, and other personnel to distribute four to six tickets per game to anyone they choose. Until recently, this practice has largely been ignored for income tax purposes, even though "an employer-provided ticket to an entertainment or sporting event" is specifically listed as a taxable fringe benefit in Reg. 1.61-21. Now that the prices of game tickets have skyrocketed, this practice has attracted the attention of the IRS as a valuable perk. The IRS has issued directives to teams to compile the value of these perks and include that value as part of the employees' compensation on Form W-2. The athlete will feel pressure from family and friends to continue to give out these comps. Certainly, they are free to do so, but the practitioner should let them know that there is a cost involved—the income tax on the imputed value of the complimentary tickets. This is not really outside income because it is treated as part of compensation, but it represents income that the athlete may be able to control within reason if he or she can occasionally "just say no."

Baseball players that sign a professional contract before entering or completing college may negotiate future payments for the costs of attending college. Although the future potential payments will be determined by specific negotiations, the general terms of the payments and continued eligibility to receive such benefits are uniformly applied under a plan established and administered by Major League Baseball (i.e., the Commissioner's office). These future "scholarship" payments can be a valuable benefit to negotiate in an initial professional contract. Although the benefits will eventually be subject to income tax, if the contracts are properly structured that tax will only be generated if, and when, the payments are actually made in the future.

Deferring Other Income by Establishing Qualified Retirement Plans

Once the athlete's outside income is identified (and reported), the next challenge is whether to establish a qualified retirement plan for that income. Qualified retirement plans (i.e., those that meet specific Code requirements) offer the advantage of immediate deductibility for contributions thereto, while no income from the plan is reportable until distributions are received from the plan.

The fact that the athlete may have actual or potential coverage under a qualified retirement plan established as part of the collective bargaining agreement between the player's union and the professional league does not prevent the player from establishing his or her own retirement plan on income treated as self-employment (SE) income. Based on the Reece case, this opportunity can even be extended to services apart from playing itself that might be rendered to the team in an independent contractor capacity, such as personal appearances and speeches.

The player will rarely have any employees, so the choice and administration of a plan can be quite simple. Self-employed individuals without employees can adopt a qualified retirement plan (normally referred to as a Keogh or HR-10 plan), a simplified employee pension (SEP) plan, a salary-reduction incentive match plan (SIMPLE-IRA or SIMPLE-401(k) plan), a traditional or one-person 401(k) plan, or an individual retirement account (IRA).

A Keogh plan can be structured as a defined benefit plan or a defined contribution plan. Defined benefit plans are designed to provide a fixed annual benefit at retirement, subject to the limitations established by the Internal Revenue Code. Annual contributions to the plan are actuarially determined. While a defined benefit plan can produce the largest amount of annual deductible contributions, this advantage must be balanced against its relative lack of flexibility and the added expense of administering the plan.

A defined contribution plan can be a profit-sharing plan or a money purchase plan. Profit sharing plans provide the most flexibility, and given the parity between deduction limits for profit sharing and money purchase pension plans, there is now less reason to establish a money purchase plan. An important advantage of a SEP is that it can be adopted after the end of the year in which the self-employment income is actually earned. However, it must be adopted and funded before the filing date of the return, including extensions.

Maximizing an Athlete's Deductible Expenses

Most of the potential deductions available to athletes fall in the general category of trade or business expenses. A major issue is determining which business is involved: the business of (a) being an employee (i.e., performing services as a team employee), (b) earning income apart from the player's employee role (i.e., "Schedule C income"), or (c) earning royalty income (Schedule E income) for use of the athlete's likeness or name. This characterization is important because deductions related to the outside income are deductible in arriving at adjusted gross income (AGI), while unreimbursed expenses related to the player's role as an employee are miscellaneous itemized deductions that are subject to various statutory limitations. Since opportunities to allocate deductions to Schedule E income are relatively limited, the discussion will focus on whether the deductions should be reported in calculating Schedule C income or on Schedule A as a miscellaneous itemized deduction.

Proper Characterization Can Save Taxes

It is almost always preferable to characterize potentially deductible expenses as Schedule C deductions. In some instances, the athlete's standard deduction might exceed itemized deductions so that treatment of these expenses as an itemized deduction would produce little or no benefit. Even if the athlete itemizes, claiming the deduction on Schedule C avoids the various limitations (or "haircuts") that apply to miscellaneous itemized deductions (the category into which unreimbursed business expense incurred as an employee falls) and to overall itemized deductions. In other situations, the athlete may have such large itemized deductions for taxes (particularly state and local income taxes) and miscellaneous itemized deductions that it creates an alternative minimum tax (AMT) problem.

Characterization of expenses as Schedule C (or Schedule E) deductions may be desirable, but cannot be arbitrarily undertaken. In many cases, the tax law is absolutely clear that expenses can only be deducted as miscellaneous itemized deductions. Other expenses may not be as clear and the practitioner's attention and analytical ability should be focused on them.

Under Temp. Reg. 1.67-1T(c), deductions may be allocated among various business and income producing activities "on a reasonable basis." As already discussed, to the extent deductions can be claimed on Schedule C, tax savings often can be achieved. The practitioner is uniquely qualified to identify deductions that are allocable and develop a reasonable basis for the allocation. A good place to start can be the practitioner's own fees, and in this area some guidance can be obtained from Rev. Rul. 92-29.

Even after the thoughtful application of allocation principles, the team athlete will likely find that a large amount of business expenses represent miscellaneous itemized deductions. These items are reportable on Form 2106 (Employee Business Expenses), which should also be

used to report any reimbursement received from the team, other than reimbursements included on the athlete's W-2 as income. Reported reimbursements on Form 2106 are offset against the expenses to produce a net amount of expenses. From Form 2106, the net expenses flow to Schedule A as miscellaneous itemized deductions, where they are subject to the same potential limitations applied to other taxpayers.

Travel Expenses

While most travel and lodging expenses of a team athlete for road trips are paid directly by the team and so are not deductible by the athlete, there can be occasions, particularly during the off-season, when an athlete may incur unpaid and unreimbursed business-related travel expenses. Here, the athlete must be coached on the Code's substantiation rules.

A team athlete will often maintain a permanent residence in a locale other than the team's home city, particularly if the athlete has children. The question is then raised as to whether expenses for lodging and meals incurred by the athlete in the home team's city are deductible. For example, is the rent paid for an apartment maintained in Chicago from April through September by the Cubs' first baseman who permanently resides with his family in Arizona deductible?

Under IRC Sec. 162(a)(2), "traveling expenses, including amounts expended for meals and lodging while away from home in the pursuit of a trade or business" are deductible. While this "away from home" language might seem to have clear application to the Cubs' first baseman maintaining a permanent residence apart from Chicago, the Section 162(a)(2) reference to taxpayer's "home" and the test for determining an individual's "tax home" is different from the tests applied in determining that individual's residence for state income tax purposes.

Rev. Rul. 93-86 defines a taxpayer's home for applying the travel expense rules as (a) the taxpayer's regular or principal (if more than one regular) place of business; or if the taxpayer has no regular place of business, (b) then at taxpayer's principal residence. Note, the primary determining factor is the location of the business. If Chicago is considered the first baseman's place of business, he would not be allowed to deduct the cost of his Chicago apartment and his meals while in Chicago. For a taxpayer to have no regular or principal place of business, his or her employment at a particular location generally must be shown to be temporary in nature. Rev. Rul. 93-68 creates a presumption that if employment at a particular location is realistically expected to last less than one year, it is considered temporary, absent persuasive facts to the contrary. If employment at a particular location is realistically expected to last more than one year, it will not be considered temporary, even if it actually lasts less than one year.

Thus, for the Cub first baseman to deduct meals and lodging while in Chicago, he must show that Chicago is not his place of business or that he has no regular place of business. If Chicago is considered his tax home, lodging, meals, and other expenses incurred there would not be deductible.

Specific application of these concepts to athletes can be found in several cases decided before the issuance of Rev. Rul. 93-86. In *Wills*, baseball great Maury Wills attempted to deduct living expenses incurred in Los Angeles while playing for the Dodgers. He maintained a residence in Spokane where his family lived year round. Even though it was conceded that Spokane constituted Wills' permanent residence, the court denied this deduction because Los Angeles was his principal place of business and so his "home" for tax purposes.

Maury Wills was a well-established player with realistic expectations that he would remain with the Los Angeles Dodgers beyond a year. The issue of whether Los Angeles might have been a *temporary* work site was not even discussed. Should this same reasoning apply to a more marginal player? The Tax Court answered this question in the affirmative in the 1975 *Gardin* case. Ron Gardin was a professional football player who played for four different NFL teams in a three year period while maintaining a residence in Tucson, Arizona, where he held several off-season jobs. Despite this almost transient situation, the Tax Court concluded that Gardin could not “reasonably expect his employment to terminate within a fixed or short period of time” and so his deductions were disallowed. This same reasoning was applied in the *Stemkowski* case, where a professional hockey player was not allowed to deduct expenses in his team’s home city based on it being a temporary location. This result was reached even though Stemkowski had been traded to the New York Rangers just prior to the year at issue. The court found that his two-year contract (which was traded by the Detroit Red Wings to the Rangers) indicated that his employment location was not temporary in nature. *Blue* is another case reaching a similar result that the team’s location did not constitute a temporary work site with respect to an established professional football player.

However, another case offers some hope. In *Horton*, a minor league hockey player was employed by several teams while maintaining a residence in Flint, Michigan. He deducted expenses in San Diego while playing there pursuant to a contract that provided his employment was to terminate within six months. In deciding that his San Diego expenses were deductible, the Tax Court noted that the taxpayer reasonably had no expectation that his tenure with the San Diego team would be indefinite or permanent.

Although more cases have ruled the location is not temporary, the amounts involved can be substantial enough that the practitioner should carefully evaluate the facts and circumstances to ascertain whether a return position is feasible for deducting living expenses incurred at the team’s home site. If a player has a track record of moving between teams frequently or is a minor league player, a good case may be developed. The frequency of player movement between teams in the modern days of free agency provides a potentially better argument for temporary work sites than when Maury Wills or Ron Gardin played.

One area worthy of particular scrutiny involves baseball players with contracts to play in Japan, Asia or Latin America, football players with contracts to play in Europe, and basketball and hockey players with contracts to play in foreign locales. The nature of these arrangements (e.g., the predominant use of single season contracts) and the evidence that can be developed showing that most players do not spend more than one season (far less than a year) in a foreign locale may provide a stronger rationale for deducting away from home expenses incurred at the team’s locale. Anyone who has experienced the cost of living in Japan or other expensive foreign locations can appreciate how important this issue can be.

Sports Is Not the Athlete’s Primary Business. Another situation that may be encountered, although increasingly infrequently, is an athlete who can establish that the sport is not his primary business. Rev. Rul. 54-147 specifically provided that if a baseball player’s nonbaseball business activities are determined to be more substantial than his baseball activities, the player’s tax home is considered to be the site of his nonbaseball activities. While this ruling seems almost quaint in this day of astronomical player salaries, it may apply to special situations, most likely minor league players, coaches, or other nonplaying personnel. Even when the player’s other business activities are not dominant, travel expenses incurred during the season to tend to the other businesses should be deductible.

Out-of-pocket Travel Expenses. Travel expenses on the road during the regular season are generally either paid directly by the club or adequately reimbursed through meal money. Expenses incurred during pre-season training can be another matter. Baseball teams in particular (and sometimes football teams) will train in a locale away from the home city. Although football teams generally require dormitory type lodging, major league baseball players and coaches generally are provided a monetary allowance for lodging and meals and are then on their own. The lodging allowance often falls short of the cost of desired accommodations, particularly considering prices during the late winter tourist seasons of Arizona and Florida. The amount by which actual meals and lodging expenses exceed the allowance should be deductible (subject to the 50% reduction applicable to meal expenses).

All travel costs must be properly documented to support their deduction. Furthermore, the practitioner should be alert to allowances for meals and lodging included in the athlete's Form W-2. Since such amounts are included in the athlete's income, they should not be treated as a reimbursement in preparing the athlete's Form 2106 and thus should not offset the deductible amount.

Other Deductible Items Can Provide Important Tax Benefits

Other expenses that are directly related to the athlete's trade or business should also be deductible. These can include:

- *Equipment and Supplies.* While items such as spikes, shoes, skates, bats, gloves, sticks, pads, and others directly used in the sport are deductible, the costs are usually borne by the team or the manufacturer. Vaseline, sand paper, or cork are not deductible by a baseball player!
- *Promotional Materials.* The cost of promotional materials (such as the player's photos or cards) can be deductible. The cost of responding to fan mail has been specifically allowed.
- *Off-season Training Costs.* Costs incurred by athletes for individual work-outs and conditioning activities or programs during the off season should be deductible, subject to the elimination of any personal recreational element. Although the player's deductions in these cases were ultimately disallowed for lack of substantiation, the court clearly accepted the concept of their deductibility.
- *Union Dues.* Most players belong to a union or player's association. A primary benefit provided by most player associations is generating licensing revenues, which are distributed to the players. Union dues are normally characterized as miscellaneous itemized deductions, reported on Schedule A. The case can be made, however, for allocating and offsetting the dues against the licensing income reported on Schedule E. The practitioner should ascertain the amounts of any dues withheld. The player will generally receive a letter from the players' union with such information and it may also appear as miscellaneous information on the W-2 issued by the team.
- *Clubhouse Dues.* Baseball players in particular traditionally make substantial payments during the year for so-called *clubhouse dues*. These are amounts paid to clubhouse attendants (both home and on the road) for providing goods and services to the players to help them prepare for the game and to wind down afterward. The payment of these clubhouse dues, which can run well into the thousands of dollars for a season, have generally been deductible as a miscellaneous itemized deduction. Athletes in other sports may deduct similar amounts paid to clubhouse attendants, trainers, and equipment managers.

Moving Expenses

Moving expenses are particularly beneficial because they are deductible in arriving at the taxpayer's adjusted gross income (AGI). The following expenses are deductible if the move is job related:

- a. The cost of transporting household goods and personal effects from the former residence to the new residence. These costs may include the cost to pack and crate, store, and insure household goods and personal effects that are delivered to the new residence.
- b. The cost of traveling from the former residence to the new residence. (Traveling expenses include lodging but not meals.)

Common nondeductible moving expenses include:

- a. Meals while moving from an old residence to a new residence.
- b. Travel expenses, meals, and lodging for a pre-move house-hunting trip.
- c. Meals and lodging while occupying temporary quarters in the area of the new job.
- d. Expenses of buying or selling a home or of getting or breaking a lease.

The requirements for this deduction are rather detailed. The move itself must be connected to starting work in a new location. The new principal place of work (i.e., the home team ballpark, stadium, or arena) must be at least 50 miles further from the old residence than the former principal place of work. The athlete must be fully employed at the general location of his move for at least 39 weeks of the 12-month period immediately following the move, unless the 39-week requirement cannot be fulfilled due to death, disability, or involuntary termination from employment.

The practitioner must be aware of and reduce the deductible moving expenses by any reimbursements received from the team. An athlete who receives a moving expense reimbursement in a year other than the year the expenses are paid can deduct the expenses in the year of reimbursement if (a) the expenses were paid in a year before the year of reimbursement, or (b) the expenses were paid in the year immediately after the year of reimbursement but on or before the due date (including extensions) for filing the tax return for the year of the reimbursement. By reporting deductions in the year of reimbursement, the athlete can avoid prepaying tax on the reimbursement income by matching revenues and expenses in the year incurred.

Charitable Contributions

Many athletes are well known for their involvement with worthy charitable causes. This involvement often consists of personal appearances on behalf of charitable causes and institutions. While this may be very valuable and beneficial to the charity, the time spent in performing these services does not generate a deduction for the athlete. Not to be overlooked, however, are any unreimbursed out-of-pocket expenses incurred by the athlete in making these appearances. This includes automobile mileage at the appropriate cents-per-mile rate as well as any unreimbursed meals or lodging expenses incurred.

Another frequent, very valuable benefit that an athlete may provide to a charity is athletic memorabilia. This can involve equipment or uniforms used by the athlete as well as autographed pictures, balls, personal mementos, etc. When this memorabilia is auctioned or

sold to provide funds for the charity, the athlete's deduction is limited to the actual cost of the item, which is often nominal or zero. This is because IRC Sec. 170(e)(1)(B) effectively limits the deduction for the donation of tangible personal property to the donor's cost basis unless the property is used directly by the charity in performing its charitable purpose or function. It can be very difficult for the athlete to understand how a donated item that sells for hundreds or even thousands of dollars can generate little or no tax benefit.

A more favorable tax result occurs when the athlete donates an item to a Hall of Fame or museum that intends to use it as a display currently or in the future. In this instance, the fair market value of the item is deductible regardless of its cost.

The validity of charitable deductions has been an area of continuing and increasing IRS scrutiny. The professional athletes are subject to the same rules concerning documentation of donations as other taxpayers. The practitioner's challenge is to educate the athlete on the need for documentation and a system whereby the needed documentation is retained.

Alternative Minimum Tax

The benefits arising from deductions for taxes and miscellaneous itemized deductions are often neutralized to the athlete because of the alternative minimum tax (AMT). The AMT has negatively impacted more and more taxpayers because it is not indexed for inflation and Congress steadfastly refuses to provide substantive relief. Professional athletes are particularly susceptible to the AMT because of the likelihood of large deductions for state and local taxes and miscellaneous itemized deductions. The potential impact of AMT should be carefully considered when projecting and planning the athlete's taxes.

Planning an Athlete's Estimated Tax Payments

Despite significant amounts of income tax withholding from an athlete's salary, the level of outside income may be such that estimated tax penalties will be incurred unless tax planning is undertaken. To address this problem, the athlete can make quarterly estimated tax payments or request the team to withhold additional amounts of income tax.

The practitioner can assist the athlete/client in developing the most beneficial level of estimated tax payments by working with the exceptions to tax underpayment penalties specified by IRC Sec. 6654:

- a. *No Prior Year Tax Liability.* The taxpayer had no tax liability for the prior tax year, was a U.S. citizen or resident for that entire year, and the prior year tax year was for a full 12-month period.
- b. *Using Prior Year Tax.* The taxpayer paid through withholding and/or timely estimates an amount equal to 100% of the prior year tax liability. For this to apply, the taxpayer must have filed a prior year return for a full 12-month tax year showing a tax liability. Special rules apply if the taxpayer had adjusted gross income of more than \$150,000 in the prior year. If that is the case, the percentage of the preceding year's tax required to meet this exception is 110%.
- c. *90% of Current-year Tax.* The taxpayer paid through withholding and/or timely estimates an amount equal to 90% of the current year tax.

The practitioner should become familiar with these exceptions provided by IRC Sec. 6654. Only the smaller applicable exception needs to be satisfied to avoid any penalty. The no prior tax year liability safe harbor may be useful for athletes signing their first professional contract. For more established players, the safe harbor based on the preceding year's income tax can prove beneficial. But since many team athletes will have AGI exceeding \$150,000, particular care should be exercised that the correct percentage is used. While relying on the prior year tax exception can produce favorable cash flow results, the amount of tax ultimately due must be accurately estimated and the appropriate funds set aside (preferably in interest-bearing investments) to be available to the athlete on the following April 15.

Planning to request that the team withhold additional amounts late in the year can be beneficial from an investment and cash flow standpoint. The athlete will have use of the funds for much of the year, but the presumption that tax is withheld evenly throughout the year should minimize or eliminate any estimated tax penalties.

Sometimes, the reverse situation is present (i.e., withholding will exceed the amount needed to avoid penalties) Here, the athlete should consider filing a revised Form W-4 with additional (supportable) exemptions. If this is done, the athlete should be told that a larger refund is not necessarily the indication of good tax planning and, in fact, indicates just the opposite. It is certainly preferable that the athlete, and not the government, have beneficial use of money throughout the year that ultimately will be refunded.

IRS Focus on Foreign Athletes and Entertainers

The IRS recently indicated it is focusing significant, high-level resources on U.S. income reporting and tax compliance by foreign athletes and entertainers who work in the United States. The agency launched an issue management team (IMT) to address compliance issues raised in this area, with the initial focus on high-income golf and tennis players, high-income musicians, and their representatives. The IRS has indicated that although the IMT was initially designed to focus on these specific groups, its scope may be broader and its activities may impact other groups as well. The agency said it is using a three-pronged approach for this initiative: (a) improving the availability of information and guidance needed to help this group comply with income reporting and tax payment requirements, (b) providing IRS enforcement personnel with information they need to identify and work compliance issues frequently encountered with this population, and (c) conducting direct compliance and enforcement activity. The IRS is focusing on issues such as the character of income, including whether it is earned for endorsements, personal services, royalties, or other things; withholding tax compliance; tax residency; treaty benefits; and whether there is a permanent establishment issue in the U.S.

Representing Professional Entertainers

Representing professional entertainers can present many similar as well as many different challenges than those encountered with professional athletes. A number of tax concepts encountered by entertainers are also encountered by professional athletes. These concepts were discussed in the preceding sections and are referenced where appropriate. This portion of the lesson focuses on concepts that are unique to, or more prevalent with, entertainers.

Common Characteristics of Entertainers

A particular characteristic shared by many entertainers is a tendency to generate large expenses that most likely will be categorized as miscellaneous itemized deductions. Items such as agent's fees, guild dues, and travel expenses, when combined with investment advisory fees, personal management fees, and fees for tax consultation and compliance, can be significant. The income tax benefit of these expenditures can be severely reduced if they are characterized as miscellaneous itemized deductions. Strategies to maximize the income tax benefits from these expenses are discussed throughout this portion of the lesson.

Another common characteristic shared by most entertainers is the potential benefits from being treated as an independent contractor rather than an employee. Entertainers may work a large number of "gigs" during the year and furnish their own costumes, musical instruments, etc., but the degree of control over the performance of the entertainer's services by the payer raises issues as to whether the entertainer should be classified as an employee or an independent contractor.

The possibility of operating through a corporate form is an issue considered by many entertainers. With the relative leveling of individual and corporate income tax rates and the leveling of contribution limits applicable to individual and corporate qualified retirement plans, there are fewer clear-cut advantages to providing services through a corporation. Nevertheless, some entertainers will operate through corporations to take advantage of the loan-out planning technique, or simply because someone incorporated them years ago for some (possibly now forgotten) reason. Furthermore, with today's litigious society, many entertainers incorporate or establish a limited liability company (LLC) to protect their personal assets from business-related claims. Some entertainers may want to operate through a corporation because they perceive it to be prestigious.

Identifying the Sources of Income Generated by Entertainers

Entertainers need to be schooled in the importance of good-faith efforts to report all income earned. The entertainer *underground* often spreads the idea that neither cash nor barter-type items needs to be reported. Unfortunately, in such situations the practitioner must often be the bad guy in convincing the client that all income must be reported. Because entertainment is a highly visible profession, the entertainer can be an inviting target when the IRS seeks to create a public example (Willie Nelson and Wesley Snipes being good cases in point). The IRS is especially mindful of the potential for unreported income in this profession and may employ special procedures to detect nonreporting. The IRS has set forth its approach in this area in its Market Segment Specialization Program (MSSP) guide titled "Entertainment—Important 1040 Issues."

The IRS recently indicated it is focusing significant, high-level resources on U.S. income reporting and tax compliance by foreign athletes and entertainers who work in the United States.

The MSSP guide notes that common forms of income received by entertainers include (a) residuals, which are periodic payments received by actors and others for re-runs of commercials, episodic television, etc.; and (b) royalties or license fees, which are periodic payments received by copyright owners, such as songwriters, recording artists, and authors, from those who perform, exhibit, run, or otherwise distribute the copyrighted work. When the examiner cannot verify income using a direct method, it may be necessary to reconstruct

income. For example, if agent commissions are paid at 10%, the entertainer's income should be at least 10 times the commission expense. Furthermore, dues for most of the guilds are comprised of an annual fee plus an additional assessment based on the prior year's earnings. Therefore, the entertainer's dues statement for 2011 may provide clues to the level of earnings for 2010.

In a March 2006 statement, IRS Commissioner Mark Everson reminded celebrity recipients of the Oscar "goodie bags," that they qualify as taxable income and must be reported on their tax return, adding that: "We want to make sure the stars 'walk the line' when it comes to these goodie bags." Distributing goodie bags has become increasingly commonplace, and news reports about the Oscar gifts for the stars have placed the value at more than \$100,000. "This has become big business for companies promoting their products. These things are not given without pride and prejudice," noted Everson. "There is a tax implication for them. We just want to make sure no one crashes into the tax code." The IRS reached agreements with the Hollywood Foreign Press Association and the Academy of Motion Picture Arts and Sciences to resolve outstanding taxes on Golden Globe and Academy Award gift baskets. Under the agreements, tax obligations were settled for gifts given through 2005, and recipients of gift baskets after 2005 will receive Forms 1099 and be responsible for satisfying their income tax obligations.

The practitioner and the client should develop a workable system to capture income information. For a start the entertainer/client needs to be able to recognize the various reporting forms (i.e., Forms W-2, 1099, etc.) and carefully accumulate them. All deposit slips should be saved. Beyond that, the practitioner should develop some form of diary-type procedure where the entertainer notes the shows performed during the year. The form for accumulating information need not be particularly fancy—a simple accordion file often suffices—it just needs to be something the entertainer will effectively use.

While the receipt of a residual or royalty payments for prior year performances is obviously welcome to the entertainer, it can produce uncertainties in tax planning. For example, the unanticipated arrival of a Form 1099 for \$15,000 in March 2010 reporting residuals paid to the entertainer during 2009 could undermine carefully constructed tax plans (and create an estimated tax underpayment). A system that is highly workable and eliminates these surprises is much desired.

When preparing the entertainer's income tax return, the practitioner may have the formidable task of reconciling the various sources of information. On the one hand, there is a concern that all income may not be reported. On the other hand, a possibly greater concern from a tax standpoint is that the same income will be reported twice. The multiplicity of sources from which an entertainer may receive income can make an entertainer particularly susceptible to reporting the same income more than once. Form W-2 or Form 1099 may come from a different name than that appearing on the check or the organization that the entertainer thinks engaged him or her. In the author's experience, awareness of this potential problem and communication with the entertainer/client is the best way to mitigate nonreporting or double reporting.

Characterization of Income Is a Key Planning Fundamental

The characterization of professional income received by an entertainer is important to the overall income tax results. The income will generally be characterized as (a) wages received for services rendered as an employee; (b) compensation received for services rendered as an independent contractor; (c) residuals for performances previously given; (d) royalties for

musical performances, compositions, screenplays, and so forth; or (e) royalties from merchandising or licensing which do not involve any personal services.

While the income from each of these categories is ordinary income, the characterization among the categories can produce different tax results. Some of the reasons for these differences include:

- a. If income constitutes wages, it will already have been subjected to payroll taxes that have been matched by the employer. If income falls within categories (b) through (d) in the preceding paragraph, it should be treated as self-employment (SE) income and subject to SE tax. If the income represents royalties involving no personal services (Schedule E income), it will not be subject to SE tax [category (e) above].
- b. Income reported as categories (b) through (d) can be considered in making tax deductible contributions to a qualified retirement (Keogh) plan.
- c. Expenses related to categories (b) through (e) are deductible “above the line” in arriving at adjusted gross income (AGI). Category (e) is the best of all worlds since it is also not subject to SE tax, but is rarely encountered except among the most recognized entertainers.
- d. Expenses related to category (a) (wages) are deductible only as itemized deductions, and so are subject to substantial limitations and additionally may provide no benefit to the extent that the entertainer is subject to the alternative minimum tax.

In most cases, the categorization of the income will be made by the payer on the information return (either Form W-2 or 1099). While the practitioner can generally rely on these characterizations in preparing the entertainer’s return, if the impact of the characterization is material and is contrary to achieving the best tax result, the practitioner may wish to discuss the nature of the services with the entertainer. Based on these discussions, the practitioner may want to contact the payer to request correction of the characterization of the income on the information return.

There is a temptation to report Form W-2 wages on a Schedule C in an attempt to optimize the income tax results. Unfortunately, there is no statutory authority for doing so and no published cases or rulings have recognized this concept. Furthermore, reporting Form W-2 wages on Schedule C may be apparent to the IRS on the face of the return. The IRS is known to actively look for this treatment and propose tax deficiencies from a reversal of the treatment. The IRS MSSP guide states, with respect to Form W-2 wages reported on Schedule C, that “no consideration should be given to performers who claim to be a . . . statutory nonemployee which would allow expenses to be taken against income not subject to either the 2% AGI limitation or Alternative Minimum Tax. There is no such statute applicable to the industry.”

Selling Self-created Musical Works

Generally, copyrights; literary, musical, or artistic compositions; letters or memorandums; or similar property are not capital assets. Therefore, the sale of such items generates ordinary income. However, at the election of a taxpayer, the sale or exchange of musical compositions or copyrights in musical works created by the taxpayer’s personal efforts (or having a basis determined by reference to the basis in the hands of the taxpayer whose personal efforts created the compositions or copyrights) is treated as the sale or exchange of a capital asset. This change is effective for sales in tax years beginning after May 17, 2006. Thus, for

example, a composer who sells his or her copyrighted composition will now pay tax at the lower rates that apply to capital gains through 2010 (i.e., a maximum rate of 15% versus the maximum ordinary income rate of 35%). A painter or author, however, is not eligible for this tax advantage.

Elections for capital asset treatment must be made separately for each musical composition (or copyright in a musical work) sold or exchanged during the tax year. Elections must be made on or before the due date (including extensions) of the income tax return for the tax year of the sale or exchange, by attaching Schedule D (Capital Gains and Losses) to the appropriate income tax form [e.g., Form 1040 (U.S. Individual Income Tax Return), Form 1065 (U.S. Return of Partnership Income), or Form 1120 (U.S. Corporation Income Tax Return)] and treating the sale or exchange as the sale or exchange of a capital asset. Once made, the election is revocable only with the consent of the Commissioner.

Special Rule for “Starving Artist” Entertainers

IRC Sec. 62(a)(2)(B) is specifically applicable to performing artists and can provide the best of both worlds—the allowance of expenses above the line even though the performer is an employee. Unfortunately, this provision is quite limited and generally applies only to “starving artists” who would pay little income tax anyway. To be eligible for this advantageous treatment, an entertainer must come within the definition of a “qualified performing artist”—an artist who has:

- a. Performed services for two or more employers (receiving at least \$200 from each),
- b. Expenses related to performing arts services that exceed 10% of the income earned from the performing arts, and
- c. An AGI of \$16,000 or less before the deduction of expenses related to performing arts.

If these tests are not met, the expenses are treated as miscellaneous itemized deductions, subject to the 2% of AGI floor on those deductions.

The last requirement (AGI of \$16,000 or less) obviously limits the applicability of the provision. While this provision can be utilized by part-time performers as well as full-time performers, the AGI limitation is based upon income from all sources. The AGI limitation has remained the same since the law’s enactment in 1986. Although limited in application, this provision can be beneficial in the right situation.

State Income Tax Planning

Entertainers may find themselves filing returns and paying taxes in a multitude of states in which they have performed. The state income tax burden can be so large that it can be a determining factor in the entertainer deciding in which state to establish permanent residence.

Example 3-5: Considering state income tax burden in establishing residency.

Sammy Strummer is a country and western singer who performs throughout the Southwest in clubs and bars. He resides in Nevada, but performs in California, Arizona, New Mexico, and Texas as well as Nevada. While Nevada and Texas do not have individual state income tax, California, Arizona, and New Mexico do. (Assume California has a 10% effective tax rate and Arizona and New Mexico both have a 5% tax rate.) Sammy’s earnings last year from the various states were \$10,000 from California,

\$25,000 from Nevada, \$12,000 from Arizona, \$8,000 from New Mexico, and \$35,000 from Texas.

Sammy is considering becoming a California resident. He asks his tax practitioner if this would make any difference in the amount of state income tax that he pays. The practitioner prepares the following analysis showing what Sammy would owe based upon his earnings from last year:

Tax on state earnings from:	State of Residence	
	Nevada	California
California	\$ 1,000	\$ 1,000
Nevada	—	2,500
Arizona	600	1,200
New Mexico	400	800
Texas	—	3,500
Total state income tax	<u>\$ 2,000</u>	<u>\$ 9,000</u>

The analysis indicates that Sammy saves \$7,000 of state income taxes by maintaining his residence in Nevada. The practitioner points out that although the state income taxes are deductible on his federal income tax return, the deduction produces little benefit because Sammy's federal tax is based on his AMT income. Based on this analysis, Sammy decides that he prefers to continue residing in Las Vegas.

The principles for determining residency and for apportioning wages among the states should have application here. While entertainers do not have a uniform allocation of income statute specifically applicable to them as athletes do, the general duty days concept would seem to be a reasonable approach to determine how much income to report in a particular state. Days spent rehearsing and other preparations for the performance, along with travel days, should be considered in addition to the actual days of performance in applying the duty days concept.

Because each state defines *resident* and *domicile* differently, it is quite possible for an entertainer to meet the definition of a resident in more than one state, so that all of his income is taxed twice. Most states allow a credit for taxes paid by residents to other states. The credit for taxes paid to another state works fairly well when the entertainer meets the definition of a resident in only one state. However, the credit may not eliminate double taxation for individuals who meet the definition of a resident in more than one state since intangible income (e.g., interest and dividends) is usually sourced to the state of residence, so no credit is allowed.

Example 3-6: Credit for taxes paid to another state may not eliminate double taxation.

Ingrid is domiciled in Connecticut but works on Broadway five days each week. She maintains an apartment in New York City but spends the night there no more than four times a month. Ingrid meets the test of a statutory resident of New York because she (1) maintains a permanent place of abode in the state and (2) spends more than 183 days of the year in New York (each working day is considered spent in New York, regardless of where Ingrid spends the night). Ingrid's income consists of \$300,000 of wages and \$75,000 of interest and dividends.

Ingrid is a resident for income tax purposes in both Connecticut and New York, so her entire net income is subject to tax in both states. New York does not allow any credit for taxes paid to Connecticut, since under New York law none of Ingrid's income is sourced

to Connecticut. (Under New York law, her earned income is sourced to the state earned, New York, and intangible income is sourced to the state of residency, also New York.) Conversely, Connecticut allows a credit for New York taxes paid on Ingrid's income that is sourced to New York under Connecticut law (her wages). However, under Connecticut law her intangible income is sourced to Connecticut. Thus, no credit is allowed for New York tax paid on the interest and dividends.

Deferred Compensation and Retirement Plans

Professional entertainers frequently experience major variations in income from year to year. This can create significantly different effective income tax rates in different years. In a year the entertainer has a number of well-paying gigs, income taxed at the top income tax rate may be received. This could be followed by a year without significant revenue producing jobs when the rate may be as low as 10%. The potential variance of income and rates suggest the use of deferred compensation planning as a budgeting and retirement planning technique, as well as a way to reduce taxes.

Nonqualified deferred compensation considerations are discussed at length in the professional athlete portion of this lesson. While the details are not restated here, two critical points that must be remembered are that (a) the agreement to defer compensation must be negotiated and documented prior to the rendering of services, and (b) by entering into the agreement the entertainer assumes a financial risk (as a general creditor of the employer).

The rules applicable to nonqualified deferral compensation have been significantly modified by new IRC Sec. 409A. These changes were discussed previously. They must be carefully considered by entertainers structuring deferred compensation.

The entertainer should consider establishing a qualified retirement plan if he or she generates significant self-employment income. Qualified plans are those that meet specific Code requirements. The plans can offer significant tax, investment and cash flow advantages because contributions are fully deductible, but, in general, no income is reportable until distributions are made.

When considering the funding of qualified plans, the entertainer should understand that these "separate pocket" funds may not be accessible without additional cost. If distributions are made to the entertainer before age 59½, an additional 10% tax is imposed unless certain exceptions can be met. This penalty tax is in addition to the regular income tax applied to the funds. Therefore, a key consideration in adopting and funding a plan is whether the entertainer can "afford" to have these funds unavailable on a long-term basis. The retirement plan should be isolated from other accounts or investments and access to the plan's assets should not be allowed unless planning suggests this is desirable.

Self-employed entertainers without employees can adopt a qualified retirement plan (normally referred to as a Keogh or HR-10 plan), a simplified employee pension plan, a salary-reduction incentive match plan, a traditional 401(k) plan, or an individual retirement account. These plans essentially offer self-employed individuals the same opportunity to accumulate retirement savings in tax-deferred accounts as individuals covered by corporate plans.

Selecting an IRA for Retirement Savings

An entertainer who does not typically earn significant income as an independent contractor and is not an active participant in an employer-maintained retirement plan may prefer to establish an IRA instead of the more complex Keogh or SEP plans. Two basic choices are available with IRAs—the traditional IRA and the Roth IRA.

A Roth IRA is simply an IRA that is designated as a Roth IRA when it is opened. The primary difference between a Roth IRA and a traditional IRA is that the tax benefits of a Roth IRA are *backloaded* rather than *frontloaded* as with deductible IRAs. Contributions to Roth IRAs are nondeductible, but earnings build up tax-free and taxpayers can eventually withdraw funds, including earnings, tax-free if the *qualified distribution rules* are met. In general, a *qualified distribution* is one that is received after the five-year period beginning with the first day of the first tax year for which a regular contribution or conversion contribution is made to any Roth IRA, and is made (a) on or after the individual is age 59½, (b) to the account owner's beneficiary or estate after the owner's death, (c) because the individual becomes disabled, or (d) to pay first-time home purchase expenses.

Withdrawals from a Roth IRA that are not qualified distributions are includable in income to the extent attributable to earnings. However, nonqualified distributions are treated first as a return of contributions. This means that no portion of a distribution from a Roth IRA is taxable until cumulative distributions from all the individual's Roth IRAs exceed the total amount contributed. Thus, contributions to a Roth IRA can be withdrawn tax-free and penalty-free at any time. This can be beneficial to entertainers who experience periods of less work and less income.

The maximum annual contribution to traditional or Roth IRAs is \$5,000 in 2010. (This maximum is subject to phase-out if the entertainer is also covered by an employer-sponsored retirement plan.) Individuals age 50 or older can make an additional \$1,000 annual catch-up contribution in 2010.

A nonrefundable tax credit of up to \$1,000 may be obtained for elective deferrals made by eligible taxpayers to a 401(k) plan, SIMPLE, SEP, or a traditional or Roth IRA. The credit is in addition to any deduction or exclusion that would otherwise apply with respect to the contribution. The calculation of the credit can be impacted by distributions received from qualified plans within the preceding two years and is subject to phase-out based on income levels (for 2010, it is completely phased out when AGI exceeds \$55,500 for a joint return or \$27,750 for a single return).

Will a Loan-out Corporation Save an Entertainer Taxes?

The basic concept of a loan-out corporation is that the entertainer establishes a wholly-owned corporation that loans out the entertainer's services for a fee. Any contract or agreement involving the entertainer's services is between the entity for which the services are provided and the loan-out corporation. The entity pays the loan-out corporation (not the entertainer), which then pays the entertainer. The loan-out corporation can be either a C corporation or an S corporation. If it is a C corporation, generally all net profits will be paid out as a year-end bonus. If it is an S corporation, the net income will be reported by the entertainer as wages, a bonus, or pass-through income (through the entertainer's ownership of the S corporation).

While the relative leveling of the individual and corporate rates and the tightening of the personal holding company and personal service corporation rules diminished the benefits once available with a loan-out corporation, the widespread use of loan-out corporations continued during a time when much larger deductible contributions could be made to a qualified corporate retirement plan than one established by an individual. Now that the retirement plan playing field has been leveled, the loan-out corporation has fewer clear advantages.

Nevertheless, the loan-out corporation can still be beneficial when the entertainer is restricted from receiving full income tax benefit from deductions that are limited statutorily based on percentages of adjusted gross income. While this restriction may arise with respect to the overall limit on itemized deductions or the medical deduction limitation, the most frequent and significant restriction to entertainers relates to expenses treated as miscellaneous itemized deductions. Miscellaneous itemized deductions can be limited (given a "haircut") by the 2% of adjusted gross income floor applied to these deductions and/or the overall limitation applied to itemized deductions of higher income taxpayers. Miscellaneous itemized deductions will provide no benefit at all to the extent that an entertainer is subject to the alternative minimum tax (AMT). Many entertainers find themselves in an AMT situation specifically because of the large amount of miscellaneous itemized deductions. If any or all of these restrictions on obtaining full benefit from these expenses appear to be a recurring problem, a loan-out corporation might be considered since these limitations on deductibility would not be present when claimed by a corporation.

The practitioner should consider the extent to which the restrictions applicable to miscellaneous itemized deductions might be lessened by classifying the entertainer's services to which the expenses relate as independent contractor rather than employee services. To the extent the expenses can be allocated to independent contractor (self-employment) income rather than employee (wage) income, the need for a loan-out corporation diminishes.

While there may be income tax reasons for establishing a loan-out corporation, there also may be a number of tax and nontax disadvantages. These include the following:

- a. The corporation does not magically transform questionable personal expenses into valid business deductions. In fact, when a corporation is involved, IRS scrutiny may be more intense and/or the likelihood of examination may be increased.
- b. Use of a loan-out corporation will involve initial and ongoing administrative expenses (which can be significant) and will also create additional month-to-month complexity.
- c. A loan-out corporation could represent a red flag to the IRS and lead to further scrutiny.
- d. A loan-out corporation may cause additional state income and franchise taxes.
- e. A loan-out corporation will likely cause the entertainer's payroll tax liability to increase.
- f. The loan-out corporation, if a C corporation, is subject to the personal service corporation and personal holding company provisions including IRC Sec. 269A. This requires constant monitoring and planning to minimize the impact of these penalty type taxes.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

28. The practitioner who has a professional athlete or entertainer as a client faces unique challenges beyond the technical tax rules. Which of the following is **not** one of those challenges?
- a. The rumor mill.
 - b. Lack of record-keeping.
 - c. Working with investment advisors.
 - d. The glamour factor.
29. A properly structured nonqualified deferred compensation agreement has which of the characteristics below?
- a. Spreads the payment of compensation into years after the compensation was actually earned.
 - b. Allows a current tax deduction to the team for contributions made to the plan on behalf of the athlete.
 - c. Is designed to meet the detailed Internal Revenue Code requirements similar to pension, profit-sharing, Keogh and 401(k) plans.
 - d. A negotiated agreement for all members of the team with team management.
30. A deferred compensation plan must meet several requirements in order to defer recognition of income, including:
- a. Secured promise to pay in the future.
 - b. Unfunded arrangement.
 - c. Utilization of trusts is prohibited.
 - d. Written agreement must be executed within 30 days services commence.
31. Under which type of irrevocable trust arrangement does the employee receive an economic benefit?
- a. Rabbi Trust.
 - b. Secular Trust.

32. State taxation can be quite complex for an athlete. When prorating income among the states under the “duty day” method, which days are included in the numerator?
- a. Days the athlete spends on the injured reserve list.
 - b. Travel days, if no game, practice, or meetings occur on that day.
 - c. Days spent on promotional activities.
 - d. Number of days the athlete performed in the state.
33. When the player’s union markets the use of player likeness and/or names on a group basis such as to trading card manufacturers, the resulting income earned by the athlete is considered what type of income?
- a. Licensing revenue.
 - b. Self-employment income.
 - c. Compensation.
 - d. Interest income.
34. Which of the following qualified plans can be structured as a defined contribution plan or a defined benefit plan?
- a. Profit-sharing plan.
 - b. Simplified employee pension plan.
 - c. Keogh plan.
 - d. Traditional 401(k) plan.
35. Deductible expenses associated with an athlete’s trade or business include all of the following, **except**:
- a. Cost of sandpaper or cork.
 - b. Union dues.
 - c. Clubhouse dues.

36. Which of the following expenses are deductible moving expenses?
- a. Meal expenses incurred while moving from old residence to new residence.
 - b. Cost of temporary lodging while waiting to move into new residence in area of new job.
 - c. Costs to pack, crate, store, and insure household goods and personal effects that are delivered to new residence.
 - d. Expense of breaking a lease at former residence.
37. Many entertainers operate through a corporate form. Which of the following characteristics is a disadvantage of operating in a corporate form?
- a. Utilization of loan-out planning technique.
 - b. Leveling of individual and corporate tax rates.
 - c. Limited liability protection.
 - d. Prestigious form of business.
38. To be eligible for the “qualified performing artist” favorable above-the-line tax deduction, the artist must meet three requirements. One of these requirements includes:
- a. Expenses related to performing arts services exceed 20% of the income earned from performing arts.
 - b. An AGI of \$32,000 or less before the deduction of expenses related to performing arts.
 - c. Classification need not be an employee, deduction available to independent contractors.
 - d. Performed services for two or more employers.
39. Which of the following is the primary factor influencing when an entertainer should consider establishing a qualified plan?
- a. She generates significant self-employment income through product endorsements.
 - b. She has employees on her staff.
 - c. She negotiated a significant raise in her salary for the current season of her hit sitcom.
 - d. She resides in California, which has a high state tax rate.

40. An entertainer may desire to shelter a portion of their income in a qualified retirement plan. If the entertainer opted to fund a Roth IRA and subsequently needed to make a withdrawal, a nonqualified distribution is treated first as:
- a. Return of capital.
 - b. Earnings.
 - c. Part earnings and part return of capital.
 - d. Capital gain.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

28. The practitioner who has a professional athlete or entertainer as a client faces unique challenges beyond the technical tax rules. Which of the following is **not** one of those challenges? **(Page 90)**
- The rumor mill. [This answer is incorrect. Athletes and entertainers have an extensive network of peers who excel at spreading myths and misinformation about federal and state tax rules. It is important that the practitioner representing a professional athlete or entertainer be aware of the rumor mill and its impact on their client's tax return as well as their understanding of the tax system.]
 - Lack of record-keeping. [This answer is incorrect. Athletes and entertainers are absorbed in their profession and they do not take the time or have the desire to maintain detailed records. The practitioner may need to develop approaches to gather the information needed to properly prepare the tax return as well as the documentation needed to substantiate expenses.]
 - Working with investment advisors. [This answer is correct. Although many athletes and entertainers use investment advisors, this practice is not unique to the industry. Any practitioner working with individuals should be accustomed to working with investment advisors gathering information necessary to prepare the tax returns and provide planning services.]**
 - The glamour factor. [This answer is incorrect. It is easy to be swept away by the glamour factor i.e., representing a celebrity. The practitioner must always maintain the highest standards of professional responsibility and due care.]
29. A properly structured nonqualified deferred compensation agreement has which of the characteristics below? **(Page 94)**
- Spreads the payment of compensation into years after the compensation was actually earned. [This answer is correct. The purpose of a nonqualified deferred compensation agreement is to spread the payment of compensation to the athlete into years after the compensation was actually earned, thus deferring tax on the earnings until actually paid to the athlete. In addition, it can be viewed as an automatic savings technique for the athlete.]**
 - Allows a current tax deduction to the team for contributions made to the plan on behalf of the athlete. [This answer is incorrect. Unlike qualified plans, the tax deduction associated with contributions made into the plan by the team are deferred until cash distributions commence from the plan. The income recognition and deduction are matched in the same reporting period.]
 - Is designed to meet the detailed Internal Revenue Code requirements similar to pension, profit-sharing, Keogh and 401(k) plans. [This answer is incorrect. Pension, profit-sharing, Keogh, and 401(k) plans are considered qualified plans by the Internal Revenue Code and are subject to very detailed requirements. Nonqualified deferred compensation plans are not subject to the numerous restrictions, and in some cases ERISA requirements, covering qualified plans.]

- d. A negotiated agreement for all members of the team with team management. [This answer is incorrect. Nonqualified deferred compensation plan is an individually negotiated arrangement between an athlete and team.]
30. A deferred compensation plan must meet several requirements in order to defer recognition of income, including: **(Page 98)**
- a. Secured promise to pay in the future. [This answer is incorrect. It is critical that the deferred compensation plan be an unsecured promise to pay. The participant will be taxed immediately once the promise to pay becomes secure. It is treated as if property with a determinable, economic benefit is received.]
- b. **Unfunded arrangement. [This answer is correct. In order to qualify as a deferred compensation plan, the plan must be an unfunded arrangement subject to the risks of creditors. Assets may be segregated into a rabbi trust which provides the employee with security that the employer cannot refuse to pay; however, the assets of the trust are subject to risk of creditors.]**
- c. Utilization of trusts is prohibited. [This answer is incorrect. Rabbi trusts and secular trusts are still allowed; however, after 2004, the assets of a rabbi trust cannot be located outside of the U.S.]
- d. Written agreement must be executed within 30 days services commence. [This answer is incorrect. The written agreement must be executed before services are rendered. The athlete employee must elect to defer the compensation by the end of the employee's tax year preceding the year in which services are performed.]
31. Under which type of irrevocable trust arrangement does the employee receive an economic benefit? **(Page 99)**
- a. Rabbi Trust. [This answer is incorrect. Under a Rabbi Trust, the employee does not receive an economic benefit because the trust assets remain accessible to the employer's creditors.]
- b. **Secular Trust. [This answer is correct. In this type of irrevocable trust arrangement, the employee receives an economic benefit because the funded amounts are secured from both the employer and its creditors. However, the deferred amounts are subject to immediate taxation.]**
32. State taxation can be quite complex for an athlete. When prorating income among the states under the "duty day" method, which days are included in the numerator? **(Page 103)**
- a. Days the athlete spends on the injured reserve list. [This answer is incorrect. Days the athlete spends on the disabled list or the injured reserve are not duty days included in the numerator of the calculation but are considered duty days included in the denominator.]
- b. Travel days, if no game, practice, or meetings occur on that day. [This answer is incorrect. Days a player does not practice, play, or attend team meetings is not

considered duty days for the numerator of the calculation. These days include travel days, if no game, practice, or meetings occur on that day. All of these days are considered duty days for the denominator in the calculation.]

- c. Days spent on promotional activities. [This answer is incorrect. Days spent on promotional activities, and other activities falling outside the period such as instructional leagues, post-season all star games, and off-season training programs are not considered duty days for the numerator but are part of the denominator in the calculation.]
 - d. **Number of days the athlete performed in the state. [This answer is correct. The duty day method is used to apportion state income based on a ratio of which the numerator equals the number of days an athlete performed in the state and the denominator equals the total number of days from the beginning of the team's official preseason training through the last game in which the team competes. Other days may be included in the denominator based on activity.]**
33. When the player's union markets the use of player likeness and/or names on a group basis such as to trading card manufacturers, the resulting income earned by the athlete is considered what type of income? **(Page 106)**
- a. **Licensing revenue. [This answer is correct. Income earned from the use of player likeness on a group basis would be considered licensing revenue. Such revenue would be reported to the player as royalty income on Form 1099-MISC and should be reported on Schedule E of the player's federal tax return.]**
 - b. Self-employment income. [This answer is incorrect. The player did not provide services in the form of an independent contractor for this revenue. Therefore, it is not considered self-employment income.]
 - c. Compensation. [This answer is incorrect. The income earned by the union for the marketing of player likeness and/or names on a group basis is not considered compensation (wage) income. The player did not perform services as an employee to receive such income.]
 - d. Interest income. [This answer is incorrect. Interest income is earned on bond investments, bank deposits, money market accounts and certificate of deposits. It is a return earned for the use of capital. Marketing of a player's likeness does not generate interest income.]
34. Which of the following qualified plans can be structured as a defined contribution plan or a defined benefit plan? **(Page 107)**
- a. Profit-sharing plan. [This answer is incorrect. A profit sharing plan is a defined contribution plan. It provides the most flexibility for contributions.]
 - b. Simplified employee pension plan. [This answer is incorrect. A simplified employee pension plan ("SEP") is a defined contribution plan. One advantage of a SEP is that it can be established after the end of the year in which the self-employment income is earned.]

- c. **Keogh plan.** [This answer is correct. A Keogh plan can be structured as a defined contribution plan or a defined benefit plan. If a defined benefit plan is selected, contributions to the plan are actuarially determined and must be made regardless of income level.]
 - d. Traditional 401(k) plan. [This answer is incorrect. A traditional 401(k) plan is a defined contribution plan subject to deduction limitations and deferral limits. These types of plans can be fairly expensive to administer.]
35. Deductible expenses associated with an athlete's trade or business include all of the following, **except: (Page 111)**
- a. **Cost of sandpaper or cork.** [This answer is correct. Only equipment and supplies directly related to the sport are deductible, such as spikes, shoes, skates, bats, gloves, sticks and pads.]
 - b. Union dues. [This answer is incorrect. Most players belong to a union or player's association. Membership dues paid to these organizations are a deductible business expense, generally treated as a miscellaneous itemized deduction. However, the practitioner should review whether a portion of the dues can be allocated to Schedule E when licensing revenue is received.]
 - c. Clubhouse dues. [This answer is incorrect. Clubhouse dues are not synonymous with club dues. Clubhouse dues are paid by baseball players to clubhouse attendees. These payments are deductible business expenses.]
36. Which of the following expenses are deductible moving expenses? **(Page 112)**
- a. Meal expenses incurred while moving from old residence to new residence. [This answer is incorrect. The cost of meals is a nondeductible expense. It does not matter if the cost is incurred while moving from the old residence to the new residence or if paid while occupying temporary quarters in the area of the new job.]
 - b. Cost of temporary lodging while waiting to move into new residence in area of new job. [This answer is incorrect. Prior law allowed a limited deduction for temporary lodging; however, current law treats this expense as nondeductible.]
 - c. **Costs to pack, crate, store, and insure household goods and personal effects that are delivered to new residence.** [This answer is correct. The cost of transporting household goods and personal effects, including pets, from the former residence to the new residence is deductible. Costs include the cost to pack, crate, store, and insure household goods and personal effects that are delivered to the new residence.]
 - d. Expense of breaking a lease at former residence. [This answer is incorrect. Expenses of buying or selling a home or of getting or breaking a lease are considered nondeductible expenses.]

37. Many entertainers operate through a corporate form. Which of the following characteristics is a disadvantage of operating in a corporate form? **(Page 115)**
- a. Utilization of loan-out planning technique. [This answer is incorrect. Some entertainers operate through a corporation to take advantage of the loan-out planning technique whereby the corporation loans out the entertainer's services for a fee.]
 - b. Leveling of individual and corporate tax rates. [This answer is correct. The difference between the individual and corporate tax rates has steadily been diminishing. Currently, the tax rates are very similar and would result in the same amount of tax being paid by the entertainer. Administratively, it is easier to be an employee or independent contractor as opposed to operating through a corporate entity.]**
 - c. Limited liability protection. [This answer is incorrect. Many entertainers incorporate by establishing a limited liability company ("LLC"), S corporation or C corporation. All of the entities provide limited liability protection to the owner/member to protect personal assets from business-related claims.]
 - d. Prestigious form of business. [This answer is incorrect. Many entertainers want to operate through a corporation because they perceive it to be prestigious. Corporation formation must follow many formal rules of organization and it may be perceived to be a savvy way to do business.]
38. To be eligible for the "qualified performing artist" favorable above-the-line tax deduction, the artist must meet three requirements. One of these requirements includes: **(Page 118)**
- a. Expenses related to performing arts services exceed 20% of the income earned from performing arts. [This answer is incorrect. Expenses related to performing arts services must exceed 10%, not 20%, of the income earned from performing arts.]
 - b. An AGI of \$32,000 or less before the deduction of expenses related to performing arts. [This answer is incorrect. The AGI requirement is more stringent. The artist must have an AGI of \$16,000 or less before the deduction of expenses related to performing arts.]
 - c. Classification need not be an employee, deduction available to independent contractors. [This answer is incorrect. You must be an employee to take this deduction. If the artist is an independent contractor, they are already taking an above-the-line deduction by deducting their expenses against self-employment income on Schedule C. This deduction provides favorable benefits for an employee.]
 - d. Performed services for two or more employers. [This answer is correct. The artist must have performed services for two or more employers. Performing services for only one employer would disqualify the artist from taking an above-the-line deduction. The deduction would be limited to a miscellaneous itemized deduction, subject to 2% of AGI floor.]**

39. Which of the following is the primary factor influencing when an entertainer should consider establishing a qualified plan? **(Page 120)**
- a. **She generates significant self-employment income through product endorsements. [This answer is correct. Self-employed taxpayers can create significant tax, investment and cash flow advantages by establishing a qualified plan because the contributions to the plan are deductible and income is not reportable under the plan until distributions are made.]**
 - b. She has employees on her staff. [This answer is incorrect. Generally, having employees makes the administrative component of a qualified plan very cumbersome. It can be done but it definitely is not the primary factor influencing the establishment of such a plan.]
 - c. She negotiated a significant raise in her salary for the current season of her hit sitcom. [This answer is incorrect. If the entertainer is treated as an employee, she cannot establish a qualified plan. If she meets the eligibility requirements for her employer's plan, she can participate in those plans if she so desires.]
 - d. She resides in California, which has a high state tax rate. [This answer is incorrect. Although the tax deduction available for establishing and funding a qualified plan would be beneficial in a state with a high tax rate such as California, it is not the primary factor influencing the decision to establish such a plan.]
40. An entertainer may desire to shelter a portion of their income in a qualified retirement plan. If the entertainer opted to fund a Roth IRA and subsequently needed to make a withdrawal, a nonqualified distribution is treated first as: **(Page 121)**
- a. **Return of capital. [This answer is correct. Nonqualified distributions are treated first as return of capital contributions. No portion of the distribution from a Roth IRA is taxable until cumulative distributions from all the individual's Roth IRAs exceed the total amount contributed.]**
 - b. Earnings. [This answer is incorrect. Nonqualified Roth IRA distributions are not taxed as if the earnings are distributed first. The tax ramifications of such distributions are more tax friendly.]
 - c. Part earnings and part return of capital. [This answer is incorrect. A traditional IRA is governed by Internal Revenue Code Section 72 as to the taxability of distributions, which prorates the distribution among earnings and return of capital. However, Roth IRA distributions are not prorated. There is an ordering rule for the taxation of Roth IRA distributions.]
 - d. Capital gain. [This answer is incorrect. Taxable distributions from retirement accounts, including nonqualified distributions from Roth IRA accounts, are considered ordinary income.]

EXAMINATION FOR CPE CREDIT

Lesson 3

Determine the best answer for each question below. Then log onto our Online Grading Center at **OnlineGrading.Thomson.com** to record your answers.

27. Since signing bonuses can represent significant income to the athlete, practitioners should carefully plan tax payments with their clients. Bonds maturing shortly before April 15 of the following year can be an effective investment for the following reason:
- Bonds generate dividend income.
 - Tax on the income earned can be deferred for two years.
 - Bonds provide a secure and liquid source for payment.
 - Bonds can be transferred in direct payment of the tax.
28. State income tax considerations are very important in planning for signing bonuses. All of the following factors indicate a person's domicile, **except**:
- Having family members in the state.
 - Drafting a will as a resident of that state.
 - Registering to vote in that state.
 - Enrolling children in schools or other activities in that state.
29. Where are qualified payments made under a deferred compensation agreement taxable?
- In the state where the team is headquartered.
 - In the state where the deferred compensation agreement originated.
 - Apportioned among the states where the athlete previously filed tax returns.
 - In the state of residence.

30. Danny Glove is contemplating deferring a portion of his salary in a deferred compensation plan offered by his team. All of the following factors should be considered when entering a deferred compensation agreement, **except**:
- a. Financial soundness of the organization.
 - b. Length of deferral period required.
 - c. Interest rate provisions included in the contract.
 - d. Inability to defer payments further if he remains injury free.
31. Which of the following statements is a disadvantage of reporting licensing revenue as royalty income?
- a. Not subject to payroll taxes.
 - b. Subject to tax only in the state of the athlete's residence.
 - c. Inability to maximize contributions to a qualified retirement plan.
 - d. Deductibility of union dues to offset income.
32. Which of the following types of income earned by a professional athlete is considered wage income reported on Form W-2?
- a. Receiving complimentary tickets.
 - b. Attending coaching clinics.
 - c. Appearing on post-game television shows.
 - d. Making personal appearances.
33. What is the primary factor in determining the deductibility of travel expenses?
- a. The athlete's principal residence.
 - b. The athlete's location of business.
 - c. The location of the athlete's family.
 - d. The state of residence as indicated on a state income tax return.

34. Which of the following expenses represent a deductible moving expense?
- a. Travel from former residence to new residence.
 - b. Meals expense incurred while moving from old residence to new residence.
 - c. Pre-move house-hunting trip.
 - d. Closing costs for selling old residence.
35. Bobby Bat, a famous baseball player, donates an autographed picture and ball to his favorite charity to auction off at their annual gala. What is Bobby's charitable tax deduction for these items?
- a. Auction proceeds.
 - b. Sales price at the ballpark's gift shop.
 - c. One-half of the fair market value.
 - d. Actual cost of the items.
36. Bobby Bat, a famous baseball player, donates an autographed picture, ball and personal memorabilia to the National Baseball Hall of Fame in Cooperstown, New York. What is Bobby's charitable tax deduction for these items?
- a. Fair market value.
 - b. One-half of the fair market value.
 - c. Difference between fair market value and cost (appreciation).
 - d. Actual cost of the items.
37. What are payments received by actors and others for re-runs of commercials and episodic television called?
- a. Royalties.
 - b. Licensing fees.
 - c. Commissions
 - d. Residuals.

38. Which of the following categories of professional income received by an entertainer is **not** subject to self-employment tax?
- a. Residuals for performances previously given.
 - b. Compensation for services rendered as an independent contractor.
 - c. Royalties from merchandise or licensing which do not involve any personal services.
 - d. Royalties for musical performances, compositions, and screenplays.
39. Expenses related to which category of income earned by an entertainer are deductible as itemized deductions?
- a. Royalties for musical performances, compositions, and screenplays.
 - b. Wages received for services rendered as an employee.
 - c. Royalties from merchandise or licensing which do not involve any personal services.
 - d. Residuals for performances previously given.
40. Which of the following distributions is considered a qualified distribution from a Roth IRA? (Assume the taxpayer made a contribution to the Roth IRA six years ago.)
- a. Disability of the taxpayer.
 - b. On or after the taxpayer is age 55½.
 - c. Elementary and secondary education expenses.
 - d. Home purchase expenses.

Glossary

Charitable Contributions – Money or property donated to a qualified charitable organization. Such donations are deductible on Schedule A as an itemized deduction.

Compensation – Wages, commissions, tips, professional fees, and net self-employment income from services rendered—earned income.

Deferred Compensation – A term used in federal income taxation for provisions for pension plans, profit-sharing plans, stock bonus plans, bond purchase plans, individual retirement plans (IRA's), and Keogh (HR-10) plans as described under Subchapter D of the Internal Revenue Code.

In all of these plans the Code contains detailed and complex rules under which compensation earned currently can be taxed in a later year when the compensation is actually received.

Domicile – An individual's permanent home and to which, whenever absent, the individual has the intent of returning. A domicile is also the legal home of a corporation—the home state.

Fair Rental Value – The amount the owner of property could reasonably expect to receive from a stranger for the same type of lodging. Generally, it is the amount at which a home with its furnishings could be rented to a similar-size family in a similar location.

Federal Insurance Contributions Act (FICA) – The law that provides for social security and Medicare benefits. This program is financed by payroll taxes imposed equally on the employer and employee. The employer is required to withhold a percentage from each employee's gross wages for Medicare tax and a percentage of each employee's wages for social security tax.

Individual Retirement Account (IRA) – A retirement plan created and contributed to by the taxpayer. It may create a limited deduction—contributions are deductible only if the taxpayer is *not* covered by any qualified tax-deferred retirement plan [Keogh, 401(k), or other employer-sponsored plan] or if the adjusted gross income (AGI) of the taxpayer is below certain specified levels. It is sometimes referred to as a *traditional IRA*.

Itemized Deductions – Deductions from adjusted gross income (AGI) that must be listed separately (on Schedule A of Form 1040) and must meet certain specified limitations, usually a percentage of AGI that must be exceeded before an amount is allowable. They are an alternative to—used when exceeding—the standard deduction, and are not necessarily dollar-for-dollar deductions.

Inventory – The aggregate of items of tangible personal property owned by the business (to which the firm has legal title) intended either for internal consumption or in the production of goods for sale.

Parsonage Allowance – The rental value of a home, or an amount designated as a housing allowance, may be excluded from the taxable income of an individual who performs the sacerdotal functions in the conduct of religious worship (i.e., a minister of the gospel), to the extent the amounts so designated are actually used to rent or provide a home for the individual and their family.

Providing a home not only includes the dwelling, but the furnishings, as well as the maintenance and upkeep.

The parsonage allowance must be designated in some official action or writing in the records of the religious organization or in the employment contract with the individual.

Qualified Retirement Plan – Qualified retirement plans, or qualified plans, are defined in IRC Section 4974(c) to be any of the following:

- A plan described in IRC Section 401(a) that includes a trust exempt from tax under IRC Section 501(a)
- An annuity plan described in IRC Section 403(a)
- An annuity contract described in IRC Section 403(b)
- An IRA (individual retirement account) described in IRC Section 408(a)
- An IRA annuity described in IRC Section 408(b)

To be qualified, the plan must follow the rules established by the IRS. When the plan is qualified under the IRS rules, the employer receives an immediate deduction for contributions to the plan, the income from the plan assets is not taxable, and the employee is taxed on the income only upon distribution from the plan.

Royalty Income – Payment received for the right to exploit a taxpayer's ownership of natural resources or a taxpayer's literary, musical, or artistic creation.

Self-employment Income – Self-employed individuals are taxed on their net income from self-employment and are entitled to social security and Medicare benefits through the payment of self-employment tax.

Trade or Business Expense – Expenses of a trade or business activity of any kind, regardless of whether or where organized, whether owned individually or otherwise, and regardless of the place of operation.

Index

A

Accountable Plan54
 Architects13

C

Calculation of Self-employment Tax.....41
 Cash Method of Accounting2
 Catch-up Contributions63
 Charitable Contributions—Athletes112
 Christian Science Practitioners and Readers31
 Church and Religious Order Defined28
 Client Expense Advances3
 Clubhouse Dues.....112

D

Deductibility of Health Insurance Costs.....59
 Deductible Expenses – Athletes.....108
 Deferred Compensation and Retirement Plans—
 Entertainers.....120
 Deferred Compensation Arrangements—
 Athletes95
 Deferred Compensation Rules99
 Dental Supply Costs.....13
 Duty Days Concept95, 103

E

Earned Income Credit63
 Electing Out of Self-employment Tax and
 FICA Coverage34
 Employee versus Independent Contractor46
 Employment Tax Issues.....34
 Endorsements and Appearance Fees.....106
 Equipment and Supplies for Athletes111
 Estimated Tax Payments—Athletes.....113
 Excluding Employees from FICA Coverage38
 Expenses Allocable to Tax-free Income.....56

F

Foreign Athletes and Entertainers.....114
 Foreign Earned Income.....54
 Form 4029.....40
 Form W-2 Reporting.....40
 Fringe Benefits—Ministers58

H

Health Care Professionals6
 High Compensation.....2
 Home Ownership49

I

Income Tax Issues—Ministers46
 IRA for Retirement Savings—Entertainers121
 IRC Sec. 49587
 Irrevocable Trust Arrangements.....99
 IRS Audit Issues.....64

L

Loan-out Corporation121

M

Members of Recognized Religious Sect32
 Members of Religious Orders31
 Minimizing Taxes on Personal Services Income91
 Minister Audit Technique Guide (ATG)64
 Minister Defined29
 Ministerial Business Expenses as Employee55
 Ministers’ Unique Tax Provisions27
 Moving Expenses—Athletes112

N

Nonaccountable Plans54

O

Office-in-home Expenses58
 Optometrist’s Disabled Access Credit13
 Optometrist’s Inventory13
 Other Income Earned by an Athlete106

P

Parsonage or Housing Allowance48
 Payments to “Of Counsel” Attorneys4
 Payroll Tax Reports.....40
 Physician Compensation Arrangements8
 Physician Employment Status.....11
 Physician Joint Ventures with Nonprofits11
 Physician Recruitment and Retention9
 Physician’s Gainsharing Arrangements10
 Political Activity by Religious Leaders65
 Professional Athletes90
 Professional Entertainers.....115
 Professional Goodwill.....1
 Prohibited Private Inurement or Private Benefit6
 PSC Restrictions2
 Pure Endorsements106

Q

Qualified Retirement Plans 107
 Qualifying as a Minister 28

R

Rabbi Trusts 99, 101
 Reimbursement Arrangements 54
 Rental Allowance 49
 Reporting Requirements 5
 Retirement Plans and IRAs 60

S

Secular Trust 99
 Self-employment Tax on Retirement Benefits of
 Ministers 45
 Selling Self-created Musical Works 118
 Signing Bonuses 91
 Sources of Income—Entertainers 115
 Starving Artist Entertainers 118
 State Income Tax Planning—Entertainers 118
 State Income Taxation 102
 State Licensure 1

T

Taxable Income versus Gifts 47
 Tax-sheltered Annuities 62
 Theological Students 31
 Training Costs, Off-season 111
 Travel Expenses—Athletes 109
 Trust Accounts 2

U

Union Dues 111
 Unlimited Personal Liability 1

V

Veterinarians 13
 Vow of Poverty 34

Testing Instructions for Examination for CPE Credit

Individuals: Special Tax Situations (DSSTG10)

1. Following these instructions is information regarding the location of the **CPE CREDIT EXAMINATION QUESTIONS**.
2. Log on to our Online Grading Center at **OnlineGrading.Thomson.com** to receive instant CPE credit. Click the purchase link and a list of exams will appear. Search for an exam by selecting Gear Up/Quickfinder in the drop-down box under Brand. **Payment of \$27** for the exam is accepted over a secure site using your credit card. Once you purchase an exam, you may take the exam three times. On the third unsuccessful attempt, the system will request another payment. Once you successfully score 70% on an exam, you may print your completion certificate from the site. The site will retain your exam completion history. If you lose your certificate, you may return to the site and reprint your certificate.
3. To receive CFP® credit, you must provide your name and CFP license number within the Online Grading Center. If Thomson Reuters does not receive your name and license number within 30 days of completion, the CFP Board will **not** award you credit.
4. Please direct any questions or comments to our Customer Service department at (800) 323-8724.

Examination for CPE Credit

To enhance your learning experience, examination questions are located immediately following each lesson. Each set of examination questions can be located on the page numbers listed below. The course is designed so the participant reads the course materials, answers a series of self-study questions, and evaluates progress by comparing answers to both the correct and incorrect answers and the reasons for each. At the end of each lesson, the participant then answers the examination questions and records answers to the examination questions by logging on to the **Online Grading System**. For more information on completing the **Examination for CPE Credit**, see the **Testing Instructions** on the preceding page.

<u>CPE Examination Questions</u>	<u>Page</u>
Lesson 1	25
Lesson 2	83
Lesson 3	133