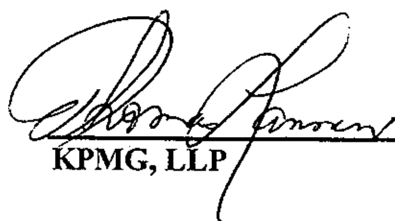
Greek Orthodox

Archdiocese

Of America

Executive Summary and Converting Priests' Remuneration From 1099 to W-2

Our conclusions are limited to the conclusions specifically set forth herein and are based on the completeness and accuracy of the above-stated facts, assumptions and representations. If any of the foregoing facts, assumptions or representations is not entirely complete or accurate, it is imperative that we be informed immediately, as the inaccuracy or incompleteness could have a material effect on our conclusions. We are relying upon the relevant provisions of the Internal Revenue Code of 1986, as amended, the regulations thereunder, and the judicial and administrative interpretations thereof. These authorities are subject to change, retroactively and/or prospectively, and any such changes could affect the validity of our conclusions. We will not update our advice for subsequent changes or modifications to the law and regulations or to the judicial and administrative interpretations thereof.



KPMG, LLP

Executive Summary - Active Priests

Effective January 1, 2001, the Greek Orthodox Archdiocese of America will change its method of reporting priests' remuneration from Form 1099, *Miscellaneous Income*, to Form W-2, *Wage and Tax Statement*. The Internal Revenue Service ("IRS") filing requirements, tax deposit provisions, and record keeping are substantially different for reporting remuneration on Form W-2. Each parish must insure that the proper records are maintained to satisfy the necessary payroll tax filing requirements and deposits. In addition, the priests should consider the related tax reporting, tax deposit and tax filing requirements associated with this change. Presented below is a summary of specific payroll requirements which will be affected.

- The IRS considers the clergy (i.e., all ordained ministers including Priests and Bishops) to be employees of the Archdiocese for federal income tax purposes and self-employed for Social Security and Medicare tax purposes. Because of their self-employed status, clergy are required to pay self-employment tax (SECA). The parish cannot withhold Social Security and Medicare tax as they do for lay employees.

- Each priest must decide the method by which his estimated tax liability will be remitted. Income tax payments generally are remitted to the IRS through withholding on their remuneration and/or through estimated tax payments. Typically, federal income tax withholding occurs evenly throughout the year, whereas estimated tax payments are payable on April 15, June 15, September 15 and January 15. Although no income tax is required to be withheld, if desired, a priest's entire tax liability (both the portion arising from federal income tax as well as SECA tax) may be remitted through federal tax withholding on their remuneration. This withholding can be accomplished by requesting the parish withhold an additional flat dollar amount from each paycheck.

- Each priest must also determine whether or not he wants the parish to withhold for state income tax purposes or pay the liability through estimated tax payments. The estimated state tax payments are payable on the same dates as federal payments.

- All remuneration included in box 1 of Form W-2 will be reported on line 1 of the priest's Form 1040, *U.S. Individual Income Tax Return*, rather than on Schedule C, *Profit or Loss from Business*.

- Any offerings for marriages, baptisms, funerals or liturgies paid through the church will be included as remuneration on Form W-2. However amounts

paid directly to the priest from parishioners would be reportable by the priest on Schedule C. The priest would be able to offset this income with any expenses incurred directly in connection with the income earned.

- The fair rental value of a parsonage provided by the church or a designated rental/housing allowance paid to the priest will not be included in taxable income. However, the amount will be subject to self employment tax.

- For priests who do not live in housing provided by the parish, it is important that documentation be maintained substantiating the amounts expended for housing. Allowable expenditures include rent, mortgage payments, utilities, property taxes, repairs, and maintenance. However, please note if the housing allowance exceeds the actual costs incurred, the excess is to be included as income for federal tax purposes.

- All unreimbursed business expenses should be reported by the priest on Form 2106, *Employee Business Expenses*, rather than on Schedule C. The amount of unreimbursed business expenses will be subject to a two percent adjusted gross income disallowance. Furthermore the priest will only receive a deduction if his itemized deductions (i.e., state taxes, charitable contributions, and unreimbursed business expenses) exceed the standard deduction ($4,400 in 2000 for unmarried and $7,350 for married filing jointly). In connection with the reporting of unreimbursed business expenses, it is imperative that the priest maintain adequate records to substantiate the expenses incurred. Adequate records would consist of written evidence maintained in an account book, diary, statement of expense or similar record. All documentary evidence, such as receipts, canceled checks, or bills should be retained to support each statement of expense.

- A priest must allocate a portion of the unreimbursed expenses to tax-free income such as rental/housing allowances. However, home mortgage interest and real estate taxes are not subject to this limitation. A priest must figure the portion of otherwise deductible expenses that cannot be deducted by multiplying the expenses by a fraction that represents the tax free portion of total remuneration. The fraction's numerator is the tax free rental or housing allowance. The denominator is all income earned from ministerial activities (including stipends and any income reported on Form 1099). If a priest has tax free rental or housing allowance and deductible ministerial expenses a statement showing the allocation should be attached to his tax return. If a priest uses the standard deduction, then this rule will have no effect on his taxable income.

Overview

Effective January 1, 2001, the Greek Orthodox Archdiocese of America will change its method of reporting priests' remuneration from Form 1099, *Miscellaneous Income*, to Form W-2, *Wage and Tax Statement*. The Internal Revenue Service ("IRS") filing requirements, tax deposit provisions, and record keeping are substantially different for reporting remuneration on Form W-2. Each parish must insure that the proper records are maintained to satisfy the necessary payroll tax filing requirements and deposits. In addition, the priests should consider the related tax reporting tax deposit and filing requirements associated with this change. Presented below is a summary of specific payroll requirements which will be affected.

Federal Taxes

The IRS considers the clergy (i.e., all ordained ministers including Priests and Bishops) to be employees of the Archdiocese for federal income tax purposes and self-employed for Social Security and Medicare tax purposes. Because of their self-employed status, clergy are required to pay self-employment tax (SECA). The parish cannot withhold Social Security and Medicare tax as they do for lay employees.

Each priest must decide the method by which his estimated tax liability will be remitted. Income tax payments generally are remitted to the IRS through withholding on their remuneration and/or through estimated tax payments. Typically, federal income tax withholding occurs evenly throughout the year, whereas estimated tax payments are payable on April 15, June 15, September 15 and January 15. Although no income tax is required to be withheld, if desired, a priest's entire tax liability (both the portion arising from federal income tax as well as SECA tax) may be remitted through federal tax withholding on their remuneration. This withholding can be accomplished by requesting the parish withhold an additional flat dollar amount from each paycheck.

The priests may request income tax withholding by submitting a completed Form W-4, *Employee's Withholding Allowance Certificate,* (see discussion below) to the parish.

Payroll Tax Forms

- *Form W-4, Employee's Withholding Allowance Certificate* - A completed Form W-4 must be obtained from each priest regardless of whether or not he elects to have taxes withheld from his wages. Priests who do not request withholding should complete only lines 1, 2, 3, 4 and 7 and sign the form. This form should not be filed with the IRS, but should be retained in the parish files. A blank copy of this form is included at Appendix A.

- *Form I-9, Employment Eligibility Verification* - A completed Form I-9 must be obtained from each priest. Section 1 is completed by the priest and Section 2 is completed by the parish. The parish is required to examine one or more forms of identification to verify employment eligibility. A blank Form I-9 and a list of acceptable documents which may be examined is included at Appendix B.

- *Payroll Tax Withholding* - The appropriate amount of payroll taxes to be withheld should be computed as follows:

  Federal Income Tax - The amount of federal income tax to be withheld is determined by reference to the information provided on the priest's Form W-4, discussed above. Tables are provided by the IRS in Circular E, *Employer's Tax Guide*. These tables set forth the appropriate withholding amounts for various payroll periods and withholding allowances claimed.

  Social Security and Medicare Tax - The combined Social Security and Medicare tax rate is currently 15.3 percent, one-half of which is paid by employers. The other half is withheld from employees' wages. Unlike non-clergy employees, **Social Security and Medicare tax cannot be withheld from or paid on behalf of priests and other members of the clergy.** If a parish provides an allowance towards a portion of the SECA tax, such portion is includible in the priest's income reported on Form W-2. However, since priests are subject to SECA, they may elect to have additional federal tax withheld to cover the SECA tax. If the priest does not elect to have an additional amount withheld, the SECA tax should be included in his quarterly estimated tax payments.

- *Payroll Tax Deposits* - Each parish is required to deposit its payroll tax liability by mailing or delivering a check, money order, or cash along with Form 8109, *Federal Tax Deposit Coupon*, to an authorized financial institution or federal reserve bank. If a parish's total deposits of Social Security, Medicare, and withheld federal income taxes were more than $200,000 in 1998 or 1999, then all depository tax liabilities that occur after 1999 must be made electronically. The Electronic Federal Tax Payment System (EFTPS) must be used to make electronic deposits. If you believe you are subject to EFTPS see Appendix C for additional information. Please note that the penalties for noncompliance are 10% of the amount required to have been deposited electronically.

  A parish is either a monthly or semi-weekly depositor depending upon the amount of its total federal employment tax liability for the previous four quarters. Monthly depositors are those employers whose total taxes for the four consecutive quarters ending on June 30 of the prior year were less than $50,000. Employers with total

taxes of $50,000 or more for the four consecutive quarters ending on June 30 of the prior year, are semi-weekly depositors. A parish which has not incurred an employment tax liability in the previous four quarters is considered to be a monthly depositor. If a parish's total federal employment tax liability for a quarter is less than $500, neither monthly nor semi-weekly deposits are required. The entire liability can be remitted with Form 941, *Employer's Quarterly Federal Return*, discussed below.

A monthly depositor is required to deposit its employment tax liability by the 15th day of the subsequent month. A semi-weekly depositor is required to deposit its employment tax liability by the following Wednesday for payments made on a Wednesday, Thursday, or Friday. Liabilities arising from payments made on Saturday, Sunday, Monday or Tuesday must be deposited by the following Friday. For payroll tax deposit purposes, an employer incurs tax liability on the date wages are paid. Thus, payroll taxes relating to checks paid on a Friday are due by the following Wednesday. If a deposit is required to be made on a day that is not a banking day, such as a Saturday, Sunday or federal holiday, the deposit is considered timely if it is made by the close of the next banking day.

- *Payroll Tax Returns* - Payroll tax returns should be prepared and filed as follows:

  Form 941, *Employer's Quarterly Federal Tax Return* - This return is prepared and filed quarterly. Form 941 summarizes the parish's payroll tax liability and corresponding deposits for the preceding quarter. The return is due on or before the last day of the month following the end of the quarter; specifically, April 30, July 31, October 31, and January 31. A blank copy of this form is included at Appendix D. It should be noted that since clergy are self-employed for Social Security and Medicare tax purposes, their remuneration will not be included when calculating the parish's portion of Social Security and Medicare tax. Therefore, the priest's remuneration will only be included on line 1 of Form 941 and not on lines 6 and 7.

  Forms W-2 and W-3, *Wage and Tax Statement and Transmittal of Wage and Tax Statement* - These forms are prepared and filed annually. Form W-2 reports the priest's earnings and withholdings for the year. The priests' copies of Form W-2 must be distributed by January 31 of the following year. Form W-3 and an additional copy of Form W-2 must be filed with the Social Security Administration by February 28 of the following year. Blank copies of these forms are included at Appendix E.

State Requirements

A majority of the states require each parish that pays taxable wages to deduct and withhold state income taxes. If the IRS relieves an employer from withholding, such determination applies for state purposes. Thus, since the IRS has determined that

withholding is not required for clergy, a parish will not be required to withhold for state purposes. Furthermore, electing to withhold for federal purposes, does not automatically make withholding for state purposes mandatory. Employees and wages for state income tax purposes is the same as the federal definition.

Clergy Remuneration

The IRS will classify most priests as dual status taxpayers. They are considered self employed for social security tax purposes, but employees for income tax purposes. The IRS has devised a 20-point test to determine the manner in which an individual should report his income. Using this test, most priests assigned to parishes will have more characteristics of an employee than of an independent contractor. Therefore, remuneration received by a priest is reportable on Form W-2.

Priests' earnings for services performed in the capacity as a priest are subject to self employment tax. Priests are individuals who are duly ordained, commissioned, or licensed by a religious body constituting a church or a church denomination. They are given the authority to conduct religious worship and administer sacraments according to the prescribed tenets and practices of that church or denomination.

Even though a priest is considered self employed in performing his ministerial services for social security tax purposes, he is normally considered an employee for income tax or retirement plan purposes. Thus, some of a priests' income will be considered income from self employment and other income may be considered income from wages.

Remuneration Includible in Taxable Income

The portion of a priest's remuneration which is considered wages is subject to federal income tax. The annual wage amount is reported on Form W-2. Since priests are considered employees for income tax purposes, wages paid to priests should be reported on Form W-2. A priest's wages include, but are not limited to:

- regular payments made by the church for services rendered
- payments while on leave
- non-qualified moving expense reimbursements and/or payments
- payments to assist priests with their SECA tax

If the above income is not included on Form W-2 then the parish could be subject to an under reporting penalty of $50 per occurrence. See Section Seven for additional discussions.

Other income subject to both federal income and self employment tax but not included as wages on Form W-2 would be reported by the priest on Schedule C of their Form 1040. This income would include honoraria and amounts given directly to a priest for the performance of sacerdotal functions such as weddings, funerals, and baptisms and other services. Any expenses directly related to amounts not received from the church can be deducted on Schedule C as self employment expense rather than on Form 2106.

Gross earnings from self employment for social security tax purposes include all of the above items plus the fair rental value of a parsonage provided by the church or rental/housing allowance paid to the priest. In computing the amount subject to self employment tax a priest is allowed to deduct from the above income any nonemployee ministerial expenses (i.e., expenses directly incurred in producing non church paid income), and allowable unreimbursed trade or business expenses incurred in performing ministerial services as an employee of the church (i.e., unreimbursed business expenses reflected on the priests' Form 2106 whether or not his itemized deductions exceed the standard deduction). These expenses are not reduced by the nondeductible portion allocated to tax-free income.

Housing or Rental Allowance (Parsonage Allowance)

The term "rental allowance" encompasses both amounts paid to a priest for lodging and housing expenses as well as the fair rental value of a residence provided by the church. Such rental allowance is not subject to federal income tax if it is designated, prior to its payment, as rental allowance pursuant to official action taken by the church or other qualified organization. The designation of an amount as rental allowance may be evidenced in an employment contract, in minutes of or in a resolution by a church or

other qualified organization or in its budget, or in any other appropriate instrument evidencing such official action. To the extent that such allowance is not used by the priest during a taxable year to rent or otherwise provide a home, the excess rental allowance must be included in the priest's gross income in the taxable year in which it is received. The IRS allows the housing allowance exclusion as long as the amount of the allowance or the fair market value of the home provided is reasonable. Thus parishes and/or the diocese should periodically review the priests total remuneration (salary and housing) to insure it is reasonable for the area served. Amounts expended for housing include rent, mortgage, interest, utilities, repairs, and property taxes. However, it does not include payments for maid, pool, or lawn type services.

Although excluded from income for income tax purposes, the rental allowance must be included in a priest's self employment income. The fair rental value represents the amount of rent that would be paid in an arms length transaction on the open market. In addition, utilities paid by the parish for parish provided housing must be included in the determination of the fair rental value. Although the rental allowance and/or fair rental value of housing provided is not required to be reported to the priest, the parish may report the amount on the priests' Form W-2 in box 14, "Other."

In *Deason v. Commissioner*, the court ruled that to the extent a minister has tax free income, a portion of the related expenses are not deductible. No deduction shall be allowed for an amount otherwise deductible which is allocable to a class of income other than interest which is wholly exempt from Federal income taxation. Therefore, a priest must allocate a portion of the expenses of conducting his ministry to tax-free income such as rental/housing allowances. However, home mortgage interest and real estate taxes are not subject to this limitation. A priest must figure the portion of otherwise deductible expenses that cannot be deducted, by multiplying the expenses by a fraction that represents the tax free portion of total remuneration. The fraction's numerator is the tax free rental or housing allowance. The denominator is all income earned from ministerial activities (including stipends and any income reported on Form 1099). If a priest has tax free rental or housing allowance and deductible ministerial expenses a statement showing the allocation should be attached to his tax return.

The effect of the "Deason Rule" on the priests will be determined on a case by case basis. If a priest uses the standard deduction, then this rule will have no effect on the priests' taxable income. Deductions are not required to be reduced in computing self employment income, as the housing allowance is subject to self employment tax.

Business Expenses

When the Archdiocese converts from reporting priests' remuneration from Form 1099 to Form W-2, the reporting of unreimbursed business expenses by the priests on their individual income tax returns will change. Traditionally, the priests have reported their income on Schedule C of Form 1040. The income has been offset by any unreimbursed expenses incurred in conjunction with earning the income. The income after expenses was the taxable income for federal income tax purposes. When the conversion is made to Form W-2 reporting, the priests will no longer report income paid from the church on Schedule C. It will be reported on line 1 of Form 1040. Consequently, no related business expenses will be reported on Schedule C. All unreimbursed business expenses will be reported on Form 2106. See copy included at Appendix F. These expenses will then flow to Schedule A and be deductible only if a priest's itemized deductions exceed his standard deduction ($4,400 in 2000 for unmarried and $7,350 in 2000 for married filing jointly) and only to the extent that the unreimbursed expenses exceed 2% of the priest's adjusted gross income. For example:

> Priest A had income from the church of $30,000 and unreimbursed business expenses of $2,000. Prior to the reporting change the priest would report $30,000 of income less $2,000 of expenses on Schedule C thus, $28,000 would be subject to tax. Under the new process, the priest would show $30,000 as wages and assuming the priest's total itemized deductions exceed his standard deduction he would be able to deduct $1,400 of the unreimbursed business expenses ($30,000 x 2% - 2,000). Thus, $28,600 would be subject to income tax.

Business Expenses Defined

Business expenses are broadly defined as all ordinary and necessary expenses paid or incurred during a taxable year in carrying on any trade or business. An employee may deduct unreimbursed expenses as long as they relate to the employee's business of being an employee. The primary unreimbursed employee business expenses incurred by a taxpayer are:

- Transportation/Auto - Amounts spent for the operation and maintenance of an automobile are deductible as a business expense to the extent that they represent the cost of transportation actually required in carrying on the employee's business. Employees can use either the standard mileage rate (31¢ for tax year 2000) or actual expenses in computing the deductible costs of operating an automobile. When utilizing the standard mileage method, the employee's deductible auto expense is calculated by multiplying the total business miles (not including commuting miles) times the standard mileage rate. If an employee elects to utilize the actual expenses incurred then he must

first calculate the business use. This is done by dividing the business miles by the total miles driven during the year. The result is the percentage business use. The employee's actual expenses are multiplied by the business use percentage to determine the deductible expense. If the employee elects to use actual expenses rather than the standard mileage method, a deduction for depreciation is allowed subject to several limitations. First, in order to use an accelerated method of depreciation, the automobile must be used at least 50% for business, otherwise the straight line method is used. Additionally, the IRS limits the deduction in any year to prescribed amounts based on the year placed in service. Thus, for an automobile placed in service in 1999, the maximum allowable deduction would be $3,060. This assumes a 100% business use. If the business use was less than 100% then the deduction would be limited to $3,060 times the business use percentage.

> For example, a priest purchases a car in 1999 for $16,000 and uses it 60% for business purposes. The allowable deduction for 1999 would be $1,836 (3,060 x 60%).

Once a method is elected it must be maintained until a new vehicle is purchased unless the business use percentage drops below 50%. If the accelerated method is elected and in a subsequent year the business use drops below 50% then the straight line method must be used for the remainder of the depreciation life.

Depreciation is reported on Form 4562, *Depreciation and Amortization*, as well as Form 2106, *Employee Business Expenses*. Regardless of the method used, it is extremely important that the taxpayer maintain a complete and accurate log of the miles driven and business purpose.

- Travel - Travel expenses are the ordinary and necessary expenses of traveling away from home for an employee's business, profession, or job. An employee is considered to be traveling away from home if the duties require him to be away from the general area of his tax home substantially longer than an ordinary day's work and sleep or rest is needed to meet the demands of work while away from home. Deductible travel expenses include transportation (i.e., airfare, train, bus, car or taxi), lodging, meals, laundry, telephone, tips and other ordinary and necessary expenses related to business travel.

- Business meals and entertainment - Generally a deduction is allowed for ordinary and necessary expenses to entertain parishioners, visiting clergy, or laity if the expenses meet the directly-related test or the associated test. Entertainment includes any activity generally considered to provide

entertainment, amusement, or recreation, and includes meals provided to parishioners, clergy or laity. The expense is directly related if the entertainment takes place in a clear business setting, the main purpose of the entertainment was the active conduct of church business, and the employee did in fact engage in business. Furthermore, the employee must have more than a general expectation of receiving some specific benefit at some future time. An expense meets the associated test if the entertainment was associated with the employee's trade or business and the entertainment directly precedes or follows a substantial business discussion. A deduction is only allowed to the extent the expense is not lavish or extravagant under the circumstances. Additionally, the deduction is limited to 50% of the unreimbursed costs.

- Business gifts - A deduction is allowed for business gifts given directly or indirectly to any one person during the year. A business gift is a gift given with the intent of some future benefit. The deduction is limited to $25 per gift per person. Incidental costs, such as engraving on jewelry, packaging, insuring and mailing are generally not included in determining the cost of the gift for purposes of the $25 limit.

Other unreimbursed business expenses include but are not limited to:

- Continuing education courses
- Subscriptions to professional journals and books used in the trade or business
- Professional dues
- Professional uniforms, including vestments, but not everyday clothes
- Long distance telephone calls made for business purposes
- Cellular phones to the extent used for business
- Professional supplies to the extent not provided by the employer. These would include religious software, homiletic aids and religious supplies.

Although the above expenses are limited to two percent of adjusted gross income for income tax purposes, the full amount can be offset against income for self employment tax purposes. Thus, if a priest has income of $30,000, housing allowance of $10,000 and unreimbursed business expenses of $5,000, his net self employment income would be $35,000. Self employment tax would be calculated on the $35,000, rather than the $40,000, of gross self employment income.

An employee must maintain adequate records to substantiate the expenses incurred. Written evidence has considerable more value than oral evidence alone, and generally an employee must prepare a written record for it to be considered adequate. The proof

needed to substantiate expenses should be maintained in an account book, diary, statement of expense, or similar record. All documentary evidence, such as receipts, canceled checks, or bills should be retained to support each statement of expense. Although receipts are not required when a per diem allowance is received from an employer, if the expense other than lodging is less than $75, or a transportation expense has been incurred for which a receipt is unavailable, it is advisable to retain all receipts relating to expenditures. Documentary evidence will normally be considered adequate if it shows the amount, date, place, and purpose of the expense. If an employee is claiming an automobile deduction, the business miles must be documented. A log showing the beginning and ending odometer reading along with a description of the business purpose of the trip (i.e., hospital visit) is the best evidence of business miles. Records of expenses should be maintained for at least 3 years. Failure to maintain adequate records could result in the disallowance of the deduction. See Appendix G for a chart from an Internal Revenue Service Publication, depicting examples of the required substantiation.

Accountable Reimbursement Plans

Typically, employers reimburse employees for amounts expended on behalf of the employer as well as for travel; marketing and public relation activities paid for by employees. The following is a general overview of the rules relating to expense allowances and other reimbursements of employee's business expenses.

There are two types of reimbursement and other expense arrangements: (1) Accountable Plans and (2) Nonaccountable Plans. Payments made under an Accountable Plan are excluded from an employee's gross income and are exempt from income and employment tax withholding and reporting requirements. Conversely, amounts paid under a nonaccountable plan are included in the employee's gross income and are subject to withholding and payment of employment taxes. Amounts paid under a nonaccountable plan are deductible to the employee only as a miscellaneous itemized deduction subject to a two percent of adjusted gross income disallowance.

A plan is considered an accountable plan if it meets three requirements:

1. The expenses must have a business purpose.
2. The expenses must be substantiated.
3. Excess payments must be returned within a reasonable period.

The first requirement of an accountable plan provides that advances, allowances (including per diem allowances) and reimbursements must be for business expenses paid or incurred in their performance of services as employees. If both the reimbursement or other expense allowance and wages are combined in a single payment, the payment must

specifically identify the amount of the reimbursement or other expense allowance. Allowable business expenses include; but are not limited to:

- traveling expenses
- meals and entertainment
- transportation
- professional dues
- professional supplies

If an employer arranges to pay an amount to an employee regardless of whether the employee incurs (or is reasonably expected to incur) business expenses, the arrangement does not have a business connection and is therefore treated as paid under a non-accountable plan.

The second requirement provides that advances, allowances, and reimbursements for business expenses must be substantiated. Substantiation is met by the employee providing the employer with sufficient information to enable the employer to identify the specific nature of each expense and to conclude that the expense is attributable to the employer's business activities. The information should identify the amount, time, place and business purpose for the expenses. One way to adequately account for expenses is for the employee to maintain an account book, diary, log, statement of expense, trip sheet or similar record. If entertainment or meals are to be reimbursed, the individuals present for the entertainment or meals should be documented as well as the specific business matter that was discussed. Entertainment includes any activity generally considered to provide entertainment, amusement or recreation such as golf, tickets to shows or sporting events.

The IRS requires receipts for travel and entertainment expenses only when those expenses are $75 or more for each reimbursable item. Although not required by the IRS, typically employers require that all expenses, other than tips and minor incidentals, submitted for reimbursement be accompanied by a receipt.

Substantiation requirements for automobile expenses are relatively simple when the employer reimburses such expenses on a per-mile basis. Rather than keeping an exact record of the amount paid for gasoline, insurance, and other costs, the employer reimburses the employee for his business mileage at the applicable standard mileage rate which for 2000 is 31¢ per business mile driven. (Note, commuting from one's home to work and back is not considered business mileage.)

Many times the requirements for substantiating actual travel and entertainment expenses of employees is too burdensome for both the employee and the employer. In this case, the use of a per diem allowance should be considered. An employee's ordinary and

necessary business expenses for lodging, meals and incidental expenses incurred while traveling away from home are deemed substantiated when an employer provides a "per diem allowance" under a reimbursement or other expense allowance arrangement that meets the accountable plan requirements discussed above. In order for the employer to use a per diem allowance to meet the substantiation requirements, the per diem allowance must be a payment that:

(1) is paid with respect to ordinary and necessary business expenses incurred by an employee for lodging, meals, and/or incidentals while away from home in connection with the performance of services as an employee,

(2) it must be reasonably calculated not to exceed the actual or anticipated expenses, and

(3) it must be paid at the applicable federal per diem rate, at a flat rate or stated schedule, or in accordance with any other service - specified rate or schedule.

The federal per diem rate is defined as being equal to the sum of the federal lodging expense rate and the federal meal and incidental expense (M&IE) rate for the locality of travel. Incidental expenses include but are not limited to, expenses for laundry and tips. It does not include taxicab fares or telephone calls. These are rates which apply to federal employees and are published each year in IRS Publication 1542 (see Appendix H). It is important to note that these federal rates can be combined or used separately. An allowance is considered to be paid according to a "flat rate or stated schedule," if it is provided on a uniform and objective basis with respect to lodging and meals and incidental expenses incurred by an employee. Such allowance may be paid with respect to the number of days away from home or any other basis that is consistently applied in accordance with reasonable business practices. If an employer pays a per diem allowance in lieu of reimbursing actual expenses for lodging, meal and incidental expenses incurred by an employee for travel away from home, the amount of the expense that is deemed substantiated for each calendar day is equal to the lesser of the per diem allowance for such day or the amount computed at the Federal per diem rate for the locality of travel. However, to the extent that the employee does not spend the full amount received under the allowance method, the employee must remit the excess to the employer or risk his reimbursements being treated as if made by a non-accountable plan.

An alternative per diem method, known as the high-low method, can be used to substantiate lodging, meal and incidental expenses in lieu of the federal per diem rates under Publication 1542. Under the high-low method, the expenses deemed substantiated by the company are equal to the lessor of the allowance paid or $185 per day for travel to high cost areas and $115 per day for travel to other areas. Whichever per diem rate applies, it is applied as if it were the Federal per diem rate for the locality of travel. For

purposes of applying the high-low substantiation method, the Federal M&IE rate shall be $42 for a high-cost locality and $34 for any other. The list included at Appendix I shows high-cost localities.

If the employer pays a per diem allowance only for meal and incidental expenses in lieu of reimbursing actual expenses, the amount of the expenses that are deemed substantiated for each calendar day is equal to the lesser of the per diem allowance for such day or the amount computed at the Federal M&IE rate for the locality of travel. A per diem allowance is treated as paid only for meal and incidental expenses if the employer pays the employee for actual lodging expenses based on receipts submitted by the employee, the employer provides the lodging, the employer pays for the lodging directly or the employer does not have a reasonable belief that lodging expenses were or will be incurred by the employee. If an employer uses this method, the high-low method described above cannot be used.

The third requirement for a reimbursement or allowance to be considered as made under an accountable plan is that an employee cannot retain amounts in excess of his or her substantiated expenses. Such excess amounts must be returned to the employer within a reasonable period of time. The IRS has defined two "safe-harbors" with respect to what will be considered reasonable:

- Fixed Date Method - Advances made within 30 days of when an expense is paid or incurred or an expense substantiated within 60 days after it is paid or incurred. All excess amounts must be returned within 120 days after an expense is paid or incurred. Note: if the 120 day period falls within the next calendar year the unreturned portion would be reported in that next taxable year even though the advance occurred in the prior year.
- Periodic Statement Method - The employer must issue periodic statements (not less than quarterly) stating the amount, if any, paid under the arrangement in excess of the expenses the employee has substantiated.

If a plan meets the requirements of business connection and substantiation but the employee fails to return, within a reasonable period of time, any amount in excess of the expenses substantiated, only the amounts paid in excess of the substantiated expenses are treated as paid under a nonaccountable plan. The excess must be included on the employee's Form W-2. The determination of whether amounts are received from an accountable plan or a nonaccountable plan is made on an employee by employee basis. For example, if one employee fails to account for his or her expenses, amounts received by the employee will be treated as having been paid from a non-accountable plan. However, this treatment of one employee will not affect those employees who do account for their expenses.

It is important to note that reimbursable expenses for which the employee claims no reimbursement are not ordinary and necessary business expenses of the employee. Thus, if an employee pays travel expenses for which he could have received reimbursement from his employer, the expenses are not deductible by the employee. In addition, an employee who incurs deductible business expenses on behalf of his employer that exceed the total of advances or reimbursements received may deduct the excess expenses if he makes an adequate accounting of the expenses and if he substantiates each element of the expenditure with records and supporting evidence such as an account book, diary, log or trip sheet.

Finally, if an employer fails to maintain adequate accounting procedures, each employee will have to substantiate his expense account information. Even though an accounting procedure calls for all the required information, it is not necessarily adequate. The employer should exercise controls over the amount paid to insure that only ordinary and necessary business expenses are paid. Thus, the expense account must be examined and approved by a person responsible directly or indirectly to the employer for a proper audit of the expense account. The person incurring the expense cannot approve his own account. See Appendix J for a chart from an Internal Revenue Services Publication summarizing the reporting of Accountable and Nonaccountable plans.

In summary, for the parish not to include reimbursed expenses, allowances or advances in the priest's W-2, the plan must meet the business connection and substantiation requirements. Any excess payments not returned, must be included in the priest's W-2. Furthermore the parish cannot pay wages and require that expenses be paid out of the wages received and still qualify the plan as an accountable plan. Thus the options available are:

- Pay the priest a salary and reimburse only substantiated business expenses, or
- Give the priest advances/allowances in addition to a base salary and include unsubstantiated amounts as income on the priest's W-2.

Other Special Situations

Legal Assistance

Generally, legal services provided by an employer to an employee, whether through reimbursement of the employee or by direct payment of legal fees and expense are includible in the employee's gross income. However, if it can be shown that the litigation is so closely connected to the organization as to be indistinguishable between the employee and the organization, then the expenses incurred will not be income to the employee. Legal expenses are deductible, even when included as income, by the employee as an itemized deduction subject to the 2% limitation only when the employee can show that the expenses are sufficiently connected with the taxpayer's business.

The determination of when legal fees are considered gross income and when they are deductible has been the subject of numerous court cases. The courts have generally ruled that unless the acts of the employee cannot be separated from the employer then the payment of fees on behalf of the employee is income to the employee. The courts have held that when an employee of the organization is involved in litigation that has a direct impact on the very survival of an organization, those expenses are truly expenses of the organization. Thus to the extent a clergy is a prominent member of the organization, there may be a strong position that any legal fees incurred would not represent income to the clergy.

The facts and circumstances of each case must be reviewed separately in order to determine whether or not the amounts are includible in the income of the employee and if included, whether or not it is deductible by the employee.

Special Medical Treatment

A key element in structuring non-wage payments on behalf of priests for special medical treatment is that the payments must be for qualified medical expenses. Qualified medical expenses include amounts paid

- for the diagnosis, cure, mitigation, treatment or prevention of disease or for the purpose of affecting any structure or function of the body
- for transportation primarily for and essential to medical care
- for qualified long term care services
- for insurance
- for lodging away from home primarily for and essential to outpatient medical care as long as the medical care is provided by a physician in a licensed hospital or medical care facility and there is no significant element of personal pleasure, recreation or vacation in the travel. The amount shall not exceed $50 per night per individual.

If the payments do not represent qualified medical expenses then they will be taxable to the priests. Generally, amounts expended by an employer on behalf of an employee for medical care is not included as gross income of the employee. This also includes reimbursements of expenses incurred for the employee's spouse or family. These amounts can be paid directly or indirectly, to the employee to reimburse the employee for expenses incurred by the employee for qualified medical care

Deductible medical expenses include:

- ambulance hire
- artificial teeth or limbs
- bone marrow transplant costs
- contact lens & eyeglasses
- crutches

- dental care
- drug or alcohol treatment center
- hearing aids
- medicine & drugs
- prosthetic devices
- wheelchairs

The IRS has issued several rulings to clarify types of expenses which qualify as medical expenses. The IRS has determined that amounts paid for treatment at a therapeutic center for alcoholism or drug addiction, and for meals and lodging furnished as a necessary incident to the treatment are deductible medical expenses. The IRS further elaborated on the deductibility of meals and lodging by stating that "where an individual is in an institution because his condition is such that the availability of medical care in such institution is a principal reason for his presence and meals and lodging are furnished as a necessary incident to such care, the entire cost of medical care, and meals, and lodging constitute an expense for medical care."

Since rehabilitation centers generally qualify as medical expenses and amounts expended by employers for employees' medical care are not included in gross income, the parishes would not be required to include the expenditures as wages on the employees' Form W-2. It is important that the expenditures truly be medical. Also, if the payment is for outpatient services, meals and lodging should not be paid on behalf of the employee unless the outpatient facility is out of town. In that instance the parishes would be able to pay $50 per night for the priest's lodging.

Disability

Generally, disability payments received by an employee through employer paid accident and health insurance are includible in income. Premium payments made by an employee with pre-tax dollars are treated as if the premiums were paid by the employer. However, if the employee pays premiums with after-tax dollars then the disability benefits received under the accident and health insurance plan are not included in the employee's income. Additionally, disability benefits received by an individual other than through his employment are not includible in the employee's income.

Thus any disability payments received by a priest which are not the result of after-tax contributions made by the priest are includible in his gross income and subject to both federal income and self-employment tax.

There is a limited exception to the above rule. In the case of payments made to a priest for the permanent loss, or loss of use, of a member or function of the body, or a permanent disfigurement, the payment is not includible in gross income. The payment may be provided on account of an injury to the employee, a spouse or a dependent. However, the income exclusion for payments for loss of limbs, disfigurement, etc. does not apply if absence from work is a prerequisite to the employee' right to receive benefits or if the amount is determined by reference to the period the employee is absent from work.

Moving/Relocation Expenses

Generally moving expenses are deductible if the expenses meet the following four part test:

(1) the taxpayer must pay or incur "moving expenses" (defined below);
(2) the moving expenses must relate to the commencement of work at a new principal place of work;
(3) the new principal place of work must be at least 50 miles from the old work
(4) the taxpayer must work at the new location for at least 39 weeks during the 12 month period immediately following the arrival at the new location.

Moving expenses are defined as only the reasonable expenses of moving household goods and personal effects from the former residence to the new residence and of traveling (including lodging) from the former residence to the new place of residence. Expenses for meals are specifically excluded from moving expenses.

Reimbursement or direct payment by an employer of moving expenses to the employee are fringe benefits excludable from the employee's income, so long as

the reimbursements or payments are for qualifying moving expenses as discussed above. Employers should furnish detailed breakdowns of reimbursements and payments to the employee. Form 4782, *Employee Moving Expense Information,* see Appendix K) may be used for this purpose.

To the extent that moving reimbursements or payments are not for qualified moving expenses, the employer must withhold federal income tax and social security tax if the payments are for a lay employee. For all employees, the employer must include nonqualified moving expense reimbursements and payments in the employee's wages on Form W-2. Qualified moving expenses should not be included in an employee's wages, however they should be shown in box 13 of Form W-2 and identified using "Code P."

Priests who make "foreign moves" in connection with a reassignment have a broader category of deductible moving expenses than those who make comparable moves within the United States. However, all or part of the deduction may be disallowed to the extent the expenses are allocated to compensation earned overseas and excluded from income.

If the dioceses desire to minimize the tax liability of moving expenses to the priests they should only reimburse qualified moving expenses. Any other payments for nonqualified expenses will result in income to the priests.

PENALTIES

Overview

Both civil and criminal penalties can be levied in connection with the failure to file information returns (Form 1099 and Form W-2) as well as the failure to make timely payroll tax deposits. The penalties vary greatly, but can be as much as 100% of the tax required to be remitted. Additionally, while the majority of the penalties are levied on the employer, certain penalties may also be levied directly on individuals.

Failure to Furnish Statements

The Failure to Furnish Statements penalty arises out of an employer's failure to provide recipients with correct information returns by the due date for these returns. Information returns include both Form 1099 and Form W-2, which must be provided to recipients by January 31st of each year. The penalty may apply if a return is not filed on time, if all required information is not included on a form, if incorrect information is included on a form, or if a taxpayer identification number is either incorrectly reported or not reported

on a form. Thus, these penalties would apply in a situation where income required to be reported on a W-2 is not reported, or if such income is reported on the incorrect form. The IRS can waive these penalties if the taxpayer can show the failure was due to reasonable cause and not due to willful neglect.

The penalty for failure to provide correct information returns is $50 per return, up to a maximum penalty of $100,000 per year. However, if it is determined that the failure to provide the information return was intentional, the penalties may be increased. Intentional disregard will be judged by the IRS based on the facts and circumstances of each case. Generally, the IRS will consider whether the taxpayer's failure was knowing and willing, whether the taxpayer had a repeated pattern of failure, and whether corrections were made once the failures were discovered. The penalties for intentional failure to file an information return are the greater of $100 per form, or 10% of the amount required to be reported on the form. There is no yearly maximum for intentional failure to file information return penalties.

Additionally, criminal penalties may be levied against employers who willfully furnish false or fraudulent statements to employees or employers who willfully fail to furnish statements to employees. Under the criminal penalties, an employer may be subject to a fine of $1,000 or imprisonment for up to one year.

Finally, there may be civil damages for the filing of fraudulent information returns. For example, if an employer willfully files a fraudulent Form W-2 (reporting payments supposedly made to an employee, but not actually made), the employee may bring a civil action against the employer. Under civil law, the employer may be liable to the employee for $5,000 or more.

Failure to Make Timely and Proper Payroll Deposits

Generally, employers must make timely deposits of income taxes withheld as well as the employer and employee portions of social security and Medicare taxes. As discussed in detail in Section One, members of the clergy are not required to have federal income taxes, social security tax, or Medicare taxes withheld from their earnings. However, they may elect to have federal income taxes withheld. In the case where various members have elected to have federal income tax withheld, various penalties apply if these deposits are not made in a timely manner using the methods prescribed by the statute (including financial institution and method of deposit). The penalty rates are based on a percentage of the amount required to be deposited and are as follows:

2% - Deposits made 1 to 5 days late.
5% - Deposits made 6 to 15 days late.
10% - Deposits made 16 or more days late.

10% - Deposits made at an unauthorized financial institution, paid directly to the IRS, or paid with an taxpayer's income tax return.

10% - Amounts subject to electronic deposit requirements but not deposited using the Electronic Federal Tax Payment System (EFTPS).

However, the most significant and far reaching penalty the IRS may assess with regard to payroll tax deposits is the Trust Fund Recovery penalty. This penalty may be levied when an employer does not properly withhold the required taxes or does not properly deposit the taxes withheld. The Trust Fund Recovery penalty is **100%** of the tax withheld or required to be withheld. Additionally, the Trust Fund Recovery penalty may not only be levied on the employer, the penalty can be levied against anyone whom the IRS deems is a responsible person with regards to the collecting, accounting for, and payment of these taxes, and who is not willfully doing so.

The IRS has provided definitions of both a "responsible person" and "willfully". According to the IRS, a "responsible person" can be an officer or employee of a corporation, a partner or employee of a partnership, an accountant, a volunteer, a director, a trustee, or an employee of a sole proprietorship. A responsible person may also be any person who signs checks for an organization or has authority to disburse funds of the organization. Thus, under this broad definition, any number of individuals could be levied with this penalty. Further, the Service defines "willfully", to mean voluntarily, consciously, and intentionally. For instance, a responsible person is acting willfully if the person knows the required actions are not taking place.

Additionally, as with all types of unpaid tax payments, the Service will charge interest on any unpaid balances. The interest will not only be accrued on unpaid tax balances, but also on previously accrued interest and penalties. Currently, the interest rate for tax delinquencies is 9%. This rate is changed and is released quarterly by the IRS.

State Penalties

Both civil and criminal penalties can be levied by the states to the parish in connection with the failure to furnish statements to employees and failure to make tax deposits.