IRS LETTER RULINGS

Letter Ruling Alert

Kristen Gurdin
Caplin & Drysdale, Chartered

Service Excludes Ministers' Housing Allowances from Compensation for Purposes of Determining Retirement Plan Contribution Limits

In a yet unreleased ruling, the Service has refused to allow an employer to consider tax-free housing allowances provided to ministers as compensation for purposes of calculating the limits on excludable retirement plan contributions that ministers can make under section 415(c). The Service reached its conclusion by determining that minister housing allowances, which are tax-free to the extent that they are spent on housing, do not fall under either of the alternative definitions of compensation applicable under section 415(c). The alternative definitions are provided in Treas. reg. section 1.415-2(d)(11).

Factual Background

Employer A, a religious organization exempt from tax under section 501(c)(3), has a substantial number of employees who qualify as "ministers of the gospel" under section 107. Employer A compensates the ministers with a regular salary and a housing allowance, which is excludable from each minister's gross income under section 107, to the extent it is actually spent on housing costs. On each minister's Wage and Tax Statement, Form W-2, Employer A reports the regular salary as "wages, tips and compensation" and the housing allowance as "other." Employer A does not verify the amount of each minister's housing allowance that is actually spent on housing, and thus excludable from gross income under section 107.

Employer A maintains a section 403(b) retirement plan, which allows employees to make salary reduction contributions up to certain limits. Among other requirements, the amount contributed was limited to the amount excludable from income under section 415(c), i.e. 25 percent of compensation. In previous years, Employer A did not treat a minister's housing allowances as compensation for purposes of determining that minister's contribution limit for the 403(b) plan, but sought an IRS ruling that would allow it to do so in the future.

IRS Analysis and Conclusions

Under section 415(c) as in effect until the end of 2001, annual contributions to section 403(b) tax-sheltered annuities may not exceed 25 percent of the plan participant's compensation from the plan sponsor for the year.[1] Employer A asked the Service to rule that minister housing allowances should be treated as compensation, for purposes of calculating these limits, despite the fact that section 107 excludes such allowances from gross income to the extent that they are actually spent on housing.

Minister housing allowances appear to be outside the standard definition of compensation for section 415(c) purposes, which includes only wages, salaries, fees for professional services, and other amounts "to the extent included in gross income." Treas. reg. section 1.415-2(d)(2). "[A]mounts which receive special tax benefits" are explicitly excluded from this definition of compensation. Treas. reg. section 1.415-2(d)(3)(iv). However, the regulations also provide two alternative definitions of compensation. They appear in Treas. reg. section 1.415-2(d)(11) as follows:

> (i) Information required to be reported under sections 6041, 6051, and 6052. Compensation is defined as wages within the meaning of section 3401(a) and all other payments of compensation to an employee by his employer (in the course of the employer's trade or business) for which the employer is required to furnish the employee a written statement under sections 6041(d), 6051(a)(3), and 6052. . . . Compensation under this paragraph (d)(11)(i) must be determined without regard to any rules under section 3401(a) that limit remuneration included in wages based on the nature or location of the employment or the services performed (such as the exception for agricultural labor in section 3401(a)(2)).
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> (ii) Section 3401(a) wages. Compensation is defined as wages within the meaning of section 3401(a) (for purposes of income tax withholding at the source) but determined without regard to any rules that limit the remuneration included in wages based upon the nature or location of the services performed (such as the exception for agricultural labor in section 3401(a)(2)).

Employer A proposed that minister housing allowances be treated as compensation for section 415(c) purposes under both of these definitions.

However, the Service first rejected the view that tax-free minister housing allowances should be included as wages subject to withholding under section 3401(a). Section 3401(a) provides that for purposes of income tax withholding obligations, wages include "all remuneration for services performed by an employee for his employer." Section 3401(a)(9) excludes remuneration paid for "services performed by a duly ordained, commissioned or licensed minister of a church in the exercise of his ministry." Employer A contended that

compensatory minister housing allowances would be included as wages under section 3401(a), if section 3401(a)(9), which excludes compensation based on the nature of the services provided, were disregarded. Therefore, the housing allowances should constitute compensation under Treas. reg. section 1.415-2(d)(11)(ii), which directs that withholding exemptions be ignored if based on the nature of the services being provided. The Service rejected this argument, reasoning that since section 3401(a) is applied to determine tax withholding obligations, its definition of wages only includes *taxable compensation*. Therefore, even if section 3401(a)(9) were disregarded, housing allowances that could be excluded from gross income under section 107 would fall outside the section 3401(a) definition of wages.

The Service also rejected Employer A's second argument that the housing allowances constitute a payment of compensation for which an employer is required to furnish the employee and the IRS with a written statement under sections 6041, 6051, and 6052. There are specific categories of compensation for which an employer must issue a written receipt under section 6051, and the Service found that minister housing allowances did not fall into any of these categories. (Section 6052, which addresses compensation paid as group term life insurance, is also inapplicable.) The Service then determined that housing allowances were not payments to a person aggregating $600 or more, including "salaries, wages, commissions, fees, other forms of compensation for services, and other fixed or determinable gains, profit or income" as described in section 6041. The Service arrived at this conclusion by interpreting the phrase "*other* fixed, annual, or determinable income" to cover only those amounts includible in gross income. Based on this reading of the statute, the Service found that an employer has no obligation to report a tax-free minister housing allowance. In addition, the Service relieved an employer of reporting responsibility for taxable portions of a minister housing allowance (portions not spent on housing), reasoning that although such amounts constitute income for section 6041, they are not "fixed and determinable" income and thus trigger no obligation to report.

Having concluded that sections 6051, 6052, and 6041 did not require the reporting of a minister housing allowance, the Service ruled that there was no basis for including such amounts in the definition of compensation under Treas. reg. section 415-2(d)(11)(i). Therefore, the Service refused to treat minister housing allowances as compensation for purposes of determining ministers' retirement plan contribution limits under section 415(c).

Commentary

Under section 415(c) as in effect until the end of this year, the position the Service articulated in this ruling has a deep negative impact on ministers. The ruling limits a minister's contributions to any section 403(b) or 401(k) plan to 25 percent of his or her non-housing allowance income. Since it is common for religious organizations to provide up to 50 percent of minister compensation in the form of such housing allowances, the Service's position could effectively halve the maximum annual retirement contributions of many ministers.

The Service's reasoning appears to be in conflict with the regulations. Treas. reg. section 1.6041-2(a)(1) plainly requires compensation other than wages to be reported on Form W-2, if the total of such payments and wages paid "aggregates $600 or more in a calendar year." The regulation does not limit the compensation that must be reported on the Form W-2 to compensation that is includible in gross income, and ministers' housing allowances are not among the categories of compensation specifically exempted from reporting requirements under Treas. reg. section 1.6041-3. Logically, it makes sense to require an employer paying a minister to report all housing allowances, since the religious organization typically does not know what amount of a minister's housing allowance is spent on housing and is therefore exempt from tax. In fact, IRS Publication 15-A, "Employer's Supplemental Tax Guide," directs churches employing ministers to report taxable compensation (not including excludable housing allowances) as wages in box 1 of the Form W-2 *and* suggests that they report housing allowances, either on a separate statement or in box 14, "Other." Thus, it seems difficult to agree with the IRS's conclusion that all minister housing allowances (even amounts subject to tax) are not included in the alternative definition of compensation under Treas. reg. section 1.415-2(d)(11)(i).

Fortunately, the Service's position will significantly affect ministers' retirement contributions only for the remainder of the 2001 tax year. Beginning on Jan. 1, 2002, The Economic Growth and Tax Relief Reconciliation Act (EGTRRA) amends section 415(c), expanding the current contribution limit from 25 percent of compensation from the participant's employer, to 100 percent of compensation from the participant's employer.[2] Accordingly, ministers will be able to include all of their non-housing allowance compensation in determining their contributions, subject to the ceiling limit.[3] This inclusion of an additional 75 percent of non-housing allowance compensation neutralizes the effect that the Service's ruling will have on ministers' retirement contributions in future years. Additionally, the new "catch-up" contributions permitted by EGTRRA for ministers who are age 50 and older will further mitigate the effect of the Service's ruling. Nevertheless, the Service's position still presents a cause for concern for those ministers and their employers who have included section 107 housing allowances for the purposes of calculating section 415(c) contribution limits in 2001 and previous years.

It is also worth noting that this ruling has the likely unintended effect of taking the position that neither section 6051 nor section 6041 require employers to report any portion of a housing allowance on a minister's Form W-2, regardless of whether or not such amounts are taxable. On this point, the flaws in the ruling's analysis should give a religious organization pause before it decides to abandon reporting these allowances.

Endnotes

[1]In any event, such contributions may not exceed $35,000 in 2001. Section 415(c).

[2]The amendment also raises the maximum limit of such contributions from $35,000 to $40,000.

[3]$40,000.