Nonqualified Deferred Compensation Plans
Special Tax Consequences

SECA, Housing Allowance and the Social Security Earnings Test

SECA Taxes

How is a minister's compensation treated for purposes of Social Security taxes?

A minister is considered self-employed for purposes of Social Security taxes with respect to services he performs in the exercise of his ministry. This means that the minister must pay SECA taxes, not the employee's share of FICA taxes. However, even though ministers are treated as self-employed for Social Security purposes, they are considered W-2 employees of the church. It is the minister's responsibility to determine when SECA taxes are due. A minister should seek competent tax advice on issues related to SECA taxes.

What compensation is subject to SECA taxes?

SECA taxes are based on an individual's "net earnings from self-employment." Net earnings are not the same as wages for federal income tax purposes. In fact, net earnings from self-employment generally amount to more than W-2 compensation and can include income that is not subject to income tax. For example, section 1402(a)(8) of the Internal Revenue Code of 1986 ("Code") specifically provides that net earnings from self-employment include a minister's housing allowance and foreign income excludable from income tax under Code section 911.

When are SECA due on contributions to nonqualified deferred compensation arrangements?

Unlike FICA taxes, SECA applies when income taxes apply. SECA taxes apply up to the amount of the Social Security wage base.

Are distributions to a minister <u>from</u> a nonqualified deferred compensation plan subject to SECA taxes?

Maybe. Unless the benefit is paid or made available at the ministers retirement, the distribution is subject to SECA. Section l402(a)(8) of the Code specifically provides that, in the case of duly ordained, commissioned or licensed ministers, SECA taxes do not apply to <u>any</u> retirement benefit received from a church plan after the individual retires. The statutory provision does not limit the types of retirement benefits that are subject to this exemption from SECA taxes. The only requirements are that the retirement benefits must come from a church plan and the benefits must be received after the individual retires. If those two requirements are met, the distributions are not subject to SECA taxes.

This rule was added to Code section l402(a)(8) in 1996. Prior to that time, the IRS had been taking the position in some audits of retired clergy that a retired minister had to pay SECA taxes on that portion of his retirement plan distribution that was excluded from income as housing allowance. However, because of concerns voiced by many denominations, as well as by many individual pastors and ministers around the country, Congress changed Code section 1402(a)(8) in 1996 specifically to deal with this problem. In doing so, Congress provided broader relief than fixing just the housing allowance problem by excluding not only housing allowance payments but all retirement payments made from church plans to retired clergy from SECA taxes.

Therefore, it seems reasonable to argue that amounts received from a nonqualified deferred compensation plan are "retirement benefits" and, if received by a retired minister, SECA taxes do no apply.

When is a minister considered to be "retired" for purposes of the Section 1402(a)(8) exclusion from net earnings?

Unfortunately, there is no guidance from the IRS on what it means to "retire" for purposes of the Code section 1402(a)(8) exclusion. Informal inquiries relating to the issue of when a minister is considered to be retired have been made to the IRS in connection with a different retirement plan issue. In response to these inquiries, the IRS indicated that it would not challenge any reasonable rule adopted by a denomination with respect to when a minister is considered to be retired.

The IRS has informally indicated that it would not challenge "any reasonable rule" adopted by a denomination for considering when a minister has retired. When is a pastor considered to be retired?"

If there is no rule established by a denomination as to when a minister is considered to be retired, a determination of the minister's retirement status will be left up to the employer and minister.

Housing Allowance

We have been discussing what happens when a minister retires and receives payments from a nonqualified deferred compensation plan. But what happens if a minister has not retired and is receiving payments from the plan? Are distributions from a nonqualified deferred compensation plan eligible for the housing allowance exclusion under Code section 107?

Probably. Section 107 is silent as to whether compensation eligible for housing allowance is limited to current compensation, and the IRS has not issued any guidance that directly addresses the question of whether distributions from a nonqualified deferred compensation plan may be excluded from income under the housing allowance provisions of the Code. However, the IRS has determined that the rental allowance exclusion under Code section 107 applies to both the rental value of a home furnished to a retired minister as part of his compensation for past services and the rental allowance paid to him as part of his compensation for past services. Rev. Rul. 63-156, 1963-2 C.B.79. In addition, the IRS has ruled that the portion of a retired minister's pension that is designated as rental allowance may be excludable under Code section 107 when properly designated by the trustees of a denomination's national pension fund.
Rev. Rul. 75-22, 1975-1 C.B. 49. (This 1975 revenue ruling specifically cited the 1963 revenue ruling as support for its holding.) The analysis in these rulings could be applied to payments from a nonqualified plan as well, since these payments represent deferred compensation for the minister's past services. Thus, for purposes of income taxation, distributions from a nonqualified plan are probably eligible for the Code section 107 housing allowance exclusion.

If the minister is not retired, do SECA taxes apply to the portion of a distribution from a non-qualified deferred compensation plan that is designated as housing allowance?

Yes, but only to the extent that the minister did not pay SECA taxes on contributions at the time they were made to the plan. As discussed earlier, section l402(a)(8) of the Code was amended in 1996 to specifically exclude from net earnings from self employment 'the rental value of any parsonage or any parsonage allowance (whether or not excludable under section 107) provided after the individual retires." Thus, this section applies only to the housing allowance paid after a minister has retired. If the minister has <u>not retired</u> it appears that SECA taxes would be due on the portion of a distribution from a nonqualified deferred compensation plan that is designated as housing allowance.

The Social Security Earnings Test

Do distributions from a nonqualified deferred compensation plan count against the Social Security earnings test?

Probably not. Under the annual earnings test, Social Security recipients, who have not reached their normal retirement age, will have their Social Security benefits reduced if they earn an annual income in excess of certain statutorily established amounts. The earnings subject to this annual earnings test include all "wages for services rendered" plus "net earnings from self-employment."

According to Social Security Administration Publications 05-10069 and 05-10063 "special payments," such as pensions and annuities, do not count for purposes of the earnings test. Although the general rule for self-employed individuals is that income counts when received, not when earned, this rule is modified for purposes of the earnings test. (Remember a minister is treated as a self-employed individual for Social Security purposes.) Under this modification, income earned prior to the date the individual became entitled to Social Security benefits does not count for purposes of the earnings test, even if it was paid after the individual became entitled to Social Security.

More specifically, according to Publication 05-10063, "special payments" that are not part of earnings for purposes of the earnings test specifically include "payments on account of retirement or deferred compensation reported on a W-2 form for one year that was earned in a previous year." In addition, this same publication states that special payments, in the case of self-employed individuals, would include income received after retirement if the individual performed the services to earn the payment before becoming entitled to Social Security benefits.

Thus, retirement distributions from a nonqualified deferred compensation plan generally would not be included in the annual earnings test because the amounts in the plan would have been earned prior to the time that the individual became entitled to Social Security.