

## Special Feature / Judah I. Kupfer, Esq.

# The Taxability of Kollel Pay: Tax and Withholding Obligations of a Kollel and Its Members

### Introduction

Moshe is a member of a new *Choshen Mishpat kollel*. As a member, he is required to attend at set times for learning with his *chavrusa* at a specific *beis medrash*, study a specific curriculum, be present at an in-depth lecture given by the *Rosh Kollel* twice a week, and score high on occasional written exams that test his knowledge of the intricate subject matter. At times, the *kollel* also requires Moshe to tutor young children with their *Chumash* studies, provide occasional *shiurim* to students of an outreach *kiruv* program that the *kollel* supports, and, twice a year, spend Shabbos in an out-of-town community to present a lecture on a topic of *halachah*. Moshe is provided with a monthly paycheck of \$600. Moshe uses this money to pay for his family's personal living expenses. Also, prior to each Sukkos and Pesach, the *kollel* provides Moshe with an additional \$400 to help defray the costs of his added holiday expenses. How does Moshe report his income? Is any or all of it taxable?

As our generation has seen a surge of Torah learning, many now find themselves in Moshe's situation and are unsure of the tax ramifications of their *kollel* pay. With the increase of government scrutiny and the penalties for infractions being so high, it is incumbent on each *kollel* and student alike to get it right.

The taxability of payments provided by a *kollel* to its members/students (which we will refer to simply as "Kollel Pay") has generated much confusion and varying views. The reason for the confusion is chiefly due to the mistaken assumption that all *kollelim* are the same. In reality, though, different *kollelim* operate in different manners and the taxability of Kollel Pay can thus vary broadly, depending on the particular circumstances of the *kollel*. In assessing the taxability of Kollel Pay, it is therefore necessary to analyze each *kollel* independently, in light of its customs, requirements, rules and regulations.

Outlined below are four broad classifications of how to categorize Kollel Pay. As each *kollel's* obligations are diverse and fact-specific, the reader is cautioned to seek specific guidance from a tax professional in applying the principles articulated below. The rules outlined below only apply to *kollel* members who are U.S. citizens — different rules apply to international students.

It is also important to note at the outset that should Kollel Pay be provided for segregated tasks, assignments, projects or services, it is possible for different portions of Kollel Pay to fit within different categories, resulting in part taxable and part non-taxable even when being paid to the same student. Later, we'll revisit Moshe's situation and seek to

apply these principles to his circumstances.

### Non-Taxable Fellowship

The first category is a non-taxable fellowship. However, such a classification will likely not apply to most *kollelim*. This category would include payments to the student used only for tuition and required fees, books, supplies, or equipment. Non-taxable fellowships are not taxable income to the student, are not subject to FICA (also known as "payroll taxes," which are made up of taxes for Social Security and Medicare equal to 15.3% of the taxpayer's salary — generally, the employer is required to pay half, i.e. 7.65%, and the employee pays the other half), and there is no requirement for the *kollel* to withhold or report these payments to either the student or the Internal Revenue Service (IRS).

A fellowship is tax free only if the student is a "candidate for a degree" at an "eligible educational institution," (each defined below) and if the student uses the fellowship to pay "qualified education expenses" such as required fees, books, supplies or equipment. Payments used to cover room, board, travel or any other living expenses would not be included. To the extent that a fellowship does not fit within these rules, it is considered a taxable fellowship.

A student is a "candidate for a degree" if (a) he attends a primary or secondary school or is pursuing a degree at a college or university, or (b) he attends an accredited (by a national recognized accreditation agency) educational institution that is authorized to provide (i) a program that is acceptable for full credit toward a bachelor's or higher degree, or (ii) a program of training to prepare students for gainful employment in a recognized occupation.

An "eligible educational institution" is one that maintains a regular faculty and curriculum and normally has a regularly enrolled body of students in attendance at the place where it carries on its educational activities.

Since Kollel Pay is most often used for personal living expenses, it will generally not fall within this category. Additionally, while some *kollelim* may qualify as "eligible educational institutions," most *kollel* students are not "candidates for a degree."

### Taxable Fellowship

The next category is a taxable fellowship. This category, typically known as a stipend and used as a living allowance, includes payments to the student other than those defined as non-taxable fellowships. There is no requirement that the recipient perform any services for the benefit of the *kollel* as a condition of receiving the payment and these payments are often made as an incentive for

students to attend the *kollel*. It is important to emphasize that if the student is being paid for services, such payment is not a fellowship at all but rather a taxable compensation for services, the third category below.

A fellowship recipient is an individual who receives a taxable and/or non-taxable fellowship, and whose activities may include: Engaging in research programs or participating in training to further his individual educational development; conducting independent research and determining what research activities he will be conducting; or providing help to a *Rosh Kollel*, provided that the activities are principally

### *It should be noted that it is possible for different portions of Kollel Pay to fit within different categories*

related to the recipient's progress rather than to the needs of the *kollel*.

To the extent, however, that a program requires teaching or research activities to be performed by the recipient and these activities are performed for the benefit of the *kollel*, or if the recipient is performing other services for the *kollel* in exchange for a payment, the payment should be characterized as a payment involving services (the third category, below) and is not a fellowship.

Although taxable fellowships are taxable income to the student, the *kollel* is not required to report them to the student or the IRS, nor is the *kollel* required to withhold tax on them. These funds are also not subject to FICA. Students are responsible for reporting these payments and remitting any tax due, which can include estimated tax filings. It is important, however, to keep in mind that low income earners may not have an obligation to pay any federal income taxes. Given the total taxable amount earned by the student (and if married, the student's spouse as well), students must determine with their tax advisor whether they have a federal income tax obligation and, if so, whether it should be paid quarterly (as estimated taxes) to the IRS or with the filing of their personal income tax return.

### Taxable Payments Involving Services

The third category involves taxable payments for services. This category is defined as payments made with respect to teaching, research and/or other activities performed for the benefit of the *kollel*, including activities for the *kollel* that may be associated with the student's

course of study and educational experience. This would include a student's teaching responsibilities, tutoring and other activities where the primary purpose is to benefit the *kollel* or an objective of the *kollel*. If, however, as part of their program of training, all *kollel* students are required to perform part-time teaching with the primary purpose to benefit the student, such responsibilities should not be deemed part-time employment for which they are receiving taxable compensation.

Compensation is taxable to the recipients, and the *kollel* is required to withhold federal and state taxes and report such payments to the IRS (the *kollel* should issue a form W-2 to the student). The *kollel* is also required to contribute to half of the student's FICA obligation and withhold the other half from the student's pay.

Please note, the student may be able to qualify to have a portion (or all) of his taxable compensation (i.e. any Kollel Pay that is taxable compensation for services) pre-designated as a parsonage housing allowance that would be exempt from federal income tax (and, in most states, state and local income tax as well). The pre-designated amount would have to actually be used that year for the student's "housing expenses." The student would still be required to pay Social Security and Medicare taxes (both parts of his FICA obligation, see next paragraph) on the entire part of his Kollel Pay that fits within this category (both the parsonage and non-parsonage amounts). To qualify for parsonage, the student must be classified as a "minister" whose job it is to conduct "ministerial services."

By being classified as a minister, the student would also be subject to certain other rules applicable to ministers with respect to their ministerial services, including: (a) an exemption from FICA — thus, the *kollel* would not be required to withhold nor pay into FICA on behalf of the student; however, the student would be required to pay both parts of the FICA obligation on his own (also known as "SECA" or "self-employment taxes") in quarterly estimated payments; (b) the *kollel* would be exempt from federal income tax withholding on the non-parsonage amount, yet the student would be required to report and pay estimated federal income tax on his own on the non-parsonage amount.

As an aside, since parsonage is only available as payment for "ministerial services," Kollel Pay classified as a fellowship would likely not be eligible to be pre-designated as a parsonage housing allowance since a fellowship, by definition, does not constitute payment for services. If only part of a student's Kollel Pay is payment for ministerial services, while another part is provided as

a fellowship, only the portion of pay categorized as payment for services may be eligible to be allocated as parsonage, assuming all the other requirements for receiving parsonage are met and that such service is ministerial in nature.

Those interested in designating part of their *kollel* pay as parsonage should seek specific guidance to ensure the proper application of the parsonage rules.

### Charitable Grant to a "Needy" Individual

In very limited circumstances, Kollel Pay may be classified as charitable grants to needy individuals — essentially, a charitable tax-free gift. The IRS defines a needy person as someone who lacks the basic necessities of life — food, clothing, shelter, medical help or transportation — because of poverty or temporary distress. A person may have short-term needs in one or more of these areas even if he or she has resources (such as insurance or inheritances) that will be available in the long run.

If a *kollel* student fits within the definition of "needy," he may be eligible to receive a charitable gift. Such funds would be tax free to the recipient. The *kollel* would not be required to report such gifts to the student or issue forms 1099 or W-2, but would be required to maintain adequate records and case histories to

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show: (i) The name and address of each recipient of aid; (ii) The amount distributed to each; (iii) The purpose for which the aid was given; (iv) The manner in which the recipient was selected; and (v) The relationship, if any, between the recipient and (a) members, officers, or trustees of the *kollel*, or (b) a grantor or substantial contributor to the *kollel* or a member of the family of either. Before making such distributions, the *kollel* should also ensure that it is authorized to make such grants to needy individuals in its organizational documents. Should the *kollel* file a year-end form 990, such information must also be disclosed on it within Schedule I.

Some tax experts are doubtful about the availability of this category to *kollel* students if the *kollel* students are required to perform any kind of service in order to receive the funds. Even if a *kollel* simply requires its students to be in attendance, such a requirement may be problematic to this classification. Additionally, if the funds are provided on a regular basis (e.g. weekly, monthly), there is a concern that the distributions

look like compensation (which is taxable) as opposed to a scenario where funds are provided only at certain times of the year, e.g., before a Yom Tov, which would seem more akin to a non-taxable charitable gift. Furthermore, if any part of the Kollel Pay provided to a particular student is deemed compensation, an employer/employee relationship is thereby created between the kollel and the student. When that occurs, there is a presumption that any and all economic benefit provided by the employer to the employee is compensation and may not be considered a tax-free gift.

#### Tying It All Together

With a background of the law in hand, we can now return to Moshe's scenario. At the outset, we can probably rule out any part of Moshe's pay being classified as a non-taxable fellowship because the pay is being used for his personal living expenses — not for tuition or other required fees or equipment.

Additionally, although the kollel may be considered an educational institution (we don't know enough about the kollel to say for certain), Moshe is likely not a candidate for a degree. So, we now need to take each of Moshe's responsibilities and examine them one by one.

First, Moshe is required to be in attendance at designated times, at a designated place, to study a set curriculum and attend bi-weekly *shuirim* given by the *Rosh Kollel*. These activities are consistent with taxable fellowship functions as Moshe is not acting to benefit the kollel in any way or performing any services. Thus, part of Moshe's Kollel Pay may be designated as a fellowship to assist him in his learning activities. For that portion of pay, the kollel would not be required to withhold federal income tax or FICA, but Moshe on his own would be required to pay federal, state and local income tax on this amount.

Second, the kollel requires Moshe to tutor children and lecture occasionally at the kollel-supported *kiruv* program. These activities represent services for which Moshe is being compensated. Thus, the part of his monthly pay representative of these services must be considered as taxable compensation. For this part of his income, the kollel is required to withhold federal income tax and FICA.

Should Moshe qualify as a "minister" (e.g. he has *semichah* or a certificate from his yeshivah detailing his qualifications to teach *limudei kodesh*), to the extent that his services qualify as "ministerial" in nature (e.g. learning *Chumash* with children and providing Torah lectures at a *kiruv* program), the kollel may pre-designate by "official action" as a housing allowance the part of Moshe's salary being paid to him in exchange for performing ministerial service. In such an instance, the kollel would not be required to withhold on this portion of Kollel Pay but Moshe would have to pay quarterly estimated SECA payments. To the extent that the pre-designated amount is actually used that year for housing expenses, it would not be subject to federal income

tax and in most cases, state and local income tax as well.

Third, Moshe is required to spend Shabbos at an out-of-town community and present a *shiur* while there. As all members of Moshe's kollel possess this responsibility and it would appear that the objective is to provide the kollel students with practical hands-on training to teach and act in a rabbinic capacity, such teaching responsibility would likely fall within the taxable fellowship category. Readers should be cautioned that the distinction between whether part-time services should be considered taxable compensation or a fellowship is often nuanced and dependent on the specific circumstances; a tax professional should be consulted in making that decision.

Last, Moshe is paid a sum of \$400 at certain times of the year to help defray holiday expenses. If Moshe were a "needy" individual (we don't know whether he has other sources of income, savings or investments to say whether he is indeed needy) who was not receiving any taxable compensation for services from the kollel, he may be able to classify these payments as a tax-free gift. However, since Moshe is receiving taxable compensation in exchange for services rendered (i.e. the part-time teaching), the IRS would consider any "gift" given from employer (the kollel) to employee (Moshe) as taxable.

This example should make clear that different kinds of activities will trigger different tax and withholding obligations — even when provided to the same kollel student.

#### When does Kollel Pay qualify as income for the Earned Income Credit and Child Tax Credit?

Should a student receive Kollel Pay as part of taxable payment involving services, such pay should be considered "earned income" for purposes of the earned income and child tax credits, so long as it is reported on a form W-2 and taxes are paid, as required. If a parsonage housing allowance is allocated, such amount would be considered "earned income" for purposes of the earned income credit, assuming self-employment tax is paid (as required), since earned income includes "the amount of the taxpayer's net earnings from self-employment." However, payments designated as parsonage would not be considered "taxable income" to qualify for the child tax credit.

Kollel Pay classified as a fellowship, whether taxable or non-taxable, is not considered earned income for purposes of the earned income and child tax credits and the receipt of a taxable fellowship may also negatively affect one's eligibility for these credits (consult your accountant for further details). Similarly, a tax-free gift is not considered earned income for purposes of these credits.

Kollel Pay classified as payment for services (even if parsonage is designated) or as a fellowship (taxable or non-taxable) should likely be declared as a source of income for purposes of other government programs/benefits, but the specific details of programs vary and must be con-

sidered individually in each state.

#### Reporting Fellowships

Whether you must report your fellowship depends on whether you must file a return and whether any part of your fellowship is taxable.

If your only income is a completely tax-free fellowship (and assuming you and your spouse don't have any other taxable sources of income), you do not have to file a tax return and no reporting is necessary. If all or part of your fellowship is taxable or if you or your spouse earns other taxable income, you are required to file a tax return and report the taxable amount, whether or not you received a form W-2.

For information on whether you must file a return, see IRS Publication 501, Exemptions, Standard Deduction, and Filing Information, or your income tax form instructions. For additional information regarding reporting, see IRS Publication 970.

#### Conclusion

The taxability of Kollel Pay is dependent on the specifics of each kollel's customs and practices. It may fall within one of four broad categories outlined in this article. However, professional guidance should be sought to ensure the proper application of these principles to the specifics of your kollel and particular circumstances.

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