Special Supplement:
Current Status of the Parsonage and Housing Allowance Exclusions
By Richard R. Hammar, J.D., LL.M., CPA

On November 22, 2013, federal district court judge Barbara Crabb of the District Court for the Western District of Wisconsin struck down the ministerial housing allowance as an unconstitutional preference for religion. *Freedom From Religion Foundation, Inc., v. Lew, 983 F. Supp. 2d 1051 (W.D. Wis. 2013)*. The ruling was in response to a lawsuit brought by the Freedom From Religion Foundation (FFRF) and two of its officers challenging the constitutionality of the housing allowance and the parsonage exclusion. The federal government, which defended the housing allowance, since it is a federal statute, asked the court to dismiss the lawsuit on the ground that the plaintiffs lacked standing to pursue their claim in federal court.

Standing is a constitutional requirement of any plaintiff in a federal case and generally means that a plaintiff must have suffered some direct injury as a result of a challenged law. The Wisconsin court concluded that the plaintiffs had standing on the ground that they would have been denied a housing allowance exclusion had they claimed one on their tax return. The government appealed this ruling to a federal appeals court—the Seventh Circuit Court of Appeals in Chicago.

On November 13, 2014, the appeals court issued its ruling reversing the Wisconsin court's decision. *Freedom From Religion Foundation, Inc., v. Lew, 773 F.3d 815 (7th Cir. 2014).* It concluded that the plaintiffs lacked standing to pursue their challenge to the housing allowance. The plaintiffs had asserted that they had standing due to their "injury" of being denied a tax-free housing allowance should they claim one on their tax returns. But the appeals court refused to base standing on theoretical injury. It concluded: "Only a person that has been denied such a benefit can be deemed to have suffered cognizable injury. The plaintiffs here have never been denied the parsonage exemption because they have never requested it; therefore, they have suffered no injury."

It suggested that this deficiency could be overcome if the FFRF's officers filed tax returns claiming a housing allowance that was later rejected by the IRS in an audit: "The plaintiffs could have sought the exemption by excluding their housing allowances from their reported income on their tax returns and then petitioning the Tax Court if the IRS were to disallow the exclusion. Alternatively, they could have . . . paid income tax on their housing allowance, claimed refunds from the IRS, and then sued if the IRS rejected or failed to act upon their claims."

The FFRF responded to the appeals court's ruling by designating a housing allowance for two of its officers. The officers reported their allowances as taxable income on their tax returns and thereafter filed amended tax returns seeking a refund of the income taxes paid on the amounts of their designated housing allowances. FFRF claims that in 2015 the IRS denied the refunds sought by its officers (one of whom had died and was represented by her executor).

Having endeavored to correct the standing problem, the FFRF renewed its legal challenge to the housing allowance in the federal district court in Wisconsin, where the litigation began.

Six developments are noteworthy:

First, on October 6, 2017, judge Barbara Crabb of the federal district court for the Western District of Wisconsin again ruled that the ministerial housing allowance is an unconstitutional preference for religion. *Gaylor v. Mnuchin, (W.D. Wis. 2017)*. Judge Crabb observed:
[The housing allowance] violates the establishment clause because it does not have a secular purpose or effect and because a reasonable observer would view the statute as an endorsement of religion.

Although defendants try to characterize [the housing allowance] as an effort by Congress to treat ministers fairly and avoid religious entanglement, the plain language of the statute, its legislative history and its operation in practice all demonstrate a preference for ministers over secular employees. Ministers receive a unique benefit . . . that is not, as defendants suggest, part of a larger effort by Congress to provide assistance to employees with special housing needs. A desire to alleviate financial hardship on taxpayers is a legitimate purpose, but it is not a secular purpose when Congress eliminates the burden for a group made up of solely religious employees but maintains it for nearly everyone else. Under my view of the current law, that type of discriminatory treatment violates the establishment clause.

Judge Crabb acknowledged that "Congress could have enacted a number of alternative exemptions without running afoul of the First Amendment. For example, Congress could have accomplished a similar goal by allowing any of the following groups to exclude housing expenses from their gross income: (1) all taxpayers; (2) taxpayers with incomes less than a specified amount; (3) taxpayers who live in rental housing provided by the employer; (4) taxpayers whose employers impose housing-related requirements on them, such as living near the workplace, being on call or using the home for work-related purposes; or (5) taxpayers who work for nonprofit organizations, including churches."

> **Key Point.** But perhaps of most interest was Judge Crabb's suggestion that the tax code be amended to apply to taxpayers "who work for tax exempt organizations under § 501(c)(3) and are on call at all times." Such an amendment would cover most clergy, but few enough employees of secular charities to be feasible as a matter of tax policy.

Second, Judge Crabb stayed the enforcement of her ruling until the end of October so that the parties could submit briefs on appropriate remedies for the plaintiffs. It is likely, though not certain, that when the issue of remedies is resolved the judge will do what she did in her earlier decision in 2014 and stay enforcement of the ruling pending an appeal. But, this is not certain and so ministers and churches should be alert to developments.[1]

Third, a ruling by the Seventh Circuit Court of Appeals would apply to ministers in that circuit, which includes the states of Illinois, Indiana, and Wisconsin. It would become a national precedent binding on ministers in all states if affirmed by the United States Supreme Court—an

[1] On December 13, 2017, Judge Crabb issued a final order agreeing that an injunction was the appropriate remedy, but declining to issue an injunction and agreeing to stay the injunctive relief 180 days after the final resolution of all appeals.

unlikely outcome because the Supreme Court accepts less than 1% of all appeals.[2] Note, however, that the IRS would have the discretion to follow or not follow such a ruling in other circuits and might be inclined to follow it nation-wide to promote consistency in tax administration.

Fourth, churches should continue to designate housing allowances for their ministers for 2018 and future years until the housing allowance is conclusively declared unconstitutional. This could occur in various ways, including the following: (1) Judge Crabb's ruling is not appealed by the government, and the IRS applies it nationally; (2) Judge Crabb's ruling is appealed to the Seventh Circuit Court of Appeals, and the court affirms Judge Crabb's ruling and the IRS elects to apply it nationally; or (3) the United States Supreme Court accepts an appeal of the appellate court's ruling, and determines that the housing allowance is an unconstitutional preference for religion in violation of the First Amendment's ban on any establishment of religion.[3] Ministers should understand that claiming a housing allowance exclusion while this litigation is pending poses a risk that the exclusion may be disallowed and an amended tax return will need to be filed. Ministers should be prepared for this outcome, though it is unlikely that the housing allowance will be declared unconstitutional retroactively. Again, be alert to future developments.

Fifth, the U.S. Department of Justice, which defends the constitutionality of federal legislation (such as the housing allowance), filed a brief with the court asking it to dismiss the FFRF's challenge to the constitutionality of the parsonage exclusion. The Department of Justice noted that section 107 of the tax code grants tax exclusions both for the rental value of parsonages provided to clergy as compensation for the performance of ministerial services and for housing allowances provided to clergy who own or rent their home. But since none of the FFRF's officers were living in housing owned by the FFRF, they lacked standing to challenge the constitutionality of section 107's exclusion of the rental value of church-owned parsonages. The court, noting that FFRF had not opposed this argument, issued a summary judgment dismissing FFRF's challenge to the constitutionality of the parsonage exclusion.

Sixth, in conclusion, ministers and churches should be aware that the housing allowance is under attack. Judge Crabb's ruling may be affirmed on appeal and applied nationwide by the IRS. Should that occur, there are three actions that will need to be implemented quickly:

(1) Many ministers will experience an immediate increase in income taxes. As a result, they should be prepared to increase their quarterly estimated tax payments to reflect the increase in income taxes in order to avoid an underpayment penalty. Note that there will be no effect on self-employment taxes for which the housing allowance is not tax-exempt.

(2) Many churches will want to increase ministers' compensation to offset the adverse financial impact. Thousands of ministers have purchased a home, and obtained a mortgage loan, on the assumption that the housing allowance would continue to be

[2] It is important to note that Judge Crabb's injunction is not limited to the State of Wisconsin and that it appears her intent is for her order to have a national reach.

[3] The case is almost certainly going to be appealed to the Seventh Circuit and eventually the Supreme Court, which may take a few years to work through the judicial system.

available as it has for more than a half century. The sudden elimination of this tax benefit will immediately thrust many clergy into a dire financial position with a mortgage loan based on a tax benefit that no longer is available. Many church leaders will want to reduce the impact of such a predicament by increasing compensation. Such an increase could be phased out over a period of years to minimize the impact on the church. I will be monitoring all future developments, and will keep you posted as they occur.

(3) Ministers who are considering the purchase of a new home should not base the amount and affordability of a home mortgage loan on the availability of a housing allowance exclusion unless and until the courts conclusively rule in favor of the constitutionality of the allowance.

Key Point. Ministers should address the continuing availability of the housing allowance with a tax professional since differing circumstances can affect any decisions made with respect to the housing allowance.

Please visit the Church Alliance website for answers to frequently-asked questions about the clergy housing allowance: http://bit.ly/CA-FAQ.