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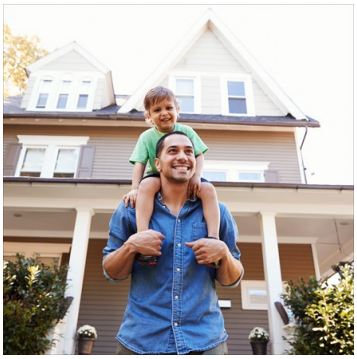

Seventh Circuit: Clergy Housing Allowance Is Constitutional

Appellate court reverses lower court ruling, preserving valuable tax benefit.

Matthew Branaugh

After an appellate court ruled the clergy housing allowance to be constitutionally permissible in March (*Gaylor v. Mnuchin*), churches across the nation breathed a collective sigh of relief. For good reason. The allowance is the most valuable tax benefit to ministers who qualify for it. It's estimated to be worth nearly $700 million a year, according to the congressional Joint Committee on Taxation.

Still, churches should be aware that the clergy housing allowance could be headed for more challenges, either from the Freedom From Religion Foundation (FFRF)—the atheist organization that brought the most recent lawsuit—or other like-minded organizations.

In a statement after the March decision by the US Court of Appeals for the Seventh Circuit in Chicago, the FFRF urged Congress to take the opportunity and intervene by repealing Section 107(2), the Tax Code provision that makes the clergy housing allowance possible. In a tweet, the Associated Press said FFRF is "reviewing options."

Whether the FFRF will petition the US Supreme Court to review the Seventh Circuit's decision remained uncertain at the time this publication went to press. The Supreme Court each year receives about 8,000 petitions, but accepts only 80. CPA Ted Batson said the prospects of a Supreme Court review should be known by sometime in June.

Further, other challenges could emerge in the future. The aforementioned efforts could be made to lobby Congress to repeal this benefit, but the likelihood of this happening is even smaller, said attorney, CPA, and Church Law & Tax senior editor Richard Hammar. A repeal would require gaining enough votes in Congress, an extremely difficult task, he noted.

Alternatively, other lawsuits could be brought. But this is unlikely for technical reasons, including the legal doctrines of res judicata, law of the case, and personal jurisdiction, Hammar said.

The bottom line for now: Church treasurers and finance committees do not have to worry about making budgetary adjustments in the coming months to accommodate for the loss of this tax benefit.

Moving toward the Seventh Circuit decision

In 2017, co-leaders of the FFRF brought their lawsuit before Judge Barbara Crabb of the District Court for the Western District of Wisconsin after their efforts to claim housing allowances were denied by the Internal Revenue Service. In light of that rejection, they argued the housing allowance exclusively benefits ministers, violating the Establishment Clause of the First Amendment. Judge Grabb agreed with the FFRF, and that's how the case ended up in the Seventh Circuit.

The 2017 decision jeopardized the benefit for clergy in Illinois, Indiana, and Wisconsin—the three states covered by the Seventh Circuit—and many predicted similar consequences nationwide, were the Seventh Circuit to affirm the decision on appeal. Such an outcome would have delivered a financial blow to houses of worship and their leaders who qualify for the benefit.

Reversing Judge Crabb's ruling

The opinion of the Seventh Circuit, authored by Circuit Judge Michael Brennan on behalf of a three-judge panel, reversed Judge Crabb's ruling, concluding the 65-year-old benefit does not offend the First Amendment.

It is the first time a federal court of this stature has evaluated the constitutional merits of the clergy housing allowance.

"FFRF claims Section 107(2) renders unto God that which is Caesar's," Brennan wrote. "But this tax provision falls into the play between the joints of the Free Exercise Clause and the Establishment Clause: neither commanded by the former, nor proscribed by the latter."

Applause . . . and cautious optimism

Church leaders, attorneys, and CPAs who serve churches nationwide applauded the decision.

"As the Seventh Circuit rightly decided, clergy members enjoy the housing (and parsonage) allowance not because they are somehow unfairly favored, but because such approach reflects sound tax policy consistent with limited government interference with religion, a level playing field for housing-related tax benefits, and appropriate deference to the role of religious institutions within our country," said Sally Wagenmaker, an attorney with Wagenmaker & Oberly in Chicago and president and chairperson of the Christian Legal Society.

"The ruling is a significant victory for religious freedom," added Noel Sterett, an attorney with Dalton & Tomich in Chicago who has argued other cases before the Seventh Circuit. "Secular workers of all different kinds, be they teachers, nurses, or prison wardens, receive tax-exempt housing when it is for the convenience of their employers. Affording religious leaders and their ministries a similar tax benefit is not preferential treatment but equal treatment."

Others cautioned leaders to take a wait-and-see approach, despite an outcome favoring churches.

"This news comes as a relief to churches and clergy across America," said CPA Michael Batts, an editorial advisor for Church Law & Tax. "Of course, given the possibility of further consideration and appeals, we're not quite to the point

in the story where we can say 'and they all lived happily ever after.'"

A "comprehensive approach"

Section 107(2) allows qualifying ministers who rent or own their own homes to receive an annual housing allowance from their employing church—and not pay federal income taxes on the designated amounts. The provision was adopted by Congress in 1954, after clergy from a variety of faith traditions indicated there was unequal tax treatment for those who were not provided a parsonage from their employing house of worship. Since 1921, clergy who live in parsonages receive federal income tax exemptions for housing-related expenses through Section 107(1) of the Tax Code.

Separately, parts of the Tax Code provide similar tax exemptions for other types of employer-employee housing arrangements.

During oral arguments regarding the appeal last October, the Seventh Circuit justices focused on which legal test should be used to evaluate Section 107(2) in light of the First Amendment. One approach involves the Supreme Court's "historical significance test." Another involves the Supreme Court's three-prong test from *Lemon v. Kurtzman*.

Brennan and the other judges opted to take a comprehensive approach. "Because the Supreme Court has not clarified which should take precedence, we evaluate FFRF's claims under both tests and associated case law," Brennan wrote.

The Seventh Circuit found the housing allowance satisfied all three prongs from *Lemon*. Under the first prong, Section 107(2) maintains a secular legislative purpose, Brennan said. "Parallel provisions" exempt employer-provided housing for employees in other job sectors, he noted. Also, Congress passed Section 107(2) to ensure equal treatment among all ministers, since only those who served at churches providing parsonages could receive the tax break under Section 107(1). And, Brennan said, Section 107(2) provided a method of administering housing allowances for ministers that avoided concerns of "excessive entanglement" by the government that would arise, were other Tax Code provisions pertaining to housing arrangements involving secular entities applied to churches.

Under the second prong of *Lemon*, determining whether the statute advances or inhibits religion, Brennan cited the Supreme Court's decision in *Walz v. Tax Comm. of City of N.Y.*, concluding the tax exemption made possible by the housing allowance statute was not synonymous with a government subsidy. And Section 107(2) met *Lemon*'s third prong since, as noted under the first prong, excessive entanglement concerns would arise were the government to administer tax-exempt housing for ministers using the same methods as applied to secular employers and employees.

Turning to *the* historical significance test, Brennan said "[t]he government and intervenors, and amici curiae supporting their position, have provided substantial evidence of a lengthy tradition of tax exemptions for religion, particularly for church-owned properties." In contrast, Brennan noted, "FFRF offers no evidence that provisions like [Section] 107(2) were historically viewed as an establishment of religion."

What the decision means for churches and clergy

The Seventh Circuit's decision keeps the housing allowance intact for churches and clergy in Illinois, Indiana, and Wisconsin. Churches and clergy nationwide also continue to enjoy the benefit. Treasurers should make sure they have designated allowances for 2019 or make any needed mid-year adjustments to currently designated allowances (see Key Tax Date in the May issue of *Church Finance Today*). Congregations also should continue to designate allowances annually until further notice.

> ***Key point.*** *The IRS audit guidelines for ministers state that the term parsonage allowance includes "church provided parsonages, rental allowances with which the minister may rent a home and housing allowances with which the minister may purchase a home."*
>
> ***Key point.*** *Parsonage and housing allowances should be (1) adopted by the church board or congregation, (2) recorded in written form (such as minutes), and (3) designated in advance of the calendar year. However, churches that fail to designate an allowance in advance of a calendar year should do so as soon as possible in the new year. The allowance will operate prospectively.*
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> **TIP** *For detailed information and tax guidance for both parsonage and housing allowances, see chapter 6 in the* Church & Clergy Tax Guide.

However, leaders also must watch to see how this storyline continues to unfold. FFRF may attempt to petition the Supreme Court, and were the Court to agree to review the case, its decision—potentially affirming or reversing the Seventh Circuit's decision—would become precedent nationwide.

With the possibility of other future challenges still very real, churches and clergy also should still evaluate and adopt contingency plans were the housing allowance benefit ever to go away (see "Tip" below). Those plans can help navigate the financial strain that would arise under such a scenario.

For now, though, such a scenario remains just that—a scenario.

> **TIP** *For recommendations and possible solutions should the housing allowance ever be eliminated, see "Facing a Future Without the Clergy Housing Allowance" in the February 2018 issue of* Church Finance Today.

"The housing allowance is constitutional. Churches may continue designating a housing allowance as they have been doing historically," said attorney and CPA Frank Sommerville, a Church Law & Tax editorial advisor. "While this decision is not final, the pressure is off of church budgets."

ChurchLawAndTax.com will continue covering this matter as new developments occur.

Matthew Branaugh is editor of content and business development for Church Law & Tax.

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