STRADLEY RONON

Nonprofit & Religious Organizations Alert

WWW.STRADLEY.COM

MARCH 2019

Stradley Ronon Stevens & Young, LLP
2005 Market Street
Suite 2600
Philadelphia, PA 19103-7018
215.564.8000 Telephone
215.564.8120 Facsimile
www.stradley.com

With other offices in:
Washington, D.C.
New York
New Jersey
Illinois
Delaware

Seventh Circuit Court of Appeals Saves Parsonage Exemption

For decades, "ministers of the gospel" have been able to exclude from income tax a "housing allowance" paid by their churches as part of their compensation. Section 107(2) of the Internal Revenue Code of 1954, as amended, excludes "the rental allowance paid to him as part of his compensation, to the extent used by him to rent or provide a home and to the extent such allowance does not exceed the fair rental value of the home, including furnishings and appurtenances such as a garage, plus the cost of utilities." After several failed lawsuits by the Freedom from Religion Foundation (FFRF) against the IRS to declare the "parsonage allowance" unconstitutional because it did not include secular entities, FFRF finally got its wish – in October 2017, Judge Barbara B. Crabb of the Western District of Wisconsin, in *Gaylor v. Mnuchin*, declared that Section 107(2) violates the Establishment Clause of the First Amendment (https://www.stradley.com/insights/publications/2017/10/nonprofit-religious-organizations-october-2017). The Treasury Department, along with several intervenor ministers, appealed to the Seventh Circuit Court of Appeals. The Seventh Circuit reversed (http://media.ca7.uscourts.gov/cgi-bin/rssExec.pl?Submit=Display&Path=Y2019/D03-15/C:18-1277:J:Brennan:aut:T:fnOp:N:2309032:S:0)the District Court and held that the parsonage exemption does not violate the Establishment Clause.

Like the District Court had below, the Seventh Circuit applied the *Lemon v. Kurtzman* test to determine whether Section 107(2) violates the Establishment Clause. A statute survives the *Lemon* test unless the challenger demonstrates that (1) it has no secular purpose, (2) its primary effect advances or inhibits religion, or (3) it fosters an excessive entanglement with religion. Unlike Judge Crabb, however, who held that providing a housing allowance to ministers serves no secular purpose, thus failing Lemon on the first prong, the Seventh Circuit accepted the Treasury Department's argument that the parsonage exemption could serve at least three secular legislative purposes. First, it eliminates discrimination against ministers (i.e., any clergy) because Congress carved out similar housing exemptions in the tax code for secular employees receiving the same benefit, known as "convenience of the employer" exemptions. Second, the parsonage exemption eliminates discrimination **between** ministers because, prior to the parsonage exemption becoming law, churches could qualify for a convenience-of-the-employer exemption only if they provided in-kind housing to the minister, which excluded smaller or poorer denominations. And third, the parsonage exemption avoids excessive entanglement with religion because it prevents the IRS from conducting intrusive inquiries (under the prior in-kind housing rule) into how religious entities organize their affairs.

As for the advancing or inhibiting religion prong of *Lemon*, the Seventh Circuit rejected FFRF's argument that it should apply Justice William Brennan's plurality opinion in *Texas Monthly v. Bullock*, which reasoned that a tax exemption for religious publications violated the establishment clause because "every tax exemption constitutes a subsidy that affects nonqualifying taxpayers." Instead, given the absence of a majority opinion, the "law" is found in the narrower concurrence signed by Justices Harry Blackmun and Sandra Day

O'Connor, which effectively limited the case to a dispute over sales tax exemptions and was not a dispute about tax exemptions generally. Applying precedent from *Walz v. Tax Commissioner and Corporation of Presiding Bishop v. Amos*, the court found that providing a tax exemption "does not connote sponsorship, financial support, and active involvement of the government in religious activity."

Finally, the court examined the excessive entanglement prong of *Lemon* as one of the Treasury Department's articulated secular purposes and agreed that the government's decision to exempt ministers from the proof requirements of other convenience-of-the-employer exemptions "prevents the IRS from conducting inquiries into how religious organizations use their facilities." While some entanglement often cannot be avoided, the court explained, only "excessive" entanglement violates the First Amendment. The Seventh Circuit concluded that Congress recognized the potential for excessive entanglement in the prior in-kind test for ministers' housing, and therefore it enacted a less entangling tax exemption.

Having concluded that Section 107(2) passed the *Lemon* test, the Seventh Circuit also examined the statute under what it called the "historical significance" test, which measures compliance with the Establishment Clause according to "references to historical practices and understandings." Applying the test, the court concluded that "FFRF offers no evidence that provisions like § 107(2) were historically viewed as an establishment of religion" and, to the contrary, the government "provided substantial evidence of a lengthy tradition of tax exemptions for religion, particularly for church-owned properties." Under both the *Lemon* and historical significance tests, therefore, the Seventh Circuit held that the parsonage exemption is constitutional.

Judge Crabb had, in addition to *Lemon*, applied an "endorsement" test to measure the validity of the parsonage allowance. In our review of the District Court opinion, we noted that Judge Crabb's constitutional analysis appeared to be on shaky ground because endorsement test analysis almost always occurs in the context of evaluating some government-sponsored religious display – such as Christmas or Hanukkah decorations. Her use of it to render a tax exemption unconstitutional was unprecedented, and indeed, the Seventh Circuit declined to apply it in its opinion. Moreover, we explained – and the Seventh Circuit agreed – that the parsonage exemption should not be viewed in isolation but rather as one of a catalog of 47 individual tax simplification, equity or relief provisions that were implemented in the 1954 overhaul of the Internal Revenue Code, including income of retirees; summer earnings of dependent children; treatment of foster children; adoptions for medical expenses; increasing equity for working mothers and working widows; providing relief for homeowners; excluding income from personal injury or sickness payments; subsistence allowance for payments to police; increasing the percentage of income that could be deducted for charitable contributions "providing the additional [percentage allowed] goes to churches, schools, and hospitals"; and many more.

It is not certain what FFRF will do in response to the decision. Given the current composition of the Supreme Court, a reversal of the Seventh Circuit decision would seem unlikely. But one thing is certain: Litigation over the legitimacy of religious exemptions will continue. FFRF has already filed suit to challenge the exemption from information returns (IRS Form 990) enjoyed by churches. As always, the only certainty is that as religious exemptions continue to be litigated, religious institutions must remain vigilant about these challenges.


Mark E. Chopko


Brandon M. Riley

For more information, contact Mark E. Chopko at 202.419.8410 or mchopki@stradley.com or Brandon M. Riley at 215.564.8147 or briley@stradley.com.