STRADLEY RONON

Nonprofit & Religious Organizations Alert

WWW.STRADLEY.COM

OCTOBER 2017

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

www.meritas.org

Our firm is a member of Meritas – a worldwide business alliance of more than 180 law offices in 80 countries, offering high-quality legal services through a closely integrated group of independent, full-service law firms.

Information contained in this publication should not be construed as legal advice or opinion or as a substitute for the advice of counsel. The enclosed materials may have been abridged from other sources. They are provided for educational and informational purposes for the use of clients and others who may be interested in the subject matter.

Copyright © 2017
Stradley Ronon Stevens & Young, LLP
All rights reserved.

Can the 'Parsonage Allowance' Exemption Be Saved?

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." Several times over the last few years, the Freedom from Religion Foundation (FFRF) has sued the IRS claiming this "parsonage allowance" was unconstitutional because it did not permit secular entities (and in this case specifically FFRF) to exclude a portion of the leadership's salaries designated as "housing allowance."

After several failed attempts, FFRF just got its wish, potentially dealing a tremendous blow to ministers across the country, and threatening them with potentially millions of dollars in new taxes.

On Oct. 6, District Judge Barbara B. Crabb of the U.S. District Court for the Western District of Wisconsin in *Gaylor v. Mnuchin* (http://www.stradley.com/~/media/Files/Publications/2017/10/Gaylor%20Opinion.pdf) declared that Section 107(2) violates the Establishment Clause of the First Amendment. She did not enjoin application of the statute pending further proceedings in her court on the scope and design of a remedy. According to Judge Crabb, "any reasonable observer would conclude that the purpose and effect of § 107(2) is to provide financial assistance to one group of religious employees without any consideration to the secular employees who are similarly situated to ministers." To reach that conclusion, Judge Crabb applied both the *Lemon v. Kurtzman* test that courts employ when litigants challenge a statute on Establishment Clause grounds and the "endorsement" test. 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. Endorsement – which has never commanded strong majority support in the Supreme Court – examines whether "the government's purpose is to endorse religion and whether the statute actually conveys a message of endorsement, viewed from the perspective of a reasonable observer." Judge Crabb concluded that providing a housing allowance to ministers serves no secular purpose, thereby failing *Lemon*. That finding synergistically bolstered her ultimate holding that the statute also failed endorsement because, if a statute serves no secular purpose, a reasonable observer could only conclude that its purpose is to benefit religion. Judge Crabb noted that, rather than singling out ministers for this favorable tax treatment, Congress could have avoided a First Amendment violation through any number of means, including, for example, permitting all taxpayers to exclude housing expenses from their gross income, or permitting just those taxpayers – such as ministers – who live in housing provided by their employer to do so.

The issue is far from settled. Given the potential negative consequences to clergy and their sponsoring ministries, there will certainly be appeals and perhaps even attempts at legislative relief. Moreover, the court's constitutional analysis appears to be on shaky ground. Endorsement test analysis almost always occurs in the context of evaluating some government-sponsored religious display – such as Christmas or Hanukkah decorations. Judge Crabb's use of it to render a tax exemption unconstitutional is unprecedented. The Supreme Court has also only used the secular purpose prong of the *Lemon* test to invalidate government-sponsored prayer or similar displays, but has generously construed it so as not to contravene the work and judgments of legislatures. Flawed analytical tools lead to flawed results.

In our review of the housing allowance, applying *Lemon*, we believe the housing allowance is constitutionally valid under the Establishment Clause. Specifically, under *Lemon*, the parsonage allowance, while aimed at providing tax relief for ministers at the time of enactment, had a valid secular purpose – to relieve perceived discrimination between smaller, less-well-off churches and older and wealthier congregations that had houses to offer their ministers. The benefit to ministers came packaged 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 increased income exemptions for retirees, treatment of foster children as dependents by the foster parent, deduction of medical expenses, increased equity for working mothers and working widows, tax breaks for homeowners, exclusion of income from personal injury or sickness payments, exclusion of subsistence payments to police, and an increase in the percentage of income that could be deducted for charitable contributions "providing the additional [percentage allowed] goes to churches, schools, and hospitals." The congressional reports in 1954 – unremarkably for the time – intended a boost for religion and ministers as the United States fought its Cold War with Communism; it was the same Congress that added the words "under God" to the Pledge of Allegiance. But a "reasonable observer," looking at the act as a whole, would see the exclusion as one of many items that was intended by Congress to bring tax equity to the country.

The court does note that the country is different than it was in 1954 on matters of religion, and that what was seen as a way to end the disparity of compensation packages for ministers between "new" and "old" churches no longer holds sway in practice. And the court gives considerable attention to debunking the application of Section 107(2) as a matter of tax law and policy, concluding that Congress flat out intended to support ministers because they were religious, and that the contemporary application of the parsonage allowance shows wide use far beyond the minister whose church cannot afford to house him but requires him to be close by and use his house as his office. In the court's words, "Congress could have created an exemption for rental housing that is provided by the church or is subject to restrictions imposed by the church (opinion at 31)." Nor is it "means tested"; rather, it is available to all regardless of income (opinion at 36). Those factors seem more to be directed at the wisdom of retaining the exemption and not at its constitutionality under the First Amendment when it was enacted. And the law does not require that every religious exemption or exclusion come packaged with identical exemptions or exclusions for nonreligious entities, or that each exclusion or exemption will be construed in isolation from the enacting legislation.

FFRF's litigation over the parsonage exemption can also be viewed as a litmus test for the wide range of religious exemptions embedded in the tax code and in other statutes and regulations. Given Judge Crabb's ruling and its specific effect on the country's large population of ministers, not to mention the broader implications for bedrock First Amendment principles, the issue appears destined for the Supreme Court, unless Congress can fashion a solution along the lines of what Judge Crabb proposes in her opinion. For now, however, the only certainty is that religious exemptions will continue to be litigated, and religious institutions and ministers alike must remain vigilant to these challenges.

Mark E. Chopko

Brandon Riley

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

© 2017 Stradley Ronon Stevens & Young, LLP