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District Court Strikes Down Federal Income Tax Exemption For Clergy Housing As Unconstitutional

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In this article, Powell and Esedebe discuss a recent district court decision that struck down a federal income tax exemption available only to clergy members for their rental allowance as unconstitutional under the establishment clause of the First Amendment. They explain the court's rationale and discuss the possible implications of this decision should it be appealed and affirmed by the Seventh Circuit and subsequently ruled on by the Supreme Court, including the financial impact on religious organizations and their ministers, the impact on church pension plans, and the availability of other tax exemptions on some employer-provided minister housing.

I. Background of Section 107 — The Parsonage Allowance

Historically, the Internal Revenue Code (the "Code") has provided special tax benefits to clergy who receive employer-assisted housing. Since 1921, section 107 and its predecessors[1] have allowed a "minister of the gospel" (a term broadly interpreted and discussed further below) to exclude from gross income the value of church-provided housing. In 1954, section 107 was amended to allow ministers to exclude from gross income the rental allowance paid to them as part of their compensation. These special clergy tax benefits, commonly known as the parsonage allowance, have been under attack by litigants and some legal scholars for years. Notably in *Warren v. Commissioner*,[2] an appeal involving an IRS challenge to the amount of the rental allowance that could be excluded by a well-known minister, the Ninth Circuit requested a briefing by the parties and amici on the constitutionality of the parsonage allowance itself.[3] However, during the course of the appeal, the constitutional issue was mooted by federal legislation, resulting in dismissal of the case.[4]

On November 22, 2013, more than a decade after *Warren v. Commissioner,* a federal district court declared the parsonage allowance unconstitutional under the establishment clause of the First Amendment. The court reasoned that, because the tax exemption singles out religious leaders for preferential treatment without providing a similar benefit to secular individuals or groups, it could not pass constitutional muster.

II. The Decision

In *Freedom from Religion Foundation Inc. v. Lew*[5] plaintiffs Freedom from Religion Foundation (the "Foundation" or "FFRF"), an organization that seeks to promote and educate the public on matters related to nontheistic beliefs, and its two atheist co-presidents brought suit challenging the constitutionality of section 107(2), which provides:

> In the case of a minister of the gospel, gross income does *not* include —
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> **(2)** 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.[6]

Initially, the plaintiffs also challenged section 107(1), which excludes "the rental value of a home furnished to [a minister] as part of his compensation," that is, the value of the parsonage in kind. However, the plaintiffs failed to oppose the defendants' argument that plaintiffs lack of standing to challenge ment to section 107(1) since

[1] *Id.*
[2] 302 F.3d 1012 (9th Cir. 2002).
[3] The National Association of Church Business Administration appeared as amicus and law professor Erwin Chemerinsky appeared as court-appointed amicus.
[4] The Clergy Housing Allowance Clarification Act of 2002, P.L. 107-181, 116 Stat. 583.
[5] No. 11-CV-626-BBC, 2013 WL 6139723 (W.D. Wis. Nov. 22, 2013).
[6] 26 U.S.C. section 107 — Rental value of parsonages (emphasis added).

FFRF did not provide them housing, and the district court granted the defendants' motion to dismiss regarding this claim.

The plaintiffs argued that under this statute they are treated unequally because ministers of the gospel receive a tax exemption, while plaintiffs do not, even though a portion of their salary from the Foundation is designated as housing allowance. As a result, the plaintiffs sought an order enjoining Treasury Secretary Jacob Lew and then acting IRS Commissioner Daniel Werfel, the defendants, from enforcing the statute as a way to eliminate this unequal treatment.

A. Standing

In her 43-page opinion, District Court Judge Barbara Crabb first tackled the question of whether the plaintiffs satisfied the requirements for standing as articulated in the Supreme Court case *Lujan v. Defenders of Wildlife*.[7]

The plaintiffs argued that their injury is the unequal treatment they receive under section 107(2), and that an order enjoining section 107(2) would redress their injury because it would eliminate this unequal treatment. The defendants argued, on the other hand, that the plaintiffs lacked standing because they had never tried to claim the exemption, and, in the defendants' view, because atheists such as the plaintiffs could conceivably qualify as ministers of the gospel, the plaintiffs should be required to first claim the exemption before challenging the statute.

The court wholly rejected the defendants' standing arguments as implausible. The court repeatedly noted that the defendants could not point to any regulations or decisions suggesting that the IRS recognizes atheism as a religion, or that the IRS would recognize an atheist minister for purposes of the parsonage allowance, or that atheists even *have* ministers. Even if there are atheist ministers, the court said, neither of the plaintiffs here could qualify for the parsonage allowance because they did not meet any of the factors courts consider in analyzing a person's ministerial status for purposes of section 107, which are: whether the individual (1) performs sacerdotal functions under the tenets and practices of the particular religious body constituting his church or church denomination; (2) conducts worship services; (3) performs services in the control, conduct, and maintenance of a religious organization that operates under the authority of a church or church denomination; (4) is ordained, commissioned, or licensed; and (5) is considered to be a spiritual leader by his religious body.[8]

The court found that because the plaintiffs "[did] not come close to meeting any of these factors," and thus could not qualify for the exemption as ministers of the gospel, "it would serve no legitimate purpose to require plaintiffs to claim the exemption and wait for the inevitable denial of their claim." Also, the court cited other cases, such as *Walz v. Tax Commission of City of New York*,[9] where nonexempt taxpayers had standing to challenge an exemption without first claiming the exemption for themselves, to show that the plaintiffs here could challenge the parsonage allowance without first applying for and being denied the exemption.

Thus, the court concluded that the plaintiffs had standing to bring a facial challenge to section 107(2) because the law denied the plaintiffs an exemption that others received, the injury was fairly traceable to the conduct of the defendants because they were responsible for implementing the Code, and the plaintiffs' injury could be redressed by a declaration that section 107(2) is unconstitutional and an order enjoining its enforcement.

B. Merits

The court then tackled the merits of the plaintiffs' claim by analyzing whether section 107(2) violated the establishment clause of the First Amendment. In analyzing the plaintiffs' claim, the court looked to the Supreme Court's prior establishment clause jurisprudence and relied on a slightly modified version of the three-pronged *Lemon v. Kurtzman*[10] test: (1) whether the government's purpose is to endorse religion; (2) whether the statute actually conveys a message of endorsement viewed from the perspective of a reasonable observer; or (3) whether the statute fosters an excessive entanglement with religion.[11]

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[7]504 U.S. 555, 560-61 (1992). Under *Lujan,* to obtain standing a plaintiff must show (1) that she suffered an injury in fact; (2) that is fairly traceable to the defendants' conduct; and (3) that is capable of being redressed by a favorable decision from the court.

[8]*See Knight v. C.I.R.*, 92 T.C. 199, 205 (1989); *see also* reg. section 1.1402(c)-5(b)(2) — Ministers and members of religious orders, which provides that services performed by a minister in the exercise of his ministry include: (1) the ministration of sacerdotal functions; (2) the conduct of religious worship; and

(Footnote continued in next column.)

(3) the control, conduct, and maintenance of religious organizations (including the religious boards, societies, and other integral agencies of such organizations) under the authority of a religious body constituting a church or church denomination.

[9]397 U.S. 664, 666-67 (1970). In *Walz,* although there was no indication that a secular owner of real estate who objected to the issuance of property tax exemptions to religious organizations had requested an exemption for himself before challenging the exemption, the Supreme Court reached the merits of his claim under the establishment clause. In *Arizona Christian Sch. Tuition Org. v. Winn*, 131 S. Ct. 1436 (2011), the Supreme Court acknowledged that it had omitted a standing analysis from *Walz* and suggested that the plaintiff there had standing but thought it inappropriate to speculate on what specific grounds the plaintiff had standing to sue.

[10]403 U.S. 602 (1971). Under *Lemon*, government action violates the establishment clause if (1) it has no secular purpose; (2) its primary effect advances or inhibits religion; or (3) it fosters an excessive entanglement with religion.

[11]*See Lynch v. Donnelly,* 465 U.S. 668, 691 (1984); *Wallace v. Jaffree,* 472 U.S. 38, 69 (1985) (O'Connor, J., concurring); *Elk Grove Unified School District v. Newdow,* 542 U.S. 1, 34 (2004) (O'Connor, J., concurring in the judgment). The Supreme Court has applied the modified *Lemon* test in several cases, *e.g.*, McCreary Cnty., Ky. v. Am. Civil Liberties Union of Ky., 545 U.S. 844 (2005); Zelman v. Simmons-Harris, 536 U.S. 639 (2002), as has the Seventh Circuit Court of Appeals, *e.g., Doe ex rel. Doe v. Elmbrook School District*, 687 F.3d 840 (7th Cir.2012); *Sherman ex rel. Sherman v. Koch*, 623 F.3d 501 (7th Cir.2010).

The court also looked to the Supreme Court's 1989 case, *Texas Monthly Inc. v. Bullock*,[12] which applied the modified *Lemon* test and held that a state sales tax exemption granted solely to religious publishers violated the establishment clause because, as the court explained, . . . the sales tax exemption provided a benefit to religious publications only without a corresponding showing that the exemption was necessary to alleviate a significant burden on free exercise.'' While the court acknowledged the factual differences between the *Texas Monthly* case and the present case, it dismissed these differences as irrelevant and concluded that ''*Texas Monthly* controls the outcome of this case.''

Prong 1: No Secular Purpose

Under the first prong of the test, the court found that section 107(2) did not have a secular purpose. First, the court observed that in some circumstances it is permissible for the federal government to accommodate religion, but said that the parsonage allowance did not fall under this umbrella. ''Defendants do not identify any reason why a requirement on ministers to pay taxes on a housing allowance is more burdensome for them than for the many millions of others who must pay taxes on income used for housing expenses.'' The court pointed to a 1984 memorandum penned by then-Treasury Secretary Donald Regan, who recommended repeal of section 107 because ''[t]here is no evidence that the financial circumstances of ministers justify special tax treatment. The average minister's compensation is low compared to other professionals, but not compared to taxpayers in general.''[13] On this basis, the court concluded that section 107(2) cannot be justified as an accommodation of religion.

Prong 2: Endorsement of Religion

The court next determined that a reasonable observer would view section 107(2) as an endorsement or advancement of religion under the second prong of the test. The defendants attempted to rebut this allegation by asserting that the impetus for section 107(2) could be traced to the convenience of the employer doctrine, later codified under section 119,[14] which allows some employees (for example, those required as part of their employment to be on call 24 hours a day) to exclude from gross income the value of housing provided by their employer in some circumstances. However, the court rejected this argument on the grounds that unlike section 119's housing criteria, ''[s]ection 107(2) does not include any limitations on the type or location of housing that a minister purchases or rents, so it cannot be described as being related to the convenience of the employer doctrine.''

Next, the defendants argued that the purpose of section 107(2) was to eliminate discrimination created by section 107(1), which excludes the rental value of a home furnished to a minister as part of his compensation. The defendants asserted that section 107(1) had a discriminatory effect because it distinguished between wealthy and more established religious sects who could afford to provide homes to their ministers and those that were less wealthy and less established who could not afford to provide such homes. Thus, according to the defendants, section 107(2) was later enacted to eliminate discrimination against ministers who could not claim the section 107(1) exemption for ministers who lived in parsonages.

The court rejected the defendants' line of reasoning on the grounds that section 107(1) was not discriminatory because it did not single out ''certain religions for more favorable treatment; rather, it gives a benefit to ministers who meet certain housing criteria. . . . '' Further, the court stated that ''to the extent that section 107(1) discriminates among religions, section 107(2) does not eliminate that discrimination but merely shifts it.'' First, the court noted that section 107(2) discriminates against those religions that do not have ministers. Second, the court suggested that section 107(2) actually '' . . . creates an imbalance even with respect to those ministers who benefit from section 107(1) because ministers who get an exemption under section 107(2) can use their housing allowance to purchase a home that will appreciate in value and still can deduct interest they pay on their mortgage and property taxes, resulting in a greater benefit than that received under section 107(1).''

The defendants then attempted to cite other provisions in the Code granting housing allowance exemptions for nonreligious reasons as evidence that section 107(2) does not advance religion.[15] However, the court again rejected the defendants' arguments as ''nonstarters'' on the basis that section 107(2) could not rationally be analogized to other housing allowance exemptions because the motivations behind each exemption were different and because the other exemptions did not implicate the establishment clause.

Prong 3: Excessive Entanglement

The court did not analyze the third prong of the test to determine whether the statute fosters an excessive entanglement with religion, stating that ''[i]n any event, because I have concluded that section 107(2) does not have a secular purpose or effect, I need not decide whether the provision fosters excessive entanglement between church and state.''

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[12]489 U.S. 1 (1989). *Texas Monthly*, as noted by Judge Crabb,is the only case in which the Supreme Court has addressed the constitutionality of a tax exemption granted solely to religious persons.

[13]U.S. Department of Treasury, ''Tax Reform for Fairness, Simplicity, and Economic Growth: The Department Report to the President,'' vol. II 49 (1984).

[14]26 U.S.C. section 119 — Meals or lodging furnished for the convenience of the employer.

[15]*See* 26 U.S.C. section 134 permitting members of the military to exclude from their gross income any ''qualified military benefit,'' which includes a housing allowance; 26 U.S.C. section 911, allowing United States citizens who live abroad to deduct a portion of their housing expenses from their gross income; 26 U.S.C. section 912, permitting certain federal employees who live abroad to exclude from their gross income ''foreign area allowances,'' which may include housing expenses.

Conclusion

In the last paragraph of her opinion, Judge Crabb concluded that section 107(2) violates the establishment clause and must be enjoined. However, she said that her holding ''does not mean that the government is powerless to enact tax exemptions that benefit religion.'' Rather, she stated '' . . . if Congress believes that there are important secular reasons for granting the exemption in section 107(2), it is free to rewrite the provision in accordance with the principles laid down in *Texas Monthly* and *Walz* so that it includes ministers as part of a larger group of beneficiaries.''

III. Potential Consequences of Decision

While the plaintiffs have heralded the court's opinion as a ''major federal court victory,'' it is important to keep in mind that the judge stayed her decision until the appeals process is complete, and the defendants filed a notice of appeal on January 24, 2014, to the Seventh Circuit.[16]

Thus, it is difficult to predict with certainty what, if any, final ramifications this decision may have. However, it raises some issues that warrant close watch of further developments in this case:

1. The financial impact on religious organizations and their ministers, if the law is upheld as unconstitutional by the Seventh Circuit or the Supreme Court. (The plaintiffs' press release indicates that the tax reduction was an estimated $2.3 billion in years 2002-2007 alone.)

2. The extent to which, if the decision is upheld, section 119 might still be available to exclude some employer-provided minister housing, particularly because the claims in the case regarding section 107(1) were dismissed for lack of standing.

3. The possible impact of the constitutional analysis on recent church pension litigation, specifically establishment clause challenges to the church plan exemption as applied to separately incorporated 501(c)(3) entities that are not actual churches (such as hospitals, schools, colleges, universities, nursing homes, thrift shops, or other charities).

4. The impact on church pension plans (which under revenue rulings could designate a part of the distribution of deferred compensation as parsonage allowance and thus excludable from income) and some other minister tax rules, such as treatment of employed ministers as subject to self-employment taxes rather than FICA, that allow ministers to exclude from gross income the portion of their compensation designated as a rental allowance.

[16]Under 28 U.S.C. section 2107(b) and Federal Rule of Appellate Procedure 4(a)(1)(B), in a civil action the federal government has 60 days after the entry of a judgment, order, or decree to file a notice of appeal before a court of appeals. As the district court here entered its judgment on November 25, 2013, the Treasury Department had until January 25, 2014, to timely file its notice of appeal. In the docketing statement, defendants asserted that both the district court and the Seventh Circuit lacked subject matter jurisdiction because, among other threshold grounds, the plaintiffs lack Article III standing, the plaintiffs' claims are barred by sovereign immunity, and the plaintiffs' claims are unripe for judicial review.