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Federal District Court Holds the Minister's Housing Allowance Unconstitutional (Again)

The federal district court for the Western District of Wisconsin has, for the second time, held the minister's housing allowance (also referred to as the parsonage allowance) under Internal Revenue Code section 107(2) unconstitutional. Gaylor v. Mnuchin, 16-cv-215-bbc (W.D. Wisc., Oct. 6, 2017). Code section 107(2) provides that a minister may exclude from his or her taxable income "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." Historically, the IRS has interpreted this to apply to deferred compensation as well, so this could have impact on church retirement plans.

The plaintiffs this time were the co-presidents of the Freedom from Religion Foundation along with the Foundation. This is the Foundation's second attempt to have the housing allowance under 107(2) held unconstitutional on the grounds that it discriminates against secular employees and violates both the establishment clause of the First Amendment and the equal protection component of the Fifth Amendment. Notably, the Foundation as plaintiff in the prior litigation initially challenged Code section 107(1) as well, which excludes from a minister's gross income "the rental value of a home furnished to [the minister] as part of his compensation," i.e., the value of living in a church-owned parsonage, but that claim had been dismissed for lack of standing. That prior litigation resulted in a holding by the judge agreeing that section 107(2) was unconstitutional, but on appeal in 2014, the Seventh Circuit vacated that judgment on the ground that Foundation lacked standing to sue. Freedom from Religion Foundation, Inc. v. Lew, 773 F.3d 815 (7th Cir. 2014).

This time around, with individual plaintiffs who had paid income tax on their housing allowance, claimed refunds from the IRS, and been rejected by the IRS, the court found that the plaintiffs had the requisite standing. Reviewing the question again, the judge has adhered to her earlier finding that 107(2) is unconstitutional.

In the opinion, the judge also gives consideration to section 107(1), but held that invalidating section 107(1) along with 107(2) "seems to stretch the limits of judicial power, particularly because a statute similar to § 107(1) existed without § 107(2) for more than 30 years." The judge also discusses section 119, which allows an employee to exclude from his or her gross income "the value of any . . . lodging furnished to him, . . . but only if . . . the employee is required to accept such lodging on the business premises of his employer as a condition of his employment", and section 280A(c)(1), which makes housing expenses tax deductible if the home or a portion of it is "exclusively used on a regular basis" for business purposes. The judge indicated that these provisions might apply if the minister meets their (narrow) requirements. The decision also notes that approximately 87% of all ministers receive cash housing allowance rather than live in church-owned parsonages.

Finally, the court ordered supplemental briefs on the possibility of a stay pending appeal and the appropriate remedy. Presumably, the decision will be appealed. Consequently, we expect the challenge to the constitutionality of the minister's housing allowance to go on. Churches should monitor the situation, as the economic effect could be significant.

With respect to church retirement plans, while existing authority supports the extension of section 107(2) to retirement payments, the IRS has had the question of whether amounts distributed to a retired minister from a pension or annuity plan should be excludible from the minister's gross income as a parsonage allowance under section 107 as a no ruling area for decades, so a change in the tax treatment of minister's pensions may be at stake as well.

If you have any questions about this, contact your Groom lawyer.

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