



Welcome to the 2020 Tax Return Preparation Guide (Ministers' Tax Guide for 2019 Returns), written exclusively for pastors and other ministers by noted CPA and attorney Richard Hammar.

The tax guide is made available as a free benefit to those we serve.

Once again, a team of GuideStone® experts has reviewed this document to ensure it meets the needs of the pastors and other church staff we are privileged to serve.

We know that ministerial tax preparation can be complicated. While this book addresses the most commonly asked questions and most commonly used forms, you can find more extensive information on the IRS website, *IRS.gov*. For specific tax advice, you'll want to consult a tax professional who is familiar with the intricacies of ministerial taxes.

This tax guide serves as a tangible reminder of our vision to honor the Lord by being a lifelong partner with our participants in enhancing their financial security. You can refer your colleagues to *GuideStone.org/TaxGuide* for copies of this booklet, in whole or in part, along with other helpful resources.

May the Lord richly bless you in the ministry you have received from Him!

Sincerely,

A handwritten signature in black ink, appearing to read "O.S. Hawkins". The signature is stylized with a large, looped initial "O" and a long horizontal stroke extending to the right.

O.S. Hawkins
President
GuideStone

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Special Supplement

CURRENT STATUS OF THE PARSONAGE AND HOUSING ALLOWANCE EXCLUSIONS

On November 22, 2013, U.S. District Court Judge Barbara Crabb of the District Court for the Western District of Wisconsin struck down the ministerial housing allowance as an unconstitutional preference for religion (*Freedom From Religion Foundation, Inc., v. Lew*, 983 F. Supp. 2d 1051 (W.D. Wis. 2013)). The ruling was in response to a lawsuit brought by the Freedom From Religion Foundation (FFRF) and two of its officers challenging the constitutionality of the housing allowance and the parsonage exclusion. The federal government, which defended the housing allowance since it is a federal statute, asked the court to dismiss the lawsuit on the ground that the plaintiffs lacked standing to pursue their claim in federal court.

Standing is a constitutional requirement of any plaintiff in a federal case and generally means that a plaintiff must have suffered some direct injury as a result of a challenged law. The Wisconsin court concluded that the plaintiffs had standing on the ground that they would have been denied a housing allowance exclusion had they claimed one on their tax return. The government appealed this ruling to a federal appeals court — the United States Court of Appeals for the Seventh Circuit in Chicago.

On November 13, 2014, the appeals court issued its ruling reversing the Wisconsin court's decision (*Freedom From Religion Foundation, Inc., v. Lew*, 773 F.3d 815 (7th Cir. 2014)). It concluded that the plaintiffs lacked standing to pursue their challenge to the housing allowance. The plaintiffs had asserted that they had standing due to their "injury" of being denied a tax-free housing allowance should they claim one on their tax returns. But the appeals court refused to base standing on theoretical injury. It concluded: "Only a person that has been denied such a benefit can be deemed to have suffered cognizable injury. The plaintiffs here have never been denied the parsonage exemption because they have never requested it; therefore, they have suffered no injury."

The court suggested that this deficiency could be overcome if the FFRF's officers filed tax returns claiming a housing allowance that were later rejected by the IRS in an audit: "The plaintiffs could have sought the exemption by excluding their housing allowances from their reported income on their tax returns and then petitioning the Tax Court if the IRS were to disallow the exclusion. Alternatively, they could have . . . paid income tax on their housing allowance, claimed refunds from the IRS, and then sued if the IRS rejected or failed to act upon their claims."

The FFRF responded to the appeals court's ruling by designating a housing allowance for two of its officers. The officers reported their allowances as taxable income on their tax returns and thereafter filed amended tax returns seeking a refund of the income taxes paid on the amounts of their designated housing allowances. FFRF claims that in 2015 the IRS denied the refunds sought by its officers (one of whom had died and was represented by her executor).

Having endeavored to correct the standing problem, the FFRF renewed its legal challenge to the housing allowance in the federal district court in Wisconsin, where the litigation began.

On October 6, 2017, Judge Crabb again ruled that the ministerial housing allowance is an unconstitutional preference for religion (*Gaylor v. Mnuchin*, (W.D. Wis. 2017)). Judge Crabb observed:

[The housing allowance] violates the Establishment Clause because it does not have a secular purpose or effect and because a reasonable observer would view the statute as an endorsement of religion.

The government promptly appealed this ruling back to the Seventh Circuit Court of Appeals in Chicago, and in March 2019, a three-judge panel unanimously reversed Judge Crabb's decision and affirmed the constitutionality of the housing allowance. It based its ruling on two grounds:

1. The Lemon Test

First, it applied the so-called Lemon test, which dates back to a 1971 Supreme Court ruling in *Lemon v. Kurtzman*, 403 U.S. 602 (1971), in which the Court announced a three-part test for evaluating claims that a state or federal law, such as the housing allowance, constitutes an impermissible establishment of religion under the First Amendment's Establishment Clause. Under the Lemon test, a law challenged on Establishment Clause grounds is valid if it meets three conditions: First, a clearly secular purpose; second, a primary effect that neither advances nor inhibits religion; and third, the law does not foster an excessive entanglement between church and state. The court concluded that all three elements were met, and so the housing allowance did not violate the First Amendment's ban on an establishment of religion.

The court concluded that there was not one, but three, legitimate secular purposes underlying the housing allowance: First, the elimination of discrimination against ministers in the tax code in several provisions granting housing benefits to secular workers. The housing allowance simply treats ministers like secular workers. Second, the elimination of discrimination

between ministers. The point here is that for many years the only tax benefit for ministerial housing was the exclusion of the fair rental value of a church-provided parsonage from taxation. Ministers who did not live in a parsonage, but instead owned or rented a home, received no tax benefit. The housing allowance was enacted by Congress in 1954 to address this discrepancy and provide parity between ministers who lived in parsonages and those who did not. A third secular purpose was the avoidance of excessive entanglement between church and state.

2. Historical Significance

The court based its decision on a second ground that it called the “historical significance test”. According to several rulings by the United States Supreme Court, the First Amendment’s Establishment Clause must be interpreted with reference to historical practices. In other words, the longer a practice has gone unchallenged, the more likely it will survive a challenge under the Establishment Clause. A perfect example of this is a 1983 Supreme Court decision upholding the constitutionality of legislative chaplains. The Court pointed out that the very first session of Congress, in which the First Amendment’s Establishment Clause was drafted, also provided funds for congressional chaplains. That’s pretty strong evidence that congressional chaplains do not constitute an unconstitutional establishment of religion. The appeals court noted that there are more than 2,500 state and federal laws providing tax exemptions of various sorts to religion, and this practice, dating back to the founding of the nation, reinforced the constitutionality of the housing allowance.

The FFRF chose not to appeal the decision by the Seventh Circuit Court of Appeals. It is possible that it, or another hostile organization, will sue in another court. Predicting the future status of a tax benefit such as the housing allowance is a difficult task, but I believe a solid case can be made for the continuation of this benefit for years to come, based on the compelling logic of the appeals court’s decision (which was based squarely on rulings by the United States Supreme Court). Any developments will be addressed in future editions of this tax guide.

How should churches and pastors respond to this ruling? Consider the following:

- Continue designating housing allowances for ministers. The housing allowance remains valid and active for all churches and qualifying clergy across the country.
- Continue to monitor developments.
- In the event that another court invalidates the housing allowance in a final decision, note the following:

- ✓ Many ministers will experience an immediate increase in income taxes. As a result, they should be prepared to increase their quarterly estimated tax payments to reflect the increase in income taxes in order to avoid an underpayment penalty. Note that there will be no effect on self-employment taxes (SECA), for which the housing allowance is not tax-exempt.
- ✓ Ministers who are considering the purchase of a new home should not base the amount and affordability of a home mortgage loan on the availability of a housing allowance exclusion unless and until the courts conclusively uphold the constitutionality of the allowance.
- ✓ Many churches will want to increase ministers’ compensation to offset the adverse financial impact. Thousands of ministers have purchased a home and obtained a mortgage loan on the assumption that the housing allowance would continue to be available as it has for more than a half century. The sudden elimination of this tax benefit will immediately thrust many clergy into a dire financial position with a mortgage loan based on a tax benefit that no longer is available. Many church leaders will want to reduce the impact of such a predicament by increasing compensation. Such an increase could be phased out over a period of years to minimize the impact on the church.
- The fair rental value of church-provided parsonages remains a federal non-taxable benefit.