1. Status of the housing allowance

The constitutional challenge to the clergy housing allowance took an important next step in October when oral arguments for the case were heard before a three-judge panel at a federal appellate court in Chicago.

At stake is a benefit estimated by some to be worth nearly $1 billion annually for clergy members, making it the most valuable tax benefit available to them. In 2017, a federal judge in Wisconsin deemed the benefit to be an unconstitutional preference for religion, invalidating it for ministers in Illinois, Indiana, and Wisconsin. However, the judge “stayed” the decision, meaning it would not go into effect until after an expected appeal was made to the US Court of Appeals for the Seventh Circuit.

The oral arguments in October did not produce a decision, and the timing for one remained uncertain as this issue of Church Law & Tax Report went to press. One should come in the near future, according to the Seventh Circuit’s clerk’s office.

If the Seventh Circuit affirms the lower court’s holding, churches and ministers in Illinois, Indiana, and Wisconsin would lose the ability to use housing allowances. Alternatively, the Seventh Circuit could reverse the lower court’s decision, leaving the benefit intact for churches and ministers in the three states.

The parsonage allowance pertaining to church-owned housing is not at issue in the current case and will not be affected by how the Seventh Circuit decides.

Though the Seventh Circuit comprises only Illinois, Indiana, and Wisconsin, religious leaders nationwide still may feel the effects of the court’s ruling in the following ways:

- Were the Seventh Circuit to affirm, the Internal Revenue Service could decide at some point to apply that decision nationwide to promote consistency among taxpayers.
- Whether the court affirms or overturns the lower court’s holding, either side could seek “certiorari” from the US Supreme Court, and any decision from the Court would become precedential for the entire country. But this scenario is unlikely because the Supreme Court accepts less than 1 percent of all appeals.

- Future challenges could be brought in other parts of the country and eventually make their way through the other federal circuit court systems. Though those courts are not bound to a Seventh Circuit decision, they would consider the decision and possibly find it persuasive.

How we got here

On November 22, 2013, federal 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 the Seventh Circuit.

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.”

It suggested that this deficiency could be overcome if the FFRF’s officers filed tax returns claiming a housing allowance that was 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. The 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 same federal district court in Wisconsin, where the litigation began. Five developments are noteworthy.

First, 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. Although defendants try to characterize [the housing allowance] as an effort by Congress to treat ministers fairly and avoid religious entanglement, the plain language of the statute, its legislative history and its operation in practice all demonstrate a preference for ministers over secular employees. Ministers receive a unique benefit… that is not, as defendants suggest, part of a larger effort by Congress to provide assistance to employees with special housing needs. A desire to alleviate financial hardship on taxpayers is a legitimate purpose, but it is not a secular purpose when Congress eliminates the burden for a group made up of solely religious employees but maintains it for nearly everyone else. Under my view of the current law, that type of discriminatory treatment violates the establishment clause.

Judge Crabb acknowledged that

Congress could have enacted a number of alternative exemptions without running afoul of the First Amendment. For example, Congress could have accomplished a similar goal by allowing any of the following groups to exclude housing expenses from their gross income: (1) all taxpayers; (2) taxpayers with incomes less than a specified amount; (3) taxpayers who
live in rental housing provided by the employer; (4) taxpayers whose employers impose housing-related requirements on them, such as living near the workplace, being on call or using the home for work-related purposes; or (5) taxpayers who work for nonprofit organizations, including churches.

**Key point.** Perhaps of most interest was Judge Crabb’s suggestion that the tax code be amended to apply to taxpayers “who work for tax exempt organizations under § 501(c)(3) and are on call at all times.” Such an amendment would cover most clergy, but few enough employees of secular charities to be feasible as a matter of tax policy.

Second, as noted above, a ruling by the Seventh Circuit would apply to ministers in that circuit, which includes Illinois, Indiana, and Wisconsin. It would become a national precedent binding on ministers in all states if affirmed by the Supreme Court—but again, the likelihood the Supreme Court accepts an appeal is extremely low. Again note, however, that the IRS would have the discretion to follow or not follow such a ruling in other circuits and might be inclined to follow it to promote consistency in tax administration.

Third, churches should continue to designate housing allowances for their ministers for 2019 and future years until the housing allowance is conclusively declared unconstitutional. Such an outcome could occur in various ways, including the following: (1) the Seventh Circuit affirms Judge Crabb’s ruling, and the IRS elects to apply it nationally; or (2) the Supreme Court accepts an appeal of the appellate court’s ruling and determines that the housing allowance is an unconstitutional preference for religion in violation of the First Amendment. Ministers should understand that claiming a housing allowance exclusion while this litigation is pending poses a risk that the exclusion may be disallowed, and an amended tax return would need to be filed. Ministers should be prepared for this outcome, though it is unlikely that the housing allowance will be declared unconstitutional retroactively. Again, be alert to future developments.

Fourth, ministers and churches should prepare for the possibility the clergy housing allowance may not be available at some point in the future. Should that occur, see the section titled “Conclusions” for three actions that should be immediately implemented (and go deeper on these three actions in “Facing a Future Without the Clergy Housing Allowance,” an article in the February 2018 issue of *Church Finance Today* that is available to ChurchLawAndTax.com subscribers).

Fifth, on January 19, 2018, the federal district court in Wisconsin granted a request by two pastors and the Diocese of Chicago and Mid-America of the Russian Orthodox Church (the “intervenors”) to intervene in the case in support of the constitutionality
of the housing allowance. The intervenors filed a motion for summary judgment and made several arguments in support of the housing allowance, including those given below. While these arguments were rejected by Judge Crabb, they may be deemed persuasive by the appeals court.

**Standing**

The intervenors noted that the Constitution limits the jurisdiction of the federal courts to “Cases” and “Controversies,” and “no Case or Controversy exists if the plaintiff lacks standing to challenge the defendant’s alleged misconduct.” To establish standing, plaintiffs bear the burden of demonstrating a “concrete injury” that is traceable to the challenged action of the defendant and that is likely to be redressed by a favorable judicial decision.

In this case, the plaintiffs were seeking only prospective relief. “They do not seek a refund of any taxes that they paid in the past; instead, they seek a nationwide injunction striking down [the housing allowance] prospectively.” To obtain this relief, it is not enough to show “past exposure to illegal conduct.” Instead, they must show “continuing, present adverse effects” that would be remedied by an injunction. The intervenors’ brief asserted that the plaintiffs have failed to demonstrate any continuing harm that would be remedied by an injunction. In fact, the available evidence suggests that they will not suffer continuing harm. According to an FFRF press release, although [the FFRF officers] were denied a refund in 2012, their request for a refund in 2013 was granted. They have produced no evidence suggesting that they will again be denied a refund in the future. Thus, absent a sufficient likelihood that [the FFRF officers] will again be wronged in a similar way, [they are] no more entitled to an injunction than any other citizen of [the United States]; and a federal court may not entertain a claim by any or all citizens who no more than assert that certain practices of [the IRS] are unconstitutional.

**Housing allowance consistent with historical understanding of the First Amendment**

The plaintiffs’ primary claim was that the housing allowance violated the Establishment Clause of the First Amendment, which provides that Congress shall make no law respecting an establishment of religion. The intervenors’ brief noted that in its most recent Establishment Clause decision, the Supreme Court reaffirmed that “the Establishment Clause must be interpreted by reference to historical practices and understandings.” *Town of Greece v. Galloway*, 134 S. Ct. 1811 (2014). The brief continues:
So what does history have to say about the tax treatment of churches and ministers...? While the Establishment Clause prohibits the types of direct financial support that prevailed in colonial establishments—land grants, direct grants from the treasury, and compulsory “tithes” to support churches and ministers—it does not bar the tax exemption at issue here. Such exemptions were common at the time of the Founding and actually further the core Establishment Clause goals of alleviating government burdens on religion, avoiding discrimination among churches, and avoiding entanglement between church and state.

**Housing allowance consistent with the Supreme Court’s Texas Monthly decision**

In 1989, the Supreme Court, in a plurality decision, invalidated a sales tax exemption that applied exclusively to “periodicals . . . that consist wholly of writings promulgating the teaching of [a] faith” and “books that consist wholly of writings sacred to a religious faith.” *Texas Monthly, Inc. v. Bullock*, 489 U.S. 1 (1989). The Court concluded that the sales tax exemption violated the Establishment Clause because it constituted a “subsidy exclusively to religious organizations.” The Court’s central holding was that a religious tax exemption would be constitutional only if it were part of a broader scheme that provided benefits to “a large number of nonreligious groups as well.” The intervenors’ brief explains: “Here, the parsonage allowance is distinguishable from the tax exemption struck down in *Texas Monthly* in important ways. First, unlike *Texas Monthly*, where the tax exemption for religious literature stood alone, the parsonage allowance is coupled with numerous tax exemptions for nonreligious housing allowances.” These include:

- exemptions for any nonreligious employee who receives lodging for the convenience of his employer [tax code § 119(a)].
- any nonreligious employee living in a foreign camp [tax code § 119(c)].
- any nonreligious employee of an educational institution [tax code § 119(d)].
- any nonreligious member of the uniformed services [tax code § 134].
- any nonreligious government employee living overseas [tax code § 912].
- any nonreligious citizen living abroad [tax code § 911].
- any nonreligious employee temporarily away from home on business [tax code §§ 162, 132].
The brief argues that “it is as if, in *Texas Monthly*, the state had coupled the tax exemption for religious literature with a tax exemption for business literature, scientific literature, educational literature, travel literature, and government literature. That would not be a form of preferential support for religious messages; it would be a form of putting religious messages on the same footing as many other secular messages.”

The brief continues:

In short, Congress has enacted a broad package of tax benefits designed to relieve workers who face unique, job-related housing requirements. The default rule is § 119(a)(2), which establishes a demanding, case-by-case test requiring all employees to demonstrate that their lodging is provided for the convenience of their employer. But Congress also relaxed this default rule in a variety of situations where the type of work, the burdens on housing, or a non-commercial working relationship make it likely that the lodging was intended to benefit the employer.

**Key point.** The FFRF suggested that these related exemptions for housing expenses apply only to a small number of secular groups. But according to congressional estimates, the annual value of these exemptions vastly exceeds the benefit provided by the housing allowance to clergy.

The federal government suggested in a reply brief to the FFRF lawsuit in Wisconsin that it is conceivable that the FFRF officers could qualify for a housing allowance because “the IRS does not require that an individual maintain theistic beliefs in order to perform functions that may be considered the duties of a minister of the gospel.” This view finds support in a 1961 ruling by the Supreme Court. *Torasco v. Watkins*, 367 U.S. 488 (1961). In the Torasco case, the Court observed that “religions” need not be based on a belief in the existence of God: “[N]either [a state nor the federal government] can constitutionally pass laws or impose requirements which aid all religions as against nonbelievers, and neither can aid those religions based on a belief in the existence of God as against those religions founded on different beliefs.”

The Court added that “among religions in this country which do not teach what would generally be considered as a belief in the existence of God are Buddhism, Taoism, Ethical Culture, Secular Humanism and others.” In *United States v. Seeger*, 380 U.S. 163 (1965), the Supreme Court interpreted the phrase “religious training and belief” to include a sincere and meaningful belief that “occupies a place in the life of its possessor parallel to that filled by the orthodox belief in God of one who clearly qualifies for the exemption. Where such beliefs have parallel positions in the lives of their respective holder we cannot say that one is ‘in relation to a Supreme Being’ and the other is not.”
In Welsh v. United States, 398 U.S. 333 (1970), the Supreme Court equated purely
moral or ethical convictions with “religious” belief.

The tax code’s special treatment of ministers and churches

The intervenors claimed that

in many cases, the First Amendment not only permits special solicitude
for churches, but requires it. In particular, the First Amendment (1)
restricts government interference in the relationship between churches
and ministers; (2) forbids government entanglement in religious
questions; and (3) prohibits government discrimination among
denominations. These three values—church autonomy, non-
entanglement, and non-discrimination—are reflected throughout the tax
code in specific protections for churches, none of which are available to
secular non-profits.

For example, several provisions protect the relationship between churches and
ministers by exempting churches from paying or withholding certain types of taxes.
The brief cites the following:

• Churches are not required to withhold federal income taxes from ministers in
the exercise of ministry. IRC 3401(a)(9).

• Churches are exempt from Social Security and Medicare taxes for wages paid to
ministers in the exercise of ministry; instead, ministers are uniformly treated
as self-employed. IRC 1402(c)(4), 1402(e), 3121(b)(8).

• Churches are exempt from state unemployment insurance funds authorized
by the Federal Unemployment Tax Act. IRC 3309(b)(1).

Other provisions protect church autonomy by exempting churches from disclosing
information: churches and certain related entities are not required to file Form 990,
which discloses sensitive financial information. IRC 6033(a)(3).

Still others reduce entanglement by offering unique procedural protections:

• Churches receive special procedural protections when subjected to a tax audit.
IRC 7611.

• Churches need not petition the IRS for recognition of their tax-exempt status
under section 501(c)(3). IRC 508(a), (c)(1)(A).
Still others modify tax provisions so that they apply neutrally among various church polities:

- Churches can maintain a single church benefits plan exempt from ERISA for employees of multiple church affiliates, regardless of common control, and for ministers, regardless of their employment status. IRC 414(e).

- Churches can include ministers in 403(b) contracts (a type of tax-deferred benefit) even if ministers do not qualify as employees. IRC 403(b)(1)(A)(iii).

- Churches can provide certain insurance to entities with common religious bonds, even if those entities are not structured to meet normal common control tests. Treas. Reg. § 1.502-1(b).

The intervenors' brief concludes:

In short, the tax code does not treat churches and ministers as ordinary employers and employees. Rather, Congress has crafted numerous tax provisions that apply only to churches and ministers. These provisions, like [the housing allowance] reduce entanglement and prevent discrimination among religions.

The housing allowance and the reduction of entanglement

Any governmental law or policy that fosters excessive entanglement between church and state is suspect under the Establishment Clause. The intervenors' brief argued that the housing allowance "is far less entangling than the next best alternative—which is applying the notoriously difficult [convenience of the employer] standard of section 119 to ministers." Section 119 of the tax code exempts from tax lodging that is (1) furnished by an employer for an employee, (2) furnished in kind, (3) on the business premises of the employer, (4) for the convenience of the employer, and (5) a condition of employment.

The brief explains:

Section 119 is extremely difficult, if not impossible, to apply to ministers. First, it requires the minister to qualify as an "employee" under IRS rules. This, in turn, requires the government to tax differentially depending on internal matters of church polity. If the minister belongs to a denomination that gives him broad autonomy or exposes him to significant economic risk, he may fail this test and be considered self-employed. Some decisions suggest that United Methodist Council ministers would qualify as employees, but Assembly of God [sic] and
various Pentecostal ministers would not. Even if a minister qualified as an employee, a section 119 exemption would be unavailable if one entity provided the housing (such as the congregation), but a different entity qualified as the “employer” (such as the diocese)—thus pressuring churches to make ministers answerable to those paying them.

Once these threshold concerns are overcome, section 119 still requires the government to decide whether a minister’s housing was “furnished for the convenience of the employer” as “a condition of his employment.” This, in turn, requires the government to decide whether the lodging is truly necessary “to enable him properly to perform the duties of his employment.”

Section 107 [the housing allowance] by contrast, recognizes that the government cannot decide which uses of a minister’s home are “necessary” to the mission of the church and which are not. It asks only whether the employee is functioning as a minister. This is an inquiry courts have been conducting for decades—not only in the tax context, but also under the First Amendment “ministerial exception.” Indeed, it is an inquiry that the Supreme Court itself said was constitutionally required just five years ago. *Hosanna-Tabor Evangelical Lutheran Church & School v. E.E.O.C.*, 565 U.S. 171 (2012).

To summarize, the plaintiffs’ argument contradicts core Establishment Clause values. If the housing allowance is eliminated, “the taxation of ministers would no longer be governed by a bright-line rule; instead, it would be governed by the notoriously fact-intensive standard of section 119. The result would be deep, church-state entanglement—with IRS officials forced to answer religious questions about the relationship between churches and ministers and the way ministers use their homes.”

**The Lemon test**

The intervenors claimed that the housing allowance satisfies the Supreme Court’s 1971 ruling in *Lemon v. Kurtzman*, 403 U.S. 602 (1971). In Lemon, the Supreme Court ruled that for a statute to survive an Establishment Clause challenge, (1) it “must have a secular legislative purpose,” (2) “its principal or primary effect must be one that neither advances nor inhibits religion,” and (3) it “must not foster an excessive government entanglement with religion.” The intervenors claimed that this test was satisfied:

Section 107(2) has the valid secular purpose of ensuring fair treatment of ministers’ housing costs under the convenience of the employer doctrine,
reducing government burdens on the exercise of religion, reducing entanglement between church and state, and eliminating discrimination among religions. Its primary effect is to accomplish precisely these goals. And applying section 107 reduces both enforcement and borderline entanglement. Furthermore, section 107 sends a message of neutrality with respect to religion, not endorsement. Just as Congress took the unique circumstances of many secular groups into account when it codified other applications of the convenience of the employer doctrine, so it did with ministers and section 107.

Widespread harm

While not an argument for upholding the constitutionality of the housing allowance, the intervenors' brief pointed out that a ruling in favor of the plaintiffs would produce widespread harm. Hardest hit would be small churches which would be forced to curtail vital ministries and, in some cases, shut down. But the harm would not be limited to small churches. The illogic of plaintiffs' argument threatens scores of longstanding federal and state tax provisions, all of which have been designed to protect the separation of church and state. Fortunately, none of this needs to happen. Plaintiffs lack standing to seek an injunction, because, despite any dispute over their 2012 taxes, the IRS has eliminated any continuing harm by granting their request for a refund of 2013 taxes. But even if the court reaches the merits, it should hold that section 107 is not only permissible under the Establishment Clause, but desirable. Accordingly, the Court should grant summary judgment to defendants on all of plaintiffs' claims.

Conclusions

Should the Freedom From Religion Foundation and its two officers ultimately prevail in their quest to strike down the housing allowance as an unconstitutional preference for religion, what would be the impact? If Judge Crabb's ruling is affirmed on appeal by the Seventh Circuit, this would only apply to ministers in that circuit, which includes Illinois, Indiana, and Wisconsin. It would become a national precedent binding on ministers in all states if affirmed by the Supreme Court—but again, that is an unlikely outcome because the Supreme Court accepts less than 1 percent of all appeals. Again note, however, that the IRS would have the discretion to follow or not follow an adverse Seventh Circuit ruling in other circuits and might be inclined to follow it nationwide to promote consistency in tax administration.

In conclusion, ministers and churches should be aware that the housing allowance remains under attack and one day may be invalidated. Should that occur, three actions
will need to be implemented quickly.

First, 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 for which the housing allowance is not tax-exempt.

Second, many churches will want to increase ministers’ compensation to offset the financial impact. Such an increase could be phased out over a period of years to minimize the impact on the church.

Third, ministers should not consider the housing allowance in assessing the affordability of a new home unless and until the courts conclusively reject the constitutional challenge to the allowance.

*Editor’s note: Go deeper on these three actions in “Facing a Future Without the Clergy Housing Allowance.”*

**2. The Tax Cuts and Jobs Act of 2017**

On December 22, 2017, President Donald Trump signed into law the $1.5 trillion, 1,097-page Tax Cuts and Jobs Act of 2017. In brief, the Act amends the Internal Revenue Code to reduce tax rates and modify credits and deductions for individuals and businesses.

With respect to individuals, the bill:

- Replaces the seven existing tax brackets (10 percent, 15 percent, 25 percent, 28 percent, 33 percent, 35 percent, and 39.6 percent) with seven new and lower brackets (10 percent, 12 percent, 22 percent, 24 percent, 32 percent, 35 percent, and 37 percent).
- Temporarily increases (through 2025) the basic standard deduction to $24,000 for married individuals filing a joint return, $18,000 for head-of-household filers, and $12,000 for all other individuals.
- The significantly increased standard deduction will reduce the number of persons who are able to itemize deductions on Schedule A (Form 1040) from 30 percent to as few as 5 percent of all taxpayers. The result will be a significant decrease in the number of taxpayers who can claim a tax deduction for contributions they make to churches and other charities. Will the loss of a charitable contribution deduction by 95 percent of all taxpayers discourage them from making contributions to their church or favorite charities? Possibly, but note the following: (1) Estimates of the impact of the new law on charitable giving differ widely. (2) IRS statistics demonstrate that the
taxpayers who give the largest percentage of their income to charity are lower income individuals who claim the standard deduction and therefore receive no “benefit” in the form of an itemized deduction for making gifts to charity. (3) Some are suggesting that some donors will be incentivized to give more to charity because of their concern over the potentially negative impact of the Act’s substantial increase in the standard deduction on charitable giving. (4) Perhaps more so than any other charitable donors, those who give to their church or other religious organization do so out of a desire to benefit the recipient rather than provide a tax break for themselves. (5) Should the substantial increase in the standard deduction result in a material decline in charitable giving, there will be increasing pressure on Congress from a wide array of prominent religious and secular charities to provide relief.

• A “section 529 plan” (also known as a “qualified tuition plan”) is a plan operated by a state or educational institution with tax advantages and potentially other incentives to make it easier to save for college and other post-secondary training for a designated beneficiary, such as a child or grandchild. The main tax advantage of a 529 plan is that earnings are not subject to federal tax and generally are not subject to state tax when used for the qualified education expenses of the designated beneficiary, such as tuition, fees, books, as well as room and board. The Tax Cuts and Jobs Act modifies section 529 plans to allow such plans to distribute not more than $10,000 in expenses for tuition incurred during the taxable year in connection with the enrollment or attendance of the designated beneficiary at a public, private, or religious elementary or secondary school. The new rules apply to distributions made after December 31, 2017.

• The Tax Cuts and Jobs Act repeals both the moving expense deduction, and the exclusion of employer reimbursements of moving expenses under an accountable arrangement—except in the case of a member of the Armed Forces of the United States on active duty who moves pursuant to a military order. This provision is effective for taxable years 2018 through 2025. As nonprofit CPA firm CapinCrouse noted in September, the IRS subsequently issued guidance indicating “employee reimbursements or payments an employer makes in 2018 for qualified moving expenses incurred in a prior year are not subject to federal income or employment taxes.” But note: the employee cannot have previously deducted the expenses in a prior tax year.

• Under the Affordable Care Act (Obamacare) individuals must be covered by a health plan that provides at least minimum essential coverage or be subject to a tax (also referred to as a penalty) for failure to maintain the coverage (commonly referred to as the “individual mandate”). The tax for any calendar month is one-twelfth of the tax calculated as an annual amount. The annual amount is equal to the greater of a flat dollar amount or an excess income amount. The flat dollar amount is the lesser of (1) the sum of the individual annual dollar amounts for the members of the taxpayer’s family and (2) 300
percent of the adult individual dollar amount. The individual adult annual dollar amount is $695 for 2017 and 2018. For an individual who has not attained age 18, the individual annual dollar amount is one half of the adult amount. The excess income amount is 2.5 percent of the excess of the taxpayer's household income for the taxable year over the threshold amount of income for requiring the taxpayer to file an income tax return. The total annual household payment may not exceed the national average annual premium for bronze-level health plans for the applicable family size offered through exchanges that year. The Tax Cuts and Jobs Act reduces the amount of the ACA's individual responsibility payment to zero with respect to health coverage status for months beginning after December 31, 2018.

• Under prior law, in determining taxable income, an individual reduced adjusted gross income (AGI) by any personal exemption deductions and either the applicable standard deduction or itemized deductions. Personal exemptions generally were allowed for the taxpayer, the taxpayer's spouse, and any dependents. For 2017, the amount deductible for each personal exemption was $4,050. This amount was indexed annually for inflation, and would have been $4,150 for 2018. The Tax Cuts and Jobs Act of 2017 repeals the deduction for personal exemptions for taxable years 2018 through 2025.

• Under prior law, individuals could claim itemized deductions for certain miscellaneous expenses. Certain of these expenses were not deductible unless, in aggregate, they exceeded 2 percent of the taxpayer's AGI. The deductions described below are subject to the aggregate 2-percent floor:
  • Appraisal fees for a casualty loss or charitable contribution;
  • Casualty and theft losses from property used in performing services as an employee;
  • Clerical help and office rent in caring for investments;
  • Hobby expenses, but generally not more than hobby income;
  • Investment fees and expenses;
  • Safe deposit box rental fees, except for storing jewelry and other personal effects;
  • Trustee's fees for an IRA, if separately billed and paid;
  • Tax preparation expenses;
  • Job search expenses in the taxpayer's present occupation;
  • Licenses and regulatory fees;
  • Passport fees for a business trip;
  • Tools and supplies used in the taxpayer's work;
  • Unreimbursed employee business expenses (see below).

Unreimbursed employee business expenses subject to the 2-percent AGI floor include such items as:
  • overnight out-of-town travel;
  • local transportation;
• meals (subject to a 50-percent AGI floor);
• entertainment (subject to a 50-percent AGI floor);
• home office expenses;
• business gifts;
• dues to professional societies;
• work-related education;
• work clothes and uniforms if required and not suitable for everyday use;
• malpractice insurance;
• subscriptions to professional journals and trade magazines related to the taxpayer’s work; and
• equipment and supplies used in the taxpayer’s work.

The Tax Cuts and Jobs Act suspends all miscellaneous itemized deductions that are subject to the 2-percent floor under present law. As a result, taxpayers may not claim the above-listed items as itemized deductions for the taxable years to which the suspension applies.

This provision is effective for taxable years 2018 through 2025 and will not apply thereafter unless extended by Congress.

One additional note: the IRS issued further guidance last fall with respect to this provision’s effects on business meals. When it comes to business meals, nonprofit CPA firm CapinCrouse said the IRS guidance “conclusively [states] meals are deductible. The rules for deducting meals have not changed unless the meal occurs in the context of entertainment, such as at a sporting event or a theater.”

• The Act temporarily increases the child tax credit to $2,000 per qualifying child (the maximum amount refundable may not exceed $1,400 per qualifying child). The credit is further modified to temporarily provide for a $500 nonrefundable credit for qualifying dependents other than qualifying children (such as aging parents). The provision generally retains the present-law definition of dependent.

• The Act allows taxpayers to claim an itemized deduction of up to $10,000 ($5,000 for married taxpayer filing a separate return) for the aggregate of:
  • State and local property taxes, and
  • State and local income taxes (or sales taxes in lieu of income taxes) paid or accrued in the taxable year.

The new rules apply to taxable years 2018 through 2025.

• Under prior law, individuals could claim an itemized deduction for unreimbursed medical expenses, but only to the extent that such expenses exceeded 10 percent of adjusted gross income. The Tax Cuts and Jobs Act
provides that, for taxable years 2017 and 2018, the threshold for deducting medical expenses shall be 7.5 percent for all taxpayers. It goes back to 10 percent in 2019.

- The alternative minimum tax (AMT) was enacted by Congress in 1969 in response to public outrage over the disclosure that 155 wealthy Americans paid no federal income taxes. From its humble beginnings a half century ago, affecting a handful of taxpayers, the AMT steadily captured more and more Americans. According to the Tax Foundation, 9.7 million Americans had to do the AMT calculations last year, and of those, 3.9 million owed additional taxes. The modifications contained in the Tax Cuts and Jobs Act of 2017 do not repeal the AMT, but ensure that very few taxpayers will be impacted by it. Specifically, the Act temporarily increases both the exemption amount and the exemption amount phaseout thresholds for the individual AMT. The AMT exemption amount is increased to $109,400 for married taxpayers filing a joint return (half this amount for married taxpayers filing a separate return), and $70,300 for all other taxpayers. The phaseout thresholds are increased to $1 million for married taxpayers filing a joint return, and $500,000 for all other taxpayers (other than estates and trusts). These amounts are indexed for inflation.

- The Tax Cuts and Jobs Act doubles the estate and gift tax exemption for estates of decedents dying after 2017 and before 2026. This is accomplished by increasing the basic exclusion amount provided in section 2010(c)(3) of the tax code from $5 million to $10 million. The $10 million amount is indexed for inflation occurring after 2011, and for 2018 was $11.2 million. This amount can be doubled to $22.4 million for married couples who establish a marital deduction trust or qualified terminable interest property trust ("QTIP" trust).

### 3. IRS releases new Form 1040

The IRS has unveiled a new and redesigned Form 1040 that reflects the many tax law changes made by the Tax Cuts and Jobs Act of 2017. Here is the text of the IRS announcement:

As part of a larger effort to help taxpayers, the Internal Revenue Service plans to streamline the Form 1040 into a shorter, simpler form for the 2019 tax season.

The new 1040—about half the size of the current version—would replace the current Form 1040 as well as the Form 1040A and the Form 1040EZ. The IRS circulated a copy of the new form and will work with the tax community to finalize the streamlined [version].
This new approach will simplify the 1040 so that all 150 million taxpayers can use the same form. The new form consolidates the three versions of the 1040 into one simple form. At the same time, the IRS will still obtain the information from each taxpayer needed to determine their tax liability or refund.

The new Form 1040 uses a “building block” approach, in which the tax return is reduced to a simple form. That form can be supplemented with additional schedules if needed. Taxpayers with straightforward tax situations would only need to file this new 1040 with no additional schedules.

Since more than nine out of 10 taxpayers use software or a tax preparer, the IRS will be working with the tax community to prepare for the streamlined Form 1040. This will also help ensure a smooth transition for people familiar with software products and the interview process used to prepare tax returns.

Taxpayers who file on paper would use this new streamlined Form 1040 and supplement it with any needed schedules.

The new Form 1040 is different from its predecessors in several ways, including the following:

- It is half the size of the previous Form 1040 and consists of two half pages.
- Health care coverage (mandatory through 2018) is reported by checking a box on page 1 (it was reported on line 61 on the 2017 form).
- All personal exemptions were repealed after 2017 and so there is no way to claim them on the 2018 Form 1040.
- Some lines have been consolidated. For example, taxable and tax-exempt interest are reported on line 2 (they had separate lines on the 2017 form).
- Wages are now reported on line 1 (instead of line 7 for the past several years).
- Adjusted gross income (AGI) is reported on line 7 (instead of line 37 for the past several years).
- Standard deduction is reported on line 8, and is significantly larger than in 2017 ($12,000 for unmarried persons and $24,000 for married persons filing jointly).
Several credits are now reported on Schedule 3 and consolidated on line 12b (they were reported on separate lines in 2017).

Many lines in the previous Form 1040 have been deleted and transferred to various schedules. For example:

1. Business income is reported on Schedule C as in prior years, but is then posted to Schedule 1 of Form 1040 rather than line 12 as in prior years. In fact, the 79 lines on the 2017 Form 1040 have been reduced to 23, a reduction of more than 50 lines.

2. Adjustments to income, reported on lines 2–37 of the 2017 Form 1040 are now reported on lines 23–36 of Schedule 1 (Form 1040).

3. Schedule 2 (Form 1040) lists taxes that were reported on lines 45–47 in the 2017 Form 1040.

4. Schedule 3 (Form 1040) lists “nonrefundable credits” (including credits for child and dependent care expenses and education credits) that were reported on lines 48–55 in the 2017 Form 1040.

5. Schedule 4 (Form 1040) lists “other taxes” (including the self-employment tax) reported on lines 57–64 in the 2017 Form 1040.

6. Schedule 5 (Form 1040) lists “other payments” (including self-employment taxes) that were reported on lines 65–75 in the 2017 Form 1040.

CAUTION The IRS has announced that there may be additional changes to the 2018 Form 1040 before it is finalized.

4. Revoking an exemption from Social Security

Will Congress give ministers another opportunity to revoke an exemption they previously sought and received from Social Security? It does not seem likely, at least for now. No bills were introduced in Congress in 2018 that would have authorized ministers to pursue a revocation.

5. Inflation adjustments for 2018

Some tax benefits were adjusted for inflation for 2018. But many remained unchanged due to the low rate of inflation. Key changes affecting 2018 returns include the following:

- The alternative minimum tax (ATM) exemption amount for tax year 2018 is greatly increased under the Tax Cuts and Jobs Act. For tax year 2018, the exemption amount for single taxpayers is $70,300 and begins to phase out at $500,000, and the exemption amount for married couples filing jointly is $109,400 and begins to phase out at $1 million.

https://www.churchlawandtax.com/site/utilities/print.html?type=article&id=158813
• For estates of any decedent passing away in tax year 2018, the basic exclusion amount is $11,180,000.

• For tax year 2018, the foreign earned income exclusion will be $104,100.

• The maximum earned income credit amount for tax year 2018 will be $6,431 for taxpayers with three or more qualifying children.

• For tax year 2018, participants who have self-only coverage in a Medical Savings Account must have an annual deductible that is not less than $2,300, but not more than $3,450. For self-only coverage, the maximum out-of-pocket expense amount is $4,550.

For tax year 2018, the floor for the annual deductible for participants with family coverage is $4,550; however, the deductible cannot be more than $6,850. For family coverage, the out-of-pocket expense limit is $8,400.

The dollar amounts for the following items remain unchanged under the new method for adjusting for inflation required by the Tax Cuts and Jobs Act:

• For tax year 2018, the annual exclusion for gifts is $15,000.

• For tax year 2018, the monthly limitation for the qualified transportation fringe benefit is $260, as is the monthly limitation for qualified parking.

• For tax year 2018, the adjusted gross income amount used by joint filers to determine the reduction in the Lifetime Learning Credit is $114,000.

• For tax year 2018, the dollar amount used to determine the penalty for not maintaining minimum essential health coverage is $695.

6. Working after retirement

Many churches employ retired persons who are receiving Social Security benefits. Persons younger than full retirement age may have their Social Security retirement benefits cut if they earn more than a specified amount. Full retirement age (the age at which you are entitled to full retirement benefits) for persons born in 1943–1954 is 66 years. If you are under full retirement age for the entire year, $1 is deducted from your benefit payments for every $2 you earn above the annual limit. For 2019, that limit is $17,640.

In the year you reach full retirement age, your monthly benefit payments are reduced by $1 for every $3 you earn above a different limit. For 2019, that limit is $46,920, but
only earnings before the month you reach full retirement age are counted.

7. Refunding charitable contributions to donors

A California court ruled that a church is not obligated to return undesignated contributions to donors absent fraud or mistake. This case is addressed as a recent development in this edition of Church Law & Tax Report. Lewis v. Double Rock Baptist Church, 2017 WL 491693 (Cal. App. Unpub.).

8. IRS not addressing several church and clergy tax issues in private letter rulings

The IRS will no longer issue private letter rulings addressing the following questions:

- “Whether an individual is a minister of the gospel for federal tax purposes.”
- “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.”
- “Whether a taxpayer who advances funds to a charitable organization and receives, therefore, a promissory note, may deduct as contributions, in one taxable year or in each of several years, amounts forgiven by the taxpayer in each of several years by endorsement on the note.”
- “Whether a transfer is a gift within the meaning of section 102” of the tax code.
- “Whether a compensation transaction satisfied the rebuttable presumption that the transaction is not an excess benefit transaction as described in § 53.4958-6 of the Excess Benefit Transactions Excise Tax Regulations.” Revenue Procedure 2018-3.

9. The new “parking lot tax” on churches

An obscure provision in the Tax Cuts and Jobs Act purports to impose a tax (the unrelated business income tax) of 21 percent on the value of free parking provided by tax-exempt organizations, including churches, to their employees. The Act added section 512(a)(7) to the tax code:

INCREASE IN UNRELATED BUSINESS TAXABLE INCOME BY DISALLOWED FRINGE.—Unrelated business taxable income of an organization shall be increased by any amount . . . which is paid or incurred by such organization for . . . any parking facility used in connection with qualified parking [i.e., parking provided to an employee on or near the
business premises of the employer) to the extent the amount paid or incurred is directly connected with an unrelated trade or business which is regularly carried on by the organization. The Secretary shall issue such regulations or other guidance as may be necessary or appropriate to carry out the purposes of this paragraph.

A prepublication draft version of IRS Publication 15-B (2018) provides some guidance:

For organizations that have employees, unrelated business taxable income (UBTI) reported on Form 990-T, is increased by any amount… which is paid or incurred by the organization after December 31, 2017 for any… parking facility used in connection with qualified parking…. This rule does not apply to the extent the amount paid or incurred is directly connected with an unrelated trade or business which is regularly carried on by the organization.

The prepublication draft version adds:

Organizations that have total gross income of at least $1,000 or more during the year from all unrelated trades or businesses including any addition to UBTI attributable to expenses for a qualified transportation fringe required by section 512(a)(7) must file Form 990-T, to report and pay tax on the resulting UBTI.

All tax-exempt organizations must pay estimated taxes for their unrelated business income if they expect their tax liability to be $500 or more. Use Form 990-W, Estimated Tax on Unrelated Business Taxable Income for Tax-Exempt Organizations, to compute these amounts.

If the combined amount of an organization’s… unrelated business taxable income, including any addition to UBTI attributable to expenses for a qualified transportation fringe required by section 512(a)(7), is $1,000 or more, the organization must report the… other unrelated business income, and the expenses paid or incurred for a qualified transportation fringe on Form 990-T.

Section 512(a)(7) contains no unequivocal exemption for churches. This means that unless and until the IRS provides relief, churches should prepare to comply with the new law by reporting the value of free employee parking to the IRS on Form 990-T and paying the unrelated business income tax (21 percent) on this income. Note the following:
• Tax professionals have reached conflicting interpretations of the meaning of this complex provision and its application to churches.

• Some believe that the provision will not affect the vast majority of churches that provide parking to employees at no charge, and that any effect will be limited to churches in high or moderate-cost parking locations.

• Several bills have been introduced in Congress that would repeal this tax, but as this issue of Church Law & Tax Report went to press, no action has been taken.

• One IRS official has announced that the IRS is considering a postponement of this provision until official guidance is provided. Again, no official action has been taken.

• Section 512(a)(7) states that the Secretary of the Treasury “shall issue such regulations or other guidance as may be necessary or appropriate to carry out the purposes of this paragraph.” Church leaders should expect guidance soon from the IRS.

• It will be difficult, if not impossible, for churches to comply with section 512(a)(7) without knowing how to determine the value of free parking provided to their employees. This calculation may be easier for churches that rent their parking lot to neighboring businesses in urban settings, but such an arrangement does not characterize most churches that do not rent their parking lot to outsiders and whose parking lots largely sit empty during the week, except for church vehicles and the vehicles of members and employees who park free of charge.

• The first $1,000 of unrelated business income is not taxed, and this exemption may insulate many churches from this tax. After all, the value of employee parking in a church’s otherwise vacant parking lot is likely to be small.

• Form 990-T is complex and intimidating, especially for those many churches that have never filed this form. Many smaller and less sophisticated churches will simply not know what to do, which will result in massive noncompliance, forcing Congress or the IRS to act either by exempting churches from this new tax or by creating a much simpler form for churches to file.

• Some tax professionals are predicting that one option the IRS may adopt is a greatly simplified version of Form 990-T.
• Section 512 of the tax code defines the term “unrelated business taxable income” as “the gross income derived by any organization from any unrelated trade or business regularly carried on by it.” Section 513 defines the term “unrelated trade or business” as “any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501. …” The important point is that the unrelated business income tax only applies to income generated by an unrelated trade or business carried on by a church or other tax-exempt organization. But for most churches whose parking lot is used without charge by employees, and is not rented to neighboring businesses, there is no underlying trade or business to generate unrelated business income or the unrelated business income tax.

• Any decision to tax churches immediately raises constitutional concerns because of the potential for excessive entanglement between church and state.

• Given the many uncertainties regarding the new parking lot tax, and the likelihood of future clarifications by the IRS or Congress, church leaders should continue to monitor developments and retain a tax professional to assist with compliance issues. Any developments will be promptly reported on ChurchLawAndTax.com.

10. Tax Court nixes grandmother’s tax scam

While perhaps of limited relevance to most churches, this case was chosen for its human interest value.

A retired grandmother was fond of shopping. Seeking to combine her love of shopping with a desire for a tax cut, she developed in 2010 what she described as her “personal tax shelter.” Having learned that a taxpayer may generally claim a charitable contribution deduction in an amount equal to the fair market value (FMV) of donated property, she assumed that the FMV of a retail item is the dollar amount shown on the price tag when the retailer first offers the item for sale. The grandmother thus saw an opportunity: If she could find items that had been heavily discounted from the amounts shown on their original price tags, she could achieve a net tax benefit simply by buying and immediately donating those items.

Virtually all of the property for which the grandmother claimed charitable contribution deductions consisted of clothing she had purchased at Talbots. She would look for clothing that had been heavily discounted (e.g., out-of-season items) and purchase dozens or hundreds of these items over the course of a year. As a valued
customer, she would thus become entitled to Talbots "points" or "appreciation dividends," which she could then deploy to get further discounts. Contrary to the grandmother's view, the FMV of an item is not the price at which a hopeful retailer initially lists that item for sale. By the time she purchased her clothing, Talbots had marked down the prices of those items three or four times. She purchased each item for a small fraction of its original list price.

The grandmother launched her personal tax shelter in 2010, when she reported noncash charitable contributions of $18,288. That figure grew to $32,672 in 2011 and to $34,401 in 2012. For 2012, she filed a delinquent Form 1040, US Individual Income Tax Return, on April 14, 2014. On Schedule A, Itemized Deductions, she reported noncash charitable contributions of $34,401, corresponding to the original retail prices of discounted items she had purchased at Talbots. She acquired these items by making an outlay of $6,047, i.e., $2,520 in cash and $3,527 in loyalty points.

The grandmother attached to her return six Forms 8283, Noncash Charitable Contributions. She described her donations as "dresses," "jackets," and other items of clothing, and she listed the donees as various Goodwill donation centers. She described her valuation method as "FMV." However, none of the Forms 8283 were executed by a Goodwill official, as the forms explicitly require.

The IRS audited the grandmother's 2012 tax return, and limited her charitable contribution deduction to her cash outlay of $2,520. The Tax Court agreed:

If property or similar items of property are valued in excess of $5,000, the taxpayer must substantiate the value of the property with a "qualified appraisal of such property." To substantiate her contributions [the grandmother] produced receipts from Talbots, marked-down price tags of purchased items, and receipts from Goodwill. On each of the latter receipts, a Goodwill employee had marked the date and location of the donation, the general types of items donated (e.g., clothing), and his signature. [The grandmother] also supplied a spreadsheet she had prepared, which we found to lack any evidentiary value.

[The grandmother] has fallen far short of substantiating noncash charitable contributions in excess of the amount the IRS allowed as a deduction. Because all of the donations were of similar items of property (i.e., clothing), they must be grouped together for purposes of determining whether the $5,000 substantiation threshold has been reached. The grandmother claimed that the value of this clothing was $34,401, but she did not obtain a qualified appraisal. Although she attached several Forms 8283 to her return, they were not executed by an official of the donee organization, as Form 8283 explicitly requires. She likewise failed to secure a valid contemporaneous written acknowledgment as required by [the tax code]. The receipts from Goodwill merely state
that she donated clothing; they do not indicate what specific items of clothing she
donated or the number of items she donated on any particular visit.

Even if [the grandmother] had satisfied the substantiation requirements discussed
above, we would still sustain the IRS's disallowance because she failed to employ a
legitimate methodology to determine the FMV of the donated clothing. The fair market
value is the price at which the property would change hands between a willing buyer
and a willing seller, neither being under any compulsion to buy or sell and both having
reasonable knowledge of relevant facts. The willing buyer-willing seller test of fair
market value is nearly as old as the federal income, estate, and gifts taxes themselves.

Contrary to [the grandmother's] view, the FMV of an item is not the price at which a
hopeful retailer initially lists that item for sale. By the time [the grandmother]
purchased her clothing, Talbots had marked down the prices of those items three or
four times. She purchased each item for a small fraction of its original list price. No
rational buyer having knowledge of the relevant facts would have paid for these items a
price higher than the price Talbots was then charging. [The grandmother] has failed to
establish for the donated items an FMV higher than her acquisition cost. Grainger v.
Commissioner, T.C. Memo. 2018-117.