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Journal

Tax Notes

Author

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Publication Date

2002-08-26



Legal Studies Paper No. 2002-18
TAX NOTES, AUGUST 26, 2002 p. 1243

Parsonage and Tax Policy: Rethinking the Exclusion

Professor Ellen P. Aprill



PARSONAGE AND TAX POLICY: RETHINKING THE EXCLUSION

By Ellen P. Aprill

Ellen P. Aprill is John E. Anderson Professor of Law and Director, Tax LL.M. Program, Loyola Law School, Los Angeles. This article is dedicated to the memory of Justice Byron White, for whom the author clerked during the 1981-82 Supreme Court Term. While she suspects that he would not have agreed with all of her arguments, she is confident that he would have relished a lively discussion of the issues. She is grateful to Len Burman, Sheldon Cohen, Deidre Dessingue, Sandy Holo, Eric Rakowski, and Edward Zelinsky for their insightful — and skeptical — comments on earlier drafts. Her gratitude, however, should not be read as implying their agreement with any of the suggestions made in the report. Mark Tseselsky and Roxana Sadighim provided valuable research assistance.

This report urges changes to the parsonage exclusion of section 107 beyond the recent amendment intended to resolve the dispute between the parties in the pending *Warren* litigation and thus prevent the Ninth Circuit from considering the constitutionality of section 107. For both furnished housing and the paid housing allowance, the proposed revision of section 107 would broaden the reach of the provision beyond ministers of the gospel to employees of any public charity. Such broadening would avoid possible Establishment

Clause problems by including religious organizations in a larger group. It would also reflect our longstanding decision to favor and encourage organizations exempt under section 501(c)(3). For revenue, as well as policy reasons, however, the benefits of revised section 107 would be limited to those employees who must be available for emergency call at all times to meet with members, clients, or patients. As so revised, section 107 would be likely to benefit employees of social service and health care organizations as well as ministers.

The report proposes additional changes to the paid housing allowance. Under the suggested revision, qualified employees who rent or own their own homes would have an exclusion limited to a maximum of \$15,000, a change that would transform the paid housing allowance into a special home office deduction. The paid housing allowance would also be subject to a phaseout as the total economic benefits paid to the employee increase above the level used to identify highly compensated employees under the pension laws, which is \$90,000 for 2002. Section 107 revised along these lines would enable Congress, in our post-September 11 world, to encourage emergency provision of pastoral care, broadly defined, to a variety of charitable recipients.

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This spring, the House and the Senate unanimously passed and President Bush signed into law H.R. 4156, the Clergy Housing Allowance Clarification Act of 2002 (CHACA).¹ CHACA amended section 107, which permits a housing exclusion for “ministers of the gospel.”² It added a provision specifying that, for tax

¹Clergy Housing Allowance Clarification Act of 2002, Pub. L. No. 107-181. See J. Christine Harris, “President Signs Bill Clarifying Housing Allowance for Clergy,” *Tax Notes*, May 27, 2002, p. 1280; “Text of H.R. 4156, Clergy Housing Allowance Clarification Act of 2002,” *Doc 2002-9258 (2 original pages)*, 2002 *TNT* 74-24; “House Unanimously Clears Bill to Address Circuit’s Constitutional Parsonage Allowance Exclusion Queries,” *Doc 2002-9265 (2 original pages)*, 2002 *TNT* 74-3; “Senate Passes Clergy Housing Bill,” *Doc 2002-11549 (1 original page)*, 2002 *TNT* 95-39.

²References are to the Internal Revenue Code of 1986 as amended and to regulations as currently in effect, unless otherwise noted.

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years beginning after December 31, 2001, the exclusion for any housing allowance paid to a minister must be limited to an amount that “does not exceed the fair rental value of the home, including furnishings and appurtenances, such as a garage, plus the cost of utilities.”³

Representative Jim Ramstad, R-Minn., introduced the provision in the House to prevent the Ninth Circuit from considering the constitutionality of section 107(2) in the *Warren* case currently pending before it.⁴ Senator Max Baucus, D-Mont., who sponsored the bill in the Senate, declared that the legislation was “good tax policy.”⁵

This article argues that we could have better tax policy if Congress were to modify what is now the parsonage exclusion. This modification would entail broadening the class of organizations with employees

entitled to a housing exclusion to all public charities, narrowing the eligible class of employees to those on 24-hour emergency call, and limiting the paid housing allowance to a specified dollar amount, with a phaseout based on the employee’s compensation. This alternative would accommodate most of the concerns expressed by the sponsors of CHACA. It would also avoid many difficulties inherent in CHACA.

Most importantly, the suggested revision should withstand any constitutional scrutiny. CHACA does not resolve the Establishment Clause issue. CHACA continues to give a special tax benefit to “ministers of the gospel.” If, on consideration in *Warren* or some future case,⁶ section 107(2) were to be declared unconstitutional, amendment of section 107(2) would become necessary.

Even if the special treatment of clergy in section 107 is constitutionally permitted, it is not constitutionally required.⁷ Whether or not section 107 is constitutional, this article urges Congress to consider important principles of tax policy even when addressing sensitive issues of religion.⁸

Part I offers the revision and an overview of the reasons for the suggested changes. Part II further discusses policy justifications for the revised section 107. Part III considers the strengths and weaknesses of a revised section 107. It concludes with a plea that Congress revise section 107 along the lines outlined in this article not only for constitutional and tax policy reasons, but also to permit a transition that would lessen the burden of any change on clergy and religious congregations.

³Prior to amendment by CHACA, section 107 of the Internal Revenue Code, which is generally known as the parsonage exclusion, read as follows:

In the case of a minister of the gospel, gross income does not include —

- (1) the rental value of a home furnished to him as part of his compensation; or
- (2) the rental allowance paid to him as part of his compensation, to the extent used by him to rent or provide a home.

CHACA added to section 107(2) the language quoted above regarding the fair market value limitation. It also included a special provision that protected those clergy, such as Reverend Warren, who for earlier reported years had not limited the amount of the exclusion for a paid housing allowance to fair market value.

⁴See “House Unanimously Clears Bill to Address Circuit’s Constitutional Parsonage Allowance Exclusion Queries,” *supra* note 2. In the Tax Court, Reverend Warren had succeeded in his challenge to the IRS position, articulated in Revenue Ruling 71-280, 1971-2 C.B. 92, that the paid housing exclusion must be limited to fair market value. *Warren v. Comm’r*, 114 T.C. 23, Doc 2000-13875 (18 original pages), 2000 TNT 96-8 (2000). The IRS appealed to the Ninth Circuit; the Ninth Circuit appointed Professor Erwin Chemerinsky as *amicus curiae* to address the section’s constitutionality and requested supplemental briefing on procedural and substantive aspects of the constitutional issue. *Warren v. Comm’r*, 282 F.3d 1119 (9th Cir. order filed on March 5, 2002) (No. 00-71217), Doc 2002-5592 (2 original pages), 2002 TNT 44-8. After CHACA was signed into law, the parties to the action filed a stipulated dismissal. Stipulation for Dismissal of Appeal, *Warren v. Comm’r* (9th Cir. 2002) (No. 00-71217), Doc 2002-13691 (8 original pages), 2002 TNT 115-63, and Professor Chemerinsky filed an opposition to dismissal and a motion to intervene, Opposition to Stipulated Dismissal and Notice of Motion to Intervene by *Amicus Curiae* Erwin Chemerinsky, *Warren v. Comm’r* (9th Cir. 2002) (No. 00-71217), Doc 2002-13690 (8 original pages), 2002 TNT 115-62. The National Association of Church Business Administration has posted all the court documents in the *Warren* litigation, including Appellees’ Conditional Reply in Support of Stipulated Dismissal and Conditional Opposition to *Amicus Curiae*’s Motion to Intervene and Professor Chemerinsky’s Reply in Support of Opposition. See <http://www.nacba.net/Warren/htm>.

⁵“Baucus Bill Would Clarify Parsonage Allowance,” Doc 2002-10360 (2 original pages), 2002 TNT 86-61.

⁶Further litigation is expected. See Opposition to Stipulated Dismissal, *supra* note 4, at 3; Rakowski, “Are Federal Income Tax Preferences for Ministers’ Housing Constitutional?” *Tax Notes*, Apr. 29, 2002, p. 775 at 779 (“In all likelihood, it is only a matter of time before a court measures section 107 against the Establishment Clause.”); Zelinsky, “Dr. Warren, Section 107, and *Texas Monthly*: A Reply,” *Tax Notes*, June 10, 2002, p. 1663 at 1665 (agreeing with Rakowski on the likelihood of some court addressing the constitutional issue.) Indeed, Professor Chemerinsky has stated in an interview with the National Association of Church Business Administration that he would probably file his own taxpayer lawsuit challenging the constitutionality of the minister housing allowance if *Warren* is dismissed. See <http://www.nacba.net/Warren/H-Astill.htm>.

⁷See *Employment Division v. Smith*, 494 U.S. 787 (1990) (Free Exercise Clause not violated by Oregon law criminalizing the use of controlled substances not aimed at promoting or restricting religious beliefs); *Swaggart Ministries v. Board of Equalization of California*, 493 U.S. 378, 387 (1990) (quoting *Follett v. Town of McCormick*, 321 U.S. 573, 578 (1944) (“a preacher is not ‘free from all financial burdens of government, including taxes on income or property’ and, ‘like other citizens, may be subject to general taxation’”).

⁸See Aprill, “Churches, Politics and the Charitable Contribution Deduction,” 42 B.C. L. Rev. 843 (2001).

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I. Proposed Revision

A. Statutory Language

Congress should consider revising section 107 along the following lines:

**Section 107 Housing Exclusion
For Certain Employees**

(a) Exclusion From Gross Income

- (1) In general. In the case of an employee of an organization exempt under section 501(c)(3), other than a private foundation (as defined in section 509(a)), who is required by the terms of employment to be available to meet with members, patients, or clients upon emergency call at all times, gross income does not include —
 - (A) the rental value of a home furnished to him by his employer; or
 - (B) up to \$15,000 of a housing allowance paid to him as such by his employer, to the extent used by him for housing expenses to rent or provide a home.
- (2) Definition of employee and employer. For purposes of this provision, the term “employee” shall include an individual treated as self-employed under sections 1402(a)(8) and 1402(c)(4) and the term “employer” shall include any organizations paying such employee income subject to self-employment tax pursuant to those provisions.
- (3) Definition of housing expenses. For purposes of this provision, the term “housing expenses” includes expenses attributable to the housing (including furnishings and appurtenances such as a garage, plus such items as utilities and insurance), but does not include interest and taxes of the kind deductible under section 163 or 164.
- (4) No double exclusion. An employee shall be entitled to an exclusion under either subparagraph (a)(1)(A) or (a)(1)(B), but not under both.

(b) Limit Based on Economic Benefit

- (1) In general. The amount that would (but for this subsection) be excluded under subsection (a)(1)(B) for any taxable year shall be reduced (but not below zero) by \$250 for each \$1,000 (or fraction thereof) by which the economic benefit received by the employee from the employer for the taxable year exceeds the amount referenced for a highly compensated employee under section 414(q)(1)(B)(i).
- (2) Economic benefit. The term “economic benefit” shall have the same meaning as the term “economic benefit” has under section 4958.

B. Explanation of Change

To give a brief overview of the suggested revision, it both broadens and narrows the current provision. It

broadens the provision beyond ministers of the gospel to include employees of any public charity exempt under section 501(c)(3). Such broadening avoids possible Establishment Clause problems by including religious organizations in a larger group. As explained further below, it also is consistent with well-established principles of tax policy regarding exempt organizations.

Both for revenue and policy reasons, however, only certain employees of such organizations would be eligible for this tax benefit. Borrowing from the regulations under section 119, the provision that permits employees to exclude from income the value of lodging or meals furnished for the convenience of the employer on the business premises, the employees would be those who must be available for emergency calls at all times to meet with members, clients, or patients. As discussed further below, by requiring a purpose integrally related to the proper performance of the employee’s duties — the so-called “noncompensatory purpose,” the emergency limitation gives a policy basis for the exclusion. At the same time, the cross-reference to section 1402(a)(8) and 1402(c), which specifies that all ministers of the gospel are subject to SECA rather than FICA, makes clear that ministers will continue to benefit from revised section 107, whether they are treated as employees or independent contractors.

Revised section 107(a)(1)(A), following current section 107(1), does not adopt all of the restrictions of section 119. In particular, the revision does not adopt the section 119 condition that the lodging be on the business premises. Revised section 107, like current section 107, requires only that the lodging be furnished to the employee. By using the “furnished” language, the revision avoids some of the difficult questions of what constitutes business premises that have arisen under section 119, difficulties that may be heightened in the case of tax-exempt organizations. Also, since revised section 107 is intended to include clergy among its beneficiaries, using the “furnished” requirement avoids intrusive inquiries into a church’s organization that the “on the business premises” and “condition of employment” tests of section 119 necessitate.

Proposed sections 107(a)(1)(B) and (b) change current law significantly. Under current law, as amended by CHACA, clergy who own their own home can exclude the amounts they have spent during the year up to the fair market value of a furnished home plus utilities.⁹ The exclusion often amounts to many tens of thousands of dollars.¹⁰ Under revised section 107, qualified employees of section 501(c)(3) organization who rent or own their own homes would have a generous but limited exclusion — a maximum of a \$15,000. The exclusion for a paid housing allowance becomes a special home office deduction, with the “office” use of the home being defined temporally instead of spatially.

⁹The amount of the housing allowance must also be designated by “official action” of the church. Reg. section 1.107-1(a).

¹⁰See discussion in text at notes 61-64 *infra*.

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Moreover, the exclusion for a paid housing allowance is subject to a phaseout as the total economic benefits paid to the employee increase above the level used to identify highly compensated employees under the pension laws, which for 2002 is \$90,000.¹¹

These proposed changes again reflect long-established principles of tax policy — that we value forced consumption differently from free consumption and that ours is a system of progressive taxation based on the ability to pay. At the same time, the limit on the exclusion for a paid housing allowance eliminates the need for a fair market value limitation on the exclusion for paid housing allowances, a limitation that was the initial basis for the dispute in the *Warren* litigation.¹² The revised version will ensure that clergy and others who meet the statutory conditions and who are not highly compensated continue to receive a generous tax benefit.

The level of economic benefit at which the paid housing allowance begins to phase out and the definition of what constitutes such economic benefit are borrowed from the recently enacted intermediate sanction regime of section 4958.¹³ Section 4958 applies to public charities (including churches) exempt under section 501(c)(3) and organizations exempt under section 501(c)(4). It imposes an excise tax on disqualified persons, defined as those who are “in a position to exercise substantial influence over the affairs of the organization,”¹⁴ who benefit from an “excess benefit transaction.”¹⁵ Excess benefit transactions include receipt of unreasonable compensation.¹⁶ The safeguards provided by section 4958 help to justify permitting more generous rules under revised section 107 for housing furnished to employees of section 501(c)(3) organizations than under section 119 for employees of for-profit organizations.

The revised provision adopts the model of section 911, which excludes from income certain housing expenses for taxpayers living abroad, to eliminate amounts deductible under section 163 or 164 from the

definition of housing expenses.¹⁷ These deductible expenses will not affect the \$15,000 limit for other housing expenses. Housing expenses up to \$15,000 nor mortgage interest and property taxes will not be subject to income tax, but neither will they be excluded twice, as under current law. Thus, the approach of revised section 107 eliminates the need for section 265(a)(6).¹⁸

II. Policy Considerations

A. Expanding the Class of Eligible Organizations

Making the benefits of revised provision available to the specified employees of section 501(c)(3) organizations takes into account both constitutional and policy considerations. Since “[g]overnment may properly include religious institutions among the variety of private, nonprofit groups that receive tax exemptions,”¹⁹ revised section 107 avoids a possible constitutional infirmity.²⁰

¹⁷Section 911 limits its housing exclusion to the excess of housing expenses over “16 percent of the salary . . . of an employee of the United States who is compensated at a rate equal to the annual rate paid for step 1 of grade GS-14.” Section 911(c)(1)(B)(i). Rather than this complicated formula, revised section 107 proposes a simple dollar limit for reasons discussed in the text at notes 62-71 *infra*.

¹⁸Although the general rule of section 265(a) denies a deduction allocable to exempt income, section 265(a)(6) provides that “no deduction shall be denied under this section for interest on a mortgage on, or real property taxes on, the home of the taxpayer by reason of the receipt of an amount as . . . a parsonage allowance excludable from gross income under section 107.”

¹⁹*Walz v. Tax Commission of the City of New York*, 397 U.S. 664, 689 (1970) (Brennan, J., concurring).

²⁰“The proverbial bottom line is that, given the Court’s current case law, tax benefits extended to religious institutions are constitutional only as part of benefits granted more broadly to secular persons.” Zelinsky, “Are Tax ‘Benefits’ for Religious Institutions Constitutionally Dependent on Benefits for Secular Entities?” 42 *B.C. L. Rev.* 805, 836 (2001). See Rakowski, *supra* note 6, at 787. But see Zelinsky, “Dr. Warren, the Parsonage Exclusion, and the First Amendment,” *Tax Notes*, Apr. 1, 2002, p. 115; Zelinsky, *supra* note 6 (arguing that the constitutional standards should not be so restrictive). Professor Dyer has also suggested expanding the class or organizations eligible for the section 107 exclusion. Dyer, “Redefining ‘Minister of the Gospel’ to Limit Establishment Clause Issues,” *Tax Notes*, June 17, 2002, p. 1809. Rather than have Congress enact such a change, however, he urges that the Ninth Circuit take it on itself to expand “minister of the gospel” to encompass persons who perform similar work for other eleemosynary organizations to avoid the constitutional issue. *Id.* at 1814. I believe that such an expansion would be an extreme case of dynamic statutory legislation, see Eskridge, “Dynamic Statutory Interpretation,” 135 *U. Pa. L. Rev.* 1479 (1987), since both the plain language and the legislative history of section 107 make clear that Congress intended to benefit only clergy. As this article demonstrates, I believe that this kind of a change calls for congressional action, and congressional action should include a con-

(Footnote 20 continued on next page.)

¹¹See 414(q)(1)(B)(i); “IRS Announces Adjustments to Pension Plan Limitations,” *Doc 2002-158* (1 original page), 2001 *TNT* 251-5.

¹²To avoid the need for fair market valuation in the case of a paid allowance and to limit the total amount that can be excluded, revised section 107 specifies that an employee can take either an exclusion for furnished housing or the exclusion for a paid allowance, but is not entitled to an exclusion for both furnished housing and a paid allowance. Under current law, ministers are entitled to both. See Rev. Rul. 59-350, 1959-2 C.B. 45 (permitting exclusion both of rental value of furnished home and additional paid amounts designated as housing allowance and designed to cover utilities).

¹³See reg. section 53.4958-3(d)(3).

¹⁴Section 4958(f)(1).

¹⁵Section 4958(a)(1).

¹⁶See reg. section 53.4958-4(b)(1)(ii) (standards for reasonable compensation).

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Quite apart from the constitutional issues, this larger class is consistent with our nation's longstanding decision to favor and encourage the broad and diverse group of organizations permitted to be exempt under section 501(c)(3) — hospitals, schools, museums, orchestras, social service agencies, and research institutions as well as churches and religious organizations.²¹ “Americans have always believed in pluralism — the idea that a free nation should be hospitable to many sources of initiative, many kinds of institutions, many conflicting beliefs, and many competing economic units. Our pluralism allows individuals and groups to pursue goals that they themselves formulate, and out of that pluralism has come virtually all of our creativity.”²²

Religious organizations play an important role in this pluralism. As Justice William J. Brennan Jr. observed, “[G]overnment grants exemptions to religious organizations because they uniquely contribute to the pluralism of American society by their religious activities.”²³ America boasts an estimated 350,000 religious congregations.²⁴ Unlike other section 501(c)(3) organizations, churches are not required to file for recognition of exemption,²⁵ so their numbers are particularly difficult to estimate. In 1997, the IRS reported a total number of section 501(c)(3) organizations of 692,700.²⁶ Churches thus clearly represent a sizeable portion of the section 501(c)(3) universe. If we were to assume that none of the approximately 350,000 churches has applied for exemption, churches would still represent 35 percent of the total number of section 501(c)(3) organizations. Because many churches do file for recognition of exemption to be on the IRS list of organizations eligible to receive tax-deductible contributions, their percentage is undoubtedly higher. Thus churches and their employees would benefit substantially from a revised section 107.

At the same time, as discussed in more detail in the next section, I expect that employees of other categories of section 501(c)(3) organizations, in particular various employees of a variety of health care organizations and

social service providers,²⁷ would also qualify under revised section 107. Based on IRS numbers, social service agencies are the most numerous of section 501(c)(3) organizations, representing close to 40 percent of the total.²⁸ A variety of social services organizations — including those that provide family counseling, residential care for the elderly or the physically or mentally handicapped, disaster assistance, or substance abuse — are likely to have employees who qualify under revised section 107. Health organizations also represent a large category of section 501(c)(3) organizations, comprising approximately 14 percent of the total and absorbing close to 60 percent of all nonprofit revenues in 1996.²⁹ Hospitals, nursing homes, drug and alcohol treatment centers, hospices — all of these and more are also likely to have employees eligible for revised section 107.

As a result, employees of churches will be one, but not the only, significant group to benefit from revised section 107. Other kinds of exempt organizations that make important contributions to our society and the richness of American civic life will be able to share in its benefit. For both tax policy and constitutional reasons, revised section 107 accommodates those who follow religions with a traditional structure of ordained clergy, those who practice religions without formal clergy, and those who follow no religion at all.

B. Availability for Emergency Call

Revised section 107 adds an explicit requirement that the housing, whether furnished to or by the taxpayer, be for a specified noncompensatory purpose. The new requirement stands in sharp contrast to current section 107, which speaks of a home or rental allowance furnished or paid “as part of compensation.”

The new requirement, that the taxpayer seeking the exclusion be required by the terms of employment to be available to meet with members, patients, or clients on emergency call at all times, is modeled on aspects of the exclusion for lodging under section 119, to which section 107 is often compared.³⁰ Regulation section 1.119-1(b)(1) explains that lodging “will be regarded as furnished to enable the employee properly to perform the duties of his employment when, for example, the lodging is furnished because the employee is required to be available for duty at all times. . . .” In the case of meals excluded under section 119 because the employee must be available for emergency call during the meal period, regulation section 1.119-1(a)(2)(iii)(a) specifies that “it must be shown that emergencies have actually occurred, or can reasonably be expected to occur, in the employer’s business which have resulted

sideration of revenue impact and general principles of tax policy. See Rakowski, *supra* note 6, at 787 (arguing that broadening the class is not a job for the courts); Rakowski, “The Parsonage Exclusion: New Developments,” *Tax Notes*, July 15, 2002, p. 429 at 436 (doubting that the Supreme Court would adopt Professor Dyer’s approach).

²¹Federal income tax exemptions for this broad category go back over 100 years. The Revenue Act of 1894, ch. 349, 32, 28 Stat. 556, exempted “corporations, companies or associations organized and conducted solely for charitable, religious or educational purposes. . . .”

²²John W. Gardner, “The Independent Sector,” in *America’s Voluntary Spirit* (Brian O’Connell, ed.), xiii 1983.

²³Walz, 397 U.S. at 689 (1970) (Brennan, J., concurring).

²⁴Lester M. Salamon, “America’s Nonprofit Sector: A Primer,” 31 (2d Ed. 1999), reprinted in Fishman and Schwarz, *Nonprofit Organizations* 13 (2d Ed. 2000).

²⁵See section 508.

²⁶Internal Revenue Service, “Tax-Exempt Organizations Registered With the IRS,” reprinted in Fishman and Schwarz, *Nonprofit Organizations* 57 (2d Ed. 2000). The IRS table notes that churches need not apply for exemption. *Id.*

²⁷Governmental entities that file for section 501(c)(3) status would be included among eligible organizations. Governmental entities that do not do so would not. See Aprill, “The Integral, the Essential, and the Instrumental: Federal Income Tax Treatment of Governmental Affiliates,” 23 *The Journal of Corporation Law* 803, 809 (1998).

²⁸See Salamon, *supra* note 24, at 15, 16.

²⁹*Id.*

³⁰See discussion at text at notes 41-49 *infra*.

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or will result, in the employer calling on the employee to perform his job during his meal period.” If a revised section 107 is adopted along the lines suggested, a similar sort of showing that employees have been called for emergencies should be required. These kinds of safeguards have worked reasonably well under section 119 and can be expected to do so as well under a revised section 107.

In part, revenue concerns motivate this new requirement for section 107 of noncompensatory purpose. If the class of those entitled to benefit under section 107 is expanded beyond “ministers of the gospel,” some limits are needed to control the revenue loss. Policy considerations also call for this requirement of a non-compensatory purpose. Allowing the value of housing to be excluded from income is an extraordinary tax benefit. The general rule is that “no deduction shall be allowed for personal, living or family expenses.”³¹ Such consumption expenses are a crucial part of our income tax base, as they would be under a consumption tax as well. Some kind of noncompensatory purpose is needed to justify the exclusion for housing.

Policy reasons can also justify limiting the benefits of revised section 107 to this particular noncompensatory purpose and to employees of section 501(c)(3) organizations. Revised section 107 would give a tax benefit to those who sacrifice their time to be available to members of a charitable class with emergency needs. It would reflect a decision by Congress that in our post-9/11 world, the federal government wants to encourage provision of pastoral care, broadly defined to include care of both body and spirit, delivered directly to members of a charitable class. For this reason, revised section 107(a)(1)(A) is available only to employees of section 501(c)(3) organizations who are on 24-hour emergency call to meet with patients, clients, and members.

To some extent, revised section 107 is the mirror image of President Bush’s Faith-Based Initiative, which would have expanded the availability of federal funds to faith organizations that provide social services. In support of the Faith-Based Initiative, a White House spokesman explained that President Bush “believes that community-serving organizations, whether sacred or secular, deserve more . . . support.”³² Instead of extending to sacred organizations governmental support currently limited to secular organizations, revised section 107 extends to secular organizations, especially social service organizations, a governmental benefit currently enjoyed only by sacred organizations.

Under the proposed statutory requirement, the housing exclusion would not extend to the executive director of an exempt organization who could be called away from home in the middle of the night in the case of an office fire. Those who would be eligible are likely to include, for example, hospice grief counselors, some

nurses, respiratory therapists, obstetricians, certain medical residents, and a variety of social workers in many health and social service organizations. The beneficiaries would be only those who, during the tax year, are expected to be and can demonstrate that they will be called on regularly by those they serve outside of their regular working hours as an integral part of their job. It recognizes that, for such employees, their home cannot fully be a sanctuary. At any moment of the day or night, it can become an extension of their place of work because of the demands of pastoral care, defined broadly to include more than the care offered by ministers.

Modern working conditions also counsel the choice of this particular noncompensatory requirement. With the widespread use of home computers and telecommuting, many of us do considerable amounts of work at home, including telephone conferences and virtual meetings. Few of us, however, are called on, as part of our work, to leave our home to aid the sick or troubled or grieving or other members of a charitable class at any hour of the day or night.

Under revised section 107, the many clergy who are on call at all times to minister to the needs of their congregation would meet this test of eligibility for the housing exclusion.³³ A minister of music, professor of religion at a theological seminary, or professor of mathematics at a church-sponsored university whose duties take place at regularly scheduled hours would not.³⁴ At the same time, other employees of section 501(c)(3)

³³A personal aside: I have just finished two years as president of a Reform Jewish congregation with a membership of almost 900 households. When I became president after years of synagogue work, I thought I had a good idea of our clergy’s duties. As president, however, I received all notices of sickness and death in our extended congregational family and with it a new appreciation of the enormous and sudden demands of pastoral care make on congregational clergy. I also know that, when my father died early on a weekend morning, it meant a great deal to me to be able to call on my rabbi.

³⁴Thus, under revised section 107, certain groups of clergy who, under very generous interpretations of section 107, have enjoyed its benefits, may no longer be eligible to do so. These groups could include ministers who teach in seminaries. See reg. section 1.107-1(a) (qualifying services of a minister of the gospel include “performance of teaching and administrative duties at theological seminaries”); LTR 199910055, *Doc 1999-9645 (9 original pages)*, 1999 TNT 49-20 (minister of music and minister of education allowed the 107 exclusion because they were ordained ministers “who [could] perform substantially all of the religious functions within the scope of the Church’s tenets and practices”); Rev. Rul. 70-549, 1970-2 C.B. 6 (because college “in practice” operated as an integral part of a church and because “all subjects taught in the college, whether in natural science, mathematics, social science, languages, etc., were taught with emphasis on religious principles and religious living,” any minister serving on the faculty as a teacher or minister entitled to section 107 exclusion); Newman, “On Section 107’s Worst Feature: The Teacher-Preacher,” *Tax Notes*, Dec. 20, 1993, p. 1505. Currently, retired clergy no longer providing services as a minister are also permitted an exclusion for housing in some circumstances. See Rev. Rul. 75-22 (board of denominational pension fund can designate portion of pension distribution as housing allowance).

³¹Section 262(a).

³²See Patti Mohr, “Republicans Build Momentum Behind Faith-Based Initiatives,” *Tax Notes*, Apr. 30, 2001, p. 733 at 733.

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organizations who make similar sacrifices of their personal lives would also be entitled to this tax benefit.

Experience under section 119 suggests that the on-call test is a relatively objective test and easy to confirm. This revision of section 107 would thus reduce intrusion into the structure and internal workings of churches. Under current law, the section 107 housing exclusion is available only to "ordained, commissioned, or licensed ministers of a church with respect to service performed in the exercise of ministry."³⁵ The regulations define such service to include "the ministration of sacerdotal functions and the conduct of religious worship, and the control, conduct, and maintenance of religious organizations . . . under the authority of a religious body constituting a church or church denomination."³⁶ The current tests enmesh the IRS and federal courts in difficult questions of theology by forcing the government to decide who is a minister engaged in the exercise of ministry.³⁷ They can require detailed examination of the constitution and bylaws of church denominations³⁸ and into theological doctrine. For example, after two cases that went to the Tax Court,³⁹ the IRS changed its position about the structure of the Jewish religion to hold that a Jewish cantor who is not ordained nonetheless can qualify for the housing allowance under section 107.⁴⁰ Revised section 107 avoids such governmental evaluation of religious beliefs, structure, and authority.

C. Furnished Housing

Although the noncompensatory purpose of revised section 107 borrows from section 119, the revision does not adopt other requirements of section 119, despite the important similarities between sections 107 and 119. Both the legislative history of CHACA and the briefs submitted to the Ninth Circuit supporting the constitutionality of the parsonage exclusion under sec-

tion 107(2) tie it, either implicitly or explicitly, to section 119. For example, CHACA as originally introduced explained that one of the purposes of section 107 and its amendments is to

recognize that clergy are required to use their homes for purposes that would otherwise qualify for favorable tax treatment, but which may require more intrusive inquiries by the government into the relationship between clergy and their respective churches with respect to activities that are inherently religious.⁴¹

Briefs in the *Warren* litigation made similar arguments. For example, the Becket Fund for Religious Liberty argued that "Congress' exemption in section 107 of the value of the home provided a minister or the cash allowance paid to the minister to provide a home is permissible legislative judgment that ministers fall within the general class of employees who are expected as part of their job duties to make the home paid for by their employer available to serve the needs of their employer."⁴²

Many supporters of section 107 who liken it to section 119 ignore important differences between the two provisions.

Under section 119, a taxpayer is allowed to exclude from income meals or lodging furnished for the convenience of the employer. Section 119 reflects a conclusion that, although in certain situations the value of meals and lodging provided to an employee "may relieve him of an expense which he would otherwise bear," the provision of such benefits is necessary for

³⁵Reg. section 1.1402(c)-5(a)(2). Reg. section 107-1(a) specifies that the rules of reg. section 1.1402(c)-5 will apply in determining who is a minister of the gospel for purposes of the parsonage exclusion.

³⁶Reg. section 1.107-1(a).

³⁷Under the current tests, for example, the IRS has determined that a chaplain employed full-time by a continuing care retirement home to counsel the sick and grieving, lead prayer meetings, teach, and conduct religious services qualified, LTR 9743037, *Doc 97-29237* (5 pages), 97 *TNT* 207-15, but an ordained minister whose duties also included a mix of education, counseling, and some sacerdotal duties, LTR 9124059, 91 *TNT* 129-36, did not. The latter ruling looked at the percentage of the minister's time devoted to each category; the former did not.

³⁸See, e.g., LTR 8915001, 89 *TNT* 83-18 (examining constitution of denomination's general council and district council bylaws).

³⁹*Silverman v. Comm'r*, 57 T.C. 727 (1972); *Salkov v. Comm'r*, 46 T.C. 290 (1966).

⁴⁰Revenue Ruling 78-301, 1978-2 C.B. 103, concluded that "Judaism traditionally recognizes a dual ministry of both rabbi and cantor," revoked Revenue Ruling 61-213, 1961-2 C.B. 27, and determined that a cantor who is not ordained but is commissioned by a particular congregation is entitled to the 107 housing exclusion.

⁴¹"House Unanimously Clears Bill to Address Circuit's Constitutional Parsonage Allowance Exclusion Queries," *Doc 2002-9265* (2 original pages), 2002 *TNT* 74-3. The version of the CHACA that passed the House and Senate did not include the findings and statement of purpose language included in H.R. 4156 as introduced. Congressman Ramstad explained that these were deleted because tax legislation historically does not include such language. 148 *Cong. Rec.* H1300 (daily ed. Apr. 16, 2002) (statement of Rep. Ramstad). See also "Clergy Housing Bill Sponsor 'Pleased' With Senate Treatment," *Doc 2002-11013* (2 original pages), 2002 *TNT* 87-2 (Congressman Ramstad's spokesperson explaining why language was deleted).

⁴²Brief *Amicus Curiae* of the Becket Fund for Religious Liberty in Support of Affirmance at 15, *Warren v. Comm'r*, 282 F.3d 1119 (9th Cir. 2002) (No. 00-71217), *Doc 2002-11965* (30 original pages), 2002 *TNT* 107-36. Similarly, the National Jewish Commission on Law and Public Affairs stated, "The policy of Section 119 extends to a rabbi's residence, even if it is not on the synagogue's premises, because the rabbi's residence is customarily utilized for the benefit of the congregation." Motion for Leave to File and Brief for the National Jewish Commission on Law and Public Affairs (COLPA) as *Amicus Curiae* in Support of the Constitutionality of Section 107(2) at 10, *Warren v. Comm'r*, 282 F.3d 1119 (9th Cir. 2002) (No. 00-71217), *Doc 2002-11963* (36 original pages), 2002 *TNT* 107-33.

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the employee to “perform the services required of him.”⁴³ It is one of many examples of mixed business and personal outlays the proper treatment of which continually challenge the tax system.⁴⁴

To safeguard its purpose, section 119 itself and the regulations under it specify a series of requirements intended to ensure the existence of business exigency, that the need for lodging is “integrally related to the proper performance of employee’s duties.”⁴⁵ Both the meals and lodging must be on the business premises of the employer. Lodging must be a condition of employment.

Thus, despite the assertions of some who defend section 107, housing owned by the congregation and provided to clergy but at a location removed from the location of the church may not be eligible for exclusion under section 119.⁴⁶ That is, many supporters of section 107 who liken it to section 119 ignore important differences between the two provisions.

Among the difficult issues under section 119 is whether lodging away from the employer’s main business location can qualify for the section 119 exclusion when the employee performs a significant portion of his duties for the employer at the distant location. Both the type and amount of activities bear on this determination. In one well-known case, *The U.S. Junior Chamber of Commerce v. United States*,⁴⁷ the official residence provided to the organization’s president during his term of office qualified as “business premises” because sufficient official business of the organization, including meetings and business entertainment, was conducted at the residence. In another case, however, housing provided to employees of a religious and educational institution did not qualify for section 119 for housing located one to three blocks away from the campus because the services performed there — grading of papers, preparation for classes, and occasional meetings with students and parents — were too insubstantial to make the lodging part of the institution’s business premises.⁴⁸ Other cases similarly find occasional entertainment of business guests or use of a telephone in the residence for calls related to em-

ployment as inadequate to qualify for the section 119 exclusion.⁴⁹

Only some clergy who live in housing owned by their congregations at a distance from the church premises would qualify for the section 119 exclusion. Many would not. Clergy who use their home as a retreat, as a personal sanctuary, defined here as a place for quiet study, reflection, and writing rather than as the place of religious worship, would not be eligible for the section 119 exclusion even if they held an occasional congregational meeting at home. Clergy who meet regularly with members of their congregation at their homes, who frequently host meetings at their homes, etc. might be deemed to satisfy section 119. Even in such a case, other IRS auditors or courts might conclude that these activities could equally have taken place on the church premises and were not for the convenience of the employer.⁵⁰

Thus, the substantive requirements of current section 107 differ considerably from those of section 119. My suggested revision of section 107 retains the “furnished” language of current section 107. It requires only that the lodging be owned (or rented) by the employer. By doing so, it avoids some of the difficult questions raised by section 119 requirements. Revised section 107 is intended to include clergy among the class to be benefited; the revision accepts the argument of supporters of section 107 that the “furnished” requirement, with its objective and bright-line test, promotes the Establishment Clause of the First Amendment by avoiding the need to make inquiries into the operation of a church to determine what constitutes the convenience of the employer. Moreover, a revised section 107 would extend to all section 501(c)(3) organizations, and the simple “furnished” requirement avoids any difficult issues of what constitutes “business” for a nonprofit charity.

Importantly, the proposed revision drops the current language “as part of compensation.” While the regulations under section 119 recognize that lodging provided for the convenience of the employer will have in part a compensatory purpose,⁵¹ some noncompensatory purpose is also required. Current section 107 has no such requirement, but, as discussed above, revised section 107 adds a noncompensatory requirement. To be eligible for the tax benefit of revised section 107, taxpayers, whether they have housing furnished to them or furnish their own, must be on-call for emergencies to meet with patients, clients, and members. Revised section 107, then, is more generous than sec-

⁴³*Benaglia v. Comm’r*, 36 B.T.A. 838, 840, 839 (1937), *acq.* 1940-1 C.B. 1.

⁴⁴See Halperin, “Business Deductions for Personal Living Expenses: A Uniform Approach to an Unsolved Problem,” 122 *U. Pa. L. Rev.* 859 (1974).

⁴⁵Stechel, 520 T.M., *Entertainment, Meals, Gift and Lodging — Deduction and Recordkeeping Requirements*, at A-110 (2001).

⁴⁶See Dyer, *supra* note 20, at 1811-13 (comparing sections 107 and 119).

⁴⁷334 F.2d 660 (Ct. Cl. 1964).

⁴⁸*Bob Jones University v. United States*, 670 F.2d 167 (Ct. Cl. 1982). This case predates the special provision for lodging supplied to an employee of a “qualified educational institution” now available under section 119(d). I doubt that many taxpayers currently eligible for the benefits of section 119(d) would also qualify under revised section 107. If I am wrong, some coordination between the two sections would be necessary.

⁴⁹*Winchell v. United States*, 564 F. Supp. 131 (D. Neb. 1983); *McDonald v. Comm’r*, 66 T.C. 223 (1976).

⁵⁰“The IRS resists the concept of functional business premises and does not rule favorably that housing is excludible if the employee does not render most of his services on those ‘business premises.’” Stechel, *supra* note 45, at A-111.

⁵¹If the conditions of the section 119 regulations are met, meals or lodging can be excluded from income even if there is a compensatory as well as a noncompensatory reason. See reg. section 1.119-1(a)(2)(ii)-(b).

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tion 119 in terms of the lodging's location, but less generous in that only those employees of section 501(c)(3) organizations who are on 24-hour emergency call can benefit.

The nature of section 501(c)(3) organizations offers a further justification for permitting only employees of section 501(c)(3) organizations, rather than employees of all businesses, to exclude the value of housing from income so long as it is furnished, whether or not on the business premises. An organization any "part of the net earnings of which inures to the benefit of any private shareholder or individual" will not qualify as exempt under section 501(c)(3).⁵² As Professor Hansmann has written, these organizations "cannot issue ownership shares that give their holders a simultaneous right to participate in both net earnings and control."⁵³ As a result, in the case of a section 501(c)(3) organization, there is less likelihood of certain abuses possible under section 119, such as a sole proprietorship incorporating in order for the 100 percent shareholder to be treated as an employee eligible for the benefit of section 119.⁵⁴

Of course, section 501(c)(3) organizations are not free from the potential for abuse. As Professor Hansmann has also observed, "managers of nonprofits often find, and take advantage of, the opportunity to profit at the expense of the organization."⁵⁵ Nonetheless, the excise tax regime of section 4958, which is applicable to section 501(c)(3) organizations but not to for-profit businesses, offers protection that permits eliminating for purposes of section 107 the business premises requirement found in section 119. Congress enacted section 4958 in 1996 to police payment of excessive compensation to employees who exercise substantial influence over a tax-exempt organization.⁵⁶ Important for revised section 107, the recently promulgated final regulations make clear that, in determining reasonable compensation, certain benefits, including those excluded under section 132 may be disregarded but larger amounts, such as lodging furnished for the convenience of the employer under section 119, may not.⁵⁷

D. Paid Allowance — Dollar Limit

The exclusion of section 119 applies only when the employer furnishes lodging to its employee. In no case does its benefit extend to allowances paid to employees to enable them to provide their own lodging. In contrast, under section 107, as amended by CHACA, clergy can exclude from income any housing allowance paid to them up to the full fair market value of their home.

⁵²Section 501(c)(3).

⁵³Hansmann, "The Rationale for Exempting Nonprofit Organizations From Corporate Income Taxation," 91 *Yale L.J.* 54, 72 (1981).

⁵⁴See *J. Grant Farms, Inc. v. Comm'r*, 49 T.C.M. 1197 (1988).

⁵⁵Hansmann, "Reforming Nonprofit Corporation Law," 129 *U.Pa. L. Rev.* 497, 504 (1981).

⁵⁶See *Report on Reforms to Improve the Tax Rules Governing Public Charities*, Subcommittee on Oversight of House Committee on Ways and Means, 103d Cong. 2d Sess. (1994).

⁵⁷See T.D. 8978, 62 *Fed. Reg.* 3076, Doc 2002-1734 (95 original pages), 2002 TNT 15-22.

The most significant changes in revised section 107 are those to the paid allowance for housing. My revision introduces two limits on any paid allowance for housing: a maximum dollar limit of \$15,000 and a phaseout based on compensation. These changes reflect both policy and practicality. As a practical matter, expanding the class of beneficiaries to all section 501(c)(3) organizations requires other limits to prevent too great a revenue loss. The dollar and income limits, like the on-call requirement, control revenue loss.

These limits also have an important source in policy considerations. In 1954, when section 107(2), the paid housing allowance provision, was introduced into the code, the legislative history stated:

Under present law, the rental value of a home furnished a minister of the gospel as a part of his salary is not included in his gross income. This is unfair to those ministers who are not furnished a parsonage, but who receive larger salaries (which are taxable) to compensate them for expenses they incur in supplying their own home. Both the House and your committee has [sic] removed the distinction in existing law by providing that the present exclusion is to apply to rental allowance paid to ministers to the extent used by them to rent or provide a home.⁵⁸

In fact, owning a home is very different from having a home furnished by an employer. Commentary on section 119 points out this distinction by questioning the convenience-of-the-employer rationale. It offers instead a rationale based on forced consumption instead of freedom of choice: "the meals-and-lodging exclusion does appear to reflect a willingness, on the part of Congress and the courts, to take account of the possibility that the taxpayer's reward may be worth less to him than their market value, and to solve the measurement problem that results by valuing the benefit received at zero."⁵⁹ In addition, those who buy their own homes using a housing allowance, unlike those who are furnished a home, have a place to live when their employment ends. They build equity in the home and have the opportunity to benefit from appreciation in the home's value.⁶⁰

⁵⁸S. Rep. No. 83-1622, at 186 (1954).

⁵⁹Marvin A. Chirelstein, *Federal Income Taxation: A Law Student's Guide to the Leading Cases and Concepts* 22 (9th Ed. 2002). Several friends active in their churches have described to me the dilemma they faced when clergy did not want to live in the parsonage on the church grounds, however, beautiful and valuable the parsonage might be. In one case, the requirement that the clergy live in the parsonage became a key issue in negotiations to hire the candidate.

⁶⁰As Richard R. Hammar, *Church and Clergy Tax Guide* (2002 Edition) at 164-65, states, "Ministers who live in church-owned parsonages experience a significant disadvantage — they do not acquire any equity in a home Some churches have helped ministers who live in parsonages avoid or at least reduce the adverse economic impact of this housing arrangement by providing them with an equity allowance over and above their stated compensation. This allowance is designed to partially or wholly compensate the minister for the 'lost opportunity' of accumulating equity in a home."

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Under current law, the housing exclusion awards clergy an enormous tax benefit, both individually and in the aggregate. The Joint Committee on Taxation has estimated that section 107 will cost the government \$400 million in lost tax revenue this year and \$500 million in future years.⁶¹ Reverend Warren excluded \$77,663 in 1993; \$76,309 in 1994, and \$79,999 in 1995.⁶² A survey of 2001 church compensation indicates that senior ministers in congregations with over 1,000 average attendance report average total compensation of over \$100,000⁶³ and ministers of such large congregations in urban areas report an average housing allowance of over \$40,000.⁶⁴ If, for ease of calculation, we assume that, without the section 107 exclusion, such ministers would be taxed at a 30 percent marginal income tax rate, section 107 saves these ministers more than \$12,000 in income taxes per year. Moreover, under section 265(a)(6), the ministers may also take the mortgage interest deduction, even though the deductions are allocable to amounts that are excluded from income.

Nonetheless, revised section 107 continues a limited exclusion for paid housing allowances to recognize, as discussed earlier, that being on call at all times does transfer the home in part into a place of work. The maximum \$15,000 exclusion for paid housing allowances becomes analogous to section 280A. It is a special home office provision, one that does not require exclusive use of a particular area or a demonstration that the home office is required for the convenience of the employer⁶⁵ and one to which Congress will have assigned a predetermined value.

⁶¹"JCT Estimates Federal Tax Expenditure for 2002-2006," *Doc 2002-1511* (35 original pages), 2002 TNT 13-12. This is the estimate prior to amendment by CHACA. The Joint Committee has estimated that the amendment of section 107 made by CHACA will save \$33 million in revenue over the period of 2002-2012. "JCT Estimates Revenue Effects of Clergy Housing Bill," *Doc 2002-9621* (1 original page), 2002 TNT 76-19.

⁶²*Warren v. Comm'r*, 114 T.C. 343, 345 (2000). He did not limit the exclusion to fair rental value, however.

⁶³James F. Cobble Jr. and Richard R. Hammar, *Church Law & Tax Report: The 2002 Compensation Handbook for Church Staff*, p. 34 (henceforth *Church Compensation Handbook*). The number of respondents for senior pastors in churches with attendance over 1,000 was 125. *Id.* at 48. The *Church Compensation Handbook* presents data from nearly 3,000 Protestant churches. While therefore not comprehensive as to all religious denominations, its findings are nonetheless illustrative. For congregations with attendance between 501-750 average reported housing allowance for 131 respondents is: \$25,383 (urban); \$25,696 (suburban); \$22,432 (medium city); \$20,032 (small town); \$39,700 (rural). For congregations with attendance over 1,000, the numbers for housing allowance in all categories are \$42,502 (urban); \$36,376 (suburban); \$28,930 (medium city); and \$29,555 (small town). *Id.* at 46, 48.

⁶⁴*Id.* at 48 (20 respondents).

⁶⁵For an office attached to the taxpayer's home, the home office deduction is permitted for a taxpayer as an employee only when there is "exclusive use" that is "for the convenience of his employer" as "the principal place of business" or "as a place of business which is used by patients, clients, or customers in meeting or dealing with the taxpayer in the normal course of his trade or business." Section 280A(c)(1).

At the same time, because mortgage interest and property taxes are already deductible under sections 163 and 164, revised section 107 specifies that the \$15,000 must consist of items other than mortgage interest and property taxes. Revised section 107 eliminates the double deduction of mortgage interest currently permitted and the need for section 265(a)(6).

By permitting this limited exclusion for paid housing allowances, revised section 107 also addresses concerns of legislators and other defenders of current section 107. For example, the limited housing allowance under revised section 107 will help newly established organizations or those in densely populated areas that cannot themselves afford to acquire property for housing for their employees, however much they would like to do so. Defenders of section 107 raised these concerns in the context of churches in the course of the *Warren* litigation,⁶⁶ but they could apply as well to other exempt organizations, such as small start-up mental health or substance abuse organizations.

The legislative history of CHACA evidences a particular concern for the plight of churches and clergy outside of large urban and suburban areas. Senator Baucus, introducing CHACA in the Senate, explained, "Especially in rural areas like we have in Montana, many congregations are small, pay is low, and ministers are very dependent upon their churches providing or paying for their housing."⁶⁷ Representative Earl Pomeroy, D-N.D., reported:

I had a very interesting roundtable meeting in North Dakota yesterday with a number of clergy terribly concerned about the underlying threat to the housing allowance. North Dakota has more churches per capita than any other State in the country, more than 2,000 churches, 78 percent of which are located in communities of under 2,500 people. These are congregations just struggling to get by. We have already lost 400 churches over the last several years, and projections are we could lose another fifty in this decade.⁶⁸

With the suggested \$15,000 dollar limit of revised section 107, the tax benefit currently afforded clergy in small towns and rural areas as well as many other categories of clergy will largely be preserved. The *Church Compensation Handbook*, for example, reports that average housing allowance for clergy in small towns is \$9,428,⁶⁹ and for senior pastors in small rural

⁶⁶See Brief of the Becket Fund for Religious Liberty, *supra* note 42 ("[S]tart-up churches and non-traditional religious associations will often lack the resources to acquire sufficient property on which they could construct both a church and a parsonage"); Brief of the National Jewish Commission on Law and Public Affairs, *supra* note 42 (Section 107 "equalized the tax burden on well-endowed landowning churches and those, like most Jewish synagogues, that operate on a shakier financial footing").

⁶⁷"Baucus Bill Would Clarify Parsonage Allowance," *supra* note 5.

⁶⁸148 Cong. Rec. H1300-1301 (daily ed. Apr. 16, 2002).

⁶⁹*Church Compensation Handbook*, *supra* note 63, at 58 (26 respondents).

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congregations \$11,210,⁷⁰ both comfortably below the suggested dollar limit. The *Church Compensation Handbook* indicates that average housing allowance for associate pastors in all categories, including those at large urban and suburban congregations, is \$17,149.⁷¹ Under revised section 107, the average associate pastor would lose only a little more than \$2,000 of their current exclusion and experience only a modest tax increase.

The dollar limit of revised section 107 also offers the advantage of eliminating the need for a fair market value limitation on the paid housing exclusion. Out-of-pocket costs up to a limit is a far more certain test and will avoid disputes about fair market value such as the one that prompted the *Warren* case. Indeed, Professor Zelinsky believes that the fair market value limitation added to section 107(2) by CHACA to bolster the provision “weakens both the constitutional and the tax policy arguments for that section by enmeshing the clergy and IRS for future years in potentially contentious controversies about the rental values of the homes of taxpayer/clergymen.”⁷² Revised section 107 avoids such problems.

E. Paid Allowance — Phaseout

Even with the on-call requirement and the dollar limit, section 107(a)(1)(b), permitting an exclusion of \$15,000 for a paid housing allowance represents an unusual and enormously generous tax benefit. Under current law, for example, the maximum deduction for an IRA is \$3,000.⁷³ Similarly, the credit currently permitted under the lifetime learning credit would, in most cases, be equivalent to a maximum deduction of less than \$7,000.⁷⁴

Revised section 107, like the IRA deduction, the child tax credit, and the HOPE and lifetime learning credits, includes a phaseout of the tax benefit. This phaseout adheres to our progressive tax system in which we attempt to tie the amount of tax paid to the taxpayer's ability to pay. It denies the extraordinary tax benefit of a housing allowance exclusion to wealthier taxpayers. The suggested phaseout seeks to aid those in need without giving a windfall to those without such need.

⁷⁰*Church Compensation Handbook*, *supra* note 63, at 44 (71 respondents).

⁷¹*Id.* at 56 (126 respondents). As discussed later, this group has an average salary below the start of the phase-out level. See text at note 83 *infra*.

⁷²Zelinsky, *supra* note 6, at 1669 n. 54.

⁷³Section 219(b)(5)(A). The deductible amount is scheduled to rise to \$4,000 in 2005 and \$5,000 in 2008. *Id.* There is a catch-up provision for individuals 50 or over permitting another \$500 to be deducted currently and another \$1,000 beginning in 2006. Section 219(b)(5).

⁷⁴This equivalence is based on the current limit for the credit of \$1,000 and an assumption of a 15 percent marginal income tax rate. Thus, a deduction of \$6,667 at a 15 percent bracket saves \$1,000 in taxes. Should the taxpayer be within the 10 percent income tax bracket, the credit would be the equivalent of a \$10,000 deduction.

The suggested phaseout is the amount used under section 414(q) to define a highly compensated employee for purposes of the pension provisions, which for 2002, is \$90,000.⁷⁵ A key reason for adopting the section 414(q) amount is that the regulations under section 4958 make important use of it.⁷⁶ This choice permits easy coordination of the section 107 benefit with the rules under the intermediate sanction regime. This suggested phaseout begins at a higher level than the phaseouts of other provisions. For 2002, the HOPE and lifetime learning credits begin phasing out at modified adjusted gross income of \$41,000 (\$82,000 in the case of a joint return),⁷⁷ and the benefit of a deductible IRA begins to phase out for a taxpayer filing a joint return at \$54,000 and \$34,000 for other taxpayers.⁷⁸ For an unmarried individual, the child tax credit begins to phase out at modified adjusted gross income of \$75,000.⁷⁹

Under the suggested phaseout, the paid housing allowance is reduced by only \$250 for each \$1,000 of total economic benefits above the section 414(q)(1)(B)(i) amount. Thus, an employee eligible under revised section 107 will receive some tax benefit until the total amount of economic benefits he receives from the employer exceeds \$150,000. Consider an employee whose total compensation package equaled \$126,000. The economic benefits would exceed the current section 414(q)(1)(B)(i) amount by \$36,000. Under the proposed phaseout, the \$15,000 paid housing exclusion would be reduced by \$9,000. The employee would be able to exclude \$6,000 of housing expenses.

This especially generous phaseout, like other aspects of revised section 107, is designed to take into account the concerns of the supporters of section 107. Both the briefs in the *Warren* case and the legislative history of CHACA repeatedly bore witness to the devastating impact loss of section 107 would have on congregations that cannot afford to pay the ministers much in salary. After passage of CHACA, Senator Charles E. Grassley, R-Iowa, issued a press release:

Without this bill, congregations nationwide would have suffered needlessly. Ministers, priests and rabbis work hard for low pay. They depend on their church or synagogue to help with their housing costs. This is especially important in rural areas, where very small congregations have trouble attracting clergy members. If Congress and the President had failed to clarify the

⁷⁵See “IRS Announces Adjustments to Pension Plan Limitations,” *Doc 2002-158* (1 original page), 2001 TNT 251-5.

⁷⁶Under the section 4958 regulations, an employee whose economic benefits total less than the section 414(q)(1)(B)(i) amount is excluded in that role from the definition of disqualified person and thus from the intermediate sanction regime. See reg. section 53.4958-3(d)(3).

⁷⁷See “IRS Releases Inflation Adjusted Tables for 2002,” *Doc 2001-30414* (16 original pages), 2001 TNT 237-14.

⁷⁸Section 219(g)(3)(B).

⁷⁹Section 24(b)(2)(C).

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parsonage housing tax allowance, churches and synagogues could have taken a huge tax hit.⁸⁰

The Church Alliance, an umbrella group of church pension funds, warned in its *amicus* brief in *Warren* that the consequences of declaring section 107(2) unconstitutional would “be felt by institutions and individuals of limited resources.”⁸¹

Under revised section 107, ministers with low incomes would still be entitled to a generous exclusion for housing expenses. For example, the *Church Compensation Handbook* reports that associate pastors serving in churches with average worship attendance of 300-499 have average compensation, including base salary, parsonage or housing allowance, retirement contribution, life and health insurance payments, and educational funds, of \$52,192.⁸² Such a pastor would not be subject to any phaseout of the housing exclusion, although, as noted earlier,⁸³ their average housing allowance of \$17,149 would subject them under revised section 107 to a small decrease in the amount excludible.

If we focus in particular on rural churches and clergy, the impact of revised section is even smaller and in many cases nonexistent. The *Church Compensation Handbook* reports that senior pastors in small (0-250) rural congregations had average compensation of \$43,525 and housing allowance of \$11,210.⁸⁴ For such clergy, revised section 107 would have no effect on their current tax benefit.

Moreover, while it is clearly the case that many congregations are able to pay their clergy at relatively low levels, it is equally true that many clergy are compensated quite highly by their churches. According to the *Church Compensation Handbook*, senior pastors at churches with average budgets of \$1 million or more had an average compensation (including base salary, housing or parsonage allowance, retirement contribution, life and health insurance payments, and educational funds) of \$99,696 and pastors at churches with average attendance of over 1,000 had average compensation of \$106,223.⁸⁵ For urban congregations with average attendance over 1,000 the median compensation was \$120,158.⁸⁶

With some adjustment to these figures, we can compare clergy to other Americans to put their income level

in context. The Bureau of the Census, defining income as “money income excluding capital gains before taxes,”⁸⁷ has provided the following income quintiles for the year 2000:⁸⁸

	Limit	Mean
Lowest	\$17,955	\$10,190
Second	\$33,006	\$25,334
Third	\$52,272	\$42,361
Fourth	\$81,960	\$65,729
Highest Fifth	(above \$81,960)	\$141,620

These numbers do not include such elements of compensation as the value of benefits such as health insurance or pension contributions.

The *Church Compensation Handbook* found that \$69,543 was the average compensation for senior pastors, an amount that includes such generally tax-free benefits as pension contributions and health insurance.⁸⁹ None of the tables in the *Church Compensation Handbook* gives average total numbers that report only base salary and housing allowance, the numbers I consider the appropriate comparison to the Census data. Based, however, on other tables in the *Church Compensation Handbook*, I would estimate that such generally tax-free benefits as pension contributions, health insurance, etc. would represent approximately \$12,000 of this total.⁹⁰ Thus, I would estimate that senior pastors' average income, defined as salary plus housing allowance, to make possible comparison to Bureau of Census data, would be \$57,543 for 2001. If so, senior pastors would place in the fourth quintile of income.⁹¹ For particular categories of clergy, more exact comparison is possible. Totalling average salary and housing allowance would put senior pastors of large

⁸⁰“Grassley Release Announcing Passage of Clergy Housing Legislation,” *Doc 2002-12258* (1 original page), 2002 TNT 98-33.

⁸¹*Amicus Curiae* Brief of the Church Alliance at 29, *Warren v. Comm’r*, 282 F.3d 1119 (9th Cir. 2002) (No. 00-71217), *Doc 2002-12520* (37 original pages), 2002 TNT 107-34.

⁸²*Church Compensation Handbook*, *supra* note 63, at 56 (126 respondents).

⁸³See text at note 71 *supra*.

⁸⁴*Church Compensation Handbook*, *supra* note 63, at 44 (71 respondents).

⁸⁵*Church Compensation Handbook*, *supra* note 63, at 34. The number of respondents for churches with average income of \$1 million or more was 272, *id.* at 43, and the number of respondents for churches with average attendance over 1,000 was 125, *id.* at 48.

⁸⁶*Id.* at 48 (20 respondents).

⁸⁷See U.S. Census Bureau, *Current Population Survey (CPS) — Definitions and Explanations* at <http://www.census.gov/hhes/www/income00.html>.

⁸⁸See U.S. Census Bureau, *Historic Income Tables*, <http://www.census.gov/hhes/income/histinc/h01.html>; <http://www.census.gov/hhes/income/histinc/h03.html>.

⁸⁹*Church Compensation Handbook*, *supra* note 63, at 41. This average represents more than 1,000 respondents. See *id.* at 42-43.

⁹⁰This is only an estimate based on data in individual tables. To give specific examples, for senior pastors with average church attendance of 100-299 (452 respondents) average salary and housing totaled \$48,777 and for senior pastors with average church attendance of 300-499 (224 respondents), average salary and housing totaled \$61,863. *Id.* at 42.

⁹¹The *Church Compensation Handbook* gives 2001 numbers; the Bureau of Census 2000 numbers. Reducing 2001 clergy compensation by the average 5 percent salary increase for pastors, see note 101 *infra*, would not change the conclusions discussed in the text regarding quintile placement.

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congregations, whether in terms of level of revenue or number of members in the fifth quintile.⁹²

Again, I wish to emphasize that not all clergy have income in the top quintiles of the American population. Many, especially in smaller congregations, do not.⁹³ But, again, established principles of tax policy counsel against giving a special tax benefit to those who do.⁹⁴ The tax policy question is whether we should bestow an extraordinary benefit on all clergy, even those who receive high levels of compensation or, instead, give some benefit both to clergy and to others who perform similar functions in our diverse society for low levels of compensation. The income phaseout of revised section 107 allows us to make a distinction based on level of compensation.

Arguably, analogizing the paid housing allowance to a home office deduction is inconsistent with any income phaseout. The home operates as an extension of the workplace no matter what the taxpayer's income. The phaseout, moreover, introduces enormous complexity to the provision. The phaseout, however, can be seen as a decision that, if employees are at levels we deem to be highly compensated, they are already being compensated for being on 24-hour emergency call. Moreover, such important considerations as the need to limit revenue loss, the desire to give some benefit to employees of eligible organizations who

supply their own housing but are paid low wages, and the desire to respect the progressivity of our tax system support the phaseout.

III. Strengths & Weaknesses of Revised Sec. 107

Like much legislation, revised section 107 seeks to accommodate simultaneously several competing policy and practical considerations. Such a goal inevitably leads to various degrees of inconsistency and the possibility for abuse of the provision. To my mind (naturally enough, since it is my proposal), these problems are not on balance fatal to revised section 107. Moreover, depending on how Congress weighs the various policy goals, variations on the revisions suggested here are possible. Congress should act quickly to adopt some such a proposal so that the changes could be phased in to ameliorate any detrimental impact on clergy and their congregations.

A. Furnished Housing vs. Paid Allowance

Revised section 107 draws a sharper distinction between furnishing housing and paying a housing allowance than does current law. Under the revised provision, the entire value of the housing is excluded from income when housing is furnished and at most \$15,000 is excluded from income when a housing allowance is paid. The basis for such a distinction is the important differences between these kinds of housing. Still, the sharp difference between these two categories makes a gaming of the provision possible. Under revised section 107, taxpayers could pick out precisely the housing they desire and arrange for their employers to purchase the home. They would in fact experience none of the constrained consumption that justifies excluding the value of the furnished housing from income.

Such a possibility is not all that troubling. The employer's ownership of the housing remains a sharp and meaningful line. The employer and not the employee will have the potential for upside appreciation and the risk of downside depreciation for furnished housing. The employee will not earn equity in the housing. The tax benefit of the exclusion for furnished housing will permit the entity to pay lower salaries and thus benefit tax exempt organizations in a manner consistent with our general policy of favoring such entities. This line drawn is similar to the one between reimbursed and unreimbursed employee expenses. To the extent that the employer is willing to bear the expense, we accept that the expense is a business expense that the employee can exclude from income; to the extent that it is not reimbursed, we question whether the expense is a personal one and thus subject its deductibility to limits under section 67.

If section 107 is intended ultimately to benefit the entity, however, the exclusion for a paid housing allowance could pose a problem. Since this benefit of the exclusion for the paid housing allowance goes directly to the employee, it is possible that the tax benefit of the housing allowance may not benefit the entity by enabling it to pay lower salaries. However, the clear limits of revised section 107 as to the amount of the exclusion for a paid allowance and the specificity of the point at which it phases out may in fact make it

⁹²Senior pastors at churches with average attendance of over 1,000 reported average salary and housing allowance of \$95,273 (141 respondents); senior pastors at churches with average budgets of more than \$1 million had average salary and housing allowance of \$87,307 (272 respondents). *Church Compensation Handbook*, *supra* note 63, at 42-43. According to *The Reform Movement Synagogue Professional Survey Task Force Report* (January 2001), the median salary and parsonage for Senior Rabbis of its more than 900 congregations would also place them in the fifth quintile.

⁹³For example, senior pastors with average church income of up to \$249,999 (325 respondents) report average salary plus housing allowance of \$42,046. See *Church Compensation Handbook*, *supra* note 63, at 43. These clergy would fall into the third or middle quintile of Census numbers.

⁹⁴Consider as well the compensation of clergy as compared to teachers, another group that contributes importantly to American society. According to a recent American Federation of Teachers survey, the average teacher salary for 1999-00 was \$41,544. For teachers in large cities with master's degrees, average maximum salary was \$51,955. F. Howard Nelson and Jewell C. Gould, "Teacher Salaries, Expenditures and Federal Revenues in School Districts Serving the Nation's Largest Cities, 1990-91 to 2000-01," Table 1-1 (October 2001), available at <http://www.aft.org/research/salary/homre.htm>. In contrast, taking either average or median compensation, base salary, and housing allowance for senior pastors in urban areas is over \$100,000, almost twice that of teachers. The federal tax code, however, gives no housing exclusion to teachers. Some states have begun allowing income exclusions for teachers. Many have objected to such exclusions on tax policy grounds. See David Brunori, "The Politics of State Taxation," 2002 STT 102-4. In California, teachers themselves rejected a proposal to exempt some of their income from state taxation. See George Skelton, "Governor Should Learn to Lose on Teacher Tax Break," *L.A. Times*, May 29, 2000, at A3.

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easier for exempt organizations to take its value into account in setting compensation than is the case under current law.⁹⁵

Still another criticism comes from the opposite direction — asking not why are there limits on the exclusion for the paid housing allowance but asking why there is any exclusion at all.⁹⁶ The analogy to section 119 suggests there is no reason for any exclusion for a paid housing allowance. Cash is easy to measure and liquid. Its transfer in exchange for services is the classic taxable event under our tax system. To the extent the home serves as a home office, the argument continues, taxpayers can and should satisfy the requirements of section 280A to receive a tax benefit. My answer to such a criticism is that the history of section 107, the concerns of its defenders, and the on-call emergency requirement of revised section 107 all support such a limited extension of the home office concept.

To make clear that the exclusion for furnished housing and that for a paid housing allowance rest on very different tax policy grounds, Congress might wish to repeal section 107, amend section 119 to include the special provisions for housing furnished to employees of public charities on 24-hour emergency call, and amend section 280A to permit the limited exclusion for a housing allowance paid to such employees.

B. Variations on the Revised Section 107

Variations on the suggestions made here are clearly possible. Revenue considerations may call for a more limited class of beneficiaries or a lower dollar limit for the paid housing exclusion and its phaseout. For example, the statute might be drafted to give the housing exclusion only to those who are required to use their homes regularly for meeting with members, clients, and patients as well as to be available for 24-hour emergency call.⁹⁷ The dollar limit for the paid housing allowance, currently very high, could be lowered.

To limit revenue loss through gaming of the expanded tax benefit under revised section 107, additional reporting requirements might be mandated. Organizations that furnish housing or pay housing

allowances under revised section 107 could be required to report the names of employees benefiting from the provision on their annual information return, Form 990.⁹⁸ Individuals benefiting from the provision could be required to keep detailed records similar to those kept for travel and entertainment expenses, regarding the instances that they were called on for emergencies.

With transition rules, the loss of the current tax benefits under section 107 would have an impact manageable by both clergy and their religious congregations, on a scale comparable to small increase in tax rates.

Congress may also wish to be more generous than my suggestion. For example, in order not to favor certain charities, Congress might exclude from income the value of housing furnished to an employee by any public charity for any purpose, not just to employees who are on 24-hour emergency call to meet with clients, patients, and members. Without expanding the benefit quite so broadly, Congress might allow the benefit of a paid housing allowance to anyone who is on 24-hour emergency call, not just those who meet with clients, patients, and members. A technician called in the middle of the night to fix the heart monitor in a cardiac unit of a hospital and the maintenance person called in the middle of the night to fix the heating in a nursing home also benefit members of a charitable class and sacrifice the sanctity of the home. Other possible changes include raising the dollar limit for the housing allowance or revising the phaseout. Eliminating the phaseout altogether and thus reducing complexity would be especially appealing, if revenue considerations permit.

Permutations and combinations of these variations are all possible. Congress may wish to give a greater benefit to those with lower salaries by increasing the limit for the paid housing exclusion and lowering the start of the income phaseout. Congress might well want to index the limit for paid housing for inflation. A key purpose in my putting forth this suggestion is to encourage policymakers to think about ways they might revise section 107.

C. Transition Provisions

Whatever version of a revised section 107 Congress might adopt, there is enormous advantage in its doing so quickly. Changes to tax provisions impose costs. Throughout the *Warren* litigation and congressional consideration of CHACA, dire predictions issued forth about the impact of loss of the housing allowance, should it be declared unconstitutional. Clergy would experience a sudden loss of their after-tax income; congregations, themselves subject to tight budgets, would be hard-pressed to make up the difference in salary

⁹⁵Based on the dozens and dozens of postings regarding the section 107 housing allowance and levels of clergy compensation that I have read over the past four years on the electronic discussion group for presidents of Reform Jewish synagogues, I do not believe that the current exclusion operates to benefit the religious congregation fully. Board members who set clergy compensation are volunteers and change frequently. Often, they are not knowledgeable about the operation of section 107, in particular the double deduction for mortgage interest and property taxes, and, as a result, underestimate the extent to which it benefits clergy.

⁹⁶As Professor Zelinsky writes, "There are considerations (e.g., taxpayer illiquidity, valuation difficulties) that as a matter of tax policy, make section 107(1) and its exclusion of housing provided in-kind more compelling than section 107(2) and its exclusion of cash parsonage allowances." Zelinsky, *supra* note 6, at 1669 n.54.

⁹⁷Provided, however, for constitutional reasons that such a class includes a significant number of taxpayers in addition to clergy.

⁹⁸Churches, however, are not required to file Form 990.

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needed to put the minister in the same after-tax position.⁹⁹

Congress could ameliorate such impacts by including transition rules in a revised section 107. Of course, transition rules themselves can take many forms. One possibility would be for Congress to phase in the provision over several years. In year 1, ministers could take the larger of (a) the exclusion under revised section 107 or (b) $\frac{2}{3}$ of the exclusion that would have been permitted under section 107 as revised by CHACA. In year 2, the choice would be between (a) revised section 107 and (b) $\frac{1}{3}$ of the exclusion that would have been permitted under section 107 as revised by CHACA. Only in year 3 would the new provision be fully applicable.

With these or some set of other transition rules,¹⁰⁰ the loss of the current tax benefits under section 107 would have an impact manageable by both clergy and their religious congregations, on a scale comparable to small increase in tax rates. Particularly if loss of these tax benefits continued to be accompanied by salary

increases,¹⁰¹ clergy would be able to adjust to the changes without drastic changes to their lifestyles and thus without the need for congregations to come up with sudden and large salary increases to compensate clergy for a sudden and large increase in income tax.

Such transition provisions can neither protect against nor withstand a finding of unconstitutionality. They can help clergy only if Congress were to act so quickly that by the time a final decision on the provision's constitutionality is made, almost certainly by the Supreme Court, new section 107 will be fully phased in and the statute of limitations on years in which any clergy took advantage of old section 107 will have run.

IV. Conclusion

The speed and unanimity with which Congress passed CHACA suggest that a revision of section 107 along the lines I have suggested here may not have a strong immediate appeal. Nonetheless, I urge policymakers to consider immediately some such revision, which, along with transition provisions, would preserve and protect some of the current benefits afforded by section 107. The results of a constitutional challenge to section 107 are uncertain. Should it be declared unconstitutional, the impact on clergy and congregations would be immediate and severe. Transition provisions would no longer be possible. Even in the absence of concerns about constitutionality, consideration of a wide variety of tax policies — encouraging the diversity of tax-exempt organizations, the special consideration that apply to forced consumption, and taxing our citizens according to their ability to pay — all call for Congress to revise section 107 to expand its benefit beyond “minister of the gospel” to encourage provision of pastoral care, broadly defined, to a variety of charitable recipients.

¹⁰¹Average pastor salary has increased more than 5 percent each year since 1997. See *Church Compensation Handbook*, *supra* note 63, at 41.

⁹⁹Of course, any salary increases would themselves be subject to tax. Thus, a minister at a 30 percent marginal tax rate with \$40,000 excluded under current section 107 would save \$12,000 in tax. If section 107 were declared unconstitutional, a church would have to increase the minister's salary by more than \$17,000 for the minister to pay tax on the now-taxable \$40,000 as well as the tax on the salary increase.

¹⁰⁰As a matter of tax policy, Congress might also wish to consider some special catch-up and other provisions for clergy pensions to make up for the loss of a paid housing allowance for pension distributions under the new tests of revised section 107. Revised section 107 will be particularly harsh on those already retired and those close to retirement age. Any special pension rules, however, would themselves raise constitutional issues.

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