In response to rising expenses, particularly employment costs, cities and towns are leaving no stone unturned in the search for additional revenue. Taxes are a major piece of that puzzle, and religious institutions should be aware that their tax status is on the minds of assessors. Houses of worship are exempt from property tax, for example, but in an environment marked by aggressive collections they must be on guard when it comes to protecting that exemption.

In some states such as Maine and Massachusetts the exemption is limited to “houses of worship,” residences of clergy, and related land and structures owned and occupied by the religious organization. Municipalities have the opportunity to dig deep into religious real estate portfolios to examine issues that might trigger tax payments.

Tax assessors are not alone in their assertion that the tax status of religious institutions warrants a closer look. Groups across the U.S. periodically push those boundaries; American Atheists, for example, recently led a suit against the IRS on the grounds that religious institutions are given unfair breaks compared to other non-profits. The Washington Post reported that the plaintiffs claimed “the American government unfairly subsidizes religious organizations that do not have to prove they do anything to benefit the American people. That is special treatment that costs $71 billion in annual tax revenue.”

The case was dismissed, but religious institutions should be prepared to face direct challenges to their exemptions. They must pay close attention to three areas that come under scrutiny:

1. Property Use

Churches often allow portions of church buildings or halls to be used by unaffiliated organizations as soup kitchens, day care centers, and other ongoing initiatives. Local assessors may seek to tax the portions of the church property used for such purposes. This brings on a difficult circumstance when buildings are not fully utilized: when property sits idle, it is subject to tax; then again, when it is loaned out or rented for other uses it is also subject to tax.
Deciding when the line is crossed between non-religious and religious activities is a murky issue. In a suburb of Boston, for example, a challenge has been brought by city assessors against the use of a large tract of land. The property is owned by a religious organization that operates a shrine and retreat center, attracting approximately half a million people each year. The city claims that by allowing the land to be used for peripheral activities (such as an annual carnival and as a polling place for local elections), the character of the use of the property has changed.

If the claim holds, the shrine in question could be liable for up to hundreds of thousands of dollars in taxes – and could set a precedent for similar cases around the country.

2. Housing Allowances

Many religious officiates no longer want to live in church-owned housing, preferring to use a housing allowance (which is exempt from income taxes) to rent property. That leaves the church-owned clergy residence vacant or put to another use, potentially subjecting it to real estate taxes.

The issue came into the spotlight a decade ago, when a tax dispute in California opened the door to questions about the constitutional legitimacy of the housing allowance. At the time, Congress responded by passing the Clergy Housing Allowance Act of 2002, which established exemptions and seemingly put the matter to rest.

A 2013 Wisconsin case, however, rejuvenated the conversation and led to a different outcome. According to a report in the American Bar Association Journal, U.S. District Judge Barbara Crabb ruled in Freedom from Religion Foundation v. Lew that the tax exemption for clergy rental allowances is unconstitutional.

“If the government were free to grant discriminatory tax exemptions in favor of religion, then it would be free to impose discriminatory taxes against religion as well,” wrote Crabb in a decision filed Nov. 22. [ii]

The ruling is awaiting appeals, and if upheld it will send significant ripples through the religious community. Clergy salaries would take a significant tax hit, while the U.S. Treasury would receive an extra $700 million per year. [iii]

3. The Sale or Re-use of Property

Membership and attendance at many churches has dwindled, resulting in consolidation, mergers or closing of many places of worship. Once shuttered, these buildings lose their tax exempt status and often force the sale of the property.
The sale itself brings a host of new concerns. Churches are often registered historic buildings, located in historic districts, or have voluntarily accepted funds in exchange for historic preservation restrictions. They also may be located in residentially zoned areas. These factors combine to severely limit the potential reuse of a church building, reducing the value of the property and making it a challenge to find a buyer.

If a sale is not feasible, the property can be rented to a third party by the religious organization. The rental income likely will be income tax exempt under the unrelated business income tax rules, but the fact that the property will now be used other than for religious or charitable purposes will almost certainly cause it to be subject to real estate taxes. Owners of religious properties should carefully assess the tradeoffs between income from a sale, and rental with possible exposure to taxes.

Challenges to real estate tax exemptions for houses of worship are not new, but they are being pursued with renewed vigor. The good news is that strong legal defenses have been constructed to protect owners and clergy. USA Today noted that “Since the 1950s, there have been several attempts to quantify religious tax exemptions — all of them wildly varied in their conclusions — and only a handful of legal challenges to those exemptions. Most were unsuccessful.” [iv]

With the right legal structure and strategy, that trend could continue for decades to come.

Endnotes

[ii] Courts are hearing new challenges to tax exemptions for religion, Lorelei Laird, ABA Journal, May 1, 2014
[iii] Ibid
[iv] Study challenges tax exemption for religious organizations, Kimberly Winston, June 16, 2012