POPHAM LAW OFFICE

TO: Barb Carroll

FROM: Wayne Popham

CC: Carol Johanneck

DATE: January 29, 2015

RE: Use of parsonages and tax exemption

A. The applicable law.

The Minnesota Constitution is the source of tax exemption for property owned by a church. Article 1, Section 10 mandates tax exemption for "all churches, church property and houses of worship." The same wording is contained in Minnesota Statutes 272.02, subd. 1(5).

The Minnesota Supreme Court has held that to be tax exempt there must be a concurrence of ownership of property by a church and a use of the property for the purpose for which the institution was organized. *In Re United Church Homes, Inc.* 195 N.W.2d 411 (1972),

I. There are two ways in which a church-owned residence may be tax exempt

a. Use by a pastor as a parsonage.

The Minnesota Supreme Court has held that a parsonage owned by a church and occupied by the pastor is an appropriate use of the property for the purposes of the church and is tax exempt. *State v. Church of Incarnation,* 196 N.W.802 (1924). The exemption does not apply to a property owned by clergy. *State v. Union Congregational Church*, 216 N.W. 325 (1927). The exemption does not apply to property owned by a church but leased for commercial use.

There has been a great deal of litigation in other states over what church positions other than the pastor can occupy a church owned residence as a parsonage. Examples have included a youth director, a choir director or a person in charge of Christian education. Results have differed in different jurisdictions. The Minnesota Supreme Court has dealt with such uses under subpart b of this opinion.

b. Use by the church for church purposes

A residence that is not used as a parsonage may still be tax exempt if it is used by the church for church purposes. In *St. John's Lutheran Church v. County of Hennepin,* 373 N.W.2d

281 (1985), the church owned a duplex next door which was occupied by a married couples who worked for the church in exchange for the use of the apartment, one couple as custodians and guards against vandalism, and the other couple as director of church music and director of Christian education. In a one-sentence opinion the Court said that the duplex was tax-exempt because use of the duplex was reasonably necessary to the accomplishment of church purposes.

In *Victory Lutheran Church v. County of Hennepin*, 373 N.W.2d 279 (1985), the house was next to the church and had been used over the years to house assistant pastors and youth directors. Presently it was occupied by a couple that did custodial services in exchange for their use of the residence. The Court reversed a denial of tax exemption without discussion.

In *Country Bible Church v. County of Grant* (2003), the Minnesota Tax Court held that a building used by a church for youth ministry activities was tax exempt.

The *United Church Homes* case involved an organization (United Church Homes) initially created by the United Churches of Christ. United Church Homes, the petitioner in the case, acquired the former Calhoun Beach Hotel and was converting part of it to senior citizen housing. The Court found that the petitioner corporation was not subject to the control of the United Churches of Christ and therefore the property was not a "church property" under the Constitution. Tax exemption was denied.

In *State v. Union Congregational Church,* 216 N.W. 326 (1927), a residence was not used as a parsonage or for its religious purposes but was rented and the rent used for its religious purposes. The Minnesota Supreme Court held that the property was not exempt from taxation. The Court said that "The term "church property" used in immediate connection with the words "churches" and "houses of worship" readily bears the same construction that it is the use or relation of the property to the purposes and activities of the church organization which determines whether or not it is church property." The Court noted that many corporations and individuals receive rental income from the business of owning property and the property is not tax exempt..

To date the Minnesota Supreme Court has been quite liberal in finding a church owned residence to be tax exempt based on the showing of use of the building by church activities. Whether this attitude will continue in the future as the composition of the Court changes is an open question.

c. Certain leases of church owned property to a non profit

In the case of Healtheast v. County of Ramsey, 749 N.W.2d 15 ((2008), the Supreme Court recognized the general rule that for a lease of property to be exempt from taxation it must both be owned by a tax exempt entity and used by that entity for a tax exempt purpose. However, the Supreme Court held that there is an exception, if the lease of property comes within the provisions of Minn.Stat. 273.19 the property remains tax exempt. The requirements for such a lease are:

1. The property must be owned by certain institutions, which include "any religious . . . society or institution, incorporated or unincorporated", i.e. a local church.
2. The lease must be for at least one year.
3. There is an exclusion for certain types of leases, but the exclusion does not apply to leases by a local church.
4. The lease must be to a nonprofit entity.

If these factors exist then the property is considered to be the property of the nonprofit entity that is leasing it and thus tax exempt. The lessee is not limited to using the property for the tax exempt purpose of the owner.

Therefore, leases of church property, which is tax exempt, to a tax exempt entity, which are for at least one year, will retain the tax exemption. If the lessee subleases the property for at least one year to a tax exempt entity that uses the property for an exempt purpose, the property will continue to remain tax exempt. The tax exempt purpose of the sub-lessee need not be the tax exempt purpose of the sub-lessor.

Lease of tax exempt property to an entity that is not tax exempt loses the tax exemption.

d. Lease of a part of a tax exempt property to an entity not tax exempt

If a part of tax exempt property is leased to an entity that is not tax exempt, the Minnesota Supreme Court has held that taxing authorities can pro-rate the exemption based on the area leased. If only a small percentage of tax exempt property is leased to an entity that is not tax exempt, it is probably less likely that the taxing authorities will bother with pro-rating the exemption.

A second practical factor may be the amount of income received from a partial lease of property to an entity that is not tax exempt. A small amount of revenue suggests an accommodation. A large rent that contributes a substantial income, on the other hand, could be viewed as a reason to pro-rate, even if the space involved is not large.

e. Temporary non-use of tax exempt property.

In the case of *Christian Business Men's Committee of Minneapolis v. State,* 38 N.W.2d 803 (1949) the Minnesota Supreme Court held that an organization which owns property that it intends to use for a tax exempt purpose has a reasonable time to commence such use. The property in that case was vacant land that the church intended to use for a building site when it had raised the necessary funds. The Court said that the organization "must demonstrate progress toward implementing its plans". It could be argued that in the case of a church parsonage that is temporarily rented for a non-exempt use that this case should be applied by the county taxing authority. A record would need to be made of "progress" in efforts to secure a lease to a non-profit entity or to resume its use as a church parsonage.

2. UBIT liability if rent of a parsonage is not tax exempt.

Unrelated business income can be a very technical tax issue. As a general rule rent from the lease of property is not subject to income tax as unrelated business income where the lessor is not providing services as part of the lease. 26 U.S.C. § 512 (b). Rent is also subject to the requirement that the property is not debt financed. If there is acquisition indebtedness at any time during the tax year then the rent for that year is subject to income tax. Each situation requires detailed analysis of the financing. If the property is subject to a mortgage detailed analysis of the facts is required.