UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF KENTUCKY
NORTHERN DIVISION
at COVINGTON

CRIMINAL ACTION NO. 11-70-DCR

UNITED STATES OF AMERICA **PLAINTIFF**

V. **DEFENDANT'S SUPPLEMENTAL BRIEFING REGARDING PARSONAGE ALLOWANCE AND HOME OFFICE DEDUCTION**

RONALD E. WEINLAND **DEFENDANT**

* * * * *

Comes now the Defendant, Ronald E. Weinland, through undersigned counsel, pursuant to the Court's Order dated May 30, 2012 [Record No. 48], and submits the following supplemental authority regarding the issue of whether the Defendant may claim a deduction under 26 U.S.C. § 280A(a)(1)(C) for the business use of his home while also receiving a portion of his compensation as a tax-exempt parsonage allowance under 26 U.S.C. § 107.

The United States is unable to cite to any section of the Internal Revenue Code, any section of the underlying Treasury Regulations, or any case law interpreting the same in support of its position that the Defendant is precluded from taking a deduction under 26 U.S.C. § 280A(a)(1)(C) for the business use of his home solely because of his receipt of tax-exempt compensation in the form of a parsonage allowance under 26 U.S.C. § 107(2). The reason is because the law does not support the United States' position. As discussed in more detail herein, even though the Defendant received a parsonage allowance from the Church during the tax years at issue, the Defendant was still permitted to claim a deduction under 26 U.S.C. § 280A(a)(1)(C),

subject to certain limitations under 26 U.S.C. § 265(a)(1), for expenses related to the business use of his home.

I. The Parsonage Allowance under 26 U.S.C. § 107.

26 U.S.C. § 107(2) provides that for a minister of the gospel, a rental allowance that is paid to the minister as part of his compensation is exempt from the minister's gross income to the extent that the minister uses the allowance is rent or provide a home. This exclusion is limited to the least of: (1) the amount that the Church designates as housing allowance; (2) the amount that the minister actually used to provide a home (which includes items such as rent, house payments, repairs, insurance, property taxes, utilities, etc.); and (3) the fair rental value of the home, including furniture, utilities and garage. Thus, under 26 U.S.C. § 107, a minister can receive both nonexempt wages and a tax-exempt parsonage allowance as his total compensation for ministry work. Nothing in 26 U.S.C. §107, or in the underlying regulation, precludes or prohibits the minister from claiming a deduction under 26 U.S.C. § 280A(a)(1)(C) for expenses related to the business use of his home.

II. The Deduction for the Business Use of A Home under 26 U.S.C. § 280A.

26 U.S.C. § 162(a) allows a taxpayer to deduct all "ordinary and necessary business expenses paid or incurred during the taxable year in carrying on any trade or business." This provision "is qualified, however, by various limitations," including 26 U.S.C. § 280A(a) which provides a general rule that no deduction is allowed with respect to the use of the taxpayer's personal residence. *Commissioner v. Soliman*, 506 U.S. 168, 172-173 (U.S. 1993). A taxpayer may nonetheless deduct expenses attributable to the business use of his home if the taxpayer qualifies for one of the exceptions to this general disallowance found in 26 U.S.C. §280A(c). *Id.* Relevant to the Court's consideration here, 26 U.S.C. § 280A(c)(1)(A) states that the limitation

in Section 280A(a) does not apply to any item to the extent such item is allocable to a portion of the taxpayer's residence "which is exclusively used on a regular basis as the principal place of business for any trade or business of the taxpayer." There is nothing in Section 280A or the underlying regulations that prohibits a taxpayer that receives a portion of his compensation in the form of a tax-exempt parsonage allowance under 26 U.S.C. § 107(2) from deducting expenses attributable to the business use of his home under 26 U.S.C. § 280A(c)(1)(A).

III. The Limitation on Expenses Related to Tax-Exempt Income Under 26 U.S.C. § 265(a)(1).

Yet, that does not mean that there is no limitation on the ability of a taxpayer that receives a parsonage allowance under 26 U.S.C. § 107(2) to deduct expenses attributable to the business use of his home under 26 U.S.C. § 280A(c)(1)(A) or any other legitimate business expenses incurred in the conduct of the taxpayer's ministerial work. 26 U.S.C. § 265(a)(1) provides:

> No deduction shall be allowed for…[a]ny amount otherwise allowable as a deduction which is allocable to one or more classes of income other than interest…wholly exempt from the taxes imposed by this subtitle….

26 U.S.C. § 265(a)(1). As a result, expenses that are "allocable to tax-exempt income are not deductible." *McFarland v. Commissioner*, T.C. Memo 1992-440 (T.C. 1992); *See Also Deason v. Commissioner*, 41 T.C. 465 (1964). Because compensation that a taxpayer receives as a designated parsonage allowance is excluded from the taxpayer's gross income under 26 U.S.C. § 107(2), Section 265(a)(1) bars the deduction of any business expenses incurred by the taxpayer to the extent such expenses are allocable to the taxpayer's tax-exempt parsonage allowance. *See McFarland*, T.C. Memo 1992-440; *See Also Deason*, 41 T.C. 465; *Dalan v. Commissioner*, T.C. Memo 1988-106 (T.C. 1988).

In determining which expenses are allocable to tax-exempt income and nonexempt income, 26 C.F.R. § 1.265-1(c) instructs that "[i]f an expense or amount otherwise allowable is indirectly allocable to both a class of nonexempt income and a class of exempt income, a reasonable proportion thereof determined in the light of all the facts and circumstances in each case **shall be allocated to each**." (emphasis added). Accordingly, in *MacFarland v. Commissioner*, the United States Tax Court held that ministry expenses incurred by the taxpayer were indirectly allocable to a class of nonexempt income and a class of exempt income when the taxpayer's only business activity was his ministry and he received both taxable compensation and tax-exempt parsonage allowance. *See MacFarland*, T.C. Memo 1992-440.

In *MacFarland*, the taxpayer's total ministerial income for the 1987 tax year was $39,109, which consisted of $28,829 taxable income and $10,280 exempt parsonage allowance. *Id.* The Tax Court calculated that the taxpayer's tax-exempt earnings represented 26.29 percent of the taxpayer's total ministerial income. *Id.* As a result, the Tax Court determined that 26.29 percent of the taxpayer's otherwise allowable expenses totaling $4,929 were not deductible. *Id.* For the 1988 tax year, the Tax Court calculated that the taxpayer's tax-exempt earnings represented 31.03 percent ($39,585 of total ministerial income of which $12,285 was tax exempt parsonage allowance) of the taxpayer's total ministerial income. *Id.* Therefore, the Tax Court determined that only 31.03 percent of the taxpayer's $3,832 in expenses for 1988 were deductible. *Id.*

Additionally, although the precedential value of the Tax Court's decision in *Young v. Commissioner*, T.C. Summary Opinion 2005-76 (T.C. 2005), is limited by 26 U.S.C. §7463(b), the underlying facts and the Tax Courts' consideration of those facts are instructive to the issue here. In *Young*, the taxpayer, a minister, was paid a salary of $78,000 of which the Church

designated $42,000 as a tax-exempt parsonage allowance and $36,000 as taxable wages. *Young*, T.C. Summary Opinion 2005-76. In addition to his salary from the Church, the taxpayer received self-employment income of $21,438 in the exercise of his ministry. *Id.* At issue was the taxpayer's ability to deduct $24,982 of expenses that the taxpayer had incurred in the exercise of his ministry. *Id.* The expenses at issue included $5,000 of "office expenses." *Id.* Consistent with 26 U.S.C. 265(a)(1) and the underlying regulations, the Tax Court allocated the expenses on a pro rata basis between the taxpayer's tax-exempt (i.e., the parsonage allowance) and nonexempt (i.e., wages) income. Of interest, the Tax Court only limited the taxpayer's "office expense" deduction to a pro rata portion under 26 U.S.C. § 265(a)(1), and did not attempt to prohibit such expenses in full simply because the taxpayer had received a tax-exempt parsonage allowance under 26 U.S.C. § 107.

Notwithstanding the discussion of these complex tax issues, the Defendant reiterates its position that the expert testimony of David or Douglass Schoepf that the Defendant seeks to offer at trial is also helpful to the jury in evaluating evidence that both the United States and the Defendant will likely offer at trial regarding the United States' allegation that the Defendant improperly used church funds to pay part of the cost to acquire the Defendant's current residence. As a hypothetical, the evidence at trial may show that the Defendant used church funds to pay that part of the acquisition cost of his house related to the basement area of the home that the church used primarily for office and work space. Expert testimony as to the fair market value for comparable commercial lease space in the area would be helpful to the jury in evaluating any such evidence. Moreover, such expert testimony would not violate Federal Rule of Evidence 704(b) as the United States suggests. The ultimate issue in this case is not the fair

market value of comparable commercial lease space in Northern Kentucky. The Schoepfs will not offer any testimony with respect to the mental state or condition of the Defendant.

Respectfully submitted,

/s/ J. Christopher Coffman
Robert C. Webb
J. Christopher Coffman
Frost Brown Todd LLC
400 W. Market Street, Floor 32
Louisville, KY 40202-3363
Phone: (502) 589-5400
Fax: (502) 581-1087
E-mail: bwebb@fbtlaw.com
ccoffman@fbtlaw.com
Counsel for Ronald E. Weinland

CERTIFICATE OF SERVICE

I hereby certify that on June 1, 2012, I electronically filed this document with the clerk of the court by using the CM/ECF system, which will send a notice of electronic filing to the counsel of record.

By: /s/ J. Christopher Coffman
J. CHRISTOPHER COFFMAN
Counsel for Ronald E. Weinland