



BY EMAIL

To: Elaine Moy
From: Michael Best & Friedrich LLP
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Subject: Rental of Parsonages

This memorandum addresses some of the potential risks and benefits of renting church-owned parsonages to individuals who are not members of the clergy. The risks associated with renting out a parsonage include, from most to least likely, a) losing the Illinois state property tax exemption, b) incurring federal Unrelated Business Income Tax, and c) loss of federal income-tax exemption for operating for non-exempt purposes. Potential benefits include a) increased revenue for the church and b) deployment of church assets for community benefit.

Risks of Renting Out Church-Owned Property

The primary risk of renting out church-owned property to third parties would be the loss of the Illinois property tax exemption to the extent the property is already exempt. Illinois law provides for an exemption of property taxes for real property used for religious purposes “as long as it is not used for a view to profit.”¹ Additionally, property that is owned by a church, religious institution, or religious denomination and specifically designated as housing for ministers and their families is also exempt.²

Illinois courts have held that, when property originally qualifying for the religious-purposes exemption was subsequently rented out for non-religious purposes, the property can lose its exemption.³ Nevertheless, property used for both exempt and non-exempt purposes may qualify for a partial exemption.⁴ An exemption under the parsonage criteria would be threatened if the property was rented to a non-minister third party. Loss of the Illinois property tax exemption could result in a substantial annual tax increase for a church. In many scenarios, the loss of the exemption could outweigh any income derived from the rent.

Turning to federal concerns, a church that currently qualifies as a federally exempt 501(c)(3) organization would want to guard against incurring Unrelated Business Income Tax (“UBIT”) under section 512 of the Internal Revenue Code. This tax applies to gross income derived by an exempt organization from trade or business that is unrelated to its exempt purpose. Fortunately, there is an exclusion from this tax for rental income.⁵ In general, to qualify for the exclusion the following must be true:

¹ 35 ILCS 200/15-40(a).

² 35 ILCS 200/15-40(b).

³ *E.g., Side Christian Church v. Dep't of Revenue*, 2017 IL App (4th) 150907-U.

⁴ *Fairview Haven v. Dep't of Revenue*, 153 Ill. App. 3d 763, 771, 506 N.E.2d 341, 347 (1987)

⁵ I.R.C. § 512(b)(3).

1. The property must be principally real property,
2. The arrangement must be a lease,
3. The rent cannot be determined based upon the income of the lessee (that is, to avoid profit sharing with the lessee), and
4. The payments under the lease must be for use of the property and not for services.⁶

If the property is subject to a loan or mortgage, however, the exclusion may not apply depending on how long the property has been held, its recent uses, and future intended uses.⁷ With careful planning and drafting a church ought to be able to rent its property without incurring UBIT.

Finally, in extreme scenarios (e.g., if the rental income inured exclusively to one member of the church or a third party),⁸ the IRS could determine that the church is no longer operating pursuant to its exempt purposes by renting out its property. If this happens, the church's federal exempt status would be threatened. But, merely renting out a parsonage would likely not prompt the loss of exempt status. For that to occur, the church would need to, for example, cease religious services and rent property for profit.

Potential Benefits of Renting Out Church-Owned Property

The primary benefit of renting out church-owned property would be increased revenue to the church. That revenue could then be used to further the mission and services of the church.

In addition, depending upon the specifics of the lease and the type of lessee, renting out the property could further the church's purpose. For example, the church could rent the property substantially below market to benefit needy individuals. Alternatively, the church could rent the property to another religious organization or other nonprofit organization. In this scenario the property might qualify for property tax exemption under a religious or other exemption or another exemption.⁹ In each of these scenarios church assets would be put to uses that would benefit its community.

It is important to remember that however the parsonage is encumbered, The Discipline of the United Methodist Church requires that the church obtain the approval of various individuals and bodies associated with the Conference before the lease or other instrument is signed.

⁶ I.R.C. § 512(b)(3)(A).

⁷ I.R.S. Publication 1828, Tax Guides for Churches & Religious Organization, at 20 <https://www.irs.gov/pub/irs-pdf/p1828.pdf>; see I.R.C. § 514(a) & (b)(3)(E).

⁸ I.R.S. P.L.R. 201411037.

⁹ 35 ILCS 200/15-65 et al.

Conclusion

The above represents some of the risks and potential benefits of renting out a church-owned parsonage to third parties. The most substantial risk would be the potential loss of the Illinois property tax exemption. Careful planning and drafting could mitigate that and other risks. Because the risks and benefits are very fact specific, we recommend consulting with counsel prior to making any decisions or renting a church parsonage to a third-party.