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Legal Sidebar

Supreme Court Hears Argument on Religious Tax Exemptions

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When can corporations claim a religious exemption to avoid paying taxes? On March 31, 2025, the Supreme Court heard oral arguments in a case that may address this question: *Catholic Charities Bureau, Inc. v. Wisconsin Labor & Industry Review Commission*. Specifically, the Court is reviewing a Wisconsin decision requiring Catholic Charities Bureau, Inc. (CCB) and four of its sub-entities to pay state unemployment taxes. At the Supreme Court, the plaintiffs argue that Wisconsin's test for whether organizations are eligible for a religious exemption draws unconstitutional distinctions between different religious organizations, violating the First Amendment's Religion Clauses. As this Legal Sidebar discusses, Wisconsin's law—along with the laws of other states—uses language that mirrors the Federal Unemployment Tax Act (FUTA). Accordingly, the Supreme Court's ruling in this case could have implications for other federal and state laws that exempt organizations operated for "religious purposes."

Legal Background and Procedural History

Wisconsin's Unemployment Compensation Act requires employers to contribute to an unemployment insurance program that pays benefits to eligible unemployed individuals. Wisconsin's law excludes employment by "an organization [1] operated primarily for religious purposes and [2] operated, supervised, controlled, or principally supported by a church or convention or association of churches."

This exemption mirrors language in federal law. Among other provisions, FUTA creates a state tax credit scheme under which the Department of Labor certifies that states have imposed a FUTA-compliant tax to fund unemployment insurance benefits. Federal law allows certain organizations to participate in the state unemployment insurance program by reimbursing the program in lieu of paying state taxes. FUTA further excludes from this reimbursement scheme services performed "in the employ of . . . an organization which is operated primarily for religious purposes and which is operated, supervised, controlled, or principally supported by a church or convention or association of churches." In this way, a state law can be certified as compliant without regard to whether it taxes a religious entity. Wisconsin's unemployment insurance exemption tracks this federal provision. *Catholic Charities Bureau* involves the Wisconsin law, but other federal laws have come up as potentially relevant context over the course of the litigation. For example, FUTA imposes a federal unemployment tax to help fund the program. The federal tax does not

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apply to employment by an organization organized and operated exclusively for a religious purpose that is exempt from income tax under 26 U.S.C. § 501(c)(3).

CCB initially began contributing to Wisconsin's unemployment insurance program in 1972, but it sought an exemption in 2016. A state agency determined that CCB and four separately incorporated sub-entities did not qualify for an exemption because they were not "operated primarily for religious purposes." CCB and the sub-entities challenged this decision in court, arguing that the agency interpreted the statute incorrectly and that its interpretation violated the Religion Clauses of the First Amendment. (This Legal Sidebar collectively refers to these plaintiffs as "CCB.")

The Wisconsin Supreme Court agreed with the state agency's decision to tax CCB and its sub-entities. The court first held that to determine whether an organization qualifies for the "religious purposes" exemption, the state "must examine both the motivations and the activities of the organization." The court expressed concern that allowing exemption based on "a single assertion of a religious motivation" would define the exemption too expansively. Instead, drawing in part from a federal decision interpreting a church's tax-exempt status under 26 U.S.C. § 501(c)(3), the state court said it would look at, for example, "whether an organization participated in worship services, religious outreach, ceremony, or religious education." Applying this standard to CCB, the court accepted the organizations' assertions that their services had a religious motivation. However, the court further concluded that their activities, including job training and training for daily living, were "primarily . . . secular." Among other factors, the court noted that the exact same services could be performed by an organization with secular motivations, and CCB did not "attempt to imbue program participants with the Catholic faith nor supply any religious materials to program participants or employees."

CCB argued that this construction of the statute violated the Religion Clauses of the U.S. Constitution's First Amendment. As background, the Establishment and Free Exercise Clauses state that "Congress shall make no law respecting an establishment of religion, or prohibiting the free exercise thereof." The Supreme Court has recognized a tension between the two Religion Clauses, and courts use a different test to analyze violations under each Clause. At the same time, the Clauses overlap. For instance, a government action that discriminates against certain religions while preferring others might violate both the Free Exercise Clause and the Establishment Clause, respectively. Both Clauses prevent the government from judging the legitimacy of religious beliefs. The doctrine sometimes known as "religious autonomy" prevents the government from interfering in disputes over religious doctrine or internal governance. Under a somewhat similar principle, a number of Supreme Court cases held that impermissible government "entanglement" with religion violated the Establishment Clause—although this entanglement inquiry was arguably "abandoned" by the Supreme Court in more recent years.

As an example, in *Larson v. Valente*, the Supreme Court invalidated a state law imposing registration and reporting requirements on charitable organizations. The law excluded religious organizations that received more than half of their contributions from members. The Court held that this exclusion impermissibly preferred certain religious denominations over others without sufficient justification, violating both Religion Clauses. The Court further determined that the law would create an excessive entanglement between the state and religion by politicizing the question of which religious organizations should be exempt, violating the Establishment Clause.

At the same time, the Supreme Court has confirmed the government's general ability to tax religious organizations. In 1982, the Court rejected an employer's Free Exercise claim to an exemption from Social Security payroll taxes. Although the payment and receipt of Social Security benefits violated the employer's religious beliefs, the Court concluded this infringement was justified because mandatory participation was essential to accomplish a comprehensive national social security system. In addition, in two different cases, the Court rejected arguments that federal tax exemptions allegedly preferred certain religions and therefore violated the Establishment Clause. In *Hernandez v. Commissioner*, the Court distinguished *Larson* by concluding that the federal tax law did not expressly differentiate between

religious sects, and the routine regulatory interaction required to implement the law would not excessively entangle church and state. In *Bob Jones University v. United States*, the Court held that although a federal tax policy had the effect of taxing some religions and not others, the policy had a religion-neutral basis and its uniform application to all schools avoided the necessity of a "potentially entangling inquiry."

In *Catholic Charities Bureau*, the Wisconsin Supreme Court rejected CCB's constitutional claims. The court held first that the law would not create excessive entanglement, saying that examining an organization's "motivations and activities . . . requires minimal judicial inquiry into religion" and is consistent with the types of inquiries conducted under religious tax exemptions throughout history. The court next concluded that the law did not impermissibly interfere with a religious organization's autonomy over its internal governance, because the law's application turned on a nonprofit's motivation and activities, not its structure. Finally, the court ruled that the law did not violate the Free Exercise Clause because the unemployment insurance system did not prevent the organizations "from fulfilling any religious function or engaging in any religious activities"; in other words, it did not impose "a constitutionally significant burden on their religious practice."

Three of the seven justices on the Wisconsin Supreme Court dissented, arguing that the majority misinterpreted the statute. One of the dissents argued that, properly interpreted, the statute "requires only that a nonprofit be operated primarily for a religious reason" rather than the majority's more searching inquiry into the "activities" of the nonprofit.

Supreme Court Appeal and Oral Arguments

As a general rule, the Supreme Court will not second-guess a state supreme court's interpretation of its own state law. When it agreed to hear the appeal in *Catholic Charities Bureau*, the Supreme Court did not signal that it would be evaluating the state court's construction of the "religious purposes" exemption in Wisconsin's unemployment tax law. Instead, it agreed to hear arguments on whether the state court's interpretation of that law violates the First Amendment. Nonetheless, the federal government filed an amicus brief arguing that the Wisconsin Supreme Court had misinterpreted the state statute. The United States claimed that the U.S. Supreme Court should correct that misconstruction because the state exemption parallels federal law. (CCB opposes this avenue for deciding the case, urging the Court to focus on the constitutional questions instead.) At oral argument, the Justices did not necessarily seem inclined to decide the case on the statutory basis urged by the United States. Justice Thomas pointed to the idea that Wisconsin remains free to interpret its statute differently from FUTA.

To summarize the parties' constitutional arguments at the Supreme Court, CCB has argued (in part) that Wisconsin is impermissibly penalizing the organization for its decisions about "church polity"—that is, its decision to structure CCB and the sub-entities as separately incorporated entities rather than as a single entity with the local Roman Catholic diocese. CCB claims the state's interpretation of its law violates constitutional principles under both Religion Clauses that protect church autonomy and prevent religious discrimination. As evidence of discrimination violating the Free Exercise Clause, CCB alleges that the state is preferring groups that proselytize, worship, or limit their services to co-religionists.

In response, the state asserts its religious exemption helps *avoid* state interference with religion by rendering the statutory scheme inapplicable to "distinctively religious activities like worship, ritual, teaching the faith, or spreading a religious message." It says this inquiry aligns with Supreme Court precedent. Answering the claims of discrimination, the state claims that CCB did not identify a valid burden on its religion. Wisconsin also emphasizes that (as mentioned above) the Supreme Court has previously rejected Free Exercise Clause challenges to the government's ability to tax religious organizations. More broadly, Wisconsin warns the Supreme Court against adopting CCB's claim that (in Wisconsin's characterization) "the Religion Clauses bar any accommodation that covers something less than all religiously oriented groups, because such accommodations improperly discriminate against left-

out groups." In its brief, the state highlights a number of federal laws that only exempt certain religious entities, cautioning the Court against a ruling that would invalidate such provisions.

At oral argument on March 31, 2025, some of the Justices appeared interested in the government's ability to limit the scope of religious exemptions, asking counsel for CCB whether the government can ever include only some religious entities and exclude others. Chief Justice Roberts questioned whether a hypothetical restaurant run by a religious group that believes in vegetarianism would be organized for "religious purposes." (His hypothetical drew from a 1991 federal appeals court case concluding that such a restaurant was not exempt from federal income tax.) Justice Jackson returned to this hypothetical in her own questioning, and some of the Justices also asked about religious hospitals. CCB's attorney claimed that such organizations would be included in the exemption if they are operated for religious purposes. He asserted that any limitations on the exemption's scope should come from assessing whether the religious motivations are sincere and whether the organization is primarily motivated by religious or commercial reasons—criteria that might not exclude the vegetarian restaurant or hospitals.

Justice Gorsuch suggested the "simplest" way to decide the case might be to conclude that the state unconstitutionally discriminated against certain types of religions, and a number of other Justices' questions returned to the discrimination issue. In Justice Gorsuch's phrasing, the decision below "distinguished between religions that proselytize and those that don't and between those who serve co-religionists and those who serve others as well." Justice Kagan also characterized the decision below as turning on whether the religious organization proselytizes, pressing Wisconsin's counsel on why this would be constitutionally acceptable. Echoing its briefs, the state's attorney argued that exempting proselytizing religions was a valid accommodation that avoids involving the state in disputes where an employee is "expressing and inculcating religious doctrine" through activities like worship, proselytization, or religious education. In some contrast, Justice Sotomayor claimed that there was no "invidious discrimination," citing prior cases where the Supreme Court had concluded the government intentionally disadvantaged certain religions. Justice Sotomayor also asserted, however, that this case seemed "very similar" to *Larson v. Valente*, mentioned above, in which the Supreme Court ruled unconstitutional a state law containing denominational preferences.

Considerations for Congress

As discussed, the "religious purposes" language in Wisconsin's statute intentionally mirrors the language of FUTA, 5 U.S.C. § 3309. A number of other state laws have similarly adopted language referring to entities organized or operated "primarily for religious purposes," both in unemployment compensation and other laws. According to CCB, for unemployment compensation purposes, four states look to an organization's activities to determine whether they operate primarily for religious purposes. Further, as the Wisconsin Supreme Court noted, federal income tax law, 26 U.S.C. § 501(c)(3), defines corporations "organized and operated exclusively for religious . . . purposes" as tax-exempt. A 501(c)(3) exemption is incorporated into the federal unemployment tax. The exemption is distinct from the language used in 5 U.S.C. § 3309 but includes the exemption of organizations operated for religious purposes.

The Supreme Court might not specifically weigh in on how best to interpret the phrase "religious purposes" as a matter of statutory interpretation. Nonetheless, if the Court announces constitutional limitations on Wisconsin's construction of this provision, these constitutional boundaries may be relevant to how federal and state laws that use similar language can be interpreted or applied. For instance, if the Supreme Court were to hold that Wisconsin impermissibly discriminated against CCB because the organization does not proselytize while delivering services, then in the future, governments might be hesitant to look to proselytization as a factor in whether an organization operates for religious purposes. As another possibility, if the Supreme Court were to hold more broadly that the Religion Clauses require the government to defer to an organization's assertion of a religious motivation for its work, this could call for the broadening of religious exemptions.

A ruling in this case could shape how the federal government interprets existing religious exemptions and could affect Congress's ability to draft new ones. Depending on how the Supreme Court rules, Congress might consider amending existing federal exemptions. Congress could make existing federal exemptions for religious organizations broader, within constitutional bounds. Alternatively, Congress might choose to eliminate certain exceptions altogether. If there is no religious exemption, the statute would not expressly discriminate on the basis of religion. CCB's counsel acknowledged at one point that it would be constitutionally permissible to tax a religious vegetarian restaurant so long as the tax applied across the board and did not discriminate "along theological lines."

This case could also implicate broader jurisprudential issues under the Religion Clauses. Accommodations for religious entities have long raised difficult constitutional questions. This particular case arises in the shadow of significant developments in the Supreme Court's Establishment Clause jurisprudence. In 2022, the Court announced that it had "abandoned" the so-called *Lemon* test that instructed courts to evaluate government actions involving religion by looking to their purpose, effect, and potential entanglement between the government and religion. At the same time, as discussed in a prior Legal Sidebar, the Supreme Court did not overrule its cases that had applied the *Lemon* test to specific circumstances, including its cases evaluating whether various forms of accommodations violate the Establishment Clause. While the parties to this case addressed the possibility of government entanglement with religion, none of them addressed the effect that abandoning the *Lemon* test's entanglement prong might have on this inquiry. The only time this issue was expressly raised in *Catholic Charities Bureau* was toward the end of oral argument, when Justice Thomas asked where this entanglement inquiry came from, if not *Lemon*. Wisconsin's attorney cited a case that had compiled *Lemon*'s three-factor inquiry one year before *Lemon*. Accordingly, if the Court issues a decision in this case that references entanglement or otherwise interprets the Establishment Clause, that could provide further insight into the appropriate inquiry going forward.

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