Office of Chief Counsel
Internal Revenue Service
memorandum

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subject: Credit Counseling Organizations

EXECUTIVE SUMMARY

This memorandum presents the legal analysis you requested of whether credit counseling organizations can qualify for exemption as charitable or educational organizations described in section 501(c)(3). This memorandum may not be used or cited as precedent.

We have reviewed the tax authorities specific to credit counseling organizations seeking exemption as well as a broad range of tax authority relating to nonprofit organizations that seek exemption despite strong resemblance to commercial operations and/or very close connections to certain private parties, who may or may not be in control of the nonprofit organization. We have also reviewed the extensive information gathered by the EO Division and the records in the examinations already underway. We believe that many credit counseling organizations will not be able to satisfy the requirements of section 501(c)(3) because of (1) operation for a substantial nonexempt purpose; (2) substantial private benefit; and, (3) in many cases, inurement.

It can and should be argued that the new generation of credit counseling organizations does not meet the criteria for exemption set forth in the two revenue rulings and case law: they are not providing any meaningful education or relief of the

poor. Because the operations of the new generation of credit counseling organizations are so different from those considered in the prior case law and revenue rulings, we strongly recommend that each case be developed to enable the Service to establish many grounds for revocation, including the lack of exempt purpose, operation for substantial nonexempt purpose and the existence of private benefit. In a number of cases, there may also be a basis for arguing for revocation based on inurement. The IDR that has been drafted by the credit counseling team aligns neatly with the legal analysis. If all the information that it seeks is collected, the necessary information for building these cases should be available in the record.

Given what we know today about the current organizations, we do not anticipate that inurement will be the sole, or even primary, ground for revocation. Nevertheless, in the course of developing the facts for purposes of determining whether inurement is present, agents may find excess benefit transactions, providing a basis for pursuing the imposition of section 4958 excise tax on the disqualified person or persons. The regulations under section 4958 provide detailed guidance on the application of those rules which will enable the development of a section 4958 case. In these cases, section 4958 taxes often will be combined with revocation based on substantial nonexempt purpose or private benefit. There are technical issues which may arise in such a circumstance that can be addressed by consulting the section 4958 compliance team. By contrast, it will be less common to pursue section 4958 taxes in a case where revocation is based solely on inurement. In these less common cases, it will be necessary to address open questions of law and policy with respect to the circumstances under which section 4958 taxes can be combined with revocation based on inurement.

BACKGROUND

As we have learned from research and materials authored by the EO Division, the credit counseling agencies developed in the 1960s were sponsored by the credit card industry, which saw an opportunity to recover some of its overdue debts through creation of social service agencies that educated the public about responsible borrowing. The Consumer Credit Counseling Service (CCCS) agencies established in this period were affiliated with the National Foundation for Consumer Credit (NFCC), a trade association that prescribed standards for its

member organizations.[1] Subsequently formed trade associations include the Association of Independent Consumer Credit Counseling Agencies (AICCCA) and the American Association of Debt Management Associations (AADMO), both of which represent the newer commercial-type organizations.

The last 40 years have seen enormous growth in the availability of credit and the amount of outstanding debt. A wave of defaults in the late 80s and early 90s brought changes to the credit-counseling industry. Ten years ago, there were about 200 credit counseling organizations in the country, 90 percent affiliated with NFCC. By 2002, by some reports there were more than 1,000 organizations, most of them independent of the CCCS and its agencies.[2]

Creditors support the credit counseling agencies by returning to them a percentage of the payments the creditors receive through the agencies, generally termed “fair share payments.” Creditors have no legal obligation to pay fair share. Until the mid to late 1990s, fair share payments were generally 12-15 percent of aggregate payments from debtors. In general, 60 percent of NFCC funding came from creditors and 40 percent from charities. The commercial-type agencies receive a smaller percentage of their support from fair share, a correspondingly larger share from fees, and none from charitable contributions.

In recent years, creditors have reduced their fair share payments because of increasing costs.[3] According to the Report of the Permanent Subcommittee on Investigations (Senate Report), with the emergence of the commercial-type credit counseling agencies and the exploding number of debt management plans (DMPs), fair share payments became increasingly expensive for creditors. As fair share payments increased, it should not surprise anyone that creditors began to examine the merits of this growing expense. These inquiries indicated that the wrong consumers were being placed on DMPs. For example, consumers who could afford to pay their debts but were looking for a break in

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[1] Credit Counseling in Crisis, Consumer Federation of America and National Consumer Law Center (April 2003), at 4. Another trade association is the Association of Independent Consumer Credit Counseling Agencies.

[2] David A. Lander, Recent Developments in Consumer Debt Counseling Agencies: The Need for Reform, *American Bankruptcy Institute Journal*, vol. 21, no. 1 (Feb. 28, 2002) , at 14

[3] “Profiteering in a Non-Profit Industry: Abusive Practices in Credit Counseling,” Staff of the Permanent Subcommittee of Investigations, U.S. Senate (Senate Report), at 25

interest rates and fees were unnecessarily and incorrectly placed on DMPs.[4]

According to the Senate Report, the creditors have begun to use their fair share policies to impose a measure of regulation on the industry. One bank imposes minimum standards before it will make any fair share payments. Payments and proposals must be made by electronic funds transfer and the agency must not be involved in any litigation. The agency must be accredited and the counselors certified. Fees must meet the bank's guidelines. If the CCA meets the eligibility requirements, it will receive 2 percent. It may receive up to an additional 7 percent depending upon the performance of its portfolio. The average fixed payment and the default rate of the agency, both equally weighted, may provide a maximum of 3.5 percent in additional fair share payments for each criterion. In addition, the agency must continue to increase new inventory, i.e., to sign up new bank card members at a growth rate of 0.25 percent.[5] (No more information was given about this measure.)

Another bank imposes a similar minimum standard before it will make any payments. Then the credit counseling agency's portfolio is measured by its payment volume and portfolio vintage. The older the account, the larger the percentage of fair share available, starting with 2 percent for new accounts and increasing to 15 percent for accounts that last 36 months.[6]

A third bank introduced what it calls a grant program for disbursing its fair share payments, under which it pays fair share according to its "perception of the agency's needs and the benefits they provide to the customer and the community."[7] The bank bases its perception on a list of 29 questions, similar to the criteria the other banks use to evaluate credit counseling agencies.

The Senate Report concludes that creditors can play a major role in eliminating abusive practices examined in the report. Some creditors are concerned, however, about appearing to favor some agencies over others, and not without reason.

In 1997, a group of independent credit counseling agencies brought antitrust suits against a group of creditors, alleging

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[4] Id. at 26
[5] Id. at 25-26
[6] Id. at 27-28
[7] Id. at 28

anti-competitive actions and policies and tortious interference. These cases were consolidated under the name In Re Consumer Credit Counseling Services Antitrust Litigation, 1997 WL 755019 (D.D.C. 1997). The CCCS agencies alleged that NFCC and its members controlled more than 70 percent of the national consumer credit market and conspired with creditors to keep new agencies out of the business. Their complaint stated that creditors dominated the board and major subcommittees of the NFCC, which set standards for the CCCS agencies. They alleged that Discover Card Services (DCS) entered into an agreement to deal exclusively with NFCC's members, and in exchange DCS reduced its fair share contribution from 15 to 12 percent. The parties entered into a settlement agreement which, among other things, removed the creditors from NFCC's national board of directors, though individual NFCC members may still have representatives from local banks on their boards.[8] The court did not comment on the incongruity of one group of alleged charities suing another for tortious interference with business opportunities.

In addition to the proliferation of the commercial type of debt counseling agencies in recent years, the number of organizations offering "credit repair" has grown. Credit repair is a service that claims to do one of two things: some credit repair agencies contact the credit reporting agencies and obtain removal of inaccurate or outdated negative items from credit reports; other agencies claim to be able to remove some or all negative items, regardless of their accuracy.

Congress attempted to address some of the consumer problems arising in this area by adopting the Credit Repair Organizations Act (CROA), 15 U.S.C. section 1679 et seq., effective April 1, 1997. The CROA, enforced by the Federal Trade Commission (FTC), imposes restrictions on credit repair organizations, including forbidding the making of untrue or misleading statements and forbidding advance payment, before services are fully performed. 15 U.S.C. section 1679b. The CROA, however, provided an additional impetus to the formation of tax-exempt credit-counseling organizations because section 501(c)(3) organizations are not subject to regulation under the CROA.

LAW AND ANALYSIS

Cases and Rulings Dealing With Credit Counseling Organizations

[8] Id. at 26

There is a limited amount of published guidance and case law specifically addressing exemption for credit counseling organizations. All of it is dated and quite summary in its description of the facts. Therefore, it is subject to interpretation as applied to the specific facts presented by the new generation of credit counseling organizations.

The Service has issued two rulings holding credit counseling organizations to be tax exempt. Rev. Rul. 65-299, 1965-2 C.B. 165, granted exemption to a 501(c)(4) organization whose purpose was to assist families and individuals with financial problems and to help reduce the incidence of personal bankruptcy. Its primary activity appears to have been counseling people in financial difficulties to "analyze the specific problems involved and counsel on the payment of their debts." The organization also advised applicants on proration and payment of debts, negotiated with creditors and set up debt repayment plans. It did not restrict its services to the needy. It made no charge for the counseling services, indicating they were separate from the debt repayment arrangements. It made "a nominal charge" for monthly prorating services to cover postage and supplies. For financial support, it relied upon voluntary contributions from local businesses, lending agencies, and labor unions. The reference to "lending agencies" suggests that what are now called fair share payments were involved.

Rev. Rul. 69-441, 1969-2 C.B. 115, granted 501(c)(3) status to an organization with two functions: it educated the public on personal money management, using films, speakers, and publications, and provided individual counseling to "low-income individuals and families." As part of its counseling, it established budget plans, i.e., debt management plans, for some of its clients. The debt management services were provided without charge. The organization was supported by contributions primarily from creditors. By virtue of aiding low income people, without charge, as well as providing education to the public, the organization qualified for section 501(c)(3) status.

The Service denied exempt status to another organization, Consumer Credit Counseling Service of Alabama, whose activities were distinguishable in that (1) it did not restrict its services to the poor and (2) it charged "a nominal fee" for its debt management plans. The agency in question was a participant in the National Foundation for Consumer Credit, which had received a group ruling and operated many related credit counseling agencies. The agency provided free information to the general public through the use of speakers, films, and

publications on the subjects of budgeting, buying practices, and the use of consumer credit. It also provided counseling to "debt-distressed individuals," not necessarily poor, and provided debt management plans at the cost of $10 per month, which fee was waived in cases of financial hardship. Its DMP related activity was a relatively small part of its activities.

When CCCS of Alabama challenged the Service's revocation action, the court held that the organization qualified as charitable and educational under section 501(c)(3). It fulfilled charitable purposes by educating the public on subjects useful to the individual and beneficial to the community. Section 1.501(c)(3)-1(d)(3)(i)(b). For this, it charged no fee. The court found that the counseling programs were also educational and charitable; the debt management and creditor intercession activities were "an integral part" of the agencies' counseling function and thus were charitable and educational. Even if this were not the case, the court viewed the debt management and creditor intercession activities as incidental to the agencies' principal functions, as only approximately 12 percent of the counselors' time was applied to debt management programs and the charge for the service was "nominal." Consumer Credit Counseling Service of Alabama, Inc. v. U.S., 44 A.F.T.R.2d (RIA) 5122 (D.D.C. 1978). The court also considered the facts that the agency was publicly supported--fair share payments were not mentioned--and that it had a board dominated by members of the general public as factors indicating a charitable operation. See also, Credit Counseling Centers of Oklahoma, Inc. v. U.S. (D.D.C. 1979), 79-2 U.S.T.C. (CCH) 9468, 45 A.F.T.R.2d (RIA) 1401 (same facts).

Outside the context of credit counseling, individual counseling has, in a number of instances, been held to be a tax-exempt charitable activity. Rev. Rul. 78-99, 1978-1 C.B. 152 (free individual and group counseling of widows); Rev. Rul. 76-205, 1976-1 C.B. 154 (free counseling and English instruction for immigrants); Rev. Rul. 73-569, 1973-2 C.B. 179 (free counseling to pregnant women); Rev. Rul. 70-590, 1970-2 C.B. 116 (clinic to help users of mind-altering drugs); Rev. Rul. 70-640, 1970-2 C.B. 117 (free marriage counseling); Rev. Rul. 68-71, 1968-1 C.B.249 (career planning education through free vocational counseling and publications sold at a nominal charge). Overwhelmingly, the counseling activities described in these rulings were provided free, and the organizations were supported by contributions from the public.

In a recent state property tax exemption case, the court found that private benefit to creditors surpassed any educational function of the organization. The dissent concluded that benefit to creditors may still be viewed as incidental if the organization performs a variety of educational functions, including some entirely unrelated to debt management.[9]

These cases and rulings do not give us a simple rule to distinguish between an exempt and a non-exempt credit counseling organization. They involve combinations of many factors. The salient facts of these cases are summarized in the following table:

TAX-EXEMPT CREDIT COUNSELING ORGANIZATIONS

	CCCS Alabama	**Rev. Rul. 69-441 501(c)(3)**	**Rev. Rul. 65-229 501(c)(4)**
Free Public Education	Yes: Major activity	Yes	No
Free Individual Counseling	Yes: Major activity	Yes	Yes
Debt Management Plans	Yes: 12% of counselors' time	Yes	Yes
Fees for DMPs	Yes: nominal ($10 per month), waived for hardship	No	Yes: nominal
Amount of Revenue from Fees	Incidental amount	None	Minor: main support from fair share and contributions
Public Support	Contributions from gov't, private found., & United Way	Some: amount not specified	Some: amount not specified

[9] The Supreme Judicial Court of Maine recently revoked the property tax exemption of an NFCC-affiliated agency on the ground that it was operated to confer private benefit upon creditors. Credit Counseling Centers, Inc. d/b/a/ CCCS v. City of South Portland, 814 A.2d 458 (2003). Its reasoning was that the magnitude of the amounts collected on behalf of creditors demonstrates that the organization's business was not "conducted exclusively for benevolent and charitable purposes," citing M.R.S.A sec. 652(1)(A). The generation of this revenue was not "purely incidental" to a charitable purpose.

Community Board	60% from general public	All members represent the public	n/a
Referrals	Yes, employers, unions, clergy	n/a	n/a
Limited to Low Income Clients	No	Yes	No
Loans	n/a	No	No

[redacted] The organizations in the CCCS cases served the general population, not just the poor, as the Service required, and they charged fees to most clients. They were supported in part by DMP fees and fair share contributions. The court found, without further analysis, that DMPs were an integral part of the counseling activity, which was educational. Organizations under audit will likely pursue a similar tactic, attempting to make a case for the educational nature of their activities. The rulings and the case law do not go into much detail as to what it takes to make a counseling activity educational, or when the collection of fees becomes so pervasive as to counteract a charitable purpose; accordingly, we can expect that organizations will attempt to use them as a basis for claiming that their operations further charitable purposes.

On the totality of the facts, we will want to argue that today's credit counseling organizations have departed so far from the facts in the cases and rulings that they no longer serve an exempt purpose. To establish a solid case under existing precedents, we will need to argue that, even if they are providing education, the organizations fail the operational test: they are furthering a substantial nonexempt purpose, and furthermore they are conferring impermissible private benefits and/or inurement. The legal analysis that should support that position is as follows.

Organizational and Operational Tests

To meet the requirements of section 501(c)(3), an organization must be both organized and operated exclusively for charitable and other enumerated purposes. The term charitable includes relief of the poor and distressed. Section 1.501(c)(3)-1(d)(2), Income Tax Regulations.

Educational organizations are also classified as charitable. The term educational includes (a) instruction or training of the individual for the purpose of improving or developing his capabilities and (b) instruction of the public on subjects useful to the individual and beneficial to the community. Section 1.501(c)(3)-1(d)(3). In other words, the two components of education are public education and individual training.

[redacted]

Whether an organization operates exclusively for charitable purposes depends on the application of the operational tests set forth in the income tax regulations. The regulations provide:

> An organization will be regarded as "operated exclusively" for [charitable] purposes only if it engages primarily in activities which accomplish one or more [charitable] purposes specified in section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of a [charitable] purpose.

Treas. Reg. § 1.501(c)(3)-1(c)(1).

An organization is not organized or operated exclusively for an exempt purpose unless it serves a public rather than a private interest. To meet this requirement, an organization must establish "that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests." Section 1. 501(c)(3)-1(d)(1)(ii). A private benefit may inure to outsiders as well as insiders. American Campaign Academy v. Commissioner, 92 T.C. 1053, 1064 (1989). In

the credit counseling cases we are familiar with, one of the purposes of the organizations appears to be to generate fees for related and unrelated for-profit entities.

An organization may operate a trade or business if it furthers an exempt purpose. The regulation provides:

> An organization may meet the requirements of section 501(c)(3) although it operates a trade or business as a substantial part of its activities, if the operation of such trade or business is in furtherance of the organization's exempt purpose or purposes and if the organization is not organized or operated for the primary purpose of carrying on an unrelated trade or business . . .. In determining the existence or nonexistence of such primary purpose, all circumstances must be considered, including the size and extent of the trade or business and the size and extent of the activities which are in furtherance of one or more exempt purposes.

Section 1.501(c)(3)-1(e). In other words, we will have to determine "whether the [organization's] exempt purpose transcends the profit motive rather than the other way around. Elisian Guild, Inc. v. U.S. 412 F.2d 121, 124 (1st Cir. 1969), rev'g 292 F. Supp. 219 (D. Mass 1968). [redacted]

The operational test focuses on the purposes furthered by an organization's activities rather than on the nature of the activities. In Aid to Artisans, Inc. v. Commissioner, 71 T.C. 202 (1978), ac'q in result in part, 1981-2 C.B.1, the court held that the organization was entitled to exemption though engaged in "profitmaking commercial activities." Nevertheless, it had the exempt purposes of supporting indigenous craftspeople in developing countries and educating the American public about crafts. On the other hand, in Federation Pharmacy Services. Inc. v. Commissioner, 72 T.C. 687, 691 (1979), aff'd. 625 F. 2d 804 (8th Cir. 1980), the court held that the sale of prescription drugs to the elderly even at a discount is "an activity that is normally carried on by a commercial profitmaking enterprise." The court added: "An organization which does not extend some of its benefits to individuals financially unable to make the

required payments reflects a commercial activity rather than a charitable one." Id. at 807.

Substantial Nonexempt Purpose

The existence of a substantial nonexempt purpose, regardless of the number or importance of exempt purposes, will cause failure of the operational test. Better Business Bureau v. U.S., 326 U.S. 279 (1945). Other cases have expressed the point as whether an organization's primary purpose is exempt or nonexempt. B.S.W. Group, Inc. v. Commissioner, 70 T.C. 352 (1978). This is an important point because the credit counseling agencies argue they are providing education. We can argue that, even if this is so, the overwhelming commercial nature of their operations and the private benefit and inurement they provide establishes that they serve a substantial nonexempt purpose.

The existence of a substantial nonexempt purpose is not always easy to establish, especially in the face of explicit statements of charitable purpose. The courts have thus developed guidelines intended to help infer the existence of a substantial non-exempt purpose.[10] These guidelines serve as an explication of section 1.501(c)(3)-1(e) of the Income Tax Regulations, a way of determining the existence and the primacy of a charitable or public purpose, considering all the circumstances. The guidelines focus on how the organization conducts its business.

A credit counseling organization that operates a business providing services to all comers and solely at market rates must establish that it does not exist primarily to further a substantial non-exempt purpose. See Airlie Foundation, Inc. v. U.S., 92 A.F.T.R.2d (RIA) 6206, (D.D.C, 2003), in which exemption was denied because operation of a conference center is not an inherently charitable activity and the center did not

[10] To help address this problem, the courts of initial jurisdiction in section 7428 declaratory judgment cases have all adopted what they call the commerciality doctrine: Tax Court, B.S.W. Group, Inc. v. Commissioner, 70 T.C. 352 (1978); the Court of Federal Claims, Easter House v. U.S., 12 Cl. Ct. 476 (1987); and the D.C. Circuit, Airlie Foundation v. U.S., 92 A.F.T.R.2d (RIA) (D.D.C. 2003). It is also the rule in several appellate courts. Elisian Guild, Inc. v. U.S., 412 F.2d 121 (1st Cir. 1969), rev'g 292 F.Supp. 219 (D. Mass. 1968); Living Faith, Inc. v. Commissioner, 950 F.2d 365 (7th Cir. 1991), aff'g T.C. Memo. 1990-484; Federation Pharmacy Services v. U.S., 625 F.2d 804 (8th Cir. 1980), aff'g 72 T.C. 687 (1989); Easter House, 846 F.2d 78 (Fed. Cir. 1988), aff'g Cl. Ct.

have significant indicia of charitable purpose. Similarly, credit counseling is not inherently charitable, and a very substantial, if not the sole, activity of the credit counseling organizations we have encountered is operating a business.

What specific factors do the courts look for in determining whether a business is carried on for a public purpose or a nonexempt purpose? First they look for traditional indicia of charitable purpose: public support and public control. Second, they ask whether the organization serves an exclusively charitable class and offers some of its services free or below cost. Third, when an organization is making a lot of money, they ask whether that money is being used for a charitable purpose or whether it is being accumulated or paid out to benefit private interests. Fourth, they look at the manner in which the business is conducted: does the business compete with commercial businesses, using similar advertising, pricing, and business methods?

With respect to the investigation of these factors, first courts regularly ask whether an organization is supported in part by contributions and whether it has a community board. These are not requirements for charitable status, but, when an organization is conducting a business, they are signs that its purpose is to serve a public, not a private, interest. This is also the significance of referrals from employers, unions, and community groups. Goldsboro Art League, Inc. v. Commissioner, 75 T.C. 337 (1980), acq. 1986-1 C.B. 1 (organization relied on volunteer help and its directors were professionals from the community); B.S.W. Group, Inc. v. Commissioner, 70 T.C. 352 (1978) (citing lack of solicitation of contributions and sole support from fees as factors disfavoring exemption); Federation Pharmacy Services, 625 F.2d at 807 (the absence of contributions or of a plan to solicit contributions, which are characteristic of a charitable institution, militated against the finding of tax-exempt status).

A second indication of charitable purpose is serving a charitable class, offering services free or substantially below cost to members of the charitable class. This is a factor the IRS also considers when an organization charges fees for services. See Rev. Rul. 71-529, 1971-2 C.B. 234 (management of university endowment funds at a fee substantially below cost is a charitable activity); Rev. Rul. 76-244, 1976-1 C.B. 155 (home delivery of meals to the elderly on a sliding scale or free, depending on recipients' ability to pay, is a charitable purpose.)

On analogy with Easter House, in which the organization operated an adoption service, we infer that a court might find support coming primarily from DMP fees to be a factor disfavoring exemption. In this case the court stated: "The substantial fees plaintiff charged were not incidental to plaintiff's exempt purposes but rather admittedly were designed to make a profit." 12 Cl. Ct. 476, 486 (1987), aff'd 846 F.2d 78 (Fed. Cir. 1988). Debt management, like the adoption services in Easter House, is not a traditionally charitable activity, and receiving support primarily from DMP fees is indicative of a nonexempt purpose. For the same reason, in Consumer Credit Counseling of Alabama v. U.S, 44 A.F.T.R. 2d (RIA) 5122 (D.D.C. 1978), discussed above, the court stressed as a factor favoring exemption that education and counseling were provided free of charge.

Third, courts have seen a factor disfavoring exemption in accumulation of large surpluses, beyond the needs of the business, especially when there is evidence of inurement or private benefit. In Easter House, the court stated: "The profit-making fee structure of the adoption service looms so large as to overshadow any of its other purposes. [Citations omitted.] . . . [A]lso . . . the plaintiff's only source of income was the fees charged adoptive parents. This is a factor indicating the commercial character of the operation." 2 Cl. Ct. 486.

Another formulation of the substantial nonexempt purpose test is whether the profits, if any, are used to further an exempt purpose. Aid to Artisans v. Commissioner, 71 T.C. 202 (1978) (all profits are earmarked for specific charitable purposes); Incorporated Trustees of the Gospel Worker Society, 510 F. Supp. 374 (D.D.C. 1981), aff'd without op. 672 F.2d 894 (D.C. Cir. 1981) (accumulation of profits long after all religious work had ceased was for no apparent charitable purpose). In this context, a credit counseling organization that budgets no money for public educational activities, apart from advertising, is signaling a possible nonexempt purpose.

The courts' point in these cases is that accumulation of large amounts of money, or payments of large amounts to insiders and outsiders, without using the money to further charitable goals is evidence of a non-exempt purpose. In American Institute for Economic Research v. U.S., 157 Ct. Cl. 548, 555(1962), the court stated: "It is not the fact of profits alone which compels this conclusion [lack of educational

purpose], for plaintiff is also hampered…by the methods it has selected to disseminate this type of subject matter." In Scripture Press Foundation, 152 Ct. Cl. 463, 470 (1961), the court objected to "the enormity of the contrast between what plaintiff has accumulated" and what it spent on religious instruction. In the credit counseling cases, we are seeing a slightly different variant on this theme: receipts of multi-millions of dollars paid out to for-profit organizations but very little going to further public purposes.

Fourth, courts have considered whether an activity is normally carried on by commercial, profit-making enterprises. See B.S.W. Group; Living Faith; Aid to Artisans. They also consider, along with other factors, whether the organization directly competes with for-profit businesses. "It is significant that Living Faith is in direct competition with other restaurants." Living Faith, 950 F.2d, at 373, citing B.S.W. Group, 70 T.C. at 358. This is an important factor when the organization does not engage in traditionally charitable activities such as providing below-cost services for a charitable class. Federation Pharmacy Services. One taxpayer was successful conducting traditionally charitable activities, education and furthering of the arts, with a business subordinate to that purpose. Goldsboro Art League. In Easter House, the court found as a negative factor: "competing with other commercial organizations providing similar services. This is far different than an organization which solicits charitable contributions." 12 Cl. Ct. at 485. The court was weighing competition together with the absence of signs of charitable purpose.

In these cases the courts were influenced by the fact that an organization had large expenditures for advertising. In Living Faith, the court objected that, not only did the organization compete with other restaurants, but it used pricing formulas common in the retail food business (lack of below-cost pricing). The court observed: "Its informational materials are apparently promotional as well." In Airlie Foundation, the court noted that the organization maintains a commercial website and pays significant advertising and promotional expenses. 92 A.F.T. R. 2d. In other words, it promoted its facilities, including elegant events facilities, aggressively without reference to any public purposes. In the credit counseling cases, we are finding examples of aggressive commercial promotion, as for instance in the transcript of a conference held to recruit independent contractor agents: "You can sit down and calculate, really fast--cha-ching, cha-ching, cha-

ching. You could be sitting at home, basically by telephone, which is what a lot of us do, and make yourself some money. I'm going to show you exactly how you do it!" Transcript of seminar, dated June 8, 2002, at 47.

In the context of credit counseling organizations, we must investigate and document all these factors: presence or absence of public control of the board or public charitable support; responsiveness to the needs of disinterested community groups, such as employers, unions, and public agencies; extent of below-cost services to the poor, and purposes for which an organization's funds are dedicated. This would include whether there are budget items for education and charitable fundraising, apart from profit-generating activities. Another key concern is whether there are large gross receipts, and evidence that the purpose for which these receipts are accumulated and used is a charitable or educational purpose. Finally, we need a detailed picture of the organizations' activities to determine whether the organizations are primarily commercial profit centers using advertising and merchandising methods indistinguishable from large volume businesses, or whether they are providing a service with a significant public education component that distinguishes it from a for-profit business.

In the context of commercial methods, if a counseling organization's method of operation is well documented, including all the items mentioned in the Service's IDRs, we will have the data on which to base an argument that deceptive business practices are evidence of substantial nonexempt purpose. Sharp business practices, including deceptive contracts and untrue statements about the law or an organization's business methods, are incompatible with the purpose of an organization claiming to be educational.

To convey the flavor of these cases, we offer the following examples: the come-on: "Absolutely free!" Then there's bait and switch: Our services are free, but clients must make a deductible charitable contribution to obtain them. The bad news is in the fine print: entering a DMP is harmful to your credit rating. The contract is hard to cancel: the services are free, so they can't be cancelled except by immediately returning all materials. The FTC has brought suit against credit counseling organizations—many of which are the same as or clones of our cases—establishing deceptive business practices. The Founding Church of Scientology, is perhaps the only case that offers analogous aggressive fund-raising practices. 188 Ct. Cl, at 501 ff.

Another potential substantial nonexempt purpose evident in these organizations is to engage in a deceptive commercial operation while avoiding regulation under the CROA, which forbids a credit counseling organization to employ misleading practices or to charge fees before services are fully performed. The CROA does not apply to exempt organizations. As noted above, the increase in the number of tax-exempt credit counseling organizations roughly coincides with the passage and effective date of the CROA.[11] By way of analogy, the Claims Court in Founding Church of Scientology v. United States, 188 Ct.Cl. 490, 501 (1969), found as a (damaging) fact that one of the reasons Scientology was organized as a religion was to evade regulation, as one state was investigating Scientology for operating a medical school without a license. 188 Cl. Ct. 490. Such facts and precedents will enable us to construct an argument that another nonexempt purpose of these organizations is evasion of regulation under the CROA.

Today's tax-exempt credit counseling organization may not closely resemble the organization in Rev. Rul. 69-441 or the . Nonetheless, we expect the organizations to argue that they function to serve the same educational purpose the organizations in the ruling and case were found to serve. Furthermore, they will likely claim that charging tuition and fees is standard among educational organizations.

[redacted]

[11] Credit Counseling in Crisis at 7, 26

[redacted]

Inurement

Another possible basis for revocation is inurement. One of the defining characteristics of a section 501(c)(3) organization is that no part of its net earnings may inure to the benefit of any private shareholder or individual. To meet this requirement, the organization must establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled directly or indirectly by such private interests. Sec. 1.501(c)(3)-1(d)(1)(ii).

Inurement refers to diversion to insiders of assets dedicated to charitable purposes. The IRS once stated the "inurement prohibition serves to prevent anyone in a position to do so from siphoning off any of a charity's . . . income or assets for personal use." GCM 39862. Incidental benefits to an insider will not defeat exemption, if the organization otherwise qualifies for tax-exempt status. Sec. 1.501(a)-1(c); Ginsburg v. Commissioner, 46 T.C. 47 (1966).

Dealings between an exempt organization and an insider or a related corporation are not prohibited, but any payment must be at fair market value. Inurement does not include payment of reasonable compensation. Birmingham Business College v. Commissioner, 276 F.2d 476, 480 (5th Cir. 1960), aff'g in part, modifying in part Carter v. Commissioner, T.C. Memo. 1958-166.

Inurement takes many forms: excessive compensation, Founding Church of Scientology v. U.S.; distribution of assets dedicated to charity, Maynard Hospital, Inc. v. Commissioner, 52 T.C. 1006 (1969); excessive rents, Founding Church of Scientology; loans, Easter House; excessive employee benefits, Rev. Rul. 56-138, 1956-1 C.B. 202; purchase of assets for more than fair market value or sale of assets for less than fair market value, Anclote Psychiatric Center, Inc. v. Commissioner, T.C. Memo. 1998-273.

In the credit counseling and credit repair cases, we are finding most of these types of inurement. The most egregious example was the sale of a for-profit business to an exempt organization for an apparently inflated price and payment of royalties for use of nonexistent software. In the same case

there were also large loans to the principals of the organization. We are also finding extensive dealings of exempt organizations with back-office service providers and other for-profit businesses, often owned by the principals. Excessive salaries, expense accounts, and loans to insiders are possibilities that should also be investigated. These fact patterns are indicative not only of substantial nonexempt purpose, but also of inurement.

To satisfy its burden of proof on this issue, the organization can establish this value in either or both the for-profit and the not-for-profit spheres. When the issue is reasonable compensation, the taxpayer must bring forth evidence of comparable salaries in the industry. When the sale of a business is in question, the baseline is sales of comparable businesses. The industry we are dealing with is characterized by generous compensation. If the taxpayer has data to establish that an officer's compensation was at fair market value, in order to meet its burden of proof and its burden of persuasion, the Service must bring forth studies to persuade a court that the salary was excessive by industry standards. See section 53.4958-6(a)(1)-(3), Treas. Reg., for a rebuttable presumption under section 4958 of reasonable compensation if certain procedures based on industry comparables are followed. Similarly, to establish the sale of a business was at an excessive price, the Service must bring forth evidence based on sales of comparable businesses. [redacted]

[redacted] in Mortex Mfg. Co. v Commissioner, T.C. Memo. 1994-110, the Tax Court rejected the Government's expert report, finding, among other things, that the alleged comparable companies on which the expert based his report were not really comparable, that the executives in question had performed extraordinary services, etc. [redacted]

Section 4958 imposes intermediate sanctions on the individuals who benefit from inurement. The primary purpose of section 4958 is to require insiders who are receiving excess benefits to make their exempt organizations whole, with the goal of keeping them operating for the benefit of the public. In Caracci v. Commissioner, 118 T.C. 379 (2002), the Service unsuccessfully argued that revocation of exempt status was appropriate where an exempt organization had been sold to a related for-profit for an inadequate price. The Tax Court agreed that the price was inadequate and upheld the imposition of taxes under section 4958, but refused to support revocation of the organization's exempt status. [redacted]

Private Benefit

Private benefit could be another basis for revocation in these cases. The private benefit theory and the substantial nonexempt purpose theory overlap substantially. They both are rooted in the operational test. The differences are not so much ones of legal principle as they are ones of the types of facts that tend to lead to the conclusion that the operational test has not been met.

Private benefit means conferring a benefit upon an individual or entity, but is distinguished from inurement in that it may or may not involve diversion of charitable assets. It also differs from inurement in that it can be conferred on both insiders and outsiders. Sometimes a private benefit is not solely financial. For instance, in American Campaign Academy, the Tax Court held that a school that trained campaign organizers conferred a partisan benefit on one political party. 92 T.C. at 1064.

As further illustrations of this type of benefit, the Service ruled that an organization formed to promote interest in classical music was not exempt because its only method of achieving its goal was to support a commercial radio station that was in financial difficulty. Rev. Rul. 76-206, 1976-1 C.B. 154. See also Peoples Prize v. Commissioner, T.C. Memo. 2004-12 (offering a prize to a for-profit business as an inducement to

produce a socially desirable car confers private benefit). In these cases the benefit was going to unrelated commercial businesses, not insiders.

Frequently the benefit conferred is strictly financial, as when an exempt organization was formed to conduct gambling on the premises of a bar. The money derived from the gambling operations was used to fund scholarships, which were apparently bona fide, though few. The organization failed the operational test because it conferred an excessive private benefit on the operators of the bar. Its primary purpose was attracting customers who would otherwise have gone elsewhere to gamble. KJ's Fund Raisers v. Commissioner, T.C. Memo. 1997-424, aff'd 166 F.3d 1200 (2d Cir. 1998).

A. Service Providers

The analysis in KJ's Fund Raisers can be applied to the relationship between the credit counseling agencies and their back-office service providers in the credit counseling industry. The credit agencies appear to be operating to benefit these service providers rather than to serve any public purpose.

The private benefit theory would apply whether or not the organizations were related to the back-office service providers. We are finding that, after the first generation of organizations whose principals owned the back-room service providers, there is now a second generation of organizations whose CEOs are relative outsiders. Some appear to be former credit counselors. A private benefit case analogous to the second–generation organizations is est of Hawaii, 71 T.C. 1067 (1979). Here the Tax Court found that an organization staffed by est (Erhardt Seminars Training) graduates was formed and operated to promote and conduct Erhardt seminars for the benefit of the for-profit company, Erhardt International. The private benefit to the company was evidenced by the considerable control it exerted over est of Hawaii's activities, including setting the tuition, requiring conduct of a certain number of seminars, and controlling the taxpayer's operations by providing managers. The similarities with credit counseling agencies are evident in that they all have a standard long-term agreement with the back-room service provider that dictates charges and methods of operation and assures long-term financial support for the service providers. For instance, should the agreement terminate, any DMPs generated by the exempt organization will remain the property of the service provider.

A number of other cases have been decided in the government's favor on the basis that an organization was established to confer private benefits on a for-profit business. In International Postgraduate Medical Foundation, T.C. Memo. 1989-36, one individual controlled both a nonprofit that ran tours aimed at doctors and their families and a for-profit travel agency that handled all the nonprofit's tour arrangements. The non-profit spent 90 percent of its revenue on travel brochures prepared to solicit customers for tours arranged by the travel agency. The tours were standard sightseeing trips, with little of the alleged medical education that was the basis for exemption. The Tax Court held the petitioner was not tax exempt. It was operated for the benefit of private interests, namely the founder's travel agency. The court found that a substantial purpose of the nonprofit was to increase the income of the travel agency. (In this case there was both inurement and private benefit.) Also, its activities were directed at providing opportunities for recreation, not education.

This case provides another analogy with the credit counseling agencies, which provide large revenues to related and unrelated for-profit businesses. As in International Postgraduate Medical Foundation, the credit counseling organizations claim to be established for an educational purpose, but the education appears to be minimal and lacking in content, and the funds seem mostly to be directed to for-profit businesses.

Private benefit is always a matter of balancing: does the organization appear to be structured and operated to confer a benefit on another organization, thereby dwarfing any claimed charitable purpose.

The credit counseling cases demonstrate multiple private benefits. In one case, independent-contractor agents are urged to promote dozens of products unrelated to the exempt function of the organization: goods and services like debt-consolidation loans, buying clubs, legal advice, downpayment assistance, computer hardware, telephone service, clothing and dietary supplements, among others. These agents are recruited with the promise of earning a lot of money. When an organization promotes its services in this way, it is claiming that it can confer private benefits on those agents. In recruiting its agents, it never mentions that it serves an exempt purpose, only that it operates to make money for its agents. In the second generation credit counseling cases, the non-insider CEOs do not

appear to be receiving excessive compensation. Some of these CEOs have stated that they are paying out a high percentage of their gross receipts for back-room services. Such a case is an illustration of private benefit. The second generation entities appear to be created by promoters for the benefit of the promoters and the back room offices, rather than to serve a public purpose.

The types of benefits described above are evidence of a substantial nonexempt purpose. The organizations are carrying on extensive business dealings, promoting a variety of products and services, which they are not treating as unrelated businesses. These have little relation to any charitable or educational purpose. Under these facts, we can argue that the organizations are operating with the purpose of providing fees to for-profit businesses, related and unrelated, enriching independent contractor agents, and promoters.

An organization is not operated exclusively for a charitable purpose if more than an insubstantial part of its activities is not in furtherance of a charitable purpose. Section 1.501(c)(3)-1(c)(1), Income Tax Regs. The constellation of facts necessary to establish private benefit includes the same type of facts necessary to establish substantial nonexempt purpose. The set of facts that applies to establish inurement is also similar to the facts necessary to establish substantial nonexempt purpose. In establishing these bases for revocation, we need only establish that the purpose or the benefit is substantial, and not incidental. These cases are full of evidentiary richness, waiting to be harvested by full development.

B. Credit Card Companies

Although the published rulings have indirectly considered the receipt of fair share payments from creditors as generally consistent with exemption under section 501(c)(3), the way in which credit counseling organizations and their trade associations have recently been tailoring their operations and standards to attend directly to concerns of credit card companies may also provide evidence to support a substantial nonexempt purpose and/or private benefit argument for revocation of exemption. To develop such arguments, it would be necessary to develop specific facts showing that the public interest and the interests of the low-income recipients of counseling services are being sacrificed in favor of the credit card companies. Whether to develop the facts with respect to

benefits to the credit card companies is an examination strategy decision.

Application of UBIT to Income Generated by DMP Sales

Section 511(a) imposes a tax on the unrelated business income of charitable organizations. The tax applies to income (1) from a trade or business, (2) regularly carried on by the organization for the production of income, (3) the conduct of which is not substantially related (other than through the production of funds) to the organization's performance of its exempt functions. Sections 511-513 of the Code.

In the cases we have seen thus far, the marketing of DMPs is by far the most substantial activity of the organization. Under this factual scenario, we will argue that the organization is not operated for an exempt purpose, but for a substantial nonexempt purpose. [redacted]

If development of a case were to establish that a credit counseling organization was generating income from selling DMPs, but that the sales activity was insubstantial in the context of the organization's overall activities, then the UBIT treatment of the income generated from DMP sales would have to be considered. If this fact pattern emerges [redacted] further legal analysis will be necessary. If the DMPs are being sold in a manner similar to the ones we have seen (large upfront and monthly fees), it is likely that we would want to assert UBTI as an alternative. However, we would have to make that determination on a case by case basis, based on the specific characteristics of the DMPs.

Claims for Exemption under Section 501(c)(4)

A credit counseling organization that receives a notice of revocation and also a notice of deficiency may elect to proceed first with the tax liability. In either the Tax Court or district court, it can raise its qualification for exemption under section 501(c)(4) as a defense against the tax liability. The law under section 501(c)(4) is significantly less well developed than under section 501(c)(3). It is clear that there is a comparable statutory bar to inurement. Therefore, the same facts that would justify revocation under section 501(c)(3) for inurement would also likely bar a claim of exemption under section 501(c)(4).

Because section 501(c)(4) organizations are supposed to pursue social welfare or other common goals of a broad group of individuals, a significant limitation on operating for private benefit has also been recognized. Treas. Reg. § 1.501(c)(4)-1(a)(2)(i) provides: "An organization is operated exclusively for the promotion of social welfare if it is primarily engaged in promoting in some way the common good and general welfare of the people of the community . . . ." Treas. Reg. § 1.501(c)(4)-1(a)(2)(ii) further provides that an organization is not "operated primarily for the promotion of social welfare if its primary activity is . . . carrying on a business with the general public in a manner similar to organizations which are operated for profit."

In Contracting Plumbers Cooperative Restoration Corp. v. United States, 488 F.2d 684 (2d Cir. 1973), cert. denied, 419 U.S. 827, 685, 687 (1974), the Court of Appeals held that an organization assisting member plumbers in their profession by repairing the cuts they made in city streets was not exempt under section 501(c)(4). The court concluded the organization was not primarily devoted to the common good because it provided substantial benefits to its private members that were different than those benefits provided to the public.

Benefit to members is a key factor precluding the exemption under section 501(c)(4) of an individual practice association ("IPA"). See Rev. Rul. 86-98, 1986-2 C.B. 74. The IPA in Rev. Rul. 86-98 negotiates agreements with HMOs on behalf of member physicians under which its members provide medical services to HMO member patients. The agreements also require the IPA to perform necessary administrative claims services. Rev. Rul. 86-98 concludes that the primary IPA beneficiaries are its member-physicians rather than the community as a whole. The IPA benefits member-physicians by functioning like a billing and collection service, and a collective bargaining representative

for them. Moreover, the IPA does not benefit the community by providing HMO patients access to otherwise unavailable medical care, and does not provide care below the customary and reasonable charges of members in their private practices.

The above case rulings confirm the principle established in the section 501(c)(4) regulations that organizations described in section 501(c)(4) must primarily promote the common good and general welfare of the people of the community as a whole rather than benefit select individuals such as members. Primarily benefiting select individuals will preclude an organization that would otherwise qualify from being described in section 501(c)(4).

When determining whether the benefit to select individuals precludes exemption because the organization does not primarily promote social welfare, the Service must first identify the benefits to select individuals. Then the Service must balance an organization's benefits to the community as a whole against its benefits to the select individuals. The factors relevant to determine whether for purposes of section 501(c)(4) an organization primarily benefits a private group, rather than the community as a whole, include whether a private group: 1) is the focus of or receives significant (or exclusive) benefits from the organization’s activities, 2) creates the organization, 3) makes up the primary membership of the organization, 4) controls the organization, and 5) provides the primary resources for the organization. This information overlaps substantially with the information that would need to be developed to make the case for revocation based on private benefit for section 501(c)(3) purposes. [redacted] we believe that if a credit counseling organization had a section 501(c)(3) exemption revoked based on operation for substantial nonexempt purpose and private benefit, we would be able to use the same underlying facts to argue that the organization also failed to qualify for section 501(c)(4) exemption.

SUMMARY AND CONCLUSION

Developments in the credit counseling industry, including proliferation of large-volume, commercial-type credit counseling agencies, have raised concern in Congress, the Federal Trade Commission, the press, and the offices of state attorneys general that credit counseling organizations no longer fulfill

an exempt purpose. At your request, we have investigated whether today's credit counseling organizations qualify for exemption as charitable or educational organizations described in Code section 501(c)(3). In so doing, we have examined IRS rulings, subsequent court cases enlarging the ambit of the tax-exempt credit counseling organization beyond the IRS definition, and legal precedents granting or denying exemption to organizations that conduct businesses as part of all of their activities.

In appropriate revocation cases, the Government can argue that commercial-type credit counseling agencies do not fulfill any educational or charitable purposes. Limited case law in the area suggests, however, that the courts may be willing to enlarge the definition of the tax-exempt credit counseling organization beyond that in IRS rulings. Commercial-type credit counseling agencies will argue, with some documentation, that their activities are educational. Consequently, we must be prepared to argue that, even if the organizations can establish that they conduct some educational activities, they still do not qualify as section 501(c)(3) organizations because a substantial part of their activities does not further exempt purposes.

Chief among the substantial nonexempt purposes we have found is conducting profit-generating activities that benefit related businesses and individuals. The way in which these organizations promote their services suggests that they may also be operating to benefit unrelated for-profit businesses, commission-based independent contractors, promoters, commercial lenders, and various other private interests. In other words, there is evidence to support a theory of revocation based on private benefit. Finally there is evidence of inurement. We should develop evidence to defend all the bases for revocation outlined in this memorandum. The data needed to do this are summed up in the Service's IDR.

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call 202-622-6070 if you have any further questions.