



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

Date: April 19, 2006
UIL: 501.00-00

Contact Person:

Identification Number:

Contact Number:

FAX Number:

Employer Identification Number:

SET:EO

Dear

We have considered your application for recognition of exemption from Federal income tax under Internal Revenue Code section 501(a) of the Internal Revenue Code as an organization described in section 501(c)(3). Based on the information provided, we have concluded that you do not qualify for exemption under that section. The basis for our conclusion is set forth below.

In your Form 1023 Application, you stated that you were incorporated or formed on September 13, 2004. However, you did not submit a copy of any conformed organizing document showing that you are either a corporation or association properly organized for exempt purposes within the meaning of section 501(c)(3). You also failed to provide proposed budgets, as part of your application.

Your primary activity, as represented in your application, will be the operation of a debt management program, involving debt negotiation and debt settlement. On page one of your "program overview," you stated that you will offer a

Our analysis of the information you provided, indicates that your primary activity will be the promotion and sale of debt negotiation and debt settlement services to the general public.

Your Board of Directors will be comprised of three individuals. Two of these individuals have work experiences that are concentrated in sales, marketing and advertising. The other individual has been employed as a secretary.

You stated that the owner of your organization is its sole employee. She is also president of the board of directors. You have projected her salary at \$20,000 per year. You also indicated that the employee will work from Monday through Friday, 8-5 pm., Saturday 9-2 pm and Sunday by appointment.

Your response to our letter dated January 3, 2005, indicated that you plan to have an advertising budget of between \$_____ and \$_____. You stated that you will advertise and promote your business through the use of the following language:

Your "program overview" also serves to aggressively advertise and promote your debt negotiation and debt settlement services. For example, you made the following statement: "Settling Debts, as you save money, we negotiate your balances to creditors."

Additionally, you made the following assertion: "In as little as 12-30 months, all of your unsecured debts will be settled and

The "program overview," included a discussion of debt consolidation and bankruptcy. You also provided a copy of an "In-Take Form," a form to "Create A Budget," and two forms with which to "Calculate Your Net Worth."

You stated that your sole source of revenue will come from payments received from creditors. However, it has been our experience and that of the Federal Trade Commission (FTC), that organizations involved in debt settlement and debt negotiation allow clients to accumulate sufficient money to both pay the creditor a certain amount and pay you an up-front fee. These fees are often substantial and may include a fee to establish the account with the creditor and a monthly service fee. Some of these organizations get an additional percentage of any savings realized through the debt settlement. (See attached press release from FTC) You did not provide a copy of any agreements to be used in your arrangements with creditors or clients that would explain and clarify your fee plan. Nor have you provided any information that would indicate creditors pay you rather than that your fees are generated through the funds paid in by your clients. You indicated that your rent payment will be \$_____ per month. However, you did not provide a copy of a lease agreement or any information regarding the terms of your lease.

Section 501(c)(3) of the Code exempts from federal income tax corporations organized and operated exclusively for charitable, educational, and other purposes, provided that no part of its net earnings inures to the benefit of any private shareholder or individual.

Section 1.501(c)(3)-1(a)(1) of the Income Tax Regulations provides that, in order to be exempt as an organization described in section 501(c)(3), an organization must be both organized and operated exclusively for one or more of the purposes specified in such section. If an organization fails to meet either the organizational test or the operational test, it is not exempt.

Section 1.501(c)(3)-1(b)(1)(i) of the regulations provides that an organization is organized exclusively for one or more exempt purposes only if its articles of organization:

- (a) Limit the purposes of such organization to one or more exempt purposes; and
- (b) Do not expressly empower the organization to engage, otherwise than as an insubstantial part of its activities, in activities that in themselves are not in furtherance of one or more exempt purposes.

Section 1.501(c)(3)-1(c)(1) of the regulations provides that an organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities that accomplish one or more of such exempt 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 an exempt purpose.

Section 1.501(c)(3)-1(c)(2) of the regulations provides that an organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole or part to the benefit of private shareholders or individuals. Section 1.501(a)-1(c) defines the words "private shareholder or individual" in section 501 to refer to persons having a personal and private interest in the activities of the organization.

Section 1.501(c)(3)-1(d)(1)(ii) of the regulations provides that an organization is not organized or operated exclusively for one or more exempt purposes unless it serves a public rather than a private interest. Thus, to meet the requirements of this subsection, it is necessary for an organization to 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.

In Birmingham Business College, Inc. v. Commissioner, 276 F.2d 476 (5th Cir. 1960), the court denied tax exemption to an organization, in part because its net earnings were distributed to its shareholders for their personal benefit. The founder of the organization and his two sisters were the only shareholders; these three and two of their spouses were the organization's trustees. The court found that the organization was operated as a business ultimately producing substantial revenues for its operators.

In B.S.W. Group, Inc. v. Commissioner, 70 T.C. 352 (1978), the court found that a corporation formed to provide consulting services was not exempt under section 501(c)(3) because its activities constituted the conduct of a trade or business that is ordinarily carried on by commercial ventures organized for profit. Its primary purpose was not charitable, educational, nor scientific, but rather commercial.

In addition, the court found that the organization's financing did not resemble that of the typical 501(c)(3) organization. It had not solicited, nor had it received, voluntary contributions from the public. Its only source of income was from fees from services, and those fees were set high enough to recoup all projected costs and to produce a profit. Moreover, it did not appear

that the corporation ever planned to charge a fee less than "cost." And finally, the corporation did not limit its clientele to organizations that were section 501(c)(3) exempt organizations.

In Easter House v. United States, 846 F. 2d 78 (Fed. Cir. 1988), aff'g 12 Cl. Ct. 476 (1987), the court found an organization that operated an adoption agency was not exempt under section 501(c)(3) of the Code because it operated for a substantial commercial purpose rather than for the exempt purposes of providing educational and charitable services to unwed mothers and children. The services for unwed mothers and children were merely provided "incident" to the organization's adoption service business. The agency's operation was funded completely by the fixed fees charged adoptive parents. It relied entirely on those fees and sought no funds from federal, state or local sources, nor engaged in fund raising programs, nor did it solicit contributions. Moreover, the court found that "adoption services do not in and of themselves constitute an exempt purpose."

In Airlie Foundation v. Commissioner, 283 F. Supp. 2d 58 (D.D.C., 2003), the court relied on the "commerciality" doctrine in applying the operational test. Because of the commercial manner in which this organization conducted its activities, the court found that it was operated for a non-exempt commercial purpose, rather than for a tax-exempt purpose. "Among the major factors courts have considered in assessing commerciality are competition with for profit commercial entities; extent and degree of below cost services provided; pricing policies; and reasonableness of financial reserves. Additional factors include, *inter alia*, whether the organization uses commercial promotional methods (e.g. advertising) and the extent to which the organization receives charitable donations."

In Rev. Rul. 61-170, 1961-1 C.B. 112, an association composed of professional private duty nurses and practical nurses which supported and operated a nurses' registry primarily to afford greater employment opportunities for its members was not entitled to exemption under section 501(c)(3) of the Code. Although the public received some benefit from the organization's activities, the primary benefit of these activities was to the organization's members.

The Credit Repair Organizations Act ("CROA"), 15 U.S.C. section 1679 et seq., effective April 1, 1997, 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. Section 501(c)(3) organizations are by definition excluded from regulation under the CROA. The CROA defines a credit repair organization as:

- (A) any person who uses any instrumentality of interstate commerce or the mails to sell, provide, or perform (or represent that such person can or will sell, provide, or perform) any service, in return for the payment of money or other valuable consideration, for the express or implied purpose of—
 - (i) improving any consumer's credit record, credit history, or credit rating, or
 - (ii) providing advice or assistance to any consumer with regard to any activity or service described in clause (i).

15 U.S.C. section 1679a(3). The courts have interpreted this definition broadly to apply to credit counseling agencies. The Federal Trade Commission's policy is that if an entity communicates with consumers in any way about the consumers' credit situation, it is providing a service covered by the CROA. In Re National Credit Management Group, LLC, 21 F. Supp. 2d 424, 458 (N.D.N.J. 1998).

In FTC v. Gill, 265 F.3d 944 (9th Cir. 2001), aff'g 183 F. Supp. 2d 1171 (2001), the appellate court inferred that a credit repair organization that first promised a "free consultation," but charged fees in advance of the full performance of services was being operated as a charity primarily for purposes of evading regulation under the CROA.

Rev. Proc. 90-27, 1990-1 C.B. 514, provides in part that exempt status will be recognized in advance of operations if proposed operations can be described in sufficient detail to permit a conclusion that the organization will clearly meet the particular requirements of the section under which exemption is claimed. A mere statement of purposes or a statement that proposed activities will be in furtherance of such purposes will not satisfy this requirement. The organization must fully describe the activities in which it expects to engage, including the standards, criteria, procedures, or other means adopted or planned, and the nature of the contemplated expenditures. Where the organization cannot demonstrate to the satisfaction of the Service that its proposed activities will be exempt, a record of actual operations may be required before a ruling or determination letter will be issued.

An organization must establish through the administrative record that it is organized and operated as a section 501(c)(3) organization. Denial of exemption may be based solely upon failure to provide information describing in adequate detail how the operational test will be met. American Science Foundation v. Commissioner, T.C. Memo. 1986-556; La Verdad v. Commissioner, 82 T.C. 215, 219 (1984); Pius XII Academy v. Commissioner, T.C. Memo. 1982-97. Exempt status can be recognized in advance of operations if proposed operations can be described in enough detail to permit a conclusion that the organization will clearly meet the requirements of section 501(c)(3). American Science Foundation v. Commissioner, T.C. Memo. 1986-556. The organization has the burden of providing sufficient documentation or other substantive information regarding its activities and operations, which would establish entitlement to tax-exempt status. Information that is vague or nonspecific is not sufficient to meet the requirements under section 501(c)(3). Tully v. Commissioner, T.C. Memo, 1999-216.

Based on our analysis of the information you submitted, we conclude that your failure to submit a conformed organizational document showing that you are organized for educational and charitable purposes within the meaning of section 501(c)(3) of the Code, does not allow you to satisfy the organizational requirements to be recognized as exempt under 501(c)(3). In addition, your failure to provide an organizational document of any type, leads us to conclude that you are operated as a sole proprietorship. Moreover, you do not satisfy the operational requirements to be recognized as exempt under section 501(c)(3) of the Code. In fact, the administrative record demonstrates that you will operate for the substantial non-exempt purpose

of operating a commercial business. Another non-exempt purpose will be your operation to avoid regulation under CROA. In addition, you have not established that your income will not inure to the benefit of your president and sole employee.

That you will be operated in the manner of a commercial business is reflected in the fact that your revenue will come exclusively from fees received from the promotion and sale of financial services, consisting of debt negotiation and debt settlement, to the general public. Moreover, the language to be used in your advertising efforts, including your "program overview," clearly demonstrates that you will aggressively market your services to the general public in the manner of an ordinary for-profit business.

You also have not provided any evidence that the fees to be charged to clients are any less than would be paid by individuals serviced by a for-profit debt settlement and debt negotiation company. In Airlie Foundation v. Commissioner, supra, one of the factors considered in assessing commerciality was the extent and degree of below cost services provided. You provided no evidence that your clients will ever receive free services, or services according to their ability or pay. Moreover, you have provided no evidence that your fees will bear any relation to the costs of providing your service, and will not be a purely profit-making tool. You have provided no economic rationale for the amount you will charge for your services. You have provided no financial studies or other information that would justify the amount of any particular fee.

You have not shown that you will receive any support from contributions from the general public, government or private foundation grants, or assistance from the United Way. In fact, you have no fundraising program to solicit such contributions. By comparison, for-profit business enterprises are supported by fees paid by those who receive services. While charitable institutions often do provide services to individuals, the cost is generally subsidized by contributors who do not receive anything in return. In B.S.W. Group, Inc. v. Commissioner, supra, the court cited lack of solicitation and sole support from fees as negative factors for exemption. See also, Easter House v. United States, supra.

You have not shown that revenue for operation of your debt settlement and debt negotiation services will be used for any purpose other than to cover operating expenses. Like any ordinary commercial business, your expenditures will apparently be used almost exclusively to pay salaries and other expenses. The limited financial information you provided showed expected expenditures for salary and rent. You have not provided any information to indicate that you plan to dedicate significant revenue to activities involving educational and/or charitable programs. In having a paid staff with no volunteer help, and having no direct expenditures for charitable and educational purposes, you are similar to the organization described in Easter House v. United States, supra, where the court determined that the organization was not exempt because its conduct of adoption services activity was in furtherance of a non-exempt commercial purpose. Thus, the totality of the facts and circumstances, show that you will be operated for the substantial non-exempt business purpose of selling debt settlement and debt negotiation services to the general public.

Your apparent attempt to avoid regulation under the CROA also indicates that you will be operated for a substantial non-exempt purpose. See 15 U.S.C. section 1679 et seq. This statute imposes restrictions on credit repair organizations, including forbidding advance payment before services are fully performed. 15 U.S.C. section 1679b. As stated above, the courts have interpreted the CROA so as to apply to the activities of credit repair organizations.

The information you provided can only be interpreted as evidence that you will charge an advance fee, a practice forbidden to for-profit organizations under the CROA. Your debt negotiation and debt settlement program will most likely require that prospective clients pay "up-front" fees. Based on the information you have submitted, it appears that you are seeking exemption as a charitable organization because your activities would not otherwise be permitted a commercial for-profit corporation. In this regard, you are similar to the organization described in FTC v. Gill, supra, in that one of your purposes appears to be evading regulation under the CROA.

Section 1.501(c)(3)-1(d)(1)(ii) of the regulations provides that an organization is not organized or operated exclusively for one or more exempt purposes unless it serves a public rather than a private interest. To meet the requirements of this subsection, 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.

Your board of directors rather than being representative of a broad cross-section of the community is controlled by your president and owner. You are similar to the nurses' registry described in Rev. Rul. 61-170 in that your primary purpose appears to be to providing an employment opportunity for her. The information you provided clearly states the she will be the only compensated employee. Even if we concluded that the public received some benefit from your activities, the primary benefit of your activities will most likely be realized by your owner.

Because your owner effectively controls your board of directors, we also cannot conclude that your assets will not inure to her benefit. This is especially the case, when we consider that you are operating as a sole proprietorship and have no charter or bylaws that state the limits of her power and also define her rights and obligations as an owner, board member and employee. Your president appears to be your founder and sole owner and as such she has unfettered control over all matters, including her own compensation, and other financial matters. Thus, your board, as presently constituted, without an organizing document has inherent conflicts of interest in all decisions that would be rendered on financial, and other matters. See Easter House, supra, in which the taxpayer similarly failed to show that no part of its earnings inured to the benefit of any private individual. Also see Birmingham Business College, supra, where the organization was controlled by the founder and his family members.

Rev. Proc. 90-27 requires an applicant to submit sufficient information during the application process for the Service to conclude that the organization is in compliance with the organizational and operational requirements of section 501(c)(3) before a ruling is issued. You failed to provide a conformed copy of any organizing documents. You failed to provide

projected budgets showing all income and expenses. You failed to provide a copy of your lease agreement. You failed to provide copies of agreements to be entered into with clients and creditors. Furthermore, you failed to fully and completely respond to all of the questions raised in our letter dated January 3, 2005. The vague and nonspecific information and documentation you provided does not meet the burden of showing that your activities and operations are such that you are entitled to recognition of exemption under section 501(c)(3). See Tully, supra.

Accordingly, we conclude that you are not organized or operated exclusively for purposes with the meaning of section 501(c)(3) of the Code and you do not qualify for exemption under that Code section. You must file federal income tax returns.

Contributions to you are not deductible under section 170 of the Code.

You have the right to file a protest if you believe this determination is incorrect. To protest, you must submit a statement of your views and fully explain your reasoning. You must submit the statement, signed by one of your officers, within 30 days from the date of this letter. We will consider your statement and decide if the information affects our determination.

You also have a right to request a conference to discuss your protest. This request should be made when you file your protest statement. An attorney, certified public accountant, or an individual enrolled to practice before the Internal Revenue Service may represent you. If you want representation during the conference procedures, you must file a proper power of attorney, Form 2848, *Power of Attorney and Declaration of Representative*, if you have not already done so. For more information about representation, see Publication 947, *Practice before the IRS and Power of Attorney*. All forms and publications mentioned in this letter can be found at www.irs.gov, Forms and Publications.

If you do not file a protest within 30 days, you will not be able to file a suit for declaratory judgment in court because the Internal Revenue Service (IRS) will consider the failure to protest as a failure to exhaust available administrative remedies. Code section 7428(b)(2) provides, in part, that a declaratory judgment or decree shall not be issued in any proceeding unless the Tax Court, the United States Court of Federal Claims, or the District Court of the United States for the District of Columbia determines that the organization involved has exhausted all of the administrative remedies available to it within the IRS.

If you do not intend to protest this determination, you do not need to take any further action. If we do not hear from you within 30 days, we will issue a final adverse determination letter. That letter will provide information about filing tax returns and other matters.

Please send your protest statement, Form 2848 and any supporting documents to this address:

Internal Revenue Service
TE/GE SE:T:EO:RA:T:

1111 Constitution Ave, N.W.
Washington, DC 20224

You may also fax your statement using the fax number shown in the heading of this letter. If you fax your statement, please call the person identified in the heading of this letter to confirm that he or she received your fax.

If you have any questions, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely,

Lois G. Lerner
Director, Exempt Organizations
Rulings & Agreements