

TAX-EXEMPT CREDIT COUNSELING ORGANIZATIONS AND THE FUTURE OF DEBT-SETTLEMENT SERVICES

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I. INTRODUCTION

On July 30, 2009, the Federal Trade Commission (FTC) proposed amendments to its Telemarketing Sales Rule that would significantly impact for-profit providers of various debt-relief services. Set out in a Notice of Proposed Rulemaking, these changes would: (1) mandate certain disclosures about the services being provided, including the cost of those services and the time frame in which debt relief would occur; (2) prohibit misrepresentations concerning the service provider's success rate in obtaining debt relief and its status as a for-profit or non-profit organization; (3) make the Telemarketing Sales Rule applicable to "in-bound" calls, i.e., calls made by consumers in response to advertising by debt-relief service providers; and (4) prohibit "advance fees," meaning that debt-relief providers could collect fees only after rendering the services in question.¹ The Notice of Proposed Rulemaking would define "debt relief service" to include any renegotiation, settlement or alteration of the terms of consumer debt, including reductions in the balance owed, interest rate, or fees.² These changes would apply only to for-profit debt-relief service providers, because the jurisdiction of the FTC does not extend to non-profit entities.³

For a number of years, for-profit debt-settlement service providers and non-profit credit counseling organizations—many of which are also exempt from federal income tax—have competed to provide services to individuals who are burdened by excessive consumer debt. Such individuals typically have three primary options: bankruptcy, debt management plans, and debt-settlement services.

The alternative of bankruptcy—which has long had many downsides for the debtor such as a long-term adverse impact on the debtor's credit rating—became significantly more problematic as a result of the enactment of The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.⁴ That

1. FTC Telemarketing Sales Rule, 16 C.F.R. § 310 (2009).

2. *Id.*

3. *Id.*

4. Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 23 (2005) (requiring also that debtors obtain credit counseling prior to

Act made it more difficult for many consumers to qualify for relief under Chapter 7 of the Bankruptcy Code, leaving Chapter 13 as the bankruptcy alternative. The Act made changes to Chapter 13 which required many consumers to repay a higher percentage of their unsecured debt than was previously the case, with liability under a plan requiring payments over a future period of three to five years.

Debt management plans should be designed to result in repayment of the full principal amount owed by the consumer. These plans, which are generally provided and administered by non-profit, tax-exempt credit counseling organizations, typically involve extensions of time to pay and, in some instances, concessions by the creditors on interest rates and fees that would otherwise apply.⁵ The credit counseling organizations receive “fair share” payments from the creditors that are a percentage of the amount of debt repaid by the consumer debtors.⁶ Debt-settlement services, by contrast, involve negotiation by the service provider to reduce the principal amount of the debt in exchange for a lump-sum payment.⁷ These services are typically provided and administered by for-profit entities, which are paid fees by the consumer debtors.⁸ The relative efficacy of debt management plans and debt-settlement services, and the number of “bad apples” within the two groups of service providers, is sharply controverted by the two camps.⁹

Not surprisingly, non-profit credit counseling organizations generally favor the prospect that the Telemarketing Sales Rule will be expanded as described in the Notice of Proposed Rulemaking, while for-profit debt-settlement providers generally oppose certain aspects of the proposed amendments. In its comments to the Notice of Proposed Rulemaking submitted to the FTC on October 26, 2009, the United States Organizations

filing for bankruptcy protection, a mandate that produced considerable additional demand for credit counseling services).

5. See, UNIFORM DEBT-MANAGEMENT SERVICES ACT Prefatory Note at 1 (Proposed by National Conference of Commissioners of Uniform State Law 2008) (explaining debt management plans generally).

6. *Id.*

7. *Id.*

8. *Id.*

9. See, e.g., Public Forum on Proposed Debt Relief Amendments, <http://www.ftc.gov/bcp/rulemaking/tsr/tsr-debtrelief/transcript.pdf> (discussing the Notice of Proposed Rulemaking held on November 4, 2009).

for Bankruptcy Alternatives (USOBA), a trade organization representing debt-settlement service providers, noted that it was

pleased to be able to support the vast majority of the proposed amendments to the TSR. Our support of the amendments to the TSR stops, however, with the proposal of a radical, “advance fee ban.” This ban is supported and promoted, not coincidentally, by not-for-profit credit counselors, which are a category of debt resolution providers not covered by the NPRM. Thus, credit counselors compete with the very for-profit debt resolution providers that are targeted by the advance fee ban. USOBA believes that the proposed ban is a form of industry protectionism, plain and simple, designed to favor credit counselors in the marketplace by crippling their competition.¹⁰

The USOBA Comment argued that:

the advance fee [ban] would injure consumers by driving reputable debt-settlement companies from the market at a time when U.S. consumers need them most. A survey of USOBA members taken after the Commission released the NPRM found that:

- 84% of USOBA members would “almost certainly” or “likely” be forced to shut down if an ‘advance fee ban’ as described by the Commission were adopted.
- 95% of USOBA members would “certainly” or “likely” be forced to lay off employees if the advance fee ban were adopted [note that 72% of these USOBA members were ‘small businesses’ (firms of 25 people or less)].
- 60% of those forced into reductions in their workforce would lay off 25 or more employees (a full 25% would lay off 50 or more workers).
- Regarding effects on consumers, 85% of USOBA members would be forced to stop offering debt relief services to new consumers if an advance fee ban were adopted.

10. Jonathan S. Massey & Leonard A. Gail, Comments of United States Business Organizations for Bankruptcy Alternatives (Oct. 26, 2009) (unpublished comment “In the Matter of Telemarketing Sales Rule – Debt Relief Amendments, R411001”), *available at* <http://www.ftc.gov/os/comments/tsrdebtreief/543670-00215.htm>, at 19.

- Existing consumers of 85% of the providers responding would lose their current debt relief services.
- 82% would be forced to reduce or limit services to consumers.¹¹

If the warnings sounded by USOBA's survey are correct, and an advance fee ban would drive most for-profit debt-settlement service providers out of business, it is appropriate to consider whether tax-exempt credit counseling organizations—which are not subject to the Telemarketing Sales Rule—could then meet the extensive public demand for debt-settlement services. These tax-exempt organizations would presumably be reluctant to expand their activities into debt-settlement services if doing so would jeopardize their tax-exempt status. This analysis leads to the question that is the focus of this Article: would a credit counseling organization that is exempt from federal income tax under Section 501(c)(3) of the Internal Revenue Code of 1986, as amended (the Code), still qualify for tax exemption if it expanded its activities to include the provision of substantial debt-settlement services?

Placing this question in context requires a summary of the history of tax exemption for credit counseling organizations, particularly the increasingly stringent requirements that the Internal Revenue Service (IRS) and Congress have placed on these organizations in response to the changes in the marketplace for debt-resolution services.

II. THE BACKGROUND OF TAX EXEMPTION AND CREDIT COUNSELING ORGANIZATIONS

Section 501(c)(3) of the Code exempts from federal income tax corporations organized and operated exclusively for charitable, educational, and certain other enumerated purposes, provided that no part of their net earnings inure to the benefit of any private shareholder or individual.¹²

Treasury Regulation § 1.501(c)(3)-1(a)(1) provides that “in order to be exempt as an organization described in

11. *Id.* at 20 (emphasis removed).

12. I.R.C. § 501(c)(3) (2006).

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.”¹³

Treasury Regulation § 1.501(c)(3)-1(c)(1) states 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.¹⁴

Certain credit counseling organizations have been recognized as exempt under Section 501(c)(3) for many years.¹⁵ The exempt purpose upon which credit counseling organizations have been granted exemption under Section 501(c)(3) is their educational objective. In the leading ruling by the IRS, the organization in question “was formed to reduce the incidence of personal bankruptcy by informing the public on personal money management by assisting low-income individuals and families who have financial problems.”¹⁶ The ruling stated the following:

The organization provides information to the public on budgeting, buying practices, and the sound use of consumer credit through the use of films, speakers, and publications. It aids low-income individuals and families who have financial problems by providing them with individual counseling and, if necessary, by establishing budget plans. Under a budget plan, the debtor voluntarily makes fixed payments to the organization. The funds are kept in a trust account and disbursed on a partial payment basis to the creditors, whose approval of the establishment of the plan is obtained by the organization. These services are provided without charge to the debtor.

13. Treas. Reg. § 1.501(c)(3)-1(a)(1) (2008).

14. Treas. Reg. § 1.501(c)(3)-1(c)(1) (2008).

15. The IRS has recognized the exemption of certain credit counseling organizations pursuant to 501(c)(4). Rev. Rul. 65-299, 1965-2 C.B. 165. Relatively few credit counseling organizations are exempt pursuant to section 501(c)(4), perhaps because certain non-tax legal distinctions turn on whether an organization is exempt specifically under section 501(c)(3). See, e.g., Credit Repair Organizations Act, 15 U.S.C. §1679(a)(3)(B)(i); *Zimmerman v. Cambridge Credit Counseling Corp.*, 409 F.3d 473 (2005). Consequently, this Article will address exemption under section 501(c)(3). The principles discussed herein are generally applicable to section 501(c)(4) organizations as well.

16. Rev. Rul. 69-441, 1969-2 C.B.115.

After granting exemption under Section 501(c)(3) to a group of credit counseling agencies, the IRS determined that this exemption had been issued inadvertently and sought to reclassify those organizations as exempt under Section 501(c)(4).¹⁷ These credit counseling agencies sought and received a declaratory judgment from the United States District Court for the District of Columbia determining that they qualified for exemption under Section 501(c)(3).¹⁸ They functioned in a manner similar to the organization described in Rev. Rul. 69-441.¹⁹ The court found that the agencies had two basic types of programs, which together constituted their principal activities: providing “information to the general public, through the use of speakers, films, and publications, on the subject of budgeting, buying practices, and the sound use of consumer credit and . . . counseling on budgeting and the appropriate use of consumer credit to debt-distressed individuals and families.”²⁰ The court also found:

As an adjunct to the counseling function described [above], an agency may provide advice as to debt proration and payment, whereby a program of a monthly distribution of money to creditors is developed and implemented. In some of these instances, an agency may be required to intercede with creditors to cause them to agree to accept such monthly payment schedule.²¹

The organizations at issue generally charged a nominal fee in connection with such debt management programs, which fee was waived in instances where its payment would work a financial hardship. Approximately 12% of the professional counselors’ time was spent in connection with debt management programs.

The court concluded that the community education and counseling assistance programs were the agencies’ primary activities. Their debt management and creditor intercession activities were “an integral part of the agencies’ counseling function, and thus are charitable and educational undertakings.

17. *Consumer Credit Counseling Serv. of Ala., Inc. v. U.S.*, 78-2 U.S.T.C. 9660 (D.D.C. 1978); *See also Credit Counseling Ctrs. of Okla., Inc. v. United States*, 79-2 U.S.T.C. 9468 (D.D.C. 1979) (drawing substantially identical analysis and conclusions).

18. *See id.*

19. *See id.*

20. *Consumer Credit Counseling Serv. of Ala.*, 78-2 U.S.T.C. at 9660.

21. *Id.*

Even if this were not the case, the agencies' proper designation as IRC § 501(c)(3) would not be disturbed, as these activities are incidental to the agencies' principal functions."²²

III. INCREASED SCRUTINY OF CREDIT COUNSELING ORGANIZATIONS BY THE INTERNAL REVENUE SERVICE

In the years since this case, the number of organizations providing counseling and other services to debtors has grown substantially.²³ Many of these organizations sought, and were granted, recognition by the IRS as tax-exempt entities.²⁴ Beginning in 2002, the IRS intensified its scrutiny of claims for exempt status by such organizations.²⁵ In a written testimony dated November 20, 2003, for the House Ways and Means Committee's Subcommittee on Oversight, Commissioner of Internal Revenue Mark Everson stated:

Our information systems reflect over 850 credit counseling organizations that have been recognized as tax exempt under section 501(c)(3). In recent years, the Service has seen an increase in applications for tax-exempt status from organizations intending to provide credit counseling services. Among the more recent applicants, we are finding credit counseling organizations that vary from the model approved in the earlier rulings and court cases. We are seeing organizations whose principal activity is selling and administering debt management plans. Often the board of directors is not representative of the community and may be related by family or business ties to the for-profit entities that service and market the debt management plans. The organizations are supported by fees from customers and from credit card companies, and the fees are much higher than those in the rulings or court cases. Finally, it does not appear that significant counseling or education is being provided. . . .

In 2002, as we saw an increasing number of allegations of credit counseling abuses, we contacted the Federal Trade Commission for assistance in understanding the developments

22. *Id.*

23. David A. Lander, *Essay: A Snapshot of Two Systems That Are Trying to Help People in Financial Trouble*, 7 AM. BANKR. INST. L. REV. 161, 162 (1999).

24. Leslie E. Linfield, *Credit Counseling Update: The "Perfect Storm" Brewing*, 24-APR AM. BANKR. INST. J. 30, 46 (2005).

25. Allen Mattison, *Can the New Bankruptcy Law Benefit Debtors Too? Interpreting the 2005 Bankruptcy Act to Clean Up the Credit-Counseling Industry and Save Debtors from Poverty*, 13 GEO. J. ON POVERTY L. & POL'Y 513, 530 (2006).

in the industry. Based on the available information, it appears that customers, served solely by the Internet, are provided debt management—not credit counseling. The individual budget assistance and public education programs that formed the original basis for exemption under section 501(c)(3) have changed. In many cases, these services appear to have been replaced by promises to restore favorable credit ratings or to provide commercial debt consolidation services.²⁶

Over the next two and a half years, the IRS acted decisively to curb the abuses that Everson described.²⁷ On May 15, 2006, the IRS issued a news release reporting this progress:

Over the past two years, the IRS has been auditing 63 credit counseling agencies, representing more than half of the revenue in the industry. To date, the audits of 41 organizations, representing more than 40 percent of the revenue in the industry, have been completed. All of the completed audits have resulted in revocation, proposed revocation or other termination of tax-exempt status.²⁸

Everson bluntly concluded:

Over a period of years, tax-exempt credit counseling became a big business dominated by bad actors. Our examinations substantiated that these organizations have not been operating for the public good and don't deserve tax-exempt status. They have poisoned an entire sector of the charitable community.²⁹

In addition to the revocations of exemption for many existing organizations, the IRS became much less likely to recognize exemption in connection with applications by newly formed entities seeking exempt status, granting exemption to only three of the 110 applicants between 2003 and 2006.³⁰ In many instances, the basis for denial of exempt status was an organization's excessive emphasis on debt management plans. Because the rationale for exemption of credit counseling agencies is a primary educational purpose, instances in which

26. *Nonprofit Credit Counseling Organizations: Hearing Before the S. Comm. On Oversight Comm. On H. Ways & Means*, 108th Cong. (2003) (statement of Mark Everson, Commissioner, Internal Revenue Service).

27. See Linfield, *supra* note 24 (discussing the process implemented to curb abuses).

28. Press Release, IRS Takes New Steps on Credit Counseling Groups Following Widespread Abuse (May 15, 2006) (on file with the IRS at IR-2006-80).

29. *Id.*

30. IRS, Credit Counseling Compliance Project, Summary & Results (2006) available at http://www.irs.gov/pub/irs-tege/cc_report.pdf.

educational activities were overshadowed by debt management plans understandably resulted in denial of exemption.

The IRS even included credit counseling agencies in its widely publicized, annual “Dirty Dozen” list of tax scams, warning that

Taxpayers should be careful with credit counseling organizations that claim they can fix credit ratings, push debt payment plans or impose high set-up fees or monthly service charges that may add to existing debt. The IRS Tax-exempt and Government Entities Division is in the process of revoking the tax-exempt status of numerous credit counseling organizations that operated under the guise of educating financially distressed consumers with debt problems while charging debtors large fees and providing little or no counseling.³¹

As Everson mentioned in his 2003 testimony, “fair share” payments from credit card companies are a significant source of financial support for many tax-exempt credit counseling organizations. In a 2004 Chief Counsel Memorandum, the IRS considered the potentially problematic character of the relationships between credit counseling organizations and the 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.³²

One source of concern among tax-exempt credit counseling organizations regarding the relationships between credit

31. Press Release, IRS Announces “Dirty Dozen” Tax Scams for 2006 (Feb. 7, 2006) (on file with the IRS at IR-2006-25).

32. I.R.S. Off. Chief Couns. Mem. 04-31-023 (July 13, 2004).

counseling organizations and credit card companies was the 2003 decision of the Maine Supreme Judicial Court denying charitable tax exemption for property owned by Credit Counseling Centers, Inc.³³ The Maine court's analysis focused on that relationship:

In the present case, the Superior Court erred in its legal conclusion that CCCS is entitled to a charitable tax exemption. In 1995, CCCS collected \$8,801,264 for the creditors of the clients with whom it works; in 1996, it collected \$9,877,179; in 1997, it collected \$11,933,638; in 1998, it collected \$13,146,614; and in 1999, it collected \$16,715,565. These creditors normally pay between 8.5% and 9% of the amount collected as a "fair share" contribution to CCCS. The magnitude of the amounts collected for creditors clearly demonstrates that CCCS's business is not "conducted *exclusively* for benevolent and charitable purposes," or that the revenue generated is not "purely incidental to a dominant purpose that is benevolent and charitable."³⁴

Even more ominously, the IRS began to cite this Maine opinion in private letter rulings denying tax-exempt status to credit counseling organizations. For example, in a 2004 ruling, the IRS articulated the following as of one of the grounds for denying exemption:

You provide substantial private benefit to credit card companies in a manner similar to the organization in *Credit Counseling Centers v. S. Portland*. Fair share is commonly defined as "that amount the organization receives from the creditors for each payment remitted to them." In the absence of any charitable or meaningful educational activities you are operating as a collection agency for these companies. The "fair share" paid by the credit card companies would undoubtedly result in significant savings over the possible costs of not recovering any of the unpaid debt owed them. Thus, these companies clearly realize substantial financial benefits through their business relationship with you. We note that your contract with clients' [sic] provides that if they drop out of the DMP, they are still obligated to pay their debts to the

33. *Credit Counseling Ctrs, Inc. v. City of South Portland*, 814 A.2d 458 (Maine 2003).

34. *Id.* at 463 (internal citations omitted).

credit card companies. This illustrates the close business relationship you have with these companies.³⁵

IV. SECTION 501(Q)

In the Pension Protection Act of 2006, Congress enacted Section 501(q) of the Code³⁶ which imposes additional requirements on credit counseling organizations claiming exempt status. The legislative history of Section 501(q) recounts the IRS's heightened scrutiny of credit counseling organizations and explains:

The provision does not diminish the requirements set forth recently by the IRS in Chief Counsel Advice 200431023 or Chief Counsel Advice 200620001 but builds on and is consistent with such requirements, and the analysis therein. The provision is not intended to raise any question about IRS actions taken, and the IRS is expected to continue its vigorous examination of the credit counseling industry, applying the additional standards provided by the provision.³⁷

The legislative history provides a useful summary of the significant additional requirements imposed by Section 501(q):

1. The organization provides credit counseling services tailored to the specific needs and circumstances of the consumer;
2. The organization makes no loans to debtors (other than loans with no fees or interest) and does not negotiate the making of loans on behalf of debtors;
3. The organization provides services for the purpose of improving a consumer's credit record, credit history, or credit rating only to the extent that such services are incidental to providing credit counseling services and does not charge any separately stated fee for any such services;

35. I.R.S. Priv. Ltr. Rul. 200450039 (Sept. 14, 2004) (emphasis removed); *See also* I.R.S. Priv. Ltr. Rul. 200450036 (Dec. 10, 2004).

36. Pension Protection Act of 2006, Pub. L. No. 109-280, § 1220, 120 Stat. 780, 1086–1088 (2006).

37. Joint Comm. On Taxation, 109th Cong., General Explanation Of Tax Legislation, at 611.

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4. The organization does not refuse to provide credit counseling services to a consumer due to inability of the consumer to pay, the ineligibility of the consumer for debt management plan enrollment, or the unwillingness of a consumer to enroll in a debt management plan;
 5. The organization establishes and implements a fee policy to require that any fees charged to a consumer for its services are reasonable, allows for the waiver of fees if the consumer is unable to pay, and except to the extent allowed by State law prohibits charging any fee based in whole or in part on a percentage of the consumer's debt, the consumer's payments to be made pursuant to a debt management plan, or on the projected or actual savings to the consumer resulting from enrolling in a debt management plan;
 6. The organization at all times has a board of directors or other governing body (a) that is controlled by persons who represent the broad interests of the public, such as public officials acting in their capacities as such, persons having special knowledge or expertise in credit or financial education, and community leaders; (b) not more than 20 percent of the voting power of which is vested in persons who are employed by the organization or who will benefit financially, directly or indirectly, from the organization's activities (other than through the receipt of reasonable directors' fees or the repayment of consumer debt to creditors other than the credit counseling organization or its affiliates) and (c) not more than 49 percent of the voting power of which is vested in persons who are employed by the organization or who will benefit financially, directly or indirectly, from the organization's activities (other than through the receipt of reasonable directors' fees);
 7. The organization does not own (except with respect to a section 501(c)(3) organization) more than 35 percent of the total combined voting power of a corporation (or profits or beneficial interest in the case of a partnership or trust or estate) that is in the trade or business of lending money, repairing credit, or providing debt

management plan services, payment processing, and similar services; and

8. The organization receives no amount for providing referrals to others for debt management plan services, and pays no amount to others for obtaining referrals of consumers.³⁸

If these requirements were not enough, Section 501(q) further limits the percentage of a credit counseling organization's revenues that may come from payments by creditors of consumers of the organization attributable to the debt management plan services.³⁹ For credit counseling organizations in existence when Section 501(q) was enacted, the percentage limits phase in over the four taxable years beginning after the first anniversary of the date of enactment, with the ultimate limitation at fifty percent of revenue.⁴⁰ New credit counseling organizations formed after enactment of Section 501(q) are subject to the fifty percent limit ab initio.⁴¹

V. *SOLUTION PLUS, INC. v. COMMISSIONER*

In 2008, the Tax Court issued a memorandum decision denying exemption to an organization that it determined was formed primarily to sell debt management programs.⁴² On its facts, the decision is by no means surprising. The organization's application for recognition of exemption claimed that it was organized for educational purposes and that sales of debt management plans would make up only a minimal part of its activities and revenues.⁴³ The information and documents supplied by the organization showed quite the opposite, that debt management plans would be the focus and bulk of the entity's activities and would be its principal source of revenue.⁴⁴ The IRS denied the application; Solution Plus sought a

38. *Id.* at 611–13.

39. *Id.* at 613.

40. The limit is eighty percent for the first taxable year of the organization, beginning after the date which is one year after the date of enactment; seventy percent for the second such taxable year beginning after such date; sixty percent for the third such taxable year beginning after such date; and fifty percent thereafter. *Id.*

41. *Id.*

42. *Solution Plus, Inc. v. Comm'r*, 95 T.C.M. (CCH) 1097 (2008).

43. *Id.* at 18.

44. *Id.* at 18–20.

declaratory judgment that this denial was erroneous.⁴⁵ In granting summary judgment for the IRS, the Tax Court concluded that Solution Plus was not organized exclusively for either educational purposes or charitable purposes and that it would not operate exclusively for charitable purposes.⁴⁶ A key basis for its last conclusion was the fact that the organization's "primary activity would be to provide DMPs to the general public for a fee that it hopes to collect from its customers and from its customers' creditors"⁴⁷

VI. THE CONSEQUENCE TO CREDIT COUNSELING ORGANIZATIONS OF PROVIDING SUBSTANTIAL DEBT-SETTLEMENT SERVICES

The question addressed by this Article assumes that the organizations in question are credit counseling organizations that are properly exempt under Section 501(c)(3). Implicit in this assumption is that such organizations satisfy the organizational test and that their activities, governance structure, and sources of financial support meet the requirements contained in Section 501(q). The precise question, therefore, is whether such an organization may expand its activities to include providing a substantial amount of debt-settlement services and continue to satisfy the operational test for tax exemption.

The Supreme Court has held that "the presence of a single non-educational purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly educational purposes."⁴⁸

Providing debt-settlement services is not inherently charitable or educational. As the IRS noted in denying an application for exemption, "No court or Internal Revenue Service ruling has indicated that the sale of debt management plans and debt-settlement services is a charitable activity."⁴⁹ Consequently, providing debt-settlement services would cause an organization to fail the operational test unless the activity is either (i)

45. *Id.* at 1–2.

46. *Id.* at 20, 22.

47. *Id.* at 9.

48. *Better Business Bureau v. United States*, 326 U.S. 279, 283 (1945).

49. I.R.S. Priv. Ltr. Rul. 200450039 (Sept. 14, 2004).

incidental to the organization's principal and exempt purpose or (ii) integral to the accomplish of such purpose.⁵⁰

For an activity to be incidental, it must be of very small scale, at least relative to the activities of the organization as a whole. Consequently, it is possible that a tax-exempt credit counseling organization could expand its activities to include a minimal amount of debt-settlement services, which might be considered incidental to the organization's principal activities. The more important question, however, involves the provision of a substantial amount of debt-settlement services by a credit counseling organization.⁵¹ By definition, such substantial services could not be incidental.

VII. AN ACTIVITY MUST BE NECESSARY TO BE INTEGRAL

The key question, therefore, is whether providing debt-settlement services would be considered integral to a credit counseling organization's exempt, educational purpose. The Tax Court addressed a similar issue in *Pulpit Resource v. Commissioner*.⁵² The stated purpose of the organization at issue was:

To advance religious preaching through publication of sermons and other resources for ministers, priests, and rabbis, and to apply proceeds to purchase of preaching materials for libraries of selected schools of theology.⁵³

The organization published and sold by subscription a quarterly journal called *Pulpit Resource* that contained sermons, sermon outlines, and articles on preaching techniques.⁵⁴ The IRS had denied the organization's application for exemption, reasoning that it operated essentially as a commercial publishing venture that specialized in religious content.⁵⁵

50. See *Consumer Credit Counseling Serv. of Ala., Inc. v. U.S.*, 78-2 U.S.T.C. 9660 (D.D.C. 1978) (giving a conclusion on whether the agency met the operational test in question).

51. Because of the great demand for debt-settlement services and the resulting magnitude of this industry, if tax-exempt credit counseling organizations provided only minimal amounts of debt-settlement services, these organizations as a group would meet only a small portion of the aggregate demand. For this reason, the relevant inquiry concerns the provision of substantial debt-settlement services by such organizations.

52. 70 T.C. 594 (1978).

53. *Id.* at 596.

54. *Id.* at 597.

55. *Id.* at 601.

The Tax Court disagreed. After reviewing the case law and setting out the tension between Pulpit Resource's exempt purpose and the "commercial or business hue" of its activity, the court explained:

[W]e must determine whether the nonexempt commercial aspect of the activity was either so independent of the religious purpose or was sufficiently substantial that it cannot be said that petitioner was "operated exclusively" for religious purposes. . . . If the sale of religious literature was an integral part of and incidental to petitioner's avowed religious purpose, that activity may be considered a part of the religious purpose or objective. We find that it was.

Apparently the only way petitioner could accomplish its objective of disseminating sermons to ministers to improve their religious preachings was by selling Pulpit Resource at a price sufficient to pay for its cost and provide Harris with a reasonable salary. It apparently received few, if any, contributions and a contest for best sermons met with little financial success. There is no evidence that petitioner was in competition with any commercial enterprise conducting the same business activity. The market for petitioner's product was so limited in scope that it would not attract a truly commercial enterprise.⁵⁶

The test of whether a non-charitable activity is an integral part of an exempt purpose is thus a test of necessity: could the exempt objective be accomplished only by the activity in question?⁵⁷

The Tax Court revisited this issue and confirmed its analysis in *Living Faith, Inc. v. Commissioner*.⁵⁸ The organization seeking exemption in that case operated a vegetarian restaurant and health food store.⁵⁹ Its exempt purpose was to advance the teachings of the Seventh-day Adventist Church concerning the significance of diet—specifically, a vegetarian diet and abstention from tobacco, alcohol, and caffeine—in promoting good health, and the importance of good health in promoting virtuous conduct.⁶⁰ The court sought to determine whether the non-exempt commercial aspect of the organization's activity—the sale of health foods—was "so independent of the religious

56. *Id.* at 611 (internal citations omitted).

57. *Id.*

58. 60 T.C.M. (CCH) 710 (1990), *aff'd*, 950 F.2d 365 (7th Cir. 1991).

59. *Id.*

60. *Id.*

purpose, i.e., furthering the dietary and health goals of the Seventh-day Adventist religion” that it caused Living Faith to fail the operational test.⁶¹

Reviewing the relevant authorities, the court focused on whether the activities at issue were an “essential ingredient” in accomplishing the exemption purpose:

In each of these rulings, the organization performed services which were *required* in order to further the tenets of a particular religion or *necessary* to enable members of a particular religion to observe its principles. By way of contrast, petitioner herein has not shown that its operations were required to further the dietary teachings of the Seventh-day Adventist Church or necessary to enable members of the Seventh-day Adventist Church to comply with its beliefs.⁶²

Confirming *Pulpit Resource*, for an activity to be an integral part of an exempt purpose, it must be strictly necessary for the accomplishment of such a purpose.⁶³

It is doubtful that the IRS or a court would find the provision of debt-settlement services to be an integral part of a credit counseling agency’s exempt purposes. Such purposes are educational and take the form of either public seminars and publications or one-on-one counseling. The educational goals are to help consumers learn to budget and spend appropriately and to make prudent use of consumer credit. There is no necessary connection between services seeking a lump sum, discounted settlement of debts, and the exempt purpose of educating consumers in budgeting and prudent borrowing.⁶⁴ It should be understood that many tax-exempt credit counseling agencies have provided their services to the public without debt-settlement services for decades.⁶⁵ Consequently, there is no

61. *Id.* (emphasis added).

62. *Id.* (emphasis added).

63. See *Pulpit Resource v. Comm’r*, 70 T.C. 594 (1978) (holding that an organization that prepared and published sermons for use by various clergy was operated exclusively for an exempt purpose).

64. Arguably, the success of debt-settlement services, while plainly benefiting debtors, might even undermine the lessons of prudence and restraint implicitly stressed in the credit counseling agencies’ exempt purposes.

65. A comment submitted to the FTC on December 18, 2009, by the Financial Education and Counseling Alliance (FECA), argued that use of “the less-than-full-balance DMP, an educationally-based alternative to the traditional debt-settlement program” would permit tax-exempt credit counseling organizations to expand into providing debt-settlement services without running afoul of Section 501(c)(3). Financial Education and Counseling Alliance, RE: comment re Telemarketing Sales Rule–Debt

credible support for an argument that providing debt-settlement services is an “essential ingredient,” a necessary activity without which the exempt educational purposes cannot be accomplished. As a result, the provision of substantial debt-settlement services by a non-profit credit counseling agency would constitute a substantial, non-exempt purpose, causing the entity to fail the operational test for exemption.

VIII. INHERENT COMMERCIALITY

In addition to testing whether an activity is necessary to accomplish the organization’s exempt purpose, courts often focus on whether the activity is so inherently commercial that it cannot be integral to an exempt purpose. This analysis is sometimes phrased as a determination of whether nonexempt commercial purposes predominate with respect to the activity in question. The Tax Court has held that “[c]ompetition with commercial firms is strong evidence of the predominance of nonexempt commercial purposes.”⁶⁶ Similarly, the Court of Claims explained that providing investment advisory services to the public in exchange for money “places plaintiff in competition with other commercial organizations providing

Relief Amendments, R411001 *available at* <http://www.ftc.gov/os/comments/tsrdebtrelief/543670-00312.pdf>. This “new method” seems to be the ivory-billed woodpecker of the debt-resolution forest—more frequently discussed than actually encountered. In response to questions from the FTC, GreenPath, Inc., a member of FECA, acknowledged:

At this time, only one major creditor offers a less-than-full-balance DMP option. Only a very small number of GreenPath consumers (less than 50) are enrolled in this program, which is provided by that creditor as part of a normal GreenPath DMP (with no additional fees or requirements). *The program does not reduce any principal debt*, but will eliminate a percentage of fees and finance charges. Our understanding is that, since no principal debt is eliminated, the consumer does not have any tax liability.”

Letter from Richard A. Bialobrzeski, Director of Government/External Relations and Communication (Jan. 15, 2010) *available at* (<http://www.ftc.gov/os/comments/tsrdebtrelief/543670-00321.pdf>) (emphasis added). The FECA comment does not explain how “less-than-full-balance DMPs” are essential to the activities of tax-exempt credit counseling organizations in light of their absence from the roster of services that such organizations have long provided. *Id.* Nor does it explain how a program that does not reduce any principal debt would be an adequate replacement for debt-settlement services. *Id.*

66. *B.S.W. Group, Inc. v. Comm’r*, 70 T.C. 352, 358 (1978). *See also* *Airlie Foundation v. I.R.S.*, 283 F. Supp. 2d 58 (D. D.C. 2003) (relying largely on *BSW Group*, the court concluded that Airlie did not qualify for tax exemption because the entity’s charitable and educational activities were incidental to its primary activity of operating a conference center that competed with a number of commercial, as well as non-commercial, entities).

similar services. Plaintiff has chosen to compete in this manner and, as a consequence, plaintiff's activities acquire a commercial hue."⁶⁷ The Court of Claims reiterated this analysis in holding that an adoption agency that competed with for-profit agencies did not qualify for tax-exempt status.⁶⁸

Because a variety of for-profit entities, including law firms, have historically provided debt-settlement services, a non-profit credit counseling agency that began offering debt-settlement services would necessarily be competing with commercial firms. Such competition is strong evidence of the predominance of non-exempt purposes in connection with this activity. The manner in which debt-settlement services have been provided up to the present thus creates a significant hurdle to the possibility that provision of such services can be taken over by tax-exempt entities.⁶⁹

IX. IMPERMISSIBLE PRIVATE BENEFIT

In addition to the question of whether providing debt-settlement services would constitute a substantial non-exempt function, the IRS might view debt-settlement services as resulting in an improper private benefit to debtors, which would provide another basis for revocation of exempt status. Private benefit is a separate concept from that of "private inurement": private inurement involves benefit to persons controlling a purportedly tax-exempt entity, while private benefit may cover benefits to outsiders as well as insiders.⁷⁰ The presence of either is incompatible with exempt status.

By contrast with debt management plans, which are designed to result in full payment of the amounts owed, debt-settlement services seek to discharge debtors' obligations for less than the

67. *American Institute for Economic Research v. U.S.*, 302 F.2d 934, 938 (Ct. Cl. 1962).

68. *Easter House v. U.S.*, 60 A.F.T.R. 2d 87-5119 (Cl. Ct. 1987).

69. If the for-profit debt-settlement service providers are driven out of business by an advance fee ban, a tax-exempt credit counseling organization that began providing such services might argue that it was not currently competing with commercial businesses. Because the demise of the commercial providers would have resulted from the tax-exempt entities prevailing on the FTC to regulate their competition out of business, a court might not view the tax-exempt entities as having sufficiently clean hands to make such an argument.

70. I.R.S. Chief Couns. Mem. 200431023 (July 30, 2004), available at <http://www.irs.gov/pub/irs-wd/0431023.pdf>; See also *American Campaign Academy v. Comm'r.*, 92 T.C. 1053, 1064 (1989).

full principal amount. Accomplishment of this goal results in taxable income to the debtors.⁷¹ The recipients of debt-settlement services are not exclusively impoverished; indeed, many of them are persons of more moderate means who have become overburdened with consumer debt for a variety of reasons. In a number of similar contexts, the IRS and the courts have found the presence of private benefits to preclude exemption under section 501(c)(3).⁷²

For example, the Tax Court has denied tax-exempt to an organization that sought to increase charitable contributions to exempt entities by providing tax and estate planning advice to donors, because the court reasoned that the tax and estate planning advice provided a private benefit to donors that was inconsistent with exempt status.⁷³ Four years later, the Tax Court carried out a similar analysis in denying exemption to an entity that operated for the purpose of promoting litigation to protect pension funds of retired New York City teachers, where a significant factor to the court's finding of impermissible private benefit was the fact that over two-thirds of retirees were not poor.⁷⁴ By contrast, the Tax Court found no impermissible private benefit in the case of an organization importing and selling handicrafts where only an insubstantial number of the artisans who made these handicrafts were not disadvantaged.⁷⁵

71. I.R.C. § 61(a)(12) (1984).

72. I.R.C. § 501(c)(3) (2006).

73. *Christian Stewardship Assistance v. Comm'r*, 70 T.C. 1037 (1978). The IRS employed a similar analysis in concluding that:

[a]n association of investment clubs formed to enable members and prospective investors to make sound investments by the mutual exchange of investment information, that carries on not only educational activities but other activities directed to the support and promotion of the economic interests of its members, does not qualify for exemption."

Rev. Rul. 76-366, 1976-2 C.B. 144. The basis for this conclusion was that "the association is serving private interests." *Id.* An extreme example of disqualifying private benefit is found in *Ecclesiastical Order of Ism of Am v. Comm'r*, 80 T.C. 833 (1983). In that case, the Tax Court denied tax exemption to an organization that recruited new members by emphasizing the tax benefits of becoming a minister in its "religion" and whose "educational" literature emphasized tax avoidance.

74. *Retired Teachers Legal Defense Fund, Inc. v. Comm'r*, 78 T.C. 280 (1982).

75. *Aid to Artisans, Inc. v. Comm'r*, 71 T.C. 202 (1978).

X. STRINGENT APPLICATION OF EXEMPTION REQUIREMENTS TO CREDIT COUNSELING ORGANIZATIONS CONTINUES

Many tax-exempt credit counseling organizations likely welcomed the enactment of Section 501(q). Its provisions provided bright-line guidance that removed the uncertainty and the apparently mounting risk to exempt status arising out of the receipt of “fair share” payments from credit card companies. Since enactment of section 501(q), it has become apparent that this action by Congress did not cause an about-face in the attitude of the IRS toward credit counseling organizations claiming tax exemption.

In a 2008 private letter ruling denying exempt status, the IRS again cited *Credit Counseling Centers, Inc. v. City of South Portland* after a four-year absence from such rulings.⁷⁶ Although section 501(q) appears to have solved the problem of what portion of a credit counseling organization’s revenues may come from fair share payments, it does not address the argument that credit card companies derive an impermissible private benefit from the activities of organizations with an excessive focus on debt management plans, particularly if the eligibility criteria for such plans appear designed more for the creditors’ benefit than the debtors’. The return of allusions to *South Portland* may hint at interest on the part of the IRS to further develop of this line of analysis.

On February 15, 2010, Marcus S. Owens, a former director of the Exempt Organizations Division of the IRS who is now in private practice, took the unusual step of publicly releasing a letter he wrote to Diane Ryan, the Chief of the IRS Appeals Office.⁷⁷ Owens wrote to complain of the refusal by the Appeals

76. I.R.S. Priv. Ltr. Rul. 200851024 (Aug. 5, 2008) (citing *Credit Counseling Centers, Inc. v. City of South Portland*, 814 A.2d 458, 460 (Me. 2003)). As in the earlier rulings, this denial of exempt status determined that the applicant:

[P]rovides substantial private benefits” to credit card companies in a manner similar to the organization in *Credit Counseling Centers v. S. Portland*. *Id.* at Issue 3. Fair share is commonly defined as “that amount the organization receives from the creditors for each payment remitted to them.” In the absence of any charitable or meaningful educational activities, which we have established, you are operating as a collection agency for these companies. The “fair share” paid by the credit card companies would undoubtedly result in significant savings over the possible costs of not recovering any of the unpaid debt owed them. Thus, these companies clearly realize substantial financial benefits through your collection activities.

Id. at 159–160.

77. Tax Analysts Document Serv., Doc. 2010-3163.

Office “to seek Technical Advice regarding whether, in light of the enactment of section 501(q) and the holdings of Consumer Credit Counseling Service of Alabama and Credit Counseling Centers of Oklahoma, debt management programs (DMPs) conducted by credit counseling organizations qualify as a charitable activity.” It appears from Owens’ letter that both the examining agent and the Appeals Office had concluded that debt management programs do not qualify as a charitable activity.

Notwithstanding Owens’ indignation, this should hardly be surprising, as it represents a continuation of the view that the IRS expressed in Private Letter Ruling 200450039.⁷⁸ Section 501(q) imposes additional requirements for certain types of organizations that otherwise qualify under Section 501(c)(3).⁷⁹ Section 501(q) is not, however, a safe harbor whose requirements, if complied with, make it unnecessary for an organization to meet the various common-law requirements that courts have constructed under Section 501(c)(3).⁸⁰ Nothing in Section 501(q) suggests that debt management programs are viewed as a charitable activity. To the contrary, Section 501(q) makes it clear that it applies to “organization[s] with respect to which the provision of credit counseling services is a substantial purpose,” i.e., it is the educational, credit-counseling function that is the charitable activity upon which exemption may be

78. I.R.S. Priv. Ltr. Rul. 200450039 (Dec. 10, 2004). As noted above, that ruling states, “No court or IRS ruling has indicated that the sale of [debt management plans and debt-settlement services] is a charitable activity.” *Id.* at 148. Similarly, the IRS observed in Chief Counsel Advisory 200431023 that “[d]ebt management, like the adoption services in Easter House, is not a traditionally charitable activity.” I.R.S. Chief Counsel Advisory 200431023 (July 30, 2004).

79. Section 501(q)(1) begins: “An organization with respect to which the provision of credit counseling services is a substantial purpose shall not be exempt from tax under subsection (a) *unless such organization is described in paragraph (3) or (4) of subsection (c) and such organization is organized and operated in accordance with the following requirements: . . .*” I.R.C. § 501(q) (2000) (emphasis added).

80. The legislative history of 501(q) says just that with respect to the revenue percentage standards for income from creditors:

Compliance with the revenues test does not mean that the organization’s debt management plan services activity is at a level that organizationally or operationally is consistent with exempt status. In other words, satisfaction of the aggregate revenues requirement (as a preliminary matter in an exemption application, or on an ongoing operational basis) provides no affirmative evidence that an organization’s primary purpose is an exempt purpose, or that the revenues that are subject to the limitation (or debt management plan services revenues more generally) are related to exempt purposes.

Joint Comm. On Taxation, 109th Cong., General Explanation Of Tax Legislation, at 613.

based.⁸¹ In addition, Owens' argument that debt management programs themselves constitute a charitable activity is inconsistent with the Tax Court's decision in *Solution Plus*.⁸²

Given the apparent unwillingness of the IRS to reverse its longstanding view that the provision of debt management plans is not itself a charitable activity, it seems very unlikely that the IRS would countenance a significant expansion into providing debt-settlement services on the part of entities claiming tax exemption.

XI. CONCLUSION

For the foregoing reasons, the provision of substantial debt-settlement services by credit counseling agencies that are currently exempt under section 501(c)(3) would likely place such organizations outside the exemption provided by section 501(c)(3) of the Code. Few credit counseling agencies would be likely to risk their exempt status, and the freedom from FTC oversight that accompanies it, in order to begin providing significant amounts of debt-settlement services. If the FTC expands the Telemarketing Sales Rule in the ways set out in the Notice of Proposed Rulemaking, and if the advance fee ban then puts a large number of for-profit debt-settlement providers out of business, it appears likely that the significant demand for debt-settlement services among consumer debtors will go largely unmet.

81. I.R.C. 501(q)(2)

82. Owens' letter does not refer to *Solution Plus*. It is perhaps part of what Owens describes as the "unidentified"—and, from our perspective, nonexistent—judicial precedent upon which the Appeals Office relied. Tax Analysts Document Serv., Doc. 2010-3163.