WRITTEN STATEMENT OF
COMMISSIONER OF INTERNAL REVENUE
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BEFORE THE
PERMANENT SUBCOMMITTEE ON INVESTIGATIONS
COMMITTEE ON GOVERNMENTAL AFFAIRS
UNITED STATES SENATE
HEARING ON
THE ROLE AND TAX-EXEMPT STATUS OF CERTAIN NOT-FOR-PROFIT CREDIT COUNSELING AGENCIES
MARCH 24, 2004

Introduction

Thank you, Mr. Chairman and Ranking Member Levin, for the opportunity to explain the role of the Internal Revenue Service (the Service) in regulating the credit counseling industry. I am pleased you are addressing an area to which the Service is devoting increasing attention and resources. Although many credit counseling organizations continue to provide important educational and charitable services that are fully envisioned by section 501(c)(3) of the Internal Revenue Code, clearly a growing number do not. We are concerned that certain organizations are now preying on those facing financial distress.

I will review our role and the general law relating to charities, the history of tax exemption for credit counseling organizations, recent trends, and our actions to combat what we see as inappropriate activity by some organizations. As you will see, we have aggressively pursued a broad approach that includes efforts to warn consumers of issues in this area, an enhanced examination program, and stricter scrutiny in our application process, as well as partnering efforts with the state attorneys general and the Federal Trade Commission. Let me assure the Subcommittee that the Service will utilize all tools available to it, including the pursuit of criminal charges if appropriate, and the revocation of tax-exempt status.

Background: The Requirements for Tax Exemption under section 501(c)(3)

The role of the Service: The Service oversees the qualification for federal tax-exempt status of all exempt organizations, including those described in section 501(c)(3) (often referred to as “charities”). Through our compliance programs, we seek to ensure that tax-exempt organizations continue to meet the statutory requirements for exemption.

In general, an organization that wants to be recognized as tax exempt under section 501(c)(3) must apply to the Service for a determination of its status. To do this, the organization files Form 1023, “Application for Recognition of

Exemption Under Section 501(c)(3) of the Internal Revenue Code". Applications often are filed in advance of actual operations and can be based upon representations of what the organization will do in the future. We review the application to determine whether the proposed activities meet the statutory requirements for tax exemption. Those that are approved receive a determination letter that recognizes the organization as tax exempt. With certain exceptions, an exempt organization must annually file Form 990, an information return that provides information on its current activities and details its income and expenditures as well as its current financial status. Forms 1023 and 990 are publicly available documents. In fact, we make Forms 990 filed by section 501(c)(3) organizations available to various web sites to facilitate public scrutiny of charities.

We also use Form 990 as a compliance tool. Our compliance efforts generally include educational contacts, the review of filed returns and, if warranted, an examination of an organization's activities and operations.

To the extent that an organization fails to meet the criteria for exemption, its application for tax exemption will be denied or, if it already is tax exempt, the exemption is subject to revocation. Denials and revocations are based on the particular facts of each case.

General Requirements for Section 501(c)(3) Exemption: Section 501(c)(3) provides for the exemption from federal income tax of entities organized and operated for charitable, educational, scientific, religious, and certain other purposes. Relieving the poor and distressed is considered a charitable purpose. Providing instruction and training for the purpose of improving or developing an individual's capabilities, or educating the public on subjects useful to the individual and beneficial to the community also are considered charitable or educational activities. To qualify for section 501(c)(3) status, an organization cannot have a nonexempt purpose that is more than insubstantial.

A section 501(c)(3) organization also must meet other requirements. For today's purposes[1], chief among these are that the organization must not distribute net earnings to insiders (the prohibition against inurement) and it must operate for the benefit of public rather than private interests (the prohibition against private benefit). 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, for-profit affiliates, or persons controlled directly or indirectly by such private interests.

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[1] To date, we have not found that credit counseling organizations have a pattern of violating the section 501(c)(3) restriction against interference in political campaigns or that they have a pattern of engaging in a substantial amount of lobbying.

History of Tax Exemption for Credit Counseling Organizations

The Service and the courts have determined that certain credit counseling organizations meet the requirements of section 501(c)(3).[2] In Rev. Rul. 69-441, 1969-2 C.B. 115, the Service held that an organization was charitable where the beneficiaries of its credit counseling services were low-income customers. The organization cited in the ruling had certain favorable factors: a major activity was providing educational information to the general public on budgeting, buying practices, and the sound use of consumer credit through the use of films, speakers, and publications; its counseling services were limited to low-income customers; it provided individual counseling; and the board of directors was representative of the community.

A credit counseling organization may qualify for tax exemption even if it does not limit its clientele to low-income individuals where the services provided are educational. In the 1970's, the courts reversed the Service's revocation of exempt status of two organizations that provided credit counseling without limiting the services to low-income individuals. See Consumer Counseling Service of Alabama v. United States, 78-2 U.S.T.C. 9660 (D.D.C. 1978), and Credit Counseling Centers of Oklahoma, Inc. v. United States, 79-2 U.S.T.C. 9468 (D.D.C. 1979). The rationale was that providing information on the sound use of consumer credit was educational because it instructs the public on subjects useful to the individual and beneficial to the community. In reaching this conclusion, the courts considered several factors. These organizations were primarily involved in educating the general public through classes and seminars. The courts considered the debt management services (payment plan and creditor intercession) an integral part of the organizations' counseling and educational function. Moreover, the debt management services were so minor that, even if not an integral part of the educational services, they were not significant enough to affect the organizations' exempt status. The boards of these organizations were representative of the general public. Finally, the fees charged were nominal and were waived where payment would create a financial hardship.

To recap, to qualify as a section 501(c)(3) credit counseling organization, existing rulings and cases indicate that an organization that provides credit counseling must limit its services to low income customers or, as its primary activity, provide education to the public on how to manage personal finances.

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[2] Credit Counseling organizations can also qualify for tax exemption under section 501(c)(4) as social welfare organizations. See Rev. Rul. 65-299, 1965-2, C.B. 165. Because contributions to section 501(c)(4) organizations are generally not tax deductible and such organizations are not exempted from consumer protection laws, few credit counseling organizations seek section 501(c)(4) status. As a result, we have not seen any significant increase in the number or activity of these organizations, and we have not addressed them in this testimony.

Recent Trends and Profile of the Industry

In recent years, the Service has seen an increase in applications for tax-exempt status from organizations intending to provide such services. Among the more recent applicants, we are finding credit counseling organizations that are substantially different from those described in the rulings and court opinions. 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. These newer organizations are supported by fees from customers and "fair share" payments from credit card companies. The fees are high in comparison to the nominal fees considered by the courts in the 1970's. Further, it does not appear that significant counseling or education is provided. As I will discuss, we have modified our application process to deal with this change in circumstances.

In 2002, as we saw an increasing number of allegations of credit counseling abuses, we contacted the Federal Trade Commission (FTC) for assistance in understanding the developments in the industry. Based on the FTC's data and our examinations, it appears that some organizations are operating solely on the internet and are providing debt management and not credit counseling. In many cases, credit counseling services have been replaced by promises to restore favorable credit ratings or to provide commercial debt consolidation services.

We also learned of the favorable treatment accorded to section 501(c)(3) consumer credit organizations under both federal and state law. Section 501(c)(3) organizations often are excluded from coverage under FTC rules, as well as state and local consumer protection laws. This exclusion appears to be one of the primary drivers for the increase in the number of these organizations. For example, the Credit Repair Organization Act of 1997 (15 U.S.C. §1679 et seq.) sought to further regulate the practice of organizations involved in "credit repair," a series of activities aimed at improving a customer's credit history. The statute exempted section 501(c)(3) organizations from the provisions of this law. Many state consumer protection laws provide similar treatment for section 501(c)(3) organizations. In 1993, for example, the California legislature imposed strict standards on credit service organizations and the credit repair industry. The California statute aims to protect the public from unfair or deceptive advertising and business practices. Most significantly, it does not apply to nonprofit organizations that have received a final determination from the Service that they are exempt under section 501(c)(3) and are not private foundations.

Two more recent developments may provide additional incentives for credit counseling organizations to seek 501(c)(3) status. The first is the provision under some proposed bankruptcy legislation requiring credit counseling before filing for bankruptcy. Although the Service takes no position on the merits of the proposal, if it becomes law we expect applications from traditional credit

counselors and the new internet-based agencies to increase. The second development relates to the "Do Not Call" list, with its exemption for charitable solicitations. Again, our purpose is not to opine on the merits of the solicitation exemption other than to note our belief that this additional benefit of exemption may also motivate organizations to seek section 501(c)(3) status. Both of these developments will require even more diligence on our part.

Actions of the Service

We are concerned that the potent combination of exemption from income tax and exemption from consumer protection laws may be encouraging persons to seek tax exemption who are motivated by profit rather than by charity. As a result, we have created a comprehensive and multi-faceted strategy to address possible abuses and have established a team to oversee the strategic management of our compliance efforts. Members of the team include individuals from all functions of our Exempt Organizations office, representatives from other Operating Divisions, as well as staff from the Office of Chief Counsel.

Steps to Warn the Consumer: We are actively pursuing avenues to warn the public about unscrupulous profiteers who prey on those in financial distress, and to set forth the characteristics of good charitable or educational programs. We have partnered with the FTC, the National Association of State Charity Officials, and other watchdog groups, who have well-established channels for disseminating information to consumers. In News Release 2003-120 and Fact Sheet 2003-117 (both released in October 2003), we informed the public that credit counseling organizations that use questionable practices may seek tax-exempt status to circumvent state and federal consumer protection laws.

We continue to look for ways to reach a broader audience with this important message. Perhaps those of you who follow "Dear Abby" saw my letter published on February 9, 2004 concerning a woman who had written to Dear Abby about her mounting credit card debt. In her response, Dear Abby said the writer should seek help from a credit counseling agency. I took this opportunity to warn the readership about possible fraudulent credit counselors. As we move forward, we will continue to publicize the problems we see to the widest available audience.

Coordination with Regulators and Industry Representatives: We are meeting with other regulators, industry representatives, and professional groups as well. We have contacted state enforcement officials from Maryland, California, and New York concerning the issues their states are facing in this area. We are engaged in discussions with the FTC on coordination of our efforts. We also are working with the FTC to set up meetings with banks and credit card companies to better understand the "fair share" payments they make to credit counseling organizations. In this regard, we have already had a productive meeting with one credit card company. We have also met with both of the

industry associations in this area to discuss problematic behavior in the industry and with the United States Bankruptcy Trustees Office on the proposed bankruptcy reform legislation. Other outreach efforts include speaking at credit counseling trade association conventions and the annual meeting of the American Bar Association to inform the industry and its attorneys of potential problems and to open a dialog with industry participants.

Examinations of High-Risk Organizations: We are aggressively searching for useful indicators of organizations that place debt management services and credit repair services above educational and charitable objectives. We have over 50 organizations that have been selected for examination. That is a substantial increase from the more than 30 I noted in my November 20, 2003 testimony before the Oversight Subcommittee of the Committee on Ways and Means. We are pursuing an overall examination strategy to ensure our efforts are rapid and have the broadest possible impact. This means we are advancing those cases first that are most important to our overall strategy in this area. We will shortly have about 50 percent of the total revenues of the known filing universe of credit counseling organizations under active examination.

As part of our strategy, we are combining the efforts of our Exempt Organizations, and Small Business/Self Employed agents in a team approach to these audits. Other parts of the Service will be involved as required. We have designated specialists to provide immediate phone or e-mail assistance to examination agents, as well as to provide on-site support when necessary. The examinations focus on specific issues, including whether the organization provides actual counseling; customer demographics; fee structure; who controls and/or contracts with the organization; the flow of money; and whether there is inurement, private benefit, or a substantial nonexempt purpose.

As I mentioned, we are pursuing these cases with vigor and with all the tools available. A typical examination may include an inquiry not only into the books and records of the credit counseling organization but also of any for-profit affiliates or other organizations that are servicing the debt management plans marketed by the nonprofit. In cases in which we see individuals or their relations operating or working for both the credit counseling and for-profit organizations, we will be pursuing the flow of money and questioning the total compensation of these individuals. In addition, we also will question the compensation of insiders of the nonprofit where compensation appears unreasonably high regardless of whether they are benefiting by reason of related for-profits. Thus, individual returns may be part of these examinations as well.

In the area of individuals involved with charities, Congress has given us a valuable tool. In general, under section 4958 of the Internal Revenue Code, persons who receive in excess of reasonable compensation from a charity are subject to a 25-percent excise tax on the excess received. If they do not "correct" this transaction (e.g., through the return of money to the charity), they

are subject to a 200-percent tax on the excess. In addition, a charity's managers may be subject to an excise tax if it is found that they knowingly participated in these transactions.

Upon completion of our examination and to the extent that a credit counseling organization fails to meet the criteria for exemption, we will revoke its tax exempt status. Revocation means that the organization will lose the benefits of exemption and will be subject to tax as a for-profit entity. Revocation will be retroactive as warranted.

We expect to see the first results in these cases this Spring and may propose revocations of tax-exempt status for some of those under examination. As I mentioned earlier, in appropriate circumstances there may be criminal referrals with respect to these organizations or individuals as well.

Determination Program Safeguards—Stemming the Proliferation of New Organizations: Our goal is to ensure that new credit counseling organizations meet all requirements before tax-exempt status is approved. All such cases are assigned to staff specially trained in credit counseling and who use a uniform inquiry letter to develop the facts and issues of the case fully and completely. Once the staff has completed work on the application, whether the proposed result is favorable or unfavorable, all applications are subject to special review. All credit counseling organizations are centrally tracked to enable us to determine with accuracy the number and profile of these organizations, and to better manage and ensure consistent quality treatment.

At present, we are actively considering almost 60 applications. We are in the process of finalizing proposed denials in a number of cases and are finalizing the development in several more. Under the privacy rules of the Internal Revenue Code, the public will not know the disposition of any case with respect to a particular applicant unless the application is approved or unless the applicant is denied exemption and challenges us in open court.

To move even more expeditiously, we are in the process of reviewing the current workload to group the cases for efficiency and to reassign cases as necessary. Moreover, we are revising our inquiry letter as we gain more experience in the field.

In the application process, we are seeing organizations that appear to be replicating the practices of existing organizations. A number were filed with boiler plate "fill in the blank" forms. We believe there are individuals whose names are associated with a number of applicants and who may be using these applications to promote a tax shelter or tax fraud. As a result, as we identify these individuals we will refer them to those parts of the Service that investigate tax shelter promoters.

Conclusion

As you can see from this discussion, the Service is committed to taking the necessary steps to ensure that organizations that hold themselves out as section 501(c)(3) credit counseling services are complying with all applicable requirements for tax exemption. That means continuing with a vigilant application process, as well as a vigorous examination program. These components, coupled with continued efforts to educate the public about the hallmarks of an acceptable credit counseling program and outreach to other oversight organizations, form a comprehensive strategy to ensure that tax exempt credit counseling organizations do not abuse their tax-exempt status. Americans deserve and will receive our protection.