

Internal Revenue Service
Appeals Office
8701 S. Gessner
MC 8000 H-AL,
Houston, TX 77074

Release Number: 201017077
Release Date: 4/16/10
Date: January 8, 2010

A=
B=
C=

UIL – 501.03-30

Department of the Treasury

Person to Contact:

Employee ID Number:

Fax:

Refer Reply to:

AP:FE:HOU:AAM

In Re:

EO Revocation

D =

Form Required to be Filed:

1120

Tax Period(s) Ended:

**Last Day to File a Petition with the
United States Tax Court:**

APR 8 2010

Certified Mail

Dear

This is a final adverse determination as to your exempt status under section 501(c)(3) of the Internal Revenue Code (IRC). It is determined that you do not qualify as exempt from Federal income tax under IRC Section 501(c)(3) effective January 1, 2003.

Our adverse determination was made for the following reasons:

You are not operated exclusively for charitable, educational, or other exempt purposes. You did not engage primarily in activities which accomplish one or more of the exempt purposes specified in section 501(c)(3). More than an insubstantial part of your activities were in furtherance of a non-exempt purpose and you were operated for the purpose of serving a private benefit rather than public interests.

Contributions to your organization are not deductible under Code section 170.

You are required to file Federal income tax returns on the form indicated above. You should file these returns within 30 days from the date of this letter, unless a request for an extension of time is granted. File the returns in accordance with their instructions, and do not send them to this office. Processing of income tax returns and assessment of any taxes due will not be delayed because you have filed a petition for declaratory judgment under Code section 7428.

If you decide to contest this determination under the declaratory judgment provisions of Code section 7428, a petition to the United States Tax Court, the United States Court of Claims, or the district court of the United States for the District of Columbia must be filed

within 90 days from the date this determination was mailed to you. Contact the clerk of the appropriate court for rules for filing petitions for declaratory judgment. To secure a petition form from the United States Tax Court, write to the United States Tax Court, 400 Second Street, N.W., Washington, D.C. 20217.

We will notify the appropriate State officials of this action, as required by Code section 6104(c). You should contact your state officials if you have any questions about how this determination may affect your state responsibilities and requirements.

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

You also have the right to contact the Office of the Taxpayer Advocate. Taxpayer Advocate assistance is not a substitute for established IRS procedures, such as the formal Appeals process. The Taxpayer Advocate cannot reverse a legally correct tax determination, or extend the time fixed by law that you have to file a petition in a United States court. The Taxpayer Advocate can, however, see that a tax matter that may not have been resolved through normal channels gets prompt and proper handling. You may call toll-free, 1-877-777-4778, and ask for Taxpayer Advocate Assistance. If you prefer, you may contact your local Taxpayer Advocate at:

Taxpayer Advocate Service
Phone:

See the enclosed Notice 1214, Helpful Contacts for Your "Notice of Deficiency" for additional Taxpayer Advocate telephone numbers and addresses.

Sincerely,

TEAM MANAGER

cc: E =

Enclosures:



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY
Internal Revenue Service
9450 Koger Blvd., Rm 298
TE/GE Group 7954
St. Petersburg, FL 33702

April 3, 2006

LEGEND

ORG = ORGANIZATION NAME XX =
DATE
ORG

Taxpayer Identification Number:

Form:

990

20XX12, 20XX12, 20XX12

Person to Contact/ID Number:

Contact Numbers:

Telephone:

Fax:

Certified Mail - Return Receipt Requested

Dear .

We have enclosed a copy of our report of examination explaining why we believe revocation of your exempt status under section 501(c)(3) of the Internal Revenue Code (Code) is necessary.

If you accept our findings, take no further action. We will issue a final revocation letter.

If you do not agree with our proposed revocation, you must submit to us a written request for Appeals Office consideration within 30 days from the date of this letter to protest our decision. Your protest should include a statement of the facts, the applicable law, and arguments in support of your position.

An Appeals officer will review your case. The Appeals office is independent of the Director, EO Examinations. The Appeals Office resolves most disputes informally and promptly. The enclosed Publication 3498, *The Examination Process*, and Publication 892, *Exempt Organizations Appeal Procedures for Unagreed Issues*, explain how to appeal an Internal Revenue Service (IRS) decision. Publication 3498 also includes information on your rights as a taxpayer and the IRS collection process.

You may also request that we refer this matter for technical advice as explained in Publication 892. If we issue a determination letter to you based on technical advice, no further administrative appeal is available to you within the IRS regarding the issue that was the subject of the technical advice.

Letter 3618 (04-2002)
Catalog Number 34809F

If we do not hear from you within 30 days from the date of this letter, we will process your case based on the recommendations shown in the report of examination. If you do not protest this proposed determination within 30 days from the date of this letter, the IRS will consider it to be a failure to exhaust your available administrative remedies. Section 7428(b)(2) of the Code provides, in part: "A declaratory judgment or decree under this section shall not be issued in any proceeding unless the Tax Court, the Claims Court, or the District Court of the United States for the District of Columbia determines that the organization involved has exhausted its administrative remedies within the Internal Revenue Service." We will then issue a final revocation letter. We will also notify the appropriate state officials of the revocation in accordance with section 6104(c) of the Code.

You have the right to contact the office of the Taxpayer Advocate. Taxpayer Advocate assistance is not a substitute for established IRS procedures, such as the formal appeals process. The Taxpayer Advocate cannot reverse a legally correct tax determination, or extend the time fixed by law that you have to file a petition in a United States court. The Taxpayer Advocate can, however, see that a tax matter that may not have been resolved through normal channels gets prompt and proper handling. You may call toll-free 1-877-777-4778 and ask for Taxpayer Advocate Assistance. If you prefer, you may contact your local Taxpayer Advocate at:

If you have any questions, please call the contact person at the telephone number shown in the heading of this letter. If you write, please provide a telephone number and the most convenient time to call if we need to contact you.

Thank you for your cooperation.

Sincere! , AD

Marsha A Ramirez
Director EO Operations

Enclosures:
Publication 892
Publication 3498
Report of Examination

Letter 3618 (04-2002)
Catalog Number 34809F

LEGEND

ORG = ORGANIZATION NAME XX = DATE CITY = CITY STATE = STATE
DIR-1 THRU DIR-3 = 1ST, 2ND & 3RD DIRECTORS PRESIDENT = PRESIDENT
SECRETARY = SECRETARY TREASURER = TREASURER COMPTROLLER =
COMPTROLLER PRESIDENT-1 = 1ST PRESIDENT EMP-1 = EMP-1 BANK-1,
BANK-2 = 1ST & 2ND BANK CO-1 THRU CO-10 = 1ST, 2ND, 3RD, 4TH, 5TH, 6TH, 7TH,
8TH, 9TH & 101h COMPANIES

ORG
TAX YEARS ENDING DECEMBER 31, 20XX, 20XX, and 20XX

ISSUES PRESENTED:

1. Whether ORG. (hereafter referred to as ORG) is operated exclusively for exempt purposes described within Internal Revenue Code section §1(c)(3):
 - a. Whether ORG is engaged primarily in activities that accomplish an exempt purpose?
 - b. Whether more than an insubstantial part of ORG activities are in furtherance of a non-exempt purpose?
 - c. Whether ORG was operated for the purpose of serving a private benefit rather than public interests?
 - d. Whether any part of the net earnings of ORG inured to the benefit of any private shareholder or individual?

FACTS

Background

ORG incorporated under the laws of the State of State as a non-stock, nonprofit corporation on March 1, 20XX.

The Internal Revenue Service issued an advance ruling letter on September 25, 20XX to ORG as an organization described under Internal Revenue Code Section §(a)(2). The advance ruling period began March 1, 20XX and ended December 31, 20XX.

In its initial Articles of Incorporation filed March 1, 20XX its stated purpose is "organized exclusively for charitable, religious, educational, and scientific purposes, including , for such purposes, the making of distributions to organizations that qualify as exempt organizations under section §(c)(3) of the Internal Revenue Code, or the corresponding section of an future federal tax code."

In its amendment to its Articles of Incorporation filed January 25, 20XX its restated purpose is "The Corporation is formed exclusively for the following non-business and non-pecuniary purposes:

- To educate the public of consumer credit problems;
 - To counsel the public about how to control debts and implement debt management;
 - To help the public reduce the incidence of personal bankruptcy'
- To inform the public on personal money management; and
- To provide financial aids to low-income individuals and families

Activity Description

The primary activity engaged in by ORG during the years ending December 31, 20XX, December 31, 20XX, and December 31, 20XX is the telephone solicitation of clients in debt management plans (hereafter DMP's). Potential clients are individuals with unsecured debt. The primary activity engaged in by ORG years 20XX, 20XX and 20XX is the telephone solicitation of clients to enroll in debt management plans (hereinafter DMPs). Potential clients are individuals with unsecured debt. A DMP is a plan whereby a client makes monthly payments to ORG to satisfy his/her unsecured debts over a 3-5 year period. Most of the debts handled in a DMP were credit card debts.

ORG receives a one-time set-up fee and then per an agreed upon "payment plan" monies received from the customer is then paid to the customer's creditors less a processing fee charge.

In this instance, potential ORG customers are procured from CO-1 & other "customer lead" providers, i.e. an ORG website. ORG attempts to contacts each of the potential customers and offers their credit counseling services¹. New customers are required to enter into a debt management plan agreement (DMP) and pay a one-time enrollment/set-up fee. Each new customer agrees to make a "bank account direct payment" or monthly check payment for the monthly "processing fee" to the "processor."

According to the terms of the processing agreement each customer's monthly payment to CO-2 consists of a monthly processing fee and the monthly payments to creditors (reducing customer debt). The taxpayer splits these fees with CO-2. Upon receiving the payment from the processor the creditor provides a revenue stream to ADA known as a "fair share payment."

ORG started operations in December 20XX.

ORG Officers shown on 20XX tax return are:

| POSITION | NAME | Period |
|-------------------------|-------------|-----------------------|
| Pres & Managing Dir | President | 1/10/20XX |
| Corp Admin & Secretary | Secretary | 1/10/20XX |
| Comptroller & Treasurer | Treasurer | 8/10/20XX |
| Comptroller & Treasurer | Comptroller | 1/10/20XX - 8/1/20XX |
| Pres, Sec & Treasurer | President-1 | 3/1/20XX - 12/17/20XX |

At inception in December 20XX, the ORG fee schedule was:

- ORG Max fee = \$ / month
- One — time setup fee = Max #

The 20XX12 fee schedule for the Debt Management Plan (DMP) is shown as:

| Current Fee Schedule | Monthly Admin Fee | Maximum Set - Up Fee |
|----------------------|-------------------|----------------------|
| Monthly DMP < \$\$ | \$ \$ \$ | \$ |
| (10s) 51 -200 | 12% of payment \$ | \$ |
| 201 - 300 | \$ \$ \$ | \$ |
| 301 -400 | \$ \$ \$ | \$ |
| 401 - \$0 | \$ \$ \$ | \$ |
| \$1- 600 | \$ \$ \$ | \$ |
| 601 - 700 | \$ \$ \$ | \$ |

¹New Federal law requires individuals to complete credit counseling prior to going bankrupt.

| | | | | |
|-----------|----|----|----|----|
| 701 - 800 | \$ | \$ | \$ | \$ |
| 801 - 900 | \$ | \$ | \$ | \$ |
| > 900 | \$ | \$ | \$ | \$ |

On August 23, 20XX ORG entered into a "debt processor" contract² with CO-2 where CO-2 would directly receive monies from the customers and process payment to the debtor with ORG guaranteed a fixed percentage of the monthly fee from clients. ORG, "agency," held a "processing services" contract³ with CO-2 Financial, "processor," for which ORG initially received a per customer maximum setup fee of \$ and a maximum monthly fee of \$\$\$. This contract says the processor shall accept active clients and setup relationships between each creditor on behalf of the client. Processor shall "deduct" net check payment arrangements when adding new creditors. Additionally, the processor earns \$ monthly fee for maintaining agency name and logo on materials.

On 12/31/XX ORG borrowed a little over \$ and hired 28 employees from CO-3. Financials for years 20XX12 and 20XX12 are:

| Year | Revenues | Expenses | Profit |
|--------|----------|----------|--------|
| 20XX12 | <\$ | | |
| 20XX12 | \$ | | |

| Year | Officer's Comp | Officer's Salaries | Program Exp | Mgmt & General | |
|--------|----------------|--------------------|-------------|----------------|---|
| 20XX12 | 0 | | 0 | 0 | 0 |
| 20XX12 | | | | | |

RA has determined that the compensation is acceptable.

| Year | Assets | Liabilities | Equity |
|--------|--------|-------------|--------|
| 20XX12 | \$ | | |
| 20XX12 | \$ | | |

Yr 20XX12 liabilities: loans to company from President of \$\$

Loan from CO-3 for \$

2nd loan was an assumption of debt owed by CO-4 of \$

CO-4 debt was to CO-5 (CO-6)

3^d loan assumed was \$ from CO-7

Financials "as of December 31, 20XX and 20XX" show ORG with the following breakout of long term liabilities:

| ORG UT Liabilities | 20XX | 20XX |
|------------------------|------|------|
| President | | |
| CO-3 | | |
| CO-7 | | |
| # CO-5 off-shore Loans | | |

² Initially CO-4 contracted "processing" with CO-3 and in the last year of its operations CO-4 contracted its processing requirements with CO-2. When CO-4 transferred its client list to ORG, the existing "processing" contract with CO-2 was picked up and continued by ORG.

³ October 22, 20XX Operating Agreement, p4. All parties act as independent contractors responsible for withholding and compensation to employees. The term of the pricing agreement was 1 year with renewal options. There is a March 28, 20XX addendum and new pricing schedule. The ORG Agreements and addendums signature is that of President.

| | | |
|--------|------|----|
| CO-4 | \$ - | \$ |
| totals | | |

NOTE: With CO-3 loan transfers ORG received CO-3-CO-4 contractual customer base payments received by CO-4 from CO-2 valued at approximately \$ / client. The customer base received was 2-3000 clients.

In October 20XX ORG's increase in liabilities was largely due to the assumption of CO-4 loans outstanding in exchange for customer list which generated income stream of CO-2's "processing" customer payments. The liabilities CO-4 transferred was a October 22, 20XX loan with CO-2 which performed same client services.

On August 23, 20XX ORG renewed the CO-4-CO-2 processing contract and the CO-4 loan transferred to ORG.

The ORG customer list revenue stream generates an income approximate to that of the loan payments.

At end of year 20XX, the loan outstanding to CO-3 was \$. The loan outstanding to President was \$\$.

In 20XX ORG paid:

| Loan from | Amount owed | Paid | End Bal |
|-----------|-------------|------|---------|
| CO-3 | | | |
| President | | | |
| total | | | |
| | | | |
| | | | |

For year 20XX, ORG's financials show predominate and major expenses of:

| Major Expenses | Expense | % of Total |
|---------------------------------|---------|------------|
| Servicing Fees | | |
| Marketing Costs | | |
| Educational seminars / meetings | | |
| totals. | | |
| TOTAL EXPENSES | | |

The \$of Educational seminars/meetings," consisted largely of the travels of EMP-1 and President. The organization has failed to document the exempt purpose of these travels. The majority of the trips were to seminars that taught sales and marketing skills.

The December 31, 20XX and 20XX ORG tax return Balance Sheet reflects⁴:

| | 20XX | 20XX |
|--------------------|------|------|
| Assets - Cash | | |
| - Notes Receivable | | |

⁴ analysis on ORG income and balance sheet in depth necessary to show income flow to the various entities and individuals

| | | |
|---------------------------|--|--|
| - Pre-paids | | |
| - Fixed Assets | | |
| - Other Assets | | |
| Total | | |
| Liab - Accounts Payable | | |
| - Loans from Officers | | |
| - Mortgages/Notes Payable | | |
| - Other Liabilities | | |
| Total | | |
| Equity | | |
| TOT Lia & Equity | | |
| | | |

The ORG Tax Return, form 990, for years 20XX and 20XX reflects:

| Year 20XX | Income | Income |
|----------------|-------------------|----------------|
| | Program Ser Rev • | Dir Public Spt |
| Gross Receipts | | |
| Tot menses | | |
| Excess | | |
| BOY Bal | | |
| EOY Bal | | |

* Client Contribution \$ Enrollment fee + monthly handling lee
 "Creditor Contributor \$

| totals | \$ | | |
|----------------|----|-----------------|----------------|
| Year 20XX | | Income | Income |
| | | Program Ser Rev | Dir Public Spt |
| Gross Receipts | | \$ | \$ |
| | | Expense | Expense |
| | | Program Svcs | Mgmt & Gen |
| Tot Expenses | | | |
| Excess | | | |
| BOY Bal | | | |
| EOY Bal | | | |

' Client Contribution \$ Enrollment lee + monthly handling fee
 "Creditor Contribution \$

| totals | | | |
|--|----|-----------|----------------------|
| " Grantee | | AICCCA | |
| | | CO-8 | |
| | | MD Grants | |
| Year 20XX expenses | | CO-2 CO-1 | ntenrated Credit Sol |
| Paid for Client servicing (processing) | \$ | | |
| Paid for Client Referrals | \$ | \$ | \$ \$ |

As of December 31, 20XX ORG promoted, marketed the DMP to 20,951 individuals and families on:

1. Budgeting;
2. Buying practices; and
3. The sound use of consumer credit.

From those counseled \$ enrolled in a DMP.

The taxpayer contends with the start of the IRS audit and by the end of year 20XX, President began to make ORG operate in accordance with tax code §(c)(3) criteria, i.e., hired qualified people to do client credit counseling. ORG today is governed by a "broad based unrelated board" performing "more like" that expected of a Code section §(c)(3) credit counseling entity. ORG performs all alleged individual educational counseling via telephone. ORG contracts the "processing" of the clients monthly DMP with CO-2 Credit Counseling, a not-for-profit entity in City, State. For example,

- In September 20XX ORG started a Community Outreach and Education Department with two staff positions, a Director and an Outreach Coordinator, both of whom conduct community events and educational programs. The Department has established partnerships with two (2) local municipalities and financial literacy partnerships with 2 major community financial institutions, Bank-1 and Bank-2, NA. Through the relationships the department conducts financial and affordable housing topics and also partners with a national provider of substance abuse recovery program, providing a monthly seminar in financial counseling assisting clients with their basic financial needs.

Note: The Revenue Agent interviewed a number of these newly hired individuals; however, the taxpayer failed to produce a long time employee for an interview.

- Counseling subjects include:
 1. money management;
 2. appropriate and affordable levels of debt;
 3. wise use of credit;
 4. solving credit problems;
 5. understanding credit reports;
 6. reestablishing credit; and
 7. alternatives to bankruptcy.
- Individuals that do wish to receive counseling, but do not wish to participate in DMP will not be charged. The monthly maintenance donation will not exceed \$.⁵

In 20XX CO-8 granted \$\$ to ORG. The CO-8 grant, in addition to the "fair share distribution to ORG," a relatively new customer since 12/20XX, was for the stated purpose of:

Allowing ORG, a member of both the CO-9 (CO-9) and CO-10 (CO-10), to continue with their mission to assist all who seek assistance through educational programs, seminars, and financial counseling through a newly created department, Community Outreach and Education. This department incorporates emergency housing assistance with HUD *offices*, SHIP, LISC, and various non-profit organizations. ORG staff conducts workshops at these meetings to educate clients in consumer related issues that directly affect their ability to purchase and maintain their homes.

⁵ The \$ flows either to ORG or the Processor and used for the processor fee. The difference belongs to ORG.

The Grant was to allow ORG to grow, both internally and externally hiring, training, and certifying new employees for the financial and educational counseling.

Most recently individuals in need of debt and credit counseling come to ORG through referrals or of their own accord. The requirement for program admission is the individual have a debt to income ratio which exceeds \$%.

ORG continues to be funded by way of:

- fees from clients which includes a setup fee and a monthly payment processing fee⁶,
- as well as grants.

Additionally ORG receives a "fair share" from the creditor, which is typically the credit card companies. In 20XX and 20XX the organization received substantially all of their income from DMP payments as discussed above.

ORG continues to contract CO-2 Credit Counseling, a City, a §1(c)(3), to process client's creditor payments in accordance with the DMP.

LAW

Section 501(a) of the Internal Revenue Code provides that an organization described in section 501(c)(3) is exempt from income tax. 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 the net earnings inure to the benefit of any private shareholder or individual. The term charitable includes relief of the poor and distressed. Section 1.501(c)(3)-1(d)(2), Income Tax Regulations.

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

Section 1.501(c)(3)-1(a)(1) of the 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(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. The existence of a substantial nonexempt purpose, regardless of the number or importance of exempt purposes, will cause failure of the operational test. Better Business Bureau of Washington, D.C. v. U.S., 326 U.S. 279 (1945).

Educational purposes include instruction or training of the individual for the purpose of improving or developing his capabilities and instruction of the public on useful and beneficial subjects. Treas. Reg. § 1.501(c)(3)-1(d)(3). In Better Business Bureau of Washington D.C., Inc. v. United States, 326 U.S. 279 (1945), the Supreme Court held that the presence of a single non-exempt purposes, if substantial in nature, will destroy the exemption regardless of the number or importance of truly exempt purposes.

The Court found that the trade association had an "underlying commercial motive" that distinguished

⁶ The difference belongs to ORG.

its educational program from that carried out by a university.

In American Institute for Economic Research v. United States, 302 F. 2d 934 (Ct. Cl. 1962), the Court considered the status of an organization that provided analyses of securities and industries and of the economic climate in general. The organization sold subscriptions to various periodicals and services providing advice for purchases of individual securities. Although the court noted that education is a broad concept, and assumed for the sake of argument that the organization had an educational purpose, it held that the organization had a significant non-exempt commercial purpose that was not incidental to the educational purpose and was not entitled to be regarded as exempt.

An organization must establish that it serves a public rather than a private interest and "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." Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii). Prohibited private interests include those of unrelated third parties as well as insiders. Christian Stewardship Assistance, Inc. v. Commissioner, 70 T.C. 1037 (1978); American Campaign Academy v. Commissioner, 92 T.C. 1053 (1989). Private benefits include an "advantage; profit; fruit; privilege; gain; for] interest." Retired Teachers Legal Fund v. Commissioner, 78 T.C. 280, 286 (1982).

An organization formed to educate people in Hawaii in the theory and practice of "est" was determined by the Tax Court to a part of a "franchise system which is operated for private benefit," and, therefore, should not be recognized as exempt under section 501(c)(3) of the Code. est of Hawaii v. Commissioner, 71 T.C. 1067, 1080 (1979). Although the organization was not formally controlled by the same individuals who controlled the for-profit entity that owned the license to the "est" body of knowledge, publications, and methods, the for-profit entity exerted considerable control over the applicant's activities by setting pricing, the number and frequency of different kinds of seminars and training, and providing the trainers and management personnel who are responsible to it in addition to setting price for the training. The court stated that the fact that the organization's rights were dependent upon its tax-exempt status showed the likelihood that the for-profit entities were trading on that status. The question for the court was not whether the payments made to the for-profit were excessive, but whether the for-profit entity benefited substantially from the operation of the organization. The court determined that there was a substantial private benefit because the organization "was simply the instrument to subsidize the for-profit corporations and not vice versa and had no life independent of those corporations."

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

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

In the case of Consumer Credit Counseling Service of Alabama, Inc. v. U.S., 44 A.F.T.R.2d 78-5052 (D.D.C. 1978), the District Court for the District of Columbia held that a credit counseling organization

qualified as charitable and educational under section 501(c)(3). It fulfilled charitable purposes by educating the public on subjects useful to the individual and beneficial to the community. Treas. Reg. § 1.501(c)(3)-1(d)(3)(i)(b). For this, it charged no fee. The court found that the counseling programs were also educational and charitable; the debt management and creditor intercession activities were "an integral part" of the agencies' counseling function and thus were charitable and educational. Even if this were not the case, the court viewed the debt management and creditor intercession activities as incidental to the agencies' principal functions, as only approximately 12 percent of the counselors' time was applied to debt management programs and the charge for the service was "nominal." The court also considered the facts that the agency was publicly supported and that it had a board dominated by members of the general public as factors indicating a charitable operation. See also, Credit Counseling Centers of Oklahoma, Inc. v. United States, 79-2 U.S.T.C. 9468 (D.D.C. 1979), in which the facts and legal analysis were virtually identical to those in Consumer Credit Counseling Centers of Alabama, Inc. v. United States, discussed immediately above.

The organizations included in the above decision waived the monthly fees when the payments would work a financial hardship. The professional counselors employed by the organizations spent about 88 percent of their time in activities such as information dissemination and counseling assistance rather than those connected with the debt management programs. The primary sources of revenue for these organizations were provided by government and private foundation grants, contributions, and assistance from labor agencies and United Way.

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

Internal Revenue Code section 501(c)(3) specifies that an exempt organization described therein is one in which "no part of the net of earnings inures to the benefit of any private shareholder or individual." The words "private shareholder or individual" in section 501 refers to persons having a personal and private interest in the activities of the organization. Treas. Reg. § 1.501(a)-1(c). The inurement prohibition provision "is designed to prevent the siphoning of charitable receipts to insiders of the charity ... " United Cancer Council v. Commissioner, 165 F.3d 1173 (7th Cir. 1999). Reasonable compensation does not constitute inurement. Birmingham Business College v. Commissioner, 276 F.2d 476, 480 (5th Cir. 1960).

Where an organization provided a source of credit to companies of which a private shareholder was either an employee or an owner, the court found that a portion of the organization's net earnings inured to the benefit of that private shareholder. Easter House v. United States, 12 Cl. Ct. 476 (1987). That such loans were made showed that the companies controlled by the private shareholder had a "source of loan credit" in the organization.

The Credit Repair Organizations Act (CROA), 15 U.S.C. § 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. § 1679b. Significantly, section 501(c)(3) organizations are 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. § 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).

Businesses are prohibited from cold-calling consumers who have put their phone numbers on the National Do-Not-Call Registry, which is maintained by the Federal Trade Commission. 16 C.F.R. § 310.4(b)(1)(iii)(B); 47 C.F.R. § 64.1200(c)(2). Section 501(c)(3) organizations are not subject to this rule against cold-calling. Because 501(c)(3) organizations are exempt from regulation under the CROA and the cold-calling restrictions, organizations that are involved in credit repair have added incentives to be recognized as section 501(c)(3) organizations even if they do not intend to operate primarily for exempt purposes.

Taxpayers Position

The taxpayer does not agree with the Internal Revenue Service position in this case. They believe they are performing educational services which would allow them to continue to qualify as an organization described in code section §(c)(3). They will provide a detailed explanation of their position in their protest.

Conclusion

The information and analysis contained in this report demonstrate that the payments received by ORG were not in accordance with Code §(c)(3) criteria. Substantially all of the revenue received, and time spent, during the years under examination were related to the sale and marketing of debt management plans (DMP) to consumers, not the provision of education to the public.

The debt incurred from related entities, the assigned client list value for the transferred customer listings, acquired for \$- \$, from CO-4 to ORG, and overall exceedingly high expenditures incurred by ORG resulted in personal inurement to President, and his companies.

These factors combine to cause ORG, a § (c)(3) entity to drown in debt while passing large sums of money to President through the various agreements with companies he controlled and also owned. In many instances creditors believe the fair share payments are to ORG but in reality the monies are transferred to the benefit of President in the form of business and loan payments to his companies.

In summary, ORG was not operated exclusively for tax exempt status criteria purposes, because it did not engage primarily in activities that accomplish an exempt purpose. More than an insubstantial part of ORG's activities are in furtherance of a non-exempt purpose, i.e., ORG was operated for the purpose of serving a private benefit rather than public interests, and a part of the net earnings of ORG inured to the benefit of a private shareholder or individual. Accordingly, it is determined that ORG is not an organization described in section §(c)(3), and exempt from income tax under section \$, effective January 1, 20XX.

NOTE: Further understanding of the issue is contained in US SENATE, Permanent Subcommittee on Investigations Report titled: *PROFITEERING INA NON-PROFIT INDUSTRY: ABUSIVE PRACTICES*

IN CREDIT COUNSELING. The report gave an overview referencing the CO-10 (CO-10) and the CO-9 (CO-9) as industry standards in assisting and educating those with excessive debt and inability to pay off that debt. In general a credit counseling agency establishes a "debt management plan (DMP)" that would over an extended time period allow the debt to be paid. Too often, client payments were absorbed in up-front and other fees with debt remaining unpaid and the client later declaring bankrupt. Credit Counseling Agencies (CCAs) such as the taxpayer generate revenues primarily in two ways, Fees and credit payment example in the study are shown below.

The following table reflects the average fees charged by CO-10 agencies. These fees are far less than those charge by the taxpayer; however, it should be noted that outcome of this case has not been determined based upon the fees charge by the taxpayer. The determination in this matter has been made based upon their substantial non-exempt purpose.

| <u>Revenue Source / Customer</u> | <u>CO-10</u> | <u>20XX</u> | <u>i3ANt< One</u> | <u>WA</u> | <u>CO-8</u> |
|----------------------------------|--------------|-------------|----------------------|---------------|-------------|
| Fees: Initial set up | | \$ | | | |
| Fees: Monthly Maintenance | | \$ | | | |
| "Fair share" creditor payments | 7% -15% | > 9% | 2% - 15% | sliding scale | |

List of Exhibits:

- Exhibit A (Specific ORG Operational Relationships) Exhibit B (Credit Counselor Call Detail) – CD ROM Exhibit C (ORG Website) Exhibit D (ORG Profit and Loss Statement) Exhibit E (ORG Lead Generation Costs) Exhibit F (Community Outreach Expenses) Exhibit G (ORG Undocumented Travel Vouchers)

ORG (ORG) was founded under the auspices of "helping people who have problems managing their debt through money management counseling, assistance in reading credit reports, solving credit problems, reestablishing credit, and alternatives to bankruptcy." These services are paid for by DMP fees.

In response to an EO RA IDR, ORG says "at inception the entity had no facilities and no employees with all activities conducted by volunteers." This fact changed instantaneously with ORG occupancy of CO-3's facility and CO-3 transfer of employees to ORG.

ORG initially had no capital stock, a "perpetual existence," no voting members and managed by its Board of Directors⁷ elected by a majority vote of members of the Corporation.

Form 1023, Application for Recognition of Exemption shows:

- Date formed: 1 March 20XX
- Revenue Generation:
 - 1.Fair Share Credit fees,
 - 2.Administrative Client Fees, and
 - 3 Donations and Grants if and when available.
- Monthly Service Fee: \$ month.
- Processing Fee: \$ - \$ depending on volume of debt.
- Projected revenue generation of:

| | 20XX | Projected | Projected | |
|-------------------------------|------|-----------|-----------|--------|
| Revenues | &t | +r 1 | yy | TOTALS |
| Gifts, Grants, Contributions | | | | |
| Fees, creditors payments, etc | | | | |
| Less: Salaries | | | | |
| Less: Expenses | | | | |
| Excess of Revenue | | | | |
| | | | | |

NOTE: In year 20XX, the number of employees is unknown but in 20XX ORG had 51 employees and 7 independent contractors. In year 20XX there were 17-18 employees. As of 16 February 20XX there were 7 counselors, 3 of which were in training.

BYLAWS OF ORG

- 3 -15 Directors serving 2 year terms,
- 1 annual meeting with special meeting as called by the President.
- President can sign all contracts and documents authorized by the Board.
- Checks, drafts, etc. signed by Board designated officers.

⁷ Original Officer(s): President-1, President/Secretary/Treasurer. Directors: President-1, DIR-1 & DIR-2, with Board Chairman: President. On 17 December 200 Articles Amendment show: President, President, Secretary, Secretary and Comptroller, Treasurer with Chairman of the Board, President. Neither the members, Officers or Board of Directors are liable for the entities debt.

EXHIBIT A

ARTICLES OF INCORPORATION – (selected)

- Article 3 — Prohibitions — No part of the net earnings of the Corporation shall inure to the benefit of, or be distributable to its members, trustees, officers, or other private persons....
 - Article 4 — Officers -- President, Secretary & Treasurer , PRESIDENT-1.
 - Article 7 — Directors — PRESIDENT-1, DIR-1 & DIR-2.
 - Article 9 — Capital Stock — None. The Corporation consists of members rather than shareholders.
 - Article 12 — Liabilities for Debts — Neither the members nor the members of the Board of Directors or officers of the Corporation shall be liable for debts of the Corporation. • AMENDED effective 17 December 20XX.
1. President, President (Chairman of the Board);
 2. Secretary, Secretary; and
 3. Treasurer: Comptroller.
 4. ARTICLES OF AMENDMENT: Replaced Article 2 in its entirety.

EXHIBIT A CO-3 (CO-3)

On 24 April 20XX "CO-3" formed a for profit partnership (partnership of 2 people with President owning 97%) to provide "credit counseling" services for individuals with large debt.

Debtors contracted with CO-3 for credit counselor services to educate and help those debtors pay their bills. The generated credit counseling revenues from those services are:

1. Initial account formation *fee* from the debtor (a large part of total revenues).
2. Account maintenance *fee* from the debtor and
3. The "fair share" *fee* received from the creditor.

Tax laws disallowed a creditor from paying a "fair share" fee to a "for profit" credit counseling service. Tax laws did allow a creditor to pay a "fair share" fee to a code § (c)(3) "not-for profit" entity.

In November 20XX CO-3 ceases its services with distribution to the partnership and with approximately \$ counselors transferring to ORG which at the same time began its services, i.e., the services operation continued with a name change only with business conducted as usual.

In year 20XX CO-3 resurrected its 2nd Code §1(c)(3) subsidiary, ORG, from its "shell status." At the beginning of 20XX, ORG's liability from "loans" was approximately \$ but at year end, in year 20XX, it was approximately \$ of which approximately \$ was owed to CO-3 Financial⁸.

The CO-3 General Partner, President, created ORG as a "not-for-profit" credit counseling entity with documents signed by one unrelated person.

- LIQUIDITY FACILITY AND LOAN AGREEMENT between ORG (borrower) and CO-3 (Lender). dated 1 December 20XX shows.

1. Lender made available a commercial loan in amount not to exceed \$.
2. Terms of loan: 10% interest with amount borrowed repaid within 6 years.
 - Loans from CO-3 (signed by Tom Hodgson -lender) to ORG (signed by President - borrower).

CO-3 Loans Date Amount Comments

to ORG 12/1/20XX \$ Max amount advanced - Float as needed to expand business -repay within 6 yrs @ 10%. Secured by assets. Total **advanced** \$ 12/27/XX=; 12/24/XX ; 12/16/XX 12/10/XX.

⁸ This fact demonstrates a relationship between CO-3 and control over ORG.

EXHIBIT A

President's control of ORG does not become apparent until the year 20XX, when he takes control.

On 31 December 20XX, CO-3 ceased, existing as a "shell entity," transferring its "remaining 10-15 people" to ORG.

CO-2⁹. DBA CCS PROCESSING SERVICES

Contractual Agreement¹⁰ between CO-3, the "Agency" (signed by President) and CO-2, the "Processor", (signed by DIR-3), dba "CO-2" and also as "CO-2."

Agency CO-3

Contracts clients for a max \$ setup fee, with max monthly fee of \$\$ and delivers active clients to the processor. Contract forms will be compatible with CO-2 form formats.

Processor CO-2

Provides initial setup of debt management clients, normal management of clients funds received, negotiations with creditors, pay to creditors, and customer service for clients.

Fee Structure,

With \$ clients per month, Processor receives \$ from each client with remaining "Agency" gross profit split 85% to Agency and 15% to CO-2. Less than \$ clients, share split is 75% for Agency and 25% for CO-2.

Contractural Restriction: All parties are acting as Independent contractors. No partnership or joint venture or similar relationship.

Operating Agreement stipulations between ORG (agency) and CO-2," are:

- The agreement allows CO-2 to perform all "processor" services.
- Processor provides software and support for client acquisition followed by processing services for the client enrolled in a debt management program.
- After the person becomes a (ORG) client, the processor provides the initial setup of debt management clients, normal management of client' funds received and creditors paid, negotiations with creditors, and customer service for clients.
- + Max setup fee of \$ with max monthly maintenance fee of \$\$ / month.
- Services are offered via internet, toll free phone, toll free fax, or mail.
- After each check-run, the processor pays the agency all remaining funds in excess of the share of the processor service fees deducted from the fair share and/or monthly client fees.
- The billed fair share continues to go directly to the agency.
- Provide all correspondence and client related documents with Agency name and logo.
- Processor earns \$1600 monthly fee for maintaining agency name and logo on materials.
- Each party to the Agreement operates as an "independent contractor."

⁹ CO-2 Operating Agreement signed 1W18102.

¹⁰ Outlines and lists services provided by the "Agency" and by the "Processor." Either party can cancel with 120 days notice without cause.

CO-1. (for profit entity)

In a 1 February 20XX contract the owner of ORG, President¹¹, who also owns 100% of CO-1, City, State, enters into a Consulting Agreement to provide customer leads to ORG.

Per a separate 1 February 20XX Agreement, EMP-1¹² with an option to acquire 10% of CO-1 is, "in turn," to receive all funds paid to CO-1.

ORG and CO-1 (new client lead provider) also enter into a "website operation and marketing agreement" where:

- Provider performs operational services for website.
- Example of service performed: Promote ORG's debt management and debt consolidation services through the ORG website and hosting the ORG website or contracting with a 3rd party to provide such hosting services.
- Payment fee: \$,\$ / year.
- Bonus: year 1=\$\$; year 2=\$; year 3=\$; year 4=\$; and year 5=\$.
- Lead Generation Fee: \$ for each client lead purchased from Provider.

As of December 31, 20XX, ORG owned CO-1 \$ for past services rendered. The POA in response to a EO RA IDR says:

There was never any money paid by ORG to CO-1 under Agreement terms. The early on Agreement was done before operating parameters were determined and that Agreement is no longer in effect, terminated on August 31, 20XX.

Note: The organization expensed the following payable amounts to CO-1:

| Year | Payable Amount | Amount Paid |
|------|----------------|-------------|
| 20XX | \$ | |
| 20XX | \$ | |

¹¹ President, with a title of Manager, initially occupied all officer positions.

¹² EO RA audit revealed ORG paid for EMP-1 to present a "sales and performance" training conference for purposes of training employees on "high impact sales, team driven," I.e., training. to promote employees in "cold call" signing of clients.