

**Written Testimony of Mark Everson
Commissioner of Internal Revenue
Before
The House Ways and Means Committee
Subcommittee on Oversight
Concerning Section 501(c)(3) Credit Counseling Organizations
November 20, 2003**

Thank you, Mr. Chairman, for the opportunity to provide this Subcommittee with information concerning the role of the Internal Revenue Service (the Service) in regulating the credit counseling industry. I commend the Subcommittee for your interest in this area. Many credit counseling organizations continue to provide valuable services that meet the definitions and requirements of exemption from taxation under section 501(c)(3) of the Internal Revenue Code. However, the operations of a growing number of credit counseling organizations no longer reflect what has long been required for tax exemption. We are concerned that certain of these organizations are now preying on those in 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 in the area, and our actions to combat what we see as inappropriate activity by some in the sector. As you will see, we are aggressively pursuing this issue with a broad approach that begins with a more in depth determination letter process and includes an enhanced examination program, as well as partnering efforts with the state attorneys general and the Federal Trade Commission.

Background on the Requirements for Tax Exemption under section 501(c)(3)

Role of the Service with respect to tax exempt organizations: The Service regulates all tax exempt organizations, of which a subset is described in section 501(c)(3). An organization seeking to be tax exempt under section 501(c)(3) generally is required to apply to the Service for a determination of its status. The organization initiates the process by filing a Form 1023, "Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code." The application often is filed in advance of actual operations and can be based on representations about what the organization will do in the future. We review the application to determine whether the organization's proposed activities satisfy the statutory requirements. After we recognize an organization as tax exempt, generally the organization is required to file an annual information return, the Form 990. The Form 990 is a self-reporting mechanism, whereby the organization provides information concerning its current activities, as well as its financial picture. Forms 990 are public documents and we image the forms from section 501(3) organizations making them available to various web sites for public scrutiny. The Service also uses the Forms 990 as part of our ongoing

effort to ensure compliance with the requirements for tax exemption. Our compliance efforts generally entail additional educational contacts, the review of filed returns and, if warranted, an examination based upon completed operations.

General requirements for tax exemption: In our review of the tax exempt status of an organization, the Service looks to both statutory and regulatory requirements. At its most basic, section 501(c)(3) provides for the exemption from federal income taxation of entities organized and operated exclusively for charitable, educational, scientific, religious, and certain other purposes. This means that an exempt organization must engage primarily in activities that accomplish charitable purposes. Relieving the poor and distressed generally 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 activities.

An exempt organization also must meet other requirements in order to be described in section 501(c)(3). Chief among these for today's discussion are that the organization must not distribute net earnings to insiders (the prohibition on inurement) and it must operate for the benefit of the public rather than for the benefit of private interests (the prohibition on private benefit). With respect to the private benefit rule, an organization must establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization or persons controlled directly or indirectly by such private interests.

History of Tax Exemption for Credit Counseling Organizations

The Service and judiciary have determined that certain credit counseling organizations meet the requirements of section 501(c)(3).¹ Credit counseling organizations may be exempt because of their charitable or educational work. The Service first provided guidance on this issue in 1969, when it addressed standards for credit counseling organizations. In Rev. Rule 69-441, 1969-2 C.B. 115, we held that the organization cited in the ruling was charitable where it included the following favorable factors: its primary activity was providing educational information to the general public on budgeting, buying practices, and

¹ This hearing and the allegations of abuse in this area are focused on section 501(c)(3) charitable organizations. We note, however, that credit counseling organizations also can 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 under that section are not tax deductible and such organizations are not exempted from consumer protection laws, few credit counseling organizations seek 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.

the sound use of consumer credit through the use of films, speakers, and publications; its counseling services were limited to low income customers and individual counseling was provided; the organization's board of directors was representative of the community; and, the organization's work in establishing budget plans and paying customer's bills was a minor portion of its overall activities.

A credit counseling organization may be tax exempt even if it does not limit its clientele to low income individuals where the services provided by the organization are educational in nature. In the 1970's, the courts reversed the Service in its revocation of the exempt status of two organizations that provided credit counseling, but did not limit their 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 courts in these cases held that providing information regarding the sound use of consumer credit was educational because it instructs the public on subjects useful to the individual and beneficial to the community. The courts considered the debt management services (the payment plan and creditor intercession) an integral part of the organizations' counseling and education function. Moreover, the debt management services were so minor that even if they were not considered educational in themselves, they were not significant enough to affect the organizations' exempt status. The boards of these organizations were controlled by the public. Finally, the fee structure was not a barrier to exemption because the fees were nominal and were waived where payment would create a financial hardship.

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

Recent Trends and Profile of the Credit Counseling Area

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. As we 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 for assistance in understanding the developments 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.

We also learned of the favorable treatment accorded to section 501(c)(3) consumer credit organizations under both federal and state regulatory schemes. Organizations recognized by the Service as described in section 501(c)(3) 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 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 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 IRC 501(c)(3) and are not private foundations.

Two more recent developments may encourage more credit counseling organizations to seek tax exempt status. The first is the proposal, under pending bankruptcy legislation, to require credit counseling prior to filing for bankruptcy. Although the Service takes no position on the merits of this proposal, if this becomes law, we expect applications from traditional credit counselors, as well as the new internet based agencies to increase. The second development relates to the recently activated Do Not Call List, with its exemption for charitable solicitations. Again, our purpose here is not to opine on the merits of the solicitation exemption other than to note for the Subcommittee our belief that the additional benefit of exemption under the Do Not Call rules may also motivate certain individuals and organizations to seek section 501(c)(3) status. To the extent that we are concerned about bad actors in the current market, both of these developments will require even more diligence on our part.

Response of the Service

The Service is concerned that the potent combination of exemption from income tax and exemption from consumer protection laws may encourage activity by individuals who are motivated by profit rather than charity. As a result, we are aggressively scrutinizing applicants and existing organizations to ensure that organizations seeking or having tax exempt status as credit counseling organizations warrant that status. We have designed a comprehensive multi-faceted strategy to address alleged abuses, and commissioned a team to oversee the strategic management of our compliance efforts. Members of this coordinating team include individuals from all functions within the exempt organizations office at the Service, as well as lawyers from the Office of the Chief Counsel.

Determination Letter Process: Our goal is to identify new credit counseling organizations as they seek exemption and ensure they meet all requirements before tax exempt status is approved. We have established a process where all incoming applications are initially reviewed to identify organizations that provide credit services. All case files are then assigned to staff specially trained in credit counseling, who use a uniform development inquiry letter to fully develop the facts of the case. Where those facts indicate non-compliance, cases are forwarded for additional development to higher graded specialists. These specialists use their broad investigatory experience to delve deeply into the complex structures and relationships of these organizations in order to determine whether they are charitable organizations. Once completed, either favorably or unfavorably, all applications are subject to special review. In addition to carefully scrutinizing individual applications, all credit counseling organizations will be centrally tracked to enable us to accurately determine the number and profile of these organizations, and to better manage and ensure consistent quality treatment.

At present, EO is considering over 40 applications. As we process these applications, we request additional information regarding whether debt management is the organization's primary purpose and the extent to which the organization engages in educational or counseling activities. We also are exploring whether some of these applicants who have contractual relationships with for-profit service providers operate in a manner that improperly benefits private interests.

Examination Process: The Service has increased the number of examinations targeted at tax-exempt credit counseling organizations. At present, over 30 organizations and related entities, including some of the largest firms, are at various stages of the examination process. These organizations represent a significant percentage of the combined gross receipts for the entire tax exempt credit counseling market. Moreover, the current workload is only the beginning of our compliance effort in this area. By year's end, we expect to follow-up on all

examination referrals, and implement an approach to identify and classify other high-risk organizations for examinations to commence in 2004.

As in the determination letter area, specialists have been designated to provide immediate phone or e-mail assistance to examination agents, and already have made visits to assist agents conducting examinations. These examinations focus on specific issues, including: whether the organization provides counseling; who the customers are; the nature of the fee structure; who controls the board and the contracts with the organization; and, whether there is inurement or impermissible private benefit. We expect to see significant results in the coming months, and within the constraints of section 6103, will publicize the outcome of our efforts.

IRS Training: We have taken a number of steps to train our agents and other law enforcement personnel. We published a 50-page Continuing Professional Education text that reviewed the law in the area of credit counseling and provided tools for reviewing applications from new organizations. In addition to the CPE text, in 2002, we held training classes on this issue for specialists who review exemption applications. Several months later, we produced a live interactive training exercise on credit counseling organizations. The presenters included representatives from the Service, a representative from the Federal Trade Commission, and a state charity official. The panel discussed the law with respect to section 501(c)(3) organizations, disclosure concerns, and consumer protection issues. In addition to our employees, attendees included guests from state and local governments and the FTC, who had the opportunity to watch the training and participate in a question and answer session.

Outreach Efforts: The Service has been active in educating the public and reaching out to other law enforcement agencies. We have partnered with the Federal Trade Commission, the National Association of State Charity Officials and other watchdog groups, who have well established channels for disseminating information to consumers, to send out a strong consumer protection message. That message, contained in News Release 2003-120 and Fact Sheet 2003-117, informs the public that credit counseling organizations using “questionable practices” may seek tax-exempt status to circumvent state and federal consumer protection laws. It advises consumers to guard against deceptive credit counseling practices by following the tips outlined in the documents. We have publicized these documents and our other credit counseling training materials on the IRS Web site.

In addition to working with consumer protection organizations, we contacted state enforcement officials from Maryland, California, and New York, concerning the issues their states are facing in this area. We also have met with the United States Bankruptcy Trustees Office concerning the previously discussed pending bankruptcy reform legislation. In addition to working with our counterparts in law enforcement, our outreach efforts include speaking at credit counseling trade

association conventions and at the annual meeting of the American Bar Association to inform the credit counseling industry and its attorneys of potential problems in this field and to open a dialog with industry participants.

Conclusion

Because of the changes in the way the credit counseling industry now operates, the Service anticipates the need for continued action to ensure compliance. Let me assure you that we are committed to taking any steps necessary to inform the public of the requirements for tax exempt status and to ensure that tax exempt credit counseling organizations comply with all applicable requirements. The public deserves and will receive our protection in the area of credit counseling services.