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IRS Denies 501(c)(3) Status to Bankruptcy Counseling Agency

AUTHORS

Jonathan L. Pompan

Jeffrey S. Tenenbaum

Matthew T. Journy

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On April 29, 2011, the Internal Revenue Service ("IRS") issued Private Letter Ruling ("PLR") 201117036 denying a nonprofit credit counseling agency ("CCA") tax-exempt status under Section 501(c)(3) of the Internal Revenue Code ("Code") because its primary activity would have been the provision of pre-bankruptcy certification and post-bankruptcy counseling for fees.

Although not the first piece of guidance to address the tax-exempt status of credit counseling agencies, this private letter ruling – addressing the particular facts of one organization – provides insight into the IRS's approach regarding bankruptcy counseling and debtor education providers, and could have a significant impact on a large number of credit counseling agencies. The impact may be more far-reaching than merely bankruptcy counseling and debtor education, and may result in a rethinking of counseling methodology and business relationships for debtor education – as well as sources of funding across the industry.

Legal Framework

As a result of amendments to the federal bankruptcy code under the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA"), with limited exceptions, federal law now requires that people who plan to file for personal bankruptcy protection must obtain a certificate of completing credit counseling from a government-approved organization within 180 days before they file. They also must complete a debtor education course from an approved provider to have their debts discharged. Present regulations allow services to be provided in-person, via the Internet, or by telephone.

Consistent with the BAPCPA, for the pre-filing counseling certification mandated by the law, tax-exempt status under Section 501(c)(3) is not required for approval as a budget or CCA under the BAPCPA, however, nonprofit status (typically incorporation as a nonprofit corporation) is a prerequisite, among other requirements. For the pre-discharge debtor education mandated by the BAPCPA, providers of financial management instructional courses can be either nonprofit or for-profit entities.

Code Section 501(c)(3) exempts from federal income tax corporations organized and operated exclusively for charitable, educational and other purposes, provided that no part of its net earnings inures to the benefit of any private shareholder or individual. In addition, Section 501(q) of the Code states that an organization that provides credit counseling services will not qualify for exemption under Section 501(c)(3) unless it is organized and operated in accordance with the highly specific requirements laid out in Section 501(q). These requirements include that the organization provide credit counseling services tailored to the specific needs and circumstances of consumers, and that the organization is organized and operated in accordance with a number of additional specified requirements.

Further, the IRS consistently has taken the position that a CCA that is seeking recognition under Section 501(c)(3) will be successful based on a review of all of the relevant facts and circumstances to determine if the organization's objective is to help clients gain a better understanding of their financial problems and develop the necessary skills to address those problems. The IRS looks at whether the organization provides each debtor with options tailored to fit his or her specific circumstances, rather than offering counseling as a mechanism to enroll individuals in debt management plans without considering the individual's best interest. In evaluating the organization's objective, the IRS consider factors such as how the organization markets its services, interviews and counsels clients, develops recommendations, and trains its counselors. In addition, founders, officers, directors, or for-profit companies cannot unduly benefit from the CCA's operations.

But, up until now, what has been less clear is how the IRS would treat an organization seeking tax-exempt status that was purely a provider of bankruptcy counseling and debtor education courses for

fees. This recent PLR sheds some critical light on this fact pattern.

PLR Factual Background

The organization seeking recognition of tax exemption in this PLR was organized for "charitable" purposes. According to the PLR, the organization represented that it would provide "[BAPCPA-] compliant Pre Bankruptcy counseling via telephone interview and online education/information collection sessions." A fee was to be charged for this service and a sliding scale for waivers of fees was applied to clients unable to pay. In addition, the organization was to provide debtor education courses, a portion of which could be completed online with assistance from a third-party nonprofit CCA that has developed an online program to fulfill the counseling requirements of the BAPCPA. There was to be a small fee per online session, and/or a work booklet. Upon completion, the appropriate certificate of completion would be issued. The fees were collected prior to the certificates being issued. According to the organization, counseling time ranged from 5 minutes to 2 hours depending on the subject and the client.

The PLR further explains that the organization's initial contact was expected to be through its website. On the website, clients could complete a registration, and, depending on the service chosen, the client was prompted to complete data collection forms using their personal financial information. Clients who needed assistance were provided a number of ways to contact counselors for help.

For the pre-discharge debtor education course, the organization used a third-party course online. All payment for those services was to be collected by the organization through its website or via money order through the mail. The third-party online course provider was to then be paid as a vendor.

In addition, through links on the organization's website, consumers were to be able to use an online budget calculator; for a fee, use a credit repair kit; and, access educational/self-help resources where the consumer would find free printable pamphlets, worksheets and links on budgeting, shopping, saving, foreclosure, bankruptcy, and so forth. According to the PLR, these would be the only free Internet resources. Although in-person and telephone counseling would be available for consumers who did not have access to the Internet, the organization anticipated that in-person or telephone counseling will be minimal, since its marketing would be strictly Internet-based. The organization also provided information that indicated that its counseling sessions would not look at any other options for dealing with the client's debt other than filing bankruptcy.

PLR Analysis and Conclusions

The IRS analyzed the factual situation and determined that the organization did not qualify for exemption as an organization described in Code Section 501(c)(3), and that it must file federal income tax returns (as a taxable corporation). The IRS based its conclusion on a determination that the organization (1) failed both the organizational and operational tests for recognition of tax-exempt status; (2) had not established an educational methodology; and (3) that its primary purpose was to sell certifications for the bankruptcy filing rather than to educate and counsel the general public. Thus, the IRS stated that the organization operated for non-exempt commercial purposes, and it had failed to establish that its activities further a tax-exempt purpose within the meaning of Code Section 501(c)(3).

In particular, the IRS determined:

- **Not Exclusively Charitable and/or Educational** – The organization devotes "most of [its] time and activities to selling bankruptcy certifications to the general public under the guise of financial counseling. [The organization has] not shown that you are operated exclusively to educate individuals for the purpose of improving or developing their capabilities. Rather, the fact that no educational materials will be provided unless the client registers for a counseling session is an indication of operation for a primarily business purpose."

- **Code Section 501(c)(3)** – "[The organization] does not limit your services to a particular charitable class of individuals such as minorities, low-income, or elderly, as described in" IRS regulations. Further, the IRS determined that the organization did not "operate a substantive on-going educational program. [The] operational focus is on fees generated from the issuance of pre-bankruptcy and post-bankruptcy certificates rather than providing on-going financial education for the general public." The IRS further determined that the organization "failed to substantiate that [it would] follow an educational methodology." In addition, the IRS focused on a lack of "any seminars, workshops, interactive on-line classes, or other educational forums on money management, consumer buying, budgeting, or financial management." Moreover, the IRS stated, "[t]here is a significant dearth of educational elements. Your post-bankruptcy service is not educational because

you do not actually conduct the post-bankruptcy class. You are, in fact, a middleman that connects your clients to the company that specializes in post-bankruptcy education."

- **Commerciality** – The IRS determined that the organization's "financial structure does not resemble that of a typical charity because it relies primarily on revenues earned by selling your bankruptcy certification services to the public. The income from fees is more than enough to cover [the] operation. Furthermore, [the] registration process and website set up begins with fee payment, after the collection of basic personal information, which illustrates that the fee revenue is the main source of the income and the primary concern."

- **Basic Business Purpose** – The IRS determined that the organization's "activities constitute the conduct of a trade or business that is ordinarily carried on by commercial ventures organized for profit." The IRS cited to a lack of a "feasible funding plan" from grants and fundraising support. Indeed, the IRS reported the organization only allocated $1,000 to such activities. The IRS stated, "while charitable institutions often do provide personal and tailored services to individuals, the cost is generally subsidized by contributors who do not receive anything in return. However, you are set up to rely on the fees you charge. There is not much need of any other source of income because computer based counseling will greatly reduce the cost of operation." In sum, the IRS stated, "[the organization's] primary activity is to provide bankruptcy certifications for fees in a self-promotional and profit-maximizing manner."

- **Code Section 501(c)(3) and 501(q)** – The IRS further determined that the organization had not demonstrated that "the structure and operation of your governing body conforms to requirements under Code Sections 501(c)(3) and 501(q). In addition, the IRS determined that the organization failed to provide credit counseling services tailored to the specific needs and circumstances of consumers in a manner consistent with Code Section 501(q). The IRS cited in support of this contention that "processes and activities will be accomplished by means of a sophisticated computer program. There will be minimal person-to-person counseling - that is especially true for the online method of counseling, [which did not require a live counselor]."

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The decision in the PLR is notable because the IRS arguably has called into question the tax-exemption viability of nonprofit bankruptcy counseling and debtor education providers that engage in no other meaningful educational activities, especially ones that do so utilizing computerized counseling and third-party service providers. Although bankruptcy providers are permitted by the federal government to provide counseling online, this ruling may have the impact of limiting such providers to taxable nonprofit organizations and not tax-exempt credit counseling agencies, due to their inability to attract outside financial support at levels sufficient to satisfy the IRS. It is unclear how much would be enough.

Further, this PLR appears to have even broader potential applicability in that tax-exempt organizations "set up to rely on fees charged to consumers" may not survive IRS scrutiny if they do not need any other sources of income "because of steps taken to reduce the cost of operation[s]."

All credit counseling agencies affected by this recent IRS ruling should carefully consider the impact of this determination in light of their own factual situation.

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Jonathan L. Pompan, Of Counsel in the Washington, DC office of Venable LLP, represents providers of consumer financial products and services and others in a wide variety of areas, including advertising and marketing law compliance, as well as in connection with Federal Trade Commission and state investigations and law enforcement actions.

Jeffrey S. Tenenbaum, a Partner in the Washington, DC office of Venable LLP, chairs Venable's Nonprofit Organizations Practice, as well as its Credit Counseling and Debt Services Practice Group.

Matthew T. Journy, an associate in the Washington, DC office of Venable LLP, counsels trade and professional associations, public charities, private foundations, credit counseling agencies, and other nonprofits on a variety of tax, governance, and general corporate matters.

*For more information, please contact Mr. Pompan at 202.344.4383 or **jlpompan@Venable.com**; Mr. Tenenbaum at 202.344.8138 or **jstenenbaum@Venable.com**; or Mr. Journy at 202.344.4589 or **mtjourny@Venable.com**.*