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IRS Denials of Tax-Exempt Status to Mortgage Foreclosure Assistance Providers Offer Lessons for Housing Counseling Agencies

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The Internal Revenue Service (IRS) is preparing an industry-wide review of tax-exempt organizations that are engaged in mortgage foreclosure assistance, including housing counseling agencies (the "compliance project"). In fact, the IRS has already begun scrutinizing closely any such organizations that have applied for exempt status recognition in recent months. In February 2013 alone, the IRS published three Private Letter Rulings (PLRs) denying tax-exempt status to organizations that purported to provide housing counseling and foreclosure assistance. The issues raised by the IRS in these rulings can be used by housing counseling agencies as a guide to potential areas that the IRS will focus on during its compliance project. Additionally, the legal analysis used by the IRS in these rulings provides some indication as to how it will likely view certain activities during its enforcement program.

The remainder of this article is organized as follows (click on the link below to jump ahead):

A. February 2013 Denials of Tax-Exempt Status.

B. IRS Enforcement Trends against Housing and Mortgage Foreclosure Assistance Organizations.

A. February 2013 Denials of Tax-Exempt Status.

1. PLR 201305013 (February 1, 2013)

This ruling concerns an organization that was formed by an individual (the Founder) who had been the owner of a taxable entity that provided mortgage modification services as part of its activities. When state laws were changed to require that mortgage modification services be provided by either nonprofit organizations or attorneys, the Founder created the organization and transferred the mortgage modification activities from his taxable business to the new organization.

The nonprofit organization's activities were limited to the provision of loan modification services, which included the development of a spending plan, an analysis of homeowners' financial positions and options, the preparation of loan mitigation applications, communication with mortgage servicers, and, when necessary, referrals to other resources. However, the organization did not provide or plan to provide any workshops, classes, or seminars to the general public. The organization's activities were conducted by a staff attorney and other employees who were formerly employed in a similar capacity by the Founder's taxable business.

The board of directors consisted of three individuals, one of whom was the Founder, though there was no indication that the Founder received any direct or indirect compensation from the organization. Additionally, the organization was provided free use of office space owned by the Founder's taxable business.

Based on these facts, the IRS denied the organization's application for tax-exempt status. Included as the grounds for the IRS decision were: (1) the organization was not engaged in educational activities; (2) the organization's activities conferred a substantial private benefit on the Founder; and (3) the composition of the organization's board of directors violated the requirements of § 501(q)(1)(D)(ii) of the Internal Revenue Code of 1986 (the Code).

Without an explanation, the IRS determined that Code § 501(q)—a section reserved for organizations engaging in a substantial amount of credit counseling activities—was applicable to the organization

even though the organization did not provide any credit counseling services aside from its loan mitigation services. In its application of Code § 501(q), the IRS determined that the organization failed the board composition requirement of Code § 501(q)(1)(D)(ii), which limits to no more than 20% the total voting power "vested in persons who are employed by the organization or who will benefit financially, directly or indirectly, from the organization's activities."

While more than 20% of the voting power was vested in the Founder, the facts in the ruling did not indicate that the Founder or any other board member received any financial benefit from the organization. In fact, the only benefits discussed in the ruling were those flowing from the Founder's taxable business to the nonprofit organization.

The IRS's treatment of the issues discussed above should alert organizations that will potentially be examined under the upcoming compliance project because the IRS treatment of these issues was extremely aggressive and, with respect to some issues, without any apparent factual foundation.

2. PLR 201307014 (February 15, 2013)

This ruling considered a foreclosure assistance organization that purchased homes at risk of foreclosure through short-sale negotiations with the mortgage holders and then sold the homes back to the homeowner at a price that was the lower of the payoff amount of the mortgage or the appraised value of the home. When selling the home back to the individual, the organization indicated that it would ascertain that the homeowner's installment payments would be less than the prior mortgage payments to ease the financial burden on the individual. If the homeowner was unable or unwilling to repurchase the house, the organization would sell the house on the open market.

The organization limited its services to individuals who met each of the following requirements: (1) homeowners who had exhausted certain other potential remedies; (2) homeowners in financial distress; (3) homeowners who did not own any other real estate; (4) situations where the home was the owner's primary residence; (5) homeowners who were able to pay all of their non-mortgage bills; and (6) homeowners whose total household income did not exceed 10% of the median family income in the organization's community.

The organization's board of directors consisted of five individuals, four of whom received financial benefits through business transactions with the organization. There was no indication in the ruling that the amounts that such individuals received from the transactions were excessive.

Based on these facts, the IRS denied the organization's application for tax-exempt status. The IRS position in PLR 201307014 was, in part, due to the IRS determination that: (1) the organization did not serve a charitable class; (2) the organization was operated in the same manner as a taxable real estate company; and (3) the organization's activities conferred a substantial private benefit and inurement on the board members.

- *Charitable Class*

In this ruling, the IRS took two seemingly contradictory positions. First, the IRS stated that the organization should not be recognized as exempt because it did "not limit [the] Program to the poor, distressed or underprivileged." However, the Program also was criticized for not being "equally accessible to the public because of your selection criteria and process." As such, the organization was criticized both for being selective in limiting its program to individuals in financial distress and for failing to limit its services to those experiencing financial distress.

- *Operated as a Taxable Entity*

The IRS also determined that the organization's operations were indistinguishable from those of commercial entities conducting a real estate business. Because the organization was primarily engaged in the activity of buying and selling houses to the public, based on the commerciality doctrine, the IRS concluded that the organization was engaged in a substantial non-exempt purpose.

- *Private Benefit/Private Inurement*

Noting that four of the organization's five board members engaged or planned to engage in business transactions with the organization, the IRS determined that the organization's "activities result in private benefit and inurement to the members of [the organization's] board."

The facts discussed in PLR 201307014 appear to support the underlying IRS determination, especially with respect to the private benefit issue. Based on the IRS focus on board composition issues, as organizations prepare for the upcoming IRS compliance program, they should pay close attention to the

composition of their own governing bodies.

3. PLR 201307015 (February 15, 2013)

In this ruling, the IRS considered the activities of a religious organization formed for the purpose of providing non-usury loans and foreclosure assistance counseling. The organization's counseling program was not approved by the U.S. Department of Housing and Urban Development (HUD), and the organization informed the IRS that it did not intend to seek HUD approval of its counseling program.

In carrying out its counseling services, the organization provided two one-hour housing counseling sessions. Additionally, through its counseling program, the organization indicated that it would negotiate with lenders to buy out high-interest loans and replace them with principal-only loans. At the time of the ruling, the organization's non-usury loan program was fairly undeveloped—no formal application process was established, and the organization had thus far made only two loans. The loans were provided to a condominium association for the purpose of hiring the construction firm owned by the organization's incorporator (the Incorporator) for a construction project.

The organization's board comprised three individuals: the Incorporator, a real estate investor, and a minister/business owner. The Incorporator was employed by and received compensation from the organization. Additionally, as noted above, the only loans provided by the organization were made for the purpose of being paid to the Incorporator's construction firm.

Based on these facts, the IRS denied the organization's application for tax-exempt status. The IRS determination in PLR 201307015 was, in part, based on the IRS position that: (1) the organization's activities did not benefit a charitable class; (2) the organization's activities conferred a substantial private benefit on the Incorporator; (3) the organization's assets inured to the benefit of the Incorporator; and (4) the composition of the organization's board and its loan negotiation activities violated the requirements of Code § 501(q).

- *Charitable Class*

Noting that neither the counseling program nor the loan program was limited to any particular groups of individuals, the IRS determined that the programs did not further a charitable purpose because they were not limited to a charitable class of individuals.

- *Private Benefit*

The IRS determined that the use of the organization's loan program to make loans to a condominium association for the purpose of hiring the Incorporator's construction firm conferred a substantial private benefit on the Incorporator.

- *Private Inurement*

As with its private benefit decision, the IRS determined that the organization's loan program "indicates the inurement of your organization's funds to" the Incorporator. However, the Service's determination regarding the existence of private inurement was not based on a determination that the compensation received by the Incorporator or the construction company was excessive; rather, the IRS based its determination on the mere existence of such payments.

Citing the U.S. District Court's decision in *Church by Mail, Inc. v. Commissioner*, 756 F.2d 1387 (1985), the IRS stated that "the critical inquiry is not whether particular contractual payments to a related for-profit organization are reasonable or excessive, but instead whether the entire enterprise is carried on in such a manner that the for-profit organization benefits substantially from the [organization]." However, the IRS misapplied the court's ruling in *Church by Mail*. While the court in *Church by Mail* did use the language cited by the IRS when determining the existence of a private benefit, the court went on to find the existence of private inurement based on additional facts demonstrating that the salaries and benefits received by insiders were excessive.

- *Code § 501(q)*

Based on the organization's foreclosure assistance counseling program, the IRS determined that the organization was required to meet the requirements of Code § 501(q), including the prohibition on the negotiation of loans and the board composition requirements. As such, the IRS determined that the organization's loan negotiation activities violated the prohibition on loan negotiation provided in Code § 501(d)(1)(A)(ii). Additionally, because one of the three members of the organization's board members received direct and indirect financial benefits, the IRS determined that the organization failed to satisfy the board composition requirements of Code § 501(q)(1)(D)(ii).

The facts discussed in PLR 201307015 appear to support the underlying adverse determination regarding the organization's tax-exempt status. However, the IRS treatment of the issues discussed above should alarm organizations that will potentially be examined under the upcoming compliance project, because the IRS treatment of these issues was extremely aggressive and, with respect to the private inurement issue, without any legal foundation. Additionally, the IRS used a very broad interpretation of Code § 501(q) to determine that its requirements were applicable to foreclosure counseling organizations.

B. IRS Enforcement Trends against Housing and Mortgage Foreclosure Assistance Organizations.

Regardless of the factual similarities that any organization has with the subjects of the recent IRS rulings, it is important that housing counseling organizations recognize the significance of these rulings and take any necessary precautions to help avoid similar results upon an IRS examination.

There are five lessons that organizations in the housing counseling and foreclosure prevention arena should take from the recently published IRS rulings.

1. The IRS is aggressively pursuing all potential areas of non-compliance.

Based on these rulings, this is probably the most important lesson that can be taken from the recently published rulings. Bad facts make bad law. Based on the facts discussed in these rulings, it appears as though the ultimate determination that the IRS reached in each ruling was correct. However, with respect to certain portions of its analysis, in reaching the correct conclusions, the IRS clearly overreached. What should be disconcerting about the IRS's aggressive position in these rulings is that it was not necessary.

- In PLR 201305013, the IRS did not need to stretch the traditional and legally supported interpretation of private benefit to reach its conclusion; tax-exempt status could have been denied solely on the basis of the organization's violation of Code § 501(q).
- Similarly, in PLR 201307015, the IRS did not need to argue that the organization's tax-exempt status should be denied on the basis of private inurement; there were sufficient other grounds to support the denial of exempt status. However, the IRS was overly aggressive in its development of other potential issues, including inurement.

Based on these published rulings, the upcoming project may very well be more focused on enforcement than it is on compliance.

2. The IRS is interpreting Code § 501(q) broadly.

As housing counseling and foreclosure prevention organizations have begun preparing for the IRS compliance project, there have been many questions regarding the application of Code § 501(q) to housing counseling organizations. The published rulings, especially PLR 201305013, indicate that the IRS intends to apply Code § 501(q) to all housing counseling and foreclosure assistance organizations that provide even minimal "counseling" or "educational" programing. As demonstrated in PLR 201307015, even the provision of two-hour-long counseling sessions was substantial enough for the IRS to apply the requirements of Code § 501(q).

What is especially disconcerting is that, while many organizations have been looking to the language of Code § 501(q)(1) and attempting to quantify whether their credit counseling activities represent a "substantial" purpose, the IRS seemed unconcerned with such an analysis.

Unless and until a court or Congress decides differently, housing counseling organizations should stop asking themselves whether they are potentially subject to Code § 501(q) and consider working under the assumption that the IRS will subject them to the requirements of Code § 501(q) regardless of whether they are engaged in the provision of credit counseling services in a "substantial" manner.

3. The IRS is skeptical of all transactions with for-profit entities controlled by organization managers.

Relationships between tax-exempt organizations and taxable entities controlled by organization managers was a prevalent issue in the recently completed IRS credit counseling compliance project, and, based on these recent rulings, it appears as though it will be an issue in the upcoming compliance project as well.

The recently published rulings demonstrated both the substantial focus on transactions with officers and directors and the aggressive pursuit of such issues by the IRS. This should be seen as a stern warning to any tax-exempt organization that enters into any transaction with entities controlled by an officers or directors.

4. The IRS does not view foreclosure assistance counseling as "educational."

The IRS decision in PLR 201305013 clearly demonstrates the IRS skepticism regarding housing counseling activities. Similarly, in PLR 201307015, the IRS seemed to give little, if any, consideration to the educational value of the organization's counseling program. As such, housing counseling organizations need to be aware of the IRS skepticism and address it by comporting their counseling program to standards that the IRS has already deemed to be educational, such as the Core Analysis Tool which the IRS developed for the use by IRS agents during examinations of credit counseling organizations.

While the IRS did not indicate the weight given to such approval, based on our experience in representing organizations in the credit counseling compliance project, it was clear that the IRS also valued programs that had been reviewed and approved by other state and federal agencies.

5. The IRS is focused on board composition.

Two of the three published rulings denied exempt status, in part, on the basis of an organization's failure to satisfy the board composition requirements of Code § 501(q)(D)(ii). All tax-exempt housing counseling and foreclosure prevention organizations need to look at the composition of their boards of directors and determine whether they satisfy this requirement for recognition of tax-exempt status. If an organization does not pass the board composition requirements of Code § 501(q)(1)(D), the organization must take immediate steps to resolve this issue or face potential revocation of tax-exempt status.

* * * * * *

The IRS determinations in the published rulings demonstrate that housing counseling organizations face an uphill battle for continued recognition of their tax-exempt status. Organizations that undertake the time and effort to learn from the IRS's prior determinations, undergo specific reviews of their operations, and adjust their operations accordingly will be far better positioned to successfully endure the IRS compliance project and to continue to be recognized as exempt well into the future.

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