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## Credit Counseling Update: The "Perfect Storm" Brewing

Written by:

Leslie E. Linfield

Institute for Financial Literacy

Portland, Maine

linfield@financiallit.org

In October 1991, the fishing boat *Andrea Gail* and her six-man crew were headed to the fertile fishing grounds of the North Atlantic seeking the "big catch." Focused on the catch and the cash, the crew was unaware that three different storms were converging into one. The ship and crew were lost in what came to be known as the "Perfect Storm." Was the crew lost because they were unaware of their environment and distracted by profits? Or were circumstances simply beyond their control?



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The same questions may soon be asked about the nonprofit credit counseling industry, as it finds itself in similarly dangerous circumstances. There are at least three regulatory and legislative fronts converging on this industry: comprehensive Internal Revenue Service (IRS) audits, the Joint Committee on Taxation (JCT) proposals and the Uniform Consumer Debt Counseling Act are being proposed by the National Conference of Commissioners on Uniform State Laws (NCCUSL). A fourth front concerns the credit counseling mandate in the new bankruptcy law.

### Hurricane IRIS

Last June, Mark Everson, Commissioner of Internal Revenue, testified before the Senate Finance Committee on the consumer credit counseling industry:

We are focusing our audit resources on those organizations with the highest risk of noncompliance with

tax law. We have selected 50 tax-exempt credit counseling organizations for examination...and will be pursuing the use of proposed revocations of exemption of credit counseling organizations in appropriate circumstances. We also plan to seek injunctions and penalties against both individuals and companies for promoting fraudulent tax schemes.<sup>1</sup>

The credit counseling industry was granted tax-exempt status under §501(c)(3) of the Code because it was deemed to be operating exclusively for charitable and educational purposes. A court case examining the issue in 1978<sup>2</sup> found in favor of the credit counseling industry, based on facts showing that only 12 percent of credit counselors' time was spent on debt management plans (DMPs).

The traditional counseling and educational programs of the credit counseling agencies (CCAs) have kept these organizations from having to write checks to Uncle Sam. However, during the late 1990s and early 2000s, the industry grew rapidly and DMPs increasingly became the focus of CCAs. This gave rise to questions by the IRS and other regulatory bodies as to whether or not these organizations still fell within the scope of their original exempt purpose.<sup>3</sup>

Jeffrey Tenenbaum (Venable LLP; Washington, D.C.) represents more than 50 credit counseling organizations and estimates that upward of 75 CCAs are under IRS review at this time. Tenenbaum explained that the audit process is long and laborious, and begins with notification of a form 990 review. The 990 is an information

tax return filed with the IRS by nonprofit agencies, and they're available for public review through organizations such as GuideStar.<sup>4</sup>

According to Tenenbaum, if the IRS has reason to believe an organization is operating outside its original tax-exempt purpose at the conclusion of the audit, the next step is to issue a 30-day letter of intention to revoke tax-exempt status. Once a nonprofit receives a 30-day letter of intention to revoke, it has two options. The first option is to do nothing, and in 30 days the CCA will no longer be exempt from paying federal income taxes. The second option, and the one Tenenbaum expects most CCAs will pursue, is to request an administrative appeal from the IRS Appeals Office. This office is independent from the audit function of the IRS and reviews the information and findings of the audit. Unlike the audits, which can take 12-18 months, the appeals process can be completed in as little as 60 days.

Should the Appeals Office find in favor of the nonprofit, the agency's §501(c)(3) status stands. However, if they find in favor of the IRS, the nonprofit's tax exempt status is immediately revoked. The organization has additional rights of appeal and the choice of three different courts (U.S. District Court, U.S. Tax Court or U.S. Court of Claims), but it also has far greater difficulties at that moment.

Once revocation occurs, the IRS can immediately calculate taxes owed, as well as penalties and interest. It is possible that even an organization with financial substance may find itself insolvent and in bankruptcy court due to a sudden tax liability.

The chapter 11 filing of AmeriDebt Inc.<sup>5</sup> in June 2004 may be the first of many such filings. In this case, the once-large CCA is facing revocation as well as pending claims by the Federal Trade Commission and numerous state attorneys general. According to chapter 11 trustee **Mark D. Taylor** (Arent Fox PLLC; Washington, D.C.), the IRS has filed a \$15 million proof of claim in anticipation of revocation. The proceeds of

<sup>1</sup> Hearing on Charitable Giving Problems and Best Practices Before the Committee on Finance U.S. Senate, 108th Cong., 2nd Sess. (2004) (statement of Mark W. Everson, Commissioner Internal Revenue).

<sup>2</sup> *Consumer Credit Counseling Service of Alabama Inc. v. United States*, 44 A.F.T.R. 2d (RIA) 5122 (D.C. 1978). The case involved 24 agencies throughout the United States. See, also, *Credit Counseling Center of Oklahoma Inc. v. United States*, 45 A.F.T.R. 2d (RIA) 1401 (D.C. 1979) (holding the same on similar facts).

<sup>3</sup> See, e.g., *Testimony of Commissioner Mark Everson before the House Ways and Means Committee, Subcommittee on Oversight* (Nov. 20, 2003) ("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.... The individual budget-assistance and public education programs that formed the original basis for exemption under §501(c)(3) have changed").

<sup>4</sup> [www.guidestar.org](http://www.guidestar.org). The GuideStar database features millions of records on public charities and private foundations, and is funded by voluntary donations.

<sup>5</sup> *In re AmeriDebt Inc.*, Case no. 04-23649-PM (Bankr. D. Md.)

the recent sale of AmeriDebt's DMP portfolio to Money Management International<sup>6</sup> (MMI), which is expected to net in excess of \$5 million, may end up paying that tax bill.

It is interesting to note that the entire audit process, up until revocation, is private. This creates an unusual tension between privacy rights and protecting the public from the malfeasance that prompted these audits to begin with. However, one must remember that the perspective of the IRS is one of tax collection, not consumer protection. Even so, IRS enforcement will undoubtedly go a long way toward protecting those consumers.

### Storm Forming inside the Beltway

On Feb. 26, 2004, the U.S. Senate Committee on Finance, chaired by Sen. Charles Grassley (R-Iowa), sent a letter to the Joint Committee on Taxation (JCT) requesting that the JCT report to Congress on ways to "curtail tax shelters, close unintended loopholes and address other areas of noncompliance in present law."<sup>7</sup> As was noted earlier, the Senate Committee on Finance held a hearing on charitable giving in June 2004. As a result of this hearing and the subsequent report issued by the JCT, certain proposals have been brought forth that will directly impact nonprofit CCAs.

The full report, entitled "Options to Improve Tax Compliance and Reform Tax Expenditures," by no means targets only the credit counseling industry. Only 12 pages of the 435-page report deal directly with CCAs. However, these 12 pages may change the industry forever.

The report gives the reader a clear understanding of how the CCAs were granted tax-exempt status. It includes the original rationale and a full recap of the conflicting revenue Rulings from 1965 and 1969,<sup>8</sup> which led to the *Consumer Credit Counseling of Alabama Inc.*<sup>9</sup> case. The report finds:

An entire industry of credit counseling...has emerged over the past 30 years, with much of this activity conducted by nonprofit organizations that initially received favorable exempt status determinations from the IRS. During this period, judicial decisions relaxed exemption standards for credit counseling organizations claiming exempt status, ultimately resulting in many organizations conducting substantial

activities that are not directly related to the charitable and educational purposes that initially formed the rationale for providing exemption from federal income tax.<sup>10</sup>

The JCT report goes on to explain that "although the IRS...believes that it can make strong legal challenges to the exempt status of many of such organizations..., legislation to establish exemption standards tailored to the peculiar aspects of the industry would provide greater certainty that further erosion of exemption standards does not occur..."<sup>11</sup>

It has been estimated that there were in excess of 1,000 CCAs as recently as 2002.<sup>12</sup> Brian Reinhart Sr., a vice president with Bank of America, estimates that mergers, closures and general retraction in the industry have reduced the number to somewhere near 400. Could Congress recognize that even with the decline, the IRS can only devote limited resources to one specific area in the tax-exempt sector?

Under the JCT proposals, specific requirements would have to be met in order for a nonprofit CCA to receive exemption under either §501(c)(3) or (c)(4) of the Code. The primary activity will have to focus on providing "educational information to the general public on budgeting, personal finance, financial literacy, saving and spending practices, and the sound use of consumer credit."<sup>13</sup> Furthermore, the CCA must not refuse services "due to inability to pay or to qualify for debt-management plan enrollment..."<sup>14</sup>

The proposals then go on to create further distinctions on which CCAs may be exempt under §501(c)(3):

1. They charge no fees (other than nominal fees) for services to low-income individuals and families for counseling or education, but waive any fees if payment would create a hardship;
2. They do not solicit voluntary contributions while client receives services;
3. They provide DMP services in connection with providing education and counseling; and
4. The aggregate of the agency's DMP services does not exceed 10 percent of the agency's total activities.

Should a CCA not meet this test, it may then be exempt under §501(c)(4) as a social welfare organization. These requirements include that:

1. It charges no fees (other than nominal fees) for services provided, but waives any fees if payment would create a hardship; and

2. DMP activities cannot be the primary activity.

The primary difference between a §501(c)(3) and (c)(4) for purposes of the CCA discussion is how contributions to the organizations are treated by the IRS. Contributions to organizations exempt under IRC §501(c)(4) are generally not deductible by donors.<sup>15</sup>

Why is this distinction important? Creditors have traditionally funded CCAs with payments known as "fair share," which is a percentage of the debt repaid to the creditor retained by the agency as a contribution.

Two major creditors, Citicorp and Bank of America, have both implemented policies moving away from paying fair share and toward grant-based giving programs requiring CCAs to apply for funding. At Bank of America, Reinhart explained that they were having difficulty determining which CCAs were "doing the right thing for the consumer." Bank of America decided to implement a hybrid policy with a smaller percentage of fair share paid across the board. Agencies demonstrating a higher commitment to education and counseling will receive additional support in the form of grants. Agencies exempt under §501(c)(4) may not qualify for this additional grant funding, depending on creditor policy.

Another area of concern for CCAs could be Housing and Urban Development (HUD) funding. Many CCAs have been receiving HUD grants for years to pay for the cost of providing housing counseling, homeownership education classes and foreclosure assistance. Last year, MMI alone received \$588,000, and a combined \$1.8 million was granted to smaller individual CCAs throughout the country. HUD regulations require agencies receiving grants to be exempt under §501(c)(3).

Finally, there are numerous private grant-making foundations and organizations that have begun to recognize the importance of financial literacy education. Organizations such as the American Express Economic Independence Fund require that an applicant be a §501(c)(3) tax-exempt entity in order to apply for funding.

By the simple act of shifting CCAs from exemption under §501(c)(3) to §501(c)(4), the JCT proposal could radically alter the landscape of the credit counseling industry. Agencies will be forced to choose between maintaining their emphasis on DMPs and maintaining their §501(c)(3) status. The Senate Finance Committee hopes to bring forth legislation as early as this spring.

<sup>6</sup> With the purchase of the 60,000 AmeriDebt DMP portfolio, MMI now becomes the largest CCA in the U.S. with a DMP portfolio estimated in excess of 150,000 clients.

<sup>7</sup> *Options to Improve Tax Compliance and Reform Tax Expenditures*, 2005 JCS-02-05.

<sup>8</sup> Rev. Rul. 65-229, 1965-2 C.B. 165, and Rev. Rul. 69-441, 1969-2 C.B. 115.

<sup>9</sup> See cases cited *supra* note 3.

<sup>10</sup> See *supra* note 7 at p. 330.

<sup>11</sup> *Id.*

<sup>12</sup> Opening statements of Hon. Max Sandlin, Hearing on Nonprofit Credit Counseling Organizations, House Ways and Means Committee, Subcommittee on Oversight (Nov. 20, 2003).

<sup>13</sup> See *supra* note 7 at p. 331.

<sup>14</sup> *Id.*

<sup>15</sup> Rev. Rul. 74-361, 1974-2 C.B. 159.

## Great Lakes Storm System Moving East

The National Conference of Commissioners on Uniform State Laws (NCCUSL), based in Chicago, will hold its annual meeting in July. One of the items that will come before them is a final draft of the Uniform Consumer Debt Counseling Act.<sup>16</sup>

A project that began in 2002, this comprehensive measure will address many of the concerns about CCAs and related industries, such as debt settlement and debt consolidation. The most recent drafts have included language requiring fee caps and mandatory education. Tentatively, the Act may be renamed the Uniform Debt Management Services Act to reflect the comprehensive scope of its coverage beyond nonprofit CCAs.

David Jones, president of the Association of Independent Consumer Credit Counseling Agencies (AICCCA), is concerned that the Act has moved in such a direction. "We are concerned it gives states the right to allow for-profit credit counseling; we think that this is bad and conflicts with what is in the best interest of consumers." Should the full NCCUSL Conference adopt the Act, individual state legislatures could begin to consider adopting it as soon January 2006.

## New Mandate from Capitol Hill

As this article is being written, the Senate has passed S. 256—the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. Within this reform measure lives a mandatory pre-filing credit counseling requirement for all consumer debtors who seek protection in bankruptcy. Only those nonprofit credit counseling agencies approved by the U.S. Trustee or bankruptcy administrator are eligible to provide these services. Who can predict the impact the above regulatory and legislative measures will have on the credit counseling industry? Can the CCAs survive this "Perfect Storm" and land the "big catch" that the mandatory counseling may bring? Are we witnessing the end of the DMP business? Will these legislative reforms move CCAs back to their origins of education and counseling? Only time will tell. ■

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<sup>16</sup> Uniform Consumer Debt Counseling Act (Tentative Draft January 2005).