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October 26, 2009

Donald S. Clark, Secretary
Federal Trade Commission
Office of the Secretary
Room H-135 (Annex T)
600 Pennsylvania Avenue, NW
Washington, DC 20850

Comment re Telemarketing Sales Rule – Debt Relief Amendments, R411001

Dear Secretary Clark:

I have been engaged by American Association of Debt Management Organizations ("AADMO") to submit this comment on the proposed Telemarketing Sales Rule amendments. I do not, however, represent AADMO. I appreciate the opportunity to comment on the notice of proposed rulemaking relating to the Telemarketing Sales Rule – Debt Relief Amendments, R411001.

Issue Considered and Our Opinion

In connection with the potential impact of the proposed amendments,[1] AADMO has requested that I address the following issue: whether a credit counseling organization that is exempt from federal income tax under Section 501(c)(3) of the Internal Revenue Code of 1986, as amended (the "Code") would jeopardize its tax-exempt status by expanding its activities to include the provision of substantial debt settlement services. For the reasons set forth below, it is my opinion that the provision of such services would place such an organization outside the tax exemption provided by Section 501(c)(3) of the Code.

[1] The proposed amendments to the Telemarketing Sales Rule may effectively put out of business many of the existing, for-profit providers of debt settlement services. If this were to occur, one serious concern is whether tax-exempt credit counseling organizations, which are not subject to the Telemarketing Sales Rule, could then meet the extensive public demand for debt settlement services. If, as this comment explains, providing substantial debt settlement services would cause such organizations to no longer meet the legal standard for tax-exemption, it is highly unlikely that they would expand their activities to include debt settlement services.

Legal Background of the Issue

Section 501(c)(3) of the Code exempts from federal income tax corporations organized and operated exclusively for charitable, educational, and certain other enumerated purposes, provided that no part of the net earnings inure to the benefit of any private shareholder or individual.

Treasury Regulation § 1.501(c)(3)-1(a)(1) 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.

Treasury Regulation § 1.501(c)(3)-1(c)(1) states 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.

Certain credit counseling organizations have been recognized as exempt under Section 501(c)(3) for many years.[2] The exempt purpose upon which credit counseling organizations have been granted exemption under Section 501(c)(3) is their educational objective. In the leading ruling by the Internal Revenue Service, the organization "was formed to reduce the incidence of personal bankruptcy by informing the public on personal money management by assisting low-income individuals and families who have financial problems." Rev. Rul. 69-441, 1969-2 C.B.115. The ruling stated that this organization

> provides information to the public on budgeting, buying practices, and the sound use of consumer credit through the use of films, speakers, and publications. It aids low-income individuals and families who have financial problems by providing them with individual counseling and, if necessary, by establishing budget plans. Under a budget plan, the debtor voluntarily makes fixed

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[2] The Internal Revenue Service has recognized the exemption of certain credit counseling organizations pursuant to Section 501(c)(4) of the Code. Rev. Rul. 65-299, 1965-2 C.B. 165. Relatively few credit counseling organizations are exempt pursuant to Section 501(c)(4), perhaps because certain non-tax legal distinctions turn on whether an organization is exempt specifically under Section 501(c)(3) (for example, the Credit Repair Organizations Act, 15 U.S.C. §1679A(3)(B)(i)). Consequently, this comment will address exemption under Section 501(c)(3). The principles discussed herein are generally applicable to Section 501(c)(4) organizations as well.

> payments to the organization. The funds are kept in a trust account and disbursed on a partial-payment basis to the creditors, whose approval of the establishment of the plan is obtained by the organization. These services are provided without charge to the debtor.

After granting exemption under Section 501(c)(3) to a group of credit counseling agencies, the Internal Revenue Service determined that this exemption had been issued inadvertently and sought to reclassify the organizations in question as exempt under Section 501(c)(4). These credit counseling agencies sought and received a declaratory judgment from the United States District Court for the District of Columbia determining that they qualified for exemption under Section 501(c)(3). *Consumer Credit Counseling Service of Alabama, Inc., et al. v. United States,* 44 A.F.T.R. 2d 5122 (D.D.C. 1978). These organizations functioned in a manner similar to the organization described in Rev. Rul. 69-441. The court found that the agencies had two basic types of programs, which together constituted their principal activities: providing "information to the general public, through the use of speakers, films, and publications, on the subject of budgeting, buying practices, and the sound use of consumer credit and ... counseling on budgeting and the appropriate use of consumer credit to debt-distressed individuals and families." The court also found:

> As an adjunct to the counseling function described [above], an agency may provide advice as to debt proration and payment, whereby a program of a monthly distribution of money to creditors is developed and implemented. In some of these instances, an agency may be required to intercede with creditors to cause them to agree to accept such monthly payment schedule.

The organizations at issue generally charged a nominal fee in connection with such debt management programs, which fee was waived in instances where its payment would work a financial hardship. Approximately 12% of the time of the professional counselors was spent in connection with debt management programs.

The court concluded that the community education and counseling assistance programs were the agencies' primary activities. Their debt management and creditor intercession activities were "an integral part of the agencies' counseling function, and thus are charitable and educational undertakings. Even if this were not the case, the agencies' proper designation as IRC § 501(c)(3) would not be disturbed, as these activities are incidental to the agencies' principal functions."

In the years since this case, the number of organizations providing counseling and other services to debtors has grown very substantially. Beginning in 2002, the Internal Revenue Service intensified its scrutiny of claims for exempt status by such organizations. The

exemptions of many existing organizations were revoked, and the Internal Revenue Service became much less likely to recognize exemption in connection with applications by newly formed entities seeking exempt status.[3] In many instances, the basis for denial of exempt status was an organization's excessive emphasis on debt management plans. Because the rationale for exemption of credit counseling agencies is a primary educational purpose, instances in which educational activities were overshadowed by debt management plans understandably resulted in denial of exemption.

In most instances, the applicants for exempt status were providing primarily debt management plans, rather than debt settlement services.[4] In recent years, many for-profit business entities have been formed to provide debt settlement services to the public. These for-profit entities have, of course, not sought tax-exempt status.

In 2006, Congress enacted Section 501(q) of the Code, which places additional limitations on credit counseling organizations that seek exemption under Section 501(c)(3). Section 501(q) arose from and, as its legislative history explains, builds on the positions that the Internal Revenue Service developed and laid out in two chief counsel memoranda.[5]

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[3] See Written Testimony of Mark Everson, Commissioner of Internal Revenue, Before the House Ways & Means Committee, Subcommittee on Oversight, Concerning Section 501(c)(3) Credit Counseling Organizations, November 20, 2003, and Credit Counseling Compliance Project, Summary of Results, May 15, 2006 (41 final and proposed revocations or terminations, affecting organizations with 41% of credit counseling industry revenues; only three applications for exemption approved out of 110 submitted); Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 109th Congress (Blue Book), addressing Section 1220 of the Pension Protection Act of 2006.

[4] As explained in the Notice of Proposed Rulemaking, debt management plans are designed to result in repayment of the full amount of the principal owed by debtors, with the period of time for such payment extended, and, in some cases, concessions by creditors with respect to the interest rate and fees that would otherwise be applicable. By contrast, debt settlement services involve the accumulation of an amount of money on behalf of the debtor with the objective of negotiating a lump sum settlement of the debtor's obligations for an amount less than the full principal balance owed.

[5] Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 109th Congress (Blue Book), addressing Section 1220 of the Pension Protection Act of 2006.

Consequence of Providing Substantial Debt Settlement Services.

The issue addressed by this comment assumes that the organizations in question are credit counseling organizations that are properly exempt under Section 501(c)(3). Implicit in this assumption is that such organizations satisfy the organizational test and that their activities, governance structure, and sources of financial support meet the requirements contained in Section 501(q). The precise question, therefore, is whether such an organization may expand its activities to include providing a substantial amount of debt settlement services and continue to satisfy the operational test for tax exemption.

The Supreme Court has held that "the presence of a single non-educational purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly educational purposes." *Better Business Bureau v. United States*, 326 U.S. 279 (1945).

Providing debt settlement services is not inherently charitable or educational. As the Internal Revenue Service noted in denying an application for exemption, "No court or Internal Revenue Service ruling has indicated that the sale of debt management plans and debt settlement services is a charitable activity." Private Letter Ruling 200450039. Consequently, providing debt settlement services would cause an organization to fail the operational test unless such activity is either (i) incidental to the organization's principal and exempt purpose or (ii) integral to the accomplish of such purpose. See *Consumer Credit Counseling Service of Alabama*.

For an activity to be incidental, it must be of very small scale, at least relative to the activities of the organizational as a whole. Consequently, it is possible that a tax-exempt credit counseling organization could expand its activities to include a minimal amount of debt settlement services, which might be considered incidental to the organization's principal activities. The question that AADMO has asked me to address, however, involves the provision of a substantial amount of debt settlement services by a credit counseling organization.[6] By definition, such substantial services would not be incidental.

The key question, therefore, is whether providing debt settlement services would be considered integral to an exempt credit counseling organization's exempt, educational purpose. The Tax Court addressed a similar issue in *Pulpit Resource v. Commissioner*, 70 T.C. 594 (1978). The stated purpose of the organization at issue was "To advance religious preaching through publication of sermons and other resources for ministers, priests, and rabbis, and to

[6] Because of the great demand for debt settlement services and the resulting magnitude of this industry, if tax-exempt credit counseling organizations provided only minimal amounts of debt settlement services, these organizations as a group would meet only a small portion of the aggregate demand. For this reason, the relevant inquiry concerns the provision of substantial debt settlement services by such organizations.

apply proceeds to purchase of preaching materials for libraries of selected schools of theology." The organization published and sold by subscription a quarterly journal called Pulpit Resource that contained sermons, sermon outlines and articles on preaching techniques. The Internal Revenue Service denied the organization's application for exemption, reasoning that it operated essentially as a commercial publishing venture that specialized in religious content.

The Tax Court disagreed. After reviewing the case law and the setting out the tension between Pulpit Resource's exempt purpose and the "commercial or business hue" of its activity, the court explained:

> [W]e must determine whether the nonexempt commercial aspect of the activity was either so independent of the religious purpose or was sufficiently substantial that it cannot be said that petitioner was "operated exclusively" for religious purposes. . . . If the sale of religious literature was an integral part of and incidental to petitioner's avowed religious purpose, that activity may be considered a part of the religious purpose or objective. *Elisian Guild, Inc. v. United States, supra.* We find that it was.
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> *Apparently the only way petitioner could accomplish its objective of disseminating sermons to ministers to improve their religious preachings was by selling Pulpit Resource at a price sufficient to pay for its cost and provide Harris with a reasonable salary.* It apparently received few, if any, contributions and a contest for best sermons met with little financial success. There is no evidence that petitioner was in competition with any commercial enterprise conducting the same business activity. The market for petitioner's product was so limited in scope that it would not attract a truly commercial enterprise.

(emphasis added). The test of whether a non-charitable activity is an integral part of an exempt purpose is thus a test of necessity: could the exempt objective be accomplished only by the activity in question.

The Tax Court revisited this issue and confirmed its analysis in *Living Faith, Inc. v. Commissioner*, T.C. Memo. 1990-484. The organization seeking exemption operated a vegetarian restaurant and health food store. Its exempt purpose was to advance the teachings of the Seventh-day Adventist Church concerning the significance of diet (specifically, a vegetarian diet and abstention from tobacco, alcohol, and caffeine) in promoting good health and the importance of good health in promoting virtuous conduct. The court sought to determine whether the nonexempt commercial aspect of the organization's activity (the sale of health

foods) was "so independent of the religious purpose, i.e., furthering the dietary and health goals of the Seventh-day Adventist religion" that it caused Living Faith to fail the operational test.

Reviewing the relevant authorities, the court focused on whether the activities at issue were an "essential ingredient" in accomplishing the exemption purpose:

> In each of these rulings, the organization performed services which were *required* in order to further the tenets of a particular religion or *necessary* to enable members of a particular religion to observe its principles. By way of contrast, petitioner herein has not shown that its operations were required to further the dietary teachings of the Seventh-day Adventist Church or necessary to enable members of the Seventh-day Adventist Church to comply with its beliefs.

(emphasis added). Confirming *Pulpit Resource*, for an activity to be an integral part of an exempt purpose, it must be strictly necessary for the accomplishment of such a purpose.

It is my opinion that the Internal Revenue Service or a court would not find the provision of debt settlement services to be an integral part of a credit counseling agency's exempt purposes. Such purposes are educational and take the form of either public seminars and publications or one-on-one counseling. The educational goals are to help consumers learn to budget and spend appropriately and to make prudent use of consumer credit. There is no necessary connection between services seeking a lump-sum, discounted settlement of debts and the exempt purpose of educating consumers in budgeting and prudent borrowing.[7] It should be understood that many tax-exempt credit counseling agencies have provided their services to the public without debt settlement services for decades. I find no credible support for an argument that providing debt settlement services is an "essential ingredient," a necessary activity without which the exempt educational purposes cannot be accomplished. Accordingly, the provision of substantial debt settlement services by a non-profit credit counseling agency would constitute a substantial, non-exempt purpose, causing such an entity to fail the operational test for exemption.

In addition to testing whether an activity is necessary to accomplish the organization's exempt purpose, courts often focus on whether the activity is so inherently commercial that it cannot be integral to an exempt purpose. This analysis is sometimes phrased as a determination of whether nonexempt commercial purposes predominate with respect to the activity in question. The Tax Court has held that "[c]ompetition with commercial firms is strong evidence of the predominance of nonexempt commercial purposes." *B.S.W. Group, Inc. v. Commissioner*, 70

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[7] Arguably, the success of debt settlement services, while plainly benefiting debtors, might even undermine the lessons of prudence and restraint implicitly stressed in credit counseling agencies' exempt purposes.

T.C. 352 (1978). Similarly, the Court of Claims explained that providing investment advisory services to the public in exchange for money "places plaintiff in competition with other commercial organizations providing similar services. Plaintiff has chosen to compete in this manner and, as a consequence, plaintiff's activities acquire a commercial hue." *American Institute for Economic Research v. U.S.*, 302 F.2d 934 (Ct. Cl. 1962); see *Easter House v. U.S.*, 60 A.F.T.R. 2d 87-5119 (Cl. Ct. 1987) (adoption agency in competition with for-profit agencies held not exempt).

Because a variety of for-profit entities (including law firms) have historically provided debt settlement services, a non-profit credit counseling agency that began offering debt settlement services would necessarily be competing with commercial firms. Such competition would be strong evidence of the predominance of nonexempt purposes in connection with this activity. The manner in which debt settlement services have been provided up to the present thus creates a significant hurdle to the possibility that provision of such services can be taken over by tax-exempt entities.

In addition to the question of whether providing debt settlement services would constitute a substantial non-exempt function, the Internal Revenue Service might view debt settlement services as resulting in improper private benefit to debtors, which would provide another basis for revocation of exempt status. By contrast with debt management plans, which are designed to result in full payment of the amounts owed, debt settlement services seek to discharge debtors' obligations for less than the full principal amount. Accomplishment of this goal results in taxable income to the debtors. Section 61(a)(12). The recipients of debt settlement services are not exclusively impoverished; indeed, many of them are persons of more moderate means who have become overburdened with consumer debt for a variety of reasons. In a number of similar contexts, the Internal Revenue Service and courts have found the presence of private benefit[8] to preclude exemption under Section 501(c)(3).[9]

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[8] Private benefit is a separate concept from that of "private inurement." Private inurement involves benefit to persons controlling a purportedly tax-exempt entity. Private benefit covers benefits to non-controlling parties. The presence of either is incompatible with exempt status.

[9] *Christian Stewardship Assistance v. Commissioner*, 70 T.C. 1037 (1978) (organization that sought to increase charitable contributions to exempt entities by providing tax and estate planning advice to donors; private benefit to donors precluded exemption); *Retired Teachers Legal Defense Fund v. Commissioner*, 78 T.C. 280 (1982) (denying exemption for entity that operated for private purpose of promoting litigation to protect pension funds of retired New York City teachers; over two-thirds of retirees were not poor); compare *Aid to Artisans, Inc. v. Commissioner*, 71 T.C. 202 (1978) (no impermissible private benefit from organization importing and selling handicrafts where only an insubstantial number of artisans were not disadvantaged).

Conclusion

For the foregoing reasons, the provision of substantial debt settlement services by credit counseling agencies that are currently exempt under Section 501(c)(3) would place such organizations outside the exemption provided by Section 501(c)(3) of the Code.

Respectfully submitted,

Robert E. Davis