Internal Revenue Service
Appeals Office
8701 S. Gessner
MC 8000 H-AL,
Houston, TX 77074

Release Number: **201321041**
Release Date: 5/24/2013
Date: February 28, 2013

Department of the Treasury

Person to Contact:

Employee ID Number:

Fax:
Refer Reply to:

In Re:

EIN:
Form Required to be Filed:

Tax Period(s) Ended:

UIL Code: 501.03-00

Certified Mail

Dear

This is a final adverse determination as to your exempt status under section 501(c)(3) of the Internal Revenue Code (IRC). It is determined that you do not qualify as exempt from Federal income tax under IRC Section 501(c)(3) effective August 1, 2000.

Our adverse determination is based on the following reasons: You have not demonstrated that you are operated exclusively for exempt purposes within the meaning of Internal Revenue Code section 501(c)(3) and Treasury Regulations section 1.501(c)(3)-1(d). You did not engage primarily in activities that accomplish one or more of the exempt purposes specified in section 501(c)(3). You are operated for a substantial non-exempt purpose. You are operated for the benefit of private rather than public interests and your activities resulted in substantial private benefit. Further, your net earnings inured to the benefit of private shareholders or individuals.

Contributions to your organization are not deductible under Code section 170.

You are required to file Federal income tax returns on the form indicated above. You should file these returns within 30 days from the date of this letter, unless a request for an extension of time is granted. File the returns in accordance with their instructions, and do not send them to this office. Processing of income tax returns and assessment of any taxes due will not be delayed because you have filed a petition for declaratory judgment under Code section 7428.

If you decide to contest this determination under the declaratory judgment provisions of Code section 7428, a petition to the United States Tax Court, the United States Court of Claims, or the district court of the United States for the District of Columbia must be filed

within 90 days from the date this determination was mailed to you. Contact the clerk of the appropriate court for rules for filing petitions for declaratory judgment. To secure a petition form from the United States Tax Court, write to the United States Tax Court, 400 Second Street, N.W., Washington, D.C. 20217.

You also have the right to contact the office of the Taxpayer Advocate. However, you should first contact the person whose name and telephone number are shown above since this person can access your tax information and can help you get answers.

You can call 1-877-777-4778 and ask for Taxpayer Advocate assistance. Or you can contact the Taxpayer Advocate from the site where the tax deficiency was determined by calling (xxx) xxx-xxxx, or writing to: Internal Revenue Service
Taxpayer Advocate Services

Taxpayer Advocate assistance cannot be used as a substitute for established IRS procedures, formal appeals processes, etc. The Taxpayer Advocate is not able to reverse legal or technically correct tax determinations, nor extend the time fixed by law that you have to file a petition in the United States Tax Court. The Taxpayer Advocate can, however, see that a tax matter that may not have been resolved through normal channels gets prompt and proper handling.

We will notify the appropriate State officials of this action, as required by Code section 6104(c).

If you have any questions, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely,

KAREN A. SKINDER
TEAM MANAGER

Enclosures:
Notice 1214 Helpful Contacts for your 'Deficiency Notice'

cc:

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY
Internal Revenue Service
107 Charles Lindbergh Boulevard
Garden City, NY 11530

December 27, 2004

ORG
ADDRESS

Taxpayer Identification Number:

Form:

Tax Year(s) Ended:
Person to Contact/ID Number:
Contact Numbers:
Telephone:
Fax:

Certified Mail - Return Receipt Requested

Dear :

We have enclosed a copy of our report of examination explaining why we believe revocation of your exempt status under section 501(c)(3) of the Internal Revenue Code (Code) is necessary.

If you accept our findings, take no further action. We will issue a final revocation letter.

If you do not agree with our proposed revocation, you must submit to us a written request for Appeals Office consideration within 30 days from the date of this letter to protest our decision. Your protest should include a statement of the facts, the applicable law, and arguments in support of your position.

An Appeals officer will review your case. The Appeals office is independent of the Director, EO Examinations. The Appeals Office resolves most disputes informally and promptly. The enclosed Publication 3498, *The Examination Process,* and Publication 892, *Exempt Organizations Appeal Procedures for Unagreed Issues,* explain how to appeal an Internal Revenue Service (IRS) decision. Publication 3498 also includes information on your rights as a taxpayer and the IRS collection process.

You may also request that we refer this matter for technical advice as explained in Publication 892. If we issue a determination letter to you based on technical advice, no further administrative appeal is available to you within the IRS regarding the issue that was the subject of the technical advice.

If we do not hear from you within 30 days from the date of this letter, we will process your case based on the recommendations shown in the report of examination. If you do not protest this proposed determination within 30 days from the date of this letter, the IRS will consider it to be a failure to exhaust your available administrative remedies. Section 7428(b)(2) of the Code provides, in part: "A declaratory judgment or decree under this section shall not be issued in any proceeding unless the Tax Court, the Claims Court, or the District Court of the United States for the District of Columbia determines that the organization involved has exhausted its administrative remedies within the Internal Revenue Service." We will then issue a final revocation letter. We will also notify the appropriate state officials of the revocation in accordance with section 6104(c) of the Code.

You have the right to contact the office of the Taxpayer Advocate. Taxpayer Advocate assistance is not a substitute for established IRS procedures, such as the formal appeals process. The Taxpayer Advocate cannot reverse a legally correct tax determination, or extend the time fixed by law that you have to file a petition in a United States court. The Taxpayer Advocate can, however, see that a tax matter that may not have been resolved through normal channels gets prompt and proper handling. You may call toll-free 1-877-777-4778 and ask for Taxpayer Advocate Assistance. If you prefer, you may contact your local Taxpayer Advocate at:

If you have any questions, please call the contact person at the telephone number shown in the heading of this letter. If you write, please provide a telephone number and the most convenient time to call if we need to contact you.

Thank you for your cooperation.

Sincerely,

R. C. Johnson
Director, EO Examinations

Enclosures:
Publication 892
Publication 3498
Report of Examination

ORG. Form 886-A

LEGEND
ORG - Organization name XXXX - Date Address - address City - city State - state MOTTO - motto ATTN - attorney
FOUNDERS - founders website - website BM-1 through BM-5 = 1st through 5th BM CO-1 through CO-12 = 1ST through 12th COMPANIES
DIRS - dirs hours - hours

ORG.
TAX YEARS ENDING

ISSUES PRESENTED:

1. Whether ORG. is operated exclusively for exempt purposes described within Internal Revenue Code section 501(c)(3):

    a. Whether ORG is engaged primarily in activities that accomplish an exempt purpose?
    b. Whether more than an insubstantial part of ORG's activities are in furtherance of a non-exempt purpose?
    c. Whether ORG was operated for the purpose of serving a private benefit rather than public interests?
    d. Whether any part of the net earnings of ORG inured to the benefit of any private shareholder or individual?

FACTS

Background

An audit of ORG. was commenced on for tax years ending and .

ORG. was incorporated under the laws of the Commonwealth of State as a non-stock, nonprofit corporation on . On , an amendment was filed with the Commonwealth of State changing the purposes as originally stated in Article IV. In a determination letter dated , ORG .was determined to be exempt from Federal income tax as an organization described in IRC section 501(c)(3). It was further determined to be classified as a public charity as described under IRC section 509(a)(2). ORG. is located at Address, City, State.

In its original Articles of Incorporation, ORG. stated in Article II that its purpose is to engage in the following activities: MOTTO.

The original Articles of Incorporation contained no other purposes. An amendment was filed on to delete the language in the original Article IV and replace it with the following:

> Said corporation is organized exclusively for charitable, educational, religious or scientific purposes, within the meaning of section 501(c)(3) of the Internal Revenue Code.
>
> No part of the net earnings of the corporation shall inure to the benefit of, or be distributable to its members, trustees, directors, officers or other private persons, except that the corporation shall be authorized and empowered to pay reasonable compensation for services rendered and to make payments and distributions in furtherance of Section 501(c)(3) purposes. No substantial part of the activities of the corporation shall be carrying on propaganda, or otherwise attempting to influence legislation, and the corporation shall not participate in , or intervene in (including the publishing or distribution of statements) any political campaign on behalf of or in opposition to any candidate for public office.
>
> Notwithstanding any other provision of these articles, the corporation shall not carry on any other activities not permitted to be carried on (a) by a corporation exempt from Federal income tax under Section 501(c)(3) of the Internal Revenue Code or (b) by a corporation, contributions to which are deductible under Section 170(c)(2) of the Internal Revenue Code.
>
> - Upon dissolution of this corporation, assets shall be distributed for one or more exempt purposes within the meaning of Section 501(c)(3) of the Internal Revenue Code, i. e., charitable, educational, religious or scientific, or

corresponding section of any future federal tax code, or shall be distributed to the Federal government, or to a state or local government for a public purpose. However, if the named recipient is not then in existence or no longer a qualified distribute, or unwilling or unable to accept the distribution, then the assets of the corporation shall be distributed to a fund, foundation or corporation organized and operated exclusively for the purposes specified in Section 501(c)(3) of the Internal Revenue Code.

ORG. is the non-profit successor to two for-profit predecessor organizations named CO-1 and CO-2. Both of these organizations were owned by BM-1 and BM-2, who are the of the taxpayer. ORG. also purchased the intangible assets of CO-1. and CO-2 for $. The purchase price was determined in a valuation made by CO-3 in a response to a request by the .

The organization used a filing service named CO-4 to file its original Certificate of Incorporation with the Commonwealth of State. The organization engaged an attorney, ATTN., to file the amended Certificate of Incorporation. The original Application 1023 was prepared and submitted by CO-5. The same firm also serves as the organization's current legal counsel.

Per the application 1023 filed by the organization, the initial Board of Directors consisted of five individuals, BM-1, President/Director, BM-2, Vice-President/Director, BM-3, Director, BM-4 and BM-5. BM-1 and BM-2 are brothers.

The activities as stated in the original Internal Revenue Service Form 1023 are to provide MOTTO services for financially distressed debtors, including negotiating with creditors to provide benefits to the debtor such as reduced principal payments, reduced or no interest rates or elimination of late charges. The organization may also refer debtors to credit repair agencies and lenders, affording the possibility of debtors obtaining debt consolidation loans.

Program participants will receive quarterly educational materials to inform them of the new company programs and policies, new and revised arrangements with creditors, and industry updates and statistics relating to program services offered.

In a Request for Additional Information from the IRS dated , the organization listed its activities as MOTTO services, education, debt settlement services and referrals.

Activity Description

The primary activity engaged in by ORG. (hereinafter ORG) during the examination years is telephone solicitation of clients to enroll in debt management plans (hereinafter DMPs). Potential clients are generally individuals with unsecured debt. A DMP is a plan whereby a client makes monthly payments to ORG to satisfy his unsecured debts over a 3-5 year period. Most of the debt handled in the DMP is either unsecured, secured by small collateral (such as household items), or is debt whereby ORG has an existing relationship or written agreement with the credit grantor allowing secured debts to be serviced in the DMP. The debt cannot be for either an existing service or an essential service (like electricity) that has been cancelled pending payment for reinstatement. The monthly payment made by the client would include the payment to each creditor plus a "Payment Program Fee" equal to 10% of the amount paid to ORG each month or $, whichever was greater. This Payment Program Fee was included in and deducted from each payment received from the client. ORG also charged a one-time "Monthly Payment Design Fee" equal to one proposed monthly payment which was payable upon the clients acceptance of the proposed monthly payment.

The taxpayer employed approximately 200 persons who purportedly worked as "counselors" (hereinafter referred to as employees). Many of the employees had a sales background, although this was not a requirement. The advertisements that were placed to hire these individuals contained phrases such as, "Do you feel your income and growth potential is limited at your present job?" and "Will train energetic individuals looking to fulfill their Financial Dreams." Other phrases used were, "Unlimited Qualified Leads" and "Unlimited Earning Potential." The headings of the advertisements were titled Unique Sales Opportunity and Collectors, as well as, Expanding Financial Services Company. The advertisements were directed to individuals with sales experience. Counseling experience was not sought.

ORG operated as a call center, whose purpose was to enroll clients in debt management plans. ORG contacted potential clients by purchasing leads from a related for-profit owned by BM-1 and BM-2, CO-6 The employees in the call center would contact the individuals listed on the lead sheets to try to enroll them in a DMP. ORG also received calls from potential clients responding to advertising in a number of media, including websites, television and radio advertisements and newspaper advertisements. Other potential clients were referred to ORG by CO-7., another related for-profit State corporation owned by BM-1 and BM-2. Contacts with clients were through phone, fax and email. Although there is a designated `walk-in' client cubicle just off of the lobby in the main office, a minimal number of contacts, if any, were made through `walk-ins'.

The organization works out of an office building that also houses CO-8 and CO-6. The office is divided into designated activity areas or departments which are labeled, however, there is no recognition of the three separate entities that are operating in this office. An uninformed individual would see what appears to be one organization with various departments. The employee (counselor) area is made up of approximately 40 cubicles flanked on either end by an elevated work platform for the CEO and Counselor Manager. Located within this same area was a Call Center for CO-6. There was nothing to indicate that this was a separate entity from ORG. It was set up as if all of these individuals were employed by the same organization. These employees would provide call routing from a third party call center to the ORG employee counselors, thus proving the necessary leads.

The call center at ORG would operate by having the employee contact a potential client by telephone. During the phone call, the employee would attempt to enroll the potential client in a DMP. The employee would ask the client for information regarding current unsecured debt. The employee would then ask the potential client for a fax number so that he/she could fax over a couple of forms. If the client did not have a fax machine, the employee would suggest looking in the yellow pages for a fax service. The employee would inform the potential client that they would call back in five minutes so that the forms could be faxed. The importance of completing the forms as soon as possible was stressed to the potential client. The forms would include an example of how much an average client could expect to save through ORG and a form which requested the clients name, address, telephone numbers and SSN, as well as, a schedule of all of the clients bills. When the employee received back the completed fax, he would go over the bills and discuss some other budget information with the potential client before the account was sent to the Credit Department for establishment of the exact payment necessary to consolidate all bills (monthly creditor payments and payment program fee). The employee would then call back the potential client with the payment amount and instructions on how and where to send it.

ORG trained its employees as if they were telemarketers. The training materials stressed the importance of telephone communication skills and ways to avoid eliciting negative responses from potential clients. Some of the phrases used were "properly servicing the client" and "strengthening your relationship with the client". The training materials contained no instructions regarding face to face "counseling" to the general public or the provision of any educational materials or information to the general public. Instead, the materials focused on the history of the debt management industry, telephone communication skills, the history of money, etc. The training materials and scripts were geared toward becoming skilled at convincing clients to enroll in a DMP. There was no mention in the training materials or scripts of providing the individuals with other option that would be more beneficial than a DMP, such as self-budgeting or restructuring the individuals finances.

Employee counselors received incentive compensation equal to 25% of the Program Design Fees generated from their clients. This amount was offset (reduced) by the

counselors base pay, similar to how a salesperson works for a draw against commission. Managers who provided "counseling" services received incentive compensation equal to 30% of the Program Service Fees received from the clients that they served. This system of providing incentives is common in the sales industry. Employees also received bonuses which were tied to the number of DMPs enrolled. Each month, the top ten employee counselors in the "company" earned bonus awards as follows:

1st	6th
2nd	7th
3rd	8th
4th	9th
5th	10th

The names of these top ten grossing employees would be posted in the office on a chart titled "TOP 10 IN THE COMPANY" for the corresponding month.

ORG employees were not restricted from obtaining outside employment except from other MOTTO companies. There were no volunteers providing assistance to ORG during the years under audit.

Employees were given a "phone script" to use in selling the DMP program. The phone scripts for XXXX were titled "Counselor Presentation Guide" and "Counselor Answer Guide". The two guides did not contain any educational information. They were aimed directly at enrolling an individual in a DMP. When an individual would ask what the fees would be, the answer guide would instruct the employee to state that they are a non-profit community service, so the "fees we charge are minimal". Actually, the fees are based on the amount of debt that is processed per client, so fees can be quite high in many situations. If an individual was behind on his bills and had no one to help him become current, the script would instruct the counselor to tell the individual to "call back when your situation improves". No educational counseling was being provided to these individuals who were most in need of the counseling. When asked what the length of an average phone call was, Treasurer BM-5 stated "12 to 15 minutes." If an individual called in looking for a loan, the ORG counselor was instructed to refer the individual to a related for-profit mortgage company. Individuals contacted were encouraged to fax in the enrollment forms as soon possible. The urgency of getting on the DMP immediately was stressed in the two guides. The script contained statements such as, "By getting you started now, you won't have to worry about paying the bills at high interest rates when they come due again. Everything will be through us" and "The client will not respond as quickly if he or she is not comfortable". The first payment had to be express mailed from the Post Office. The script instructed the ORG employee to inform individuals that express mail had to be used because there is a tracking number needed on the receipt that is used to activate the DMP. The real reason for requiring express mail was to guarantee receipt of the first payment, which is the taxpayer's set-up fee. No portion of this fee was to go to the client's creditors.

In a typical call to a potential client, the employee states his name and that he is calling in regard to the consolidation that the individual is applying/has applied for. They begin by stating that the organization is not a loan company but is a debt management firm and they can consolidate all of the individuals unsecured bills into one simple payment. The payment would be made once a month to ORG and individual checks would be disbursed by ORG to the creditors at reduced interest rates. They further advise that the program will get the individual out of debt much faster and save the client a lot of money.

During the years under examination ORG dealt primarily with unsecured credit card debt, therefore assuring that they received fair share revenue from the creditors. ORG would not receive fair share revenue if it handled other unsecured debt, such as, medical bills. ORG stressed in all of its advertising and brochures that an individual can receive rebate checks every six months when payments were on time. It stated that creditors who make fair share contributions give back anywhere from 5% to 10% of the money collected for them by MOTTO agencies. Of this amount, a small percentage is rebated to the client if payments are on time for six months. This is referred to as the "Goodpayer Program". ORG stated that up to 50% of the fair share revenue collected per client is rebated back to the client every 6 months as a "bonus". A review of the forms 990 for XXXX and XXXX showed that approximately 7% of all fair share revenue collected was rebated in XXXX and 18% in XXXX.

When a customer agreed to a DMP, the individual signed a Service Agreement, which provided for the monthly payments. It also provided, "Using the credit card and other debt information provided by the CLIENT, ORG will analyze the CLIENT's debt structure, research creditor practices and calculate a proposed monthly payment amount acceptable to the CLIENT." Also, "ORG's Monthly Payment Design Fee for creating an acceptable proposed Monthly Payment will be equivalent to one proposed Monthly Payment and will be payable upon the CLIENT's acceptance of the proposed Monthly Payment." The monthly service fee is described in the Service Agreement as follows, "ORG's Payment Program Fee for setting up the creditor accounts, obtaining the cooperation of your creditors to any interest rate or other reductions that may be obtained, and receiving and paying out your monthly payments to your creditors will be ten (10%) percent of the amount you pay to ORG each month or $ whichever is greater. This Payment Program Fee shall be included in and deducted from each payment received from the CLIENT. If you desire to add additional creditor accounts at a later date, an additional monthly service charge will be due for those additional accounts." Pursuant to these provisions, the first monthly payment went entirely to ORG and the clients creditors received no payment for that month.

According to ORG, the enrollment fee or Payment Design Fee was not waived for any client during the years under examination. It stated that only employees and their relatives that enrolled in the ORG debt management plan were able to have their enrollment fees waived. This did not apply to monthly service fees. Therefore, the Payment Design Fee was not voluntary for clients.

ORG advertised its services on its website, website which made its debut in
It also produced television commercials and ran advertisements in various newspapers and magazines, in which it advertised its services to the general public. These various forms of media were used to generate client interest in its debt management program. ORG's fees are not explained or mentioned in any of its advertising. It does, however, mention a "free debt consultation." It also mentions that it is a section 501(c)(3) non-profit organization. In the website ORG claims: "It may seem hard to believe right now, but financial freedom is within your grasp. Our exclusive Debt Management Program has assisted thousands of people just like you – people who are tired of wasting money on high interest rates. Our program allows you to make ONE SIMPLE PAYMENT each month to handle all of your creditors. As you pay the bills through our company, we're able to gain certain benefits from your creditors to SAVE YOU MONEY". Many of the advertisements focus on ORG's ability to have credit card interest rates reduced. One advertisement in the CO-9 states, "Many credit card companies will reduce their rates between 6 and 9 percent through ORG. Some will even reduce their interest rates to ZERO!"

In addition, ORG purchases advertising and client leads. ORG pays CO-10, which is owned by BM-1, to procure advertising space/time and provide other marketing services. ORG had a subscription services agreement with CO-6, to provide "leads" or potential client listings. ORG pays a fee to Debt Relief for each potential client that executes a Service Agreement to participate in the ORG Debt Management Program. This fee increased from $ per client in a subscription services agreement effective to $ per client in a subscription services agreement effective . In the minutes to the Board of Directors meeting it was noted per CFO BM-5 that a recent assessment revealed that the profit to ORG for each valid referral is $. The Board, therefore, agreed to increase the referral fees from $ (effective) to $ (effective). The fees that the taxpayer paid to these related for-profits were not determined at arms length.

The taxpayer did not limit its debt management program to a charitable class. It had no established procedure or policy in place that would allow for a waiver or reduction of the first payment or monthly fee. ORG had no policy or guideline in place to waive the fee for individuals or families to whom the payment would cause financial hardship. ORG's debt management program was not designed to distinguish between the indigent, non-indigent or low-income individuals or families. If a counselor were to try to have the fees waived for a particular consumer, he would lose his incentive compensation, which was based on the total Program Design fees generated. Based on the manner in which the program was administered, the debt management plan did not serve a charitable purpose.

The primary activity of ORG was enrolling potential clients in Debt Management Plans. ORG provided minimal, if any, educational outreach for the tax years ending XXXX and XXXX. After the onset of this examination the organization decided that it would try to increase its outreach activities. The organization claims to educate individuals

through the use of its website, newsletter and counselors. In XXXX, any individual who was behind on his bills would not be accepted into a DMP. Instead, the script would instruct the counselor to tell the individual to "call back when your situation improves". In XXXX any individual who was behind on his bills would be instructed (via the script) to "visit our Website website to access our Education Center." An individual would need access to the internet to visit the website. The counselors were screening out individuals who did not qualify for a DMP. Minimal, if any, education was provided to these individuals. When asked to provide copies of any logs or records documenting all face-to-face counseling done by the organization in XXXX and XXXX, the organization responded that "no permanent records were maintained." During XXXX and XXXX the organization provided a quarterly newsletter to its clients, prospective clients and any other interested party, according to its application 1023. Also, for in XXXX, the organization provided a set of VCR tapes and a workbook titled, "Your Financial Future, Understanding Credit, Debt and Planning for Tomorrow" to all DMP clients. Non-DMP individuals did not receive this material.

There is little evidence to prove that the primary activity of ORG was anything other than the telephone solicitation and selling of DMPs to individuals in debt.

Relationship with CO-2 of State

When ORG enrolled a debtor, the first payment, the Payment Design Fee, was made to ORG. Once the client was enrolled in a DMP, all processing was done through CO-2 of State. This included providing customer service support to ORG. The original fulfillment agreement called for CO-2 to provide certain equipment , staff and services to ORG for "a fee calculated to be equivalent to the actual cost to CO-2 of providing the equipment, staff and services." The agreement was signed by BM-1 as President of both ORG and CO-2. In the administration of this agreement, operating funds were forwarded from ORG to CO-2 throughout the year. At year end, the "actual cost" as specified in the agreement was determined under an allocation of actual CO-2 expenses to ORG based on the percentage of "first pay" dollars for the entities that were serviced by CO-2. "First Pay" dollars are the Program Design Fees that represent the first payment made by each client. During XXXX and XXXX, CO-2 serviced DMP clients primarily for ORG. A small amount of servicing was also done for a State attorney.

A review of the ORG balance sheet on form 990 for tax year ending showed a Prepaid Expense asset balance of $. A review of the forms 11205 for CO-2 for tax years ending **and** showed ordinary income for the two years totaling approximately $ dollars. BM-1 and BM-2, as equal partners, took equal distributions in tax years ending **and** totaling approximately $ dollars. CO-2 was supposed to be providing services to ORG "at cost", yet the forms 11205 were showing ordinary income.

In a memorandum dated from BM-5, CFO of ORG, it was decided based upon discussions with CO-11 that a Management Fee would be charged by CO-2 to ORG in the amount of $ per client, per month. The fee was charged retroactive to . This fee effectively eliminated the Prepaid Expense and created an additional billing from CO-2 to ORG in the amount of $.

In reviewing the memorandum from BM-5, CFO, it was apparent that CO-2 was no longer providing the processing services to ORG "at cost", as stated in the fulfillment agreement. In referring to the additional Management Fee, the memorandum stated, "this fee will provide CO-2 of State with the necessary funding for it to continue to provide its services to ORG and ORG/CO-2 Budget Planning (a related corporation with a 1023 application pending)." Three months later, CO-2 of State became inactive and a new processor called CO-2 took over the processing for ORG.

CO-2 distributed the payments to creditors and ORG solicited the "fair share" contributions from the credit card companies. The term "fair share" refers to a payment made by the credit card companies who are receiving payments pursuant to a DMP. Typically, credit card companies pay a "fair share", which is a stated percentage of debt (generally between 5% and 10% of debt collected per client), to MOTTO organizations that set up DMPs. The percentage paid back as "fair share" is generally determined by each creditor in advance. Credit card companies will only make "fair share" payments to organizations recognized as exempt under section 501(c)(3) of the Internal Revenue Code.

Sale of Intangible Assets

The taxpayer to get started in the MOTTO industry purchased the intangible assets of CO-1. and CO-2, two for-profit entities owned by BM-1 and BM-2 for $. The received payments of interest and principal from ORG for its purchase of their MOTTO business assets, including "goodwill" and "know how". The $ dollar purchase price was paid down to $ in only five years. Thus the not-for-profit ORG transferred to CO-1. and CO-2 approximately $ over the course of five years, even though ORG had 50 years at 7% interest under the terms of the agreement to repay the two for-profit entities.

ORG
Corp.
Analysis of Sources of Income

Per Form 990:

Source:	
Gifts, Grants, Contributions	
DMP set up fees (First Pays)	
DMP continuation service fees	
Payments from creditors (fairshare)	
Dividends and Interest	
Investment Income (Cap G/L)	
Other - Misc.	
Total	

Breakdown of income sources
Contributions
DMP administration
Investments
Other

The above income figures were taken from ORG's Forms 990. Based on these figures, substantially all of ORG's income was generated from the administration of the Debt Management Plans.

Analysis by ORG. **Income/Distributions Generated**

Source	
ORG. (Form 990 Salary)	
BM-1	
BM-2	
CO-2(Form 1120S Salary)	
BM-1	
BM-2	
CO-2 (K-1 Ordinary Income):	
BM-1	
BM-2	
CO-6 (Form 1120S Salary)	
BM-1	
CO-6 (K-1 Ordinary Income):	
BM-1	
BM-2	
CO-12 (K-1 Ordinary Income)	
BM-1	
CO-2 (K-1 Distributions)	
BM-1	
BM-2	
CO-1. (K-1 Distributions)	
BM-1	
BM-2	
Total	
Grand Total	

Compensation

ORG's Forms 990 states that both BM-1 and BM-2 worked an average of hours per week during the years under audit. In tax year , BM-1 and BM-2 each received $ in compensation, benefits and deferred compensation from ORG in their positions as President/Director and Vice President/Director. In tax year ending , ORG paid them each $

in compensation. BM-1 and BM-2 also drew salaries from their related for-profit entities, CO-2 of State and CO-6

Example of a DMP (Sample)

If an individual client had 10 creditors and ORG calculated a total payment to creditors of $ the monthly service fee would be $ (10% of the total payments to creditors). The monthly payment would, therefore, equal $ ($ plus $). ORG would also charge the client a one-time Payment Design Fee of $. The Payment Design Fee is equal to one monthly payment and the client would have to express mail a certified check for $ and the signed Service Agreement immediately upon execution of the agreement. None of this payment would go to the creditors. It is the design services fee charged by ORG. ORG's payments to creditors would not start until after it received the clients second payment which was due 30 days after the Payment Design Fee.

LAW

Section 501(a) of the Internal Revenue Code provides that an organization described in section 501(c)(3) is exempt from income tax. Section 501(c)(3) of the Internal Revenue Code exempts from federal income tax corporations organized and operated exclusively for charitable, educational, and other purposes, provided that no part of the net earnings inure to the benefit of any private shareholder or individual. The term charitable includes relief of the poor and distressed. Income Tax Regs. Section 1.501(c)(3)-1(d)(2).

The term educational includes (a) instruction or training of the individual for the purpose of improving or developing his capabilities and (b) instruction of the public on subjects useful to the individual and beneficial to the community. Treas. Reg. § 1.501(c)(3)-1(d)(3). In other words, the two components of education are public education and individual training.

Section 1.501 (c)(3)-1 (a)(1) of the Regulations 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.

Section 1.501 (c)(3)-1(c)(1) of the regulations provides 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. The existence of a substantial nonexempt purpose, regardless of the number or importance of exempt

purposes, will cause failure of the operational test. Better Business Bureau of Washington. D.C. v. U.S., 326 U.S. 279 (1945).

Educational purposes include instruction or training of the individual for the purpose of improving or developing his capabilities and instruction of the public on useful and beneficial subjects. Treas. Reg. § 1.501(c)(3)-l(d)(3). In Better Business Bureau of Washington D.C.. Inc. v. United States, 326 U.S. 279 (1945), the Supreme Court held that the presence of a single non-exempt purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly exempt purposes. The Court found that the trade association had an "underlying commercial motive" that distinguished its educational program from that carried out by a university.

In American Institute for Economic Research v. United States, 302 F. 2d 934 (Ct. CI. 1962), the Court considered the status of an organization that provided analyses of securities and industries and of the economic climate in general. The organization sold subscriptions to various periodicals and services providing advice for purchases of individual securities. Although the court noted that education is a broad concept, and assumed for the sake of argument that the organization had an educational purpose, it held that the organization had a significant nonexempt commercial purpose that was not incidental to the educational purpose and was not entitled to be regarded as exempt.

An organization must establish that it serves a public rather than a private interest and "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." Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii). Prohibited private interests include those of unrelated third parties as well as insiders. Christian Stewardship Assistance. Inc. v. Commissioner, 70 T.C. 1037 (1978); American Campaign. Academy v. Commissioner, 92 T.C. 1053 (1989). Private benefits include an "advantage; profit; fruit; privilege; gain; [or] interest." Retired Teachers Legal Fund v. Commissioner, 78 T.C. 280, 286 (1982).

An organization formed to educate people in Hawaii in the theory and practice of "est" was determined by the Tax Court to be part of a "franchise system which is operated for private benefit," and, therefore, should not be recognized as exempt under section 501(c)(3) of the Internal Revenue Code. est of Hawaii v. Commissioner. 71 T.C. 1067, 1080 (1979). Although the organization was not formally controlled by the same individuals who controlled the for-profit entity that owned the license to the "est" body of knowledge, publications, and methods, the for-profit entity exerted considerable control over the applicant's activities by setting pricing, the number and frequency of different kinds of seminars and training, and providing the trainers and management personnel who are responsible to it, in addition to setting the price for the training. The court stated that the fact that the organization's rights were dependent upon its tax-exempt status showed the likelihood that the for-profit entities were trading on that status. The question for the court was not whether the payments made to the for-profit were excessive, but whether the for-profit entity benefited substantially from the operation of the organization. The court determined that there was a substantial private benefit because

the organization "was simply the instrument to subsidize the for-profit corporations and not vice versa and had no life independent of those corporations."

Private benefit does not necessarily involve the flow of funds from an exempt organization to a private party. Rev. Rul. 76-206, 1976-1 C.B. 154, considered an organization formed to promote broadcasting of classical music in a particular community. The organization carried on a variety of activities designed to stimulate public interest in the classical music programs of a for-profit radio station, and thereby enable the station to continue broadcasting such music. The activities included soliciting sponsors, soliciting subscriptions to the station's program guide, and distributing pamphlets and bumper stickers encouraging people to listen to the station. The organization's board of directors represented the community at large and did not include any representatives of the for-profit radio station. The revenue ruling concludes that the organization's activities enable the radio station to increase its total revenues and therefore benefit the for-profit radio station in more than an incidental way. Therefore, the organization is serving a private rather than a public interest and does not qualify for exemption.

In International Postgraduate Medical Foundation v. Commissioner, the Tax Court held that the exempt status of a corporation under IRC 501(c)(3) was properly revoked because the corporation was not operated exclusively for exempt purposes. The corporation conducted continuing medical educational tours abroad. The purposes of the corporation consisted of 1) providing benefits to a for-profit travel agency that arranged tours for the corporation's seminars, and 2) providing sightseeing and recreational activities. The corporation was formed by the owner of the travel agency to obtain customers for his business. The owner controlled the corporation and exercised that control to benefit his travel agency.

The Service has issued two rulings holding credit counseling organizations to be tax exempt. Rev. Rul. 65-299, 1965-2 C.B. 165, granted exemption to a 501(c)(4) organization whose purpose was to assist families and individuals with financial problems and to help reduce the incidence of personal bankruptcy. Its primary activity appears to have been meeting with people in financial difficulties to "analyze the specific problems involved and counsel on the payment of their debts." The organization also advised applicants on proration and payment of debts, negotiated with creditors and set up debt repayment plans. It did not restrict its services to the needy. It made no charge for the counseling services, indicating they were separate from the debt repayment arrangements. It made "a nominal charge" for monthly prorating services to cover postage and supplies. For financial support, it relied upon voluntary contributions from local businesses, lending agencies, and labor unions.

Rev. Rul. 69-441, 1969-2 C.B. 115, granted 501(c)(3) status to an organization with two functions: it educated the public on personal money management, using films, speakers, and publications, and provided individual counseling to "low-income individuals and families." As part of its counseling, it established budget plans, i.e. debt management plans, for some of its clients. The debt management services were provided without charge. The organization was supported by contributions primarily

from creditors. By virtue of aiding low income people, without charge, as well as providing education to the public, the organization qualified for section 501(c)(3) status.

In the case of Consumer Credit Counseling Service of Alabama. Inc. v. U.S., 44 A.F.T.R. 2nd 78-5052 (D.D.C. 1978), the District Court for the District of Columbia held that a credit counseling organization qualified as charitable and educational under section 501(c)(3). It fulfilled charitable purposes by educating the public on subjects useful to the individual and beneficial to the community. Treas. Reg. § 1.501(c)(3)-1(d)(3)(i)(b). For this, it charged no fee. The court found that the counseling programs were also educational and charitable; the debt management and creditor intercession activities were "an integral part" of the agencies' counseling function and thus were charitable and educational. Even if this were not the case the court viewed the debt management and creditor intercession activities as incidental to the agencies' principal functions, as only approximately 12 percent of the counselors' time was applied to debt management programs and the charge for the service was "nominal." The court also considered the facts that the agency was publicly supported and that it had a board dominated by members of the general public as factors indicating a charitable operation. See also, Credit Counseling Centers of Oklahoma. Inc. v. United States, 79-2 U.S.T.C. 9468 (D.D.C. 1979), in which the facts and legal analysis were virtually identical to those in Consumer Credit Counseling Centers of Alabama, Inc. v. United States, discussed immediately above.

The organizations included in the above decision waived the monthly fees when the payments would cause a financial hardship. The professional counselors employed by the organizations spent about 88 percent of their time in activities such as information dissemination and counseling assistance rather than those connected with the debt management programs. The primary sources of revenue for these organizations were provided by government and private foundation grants, contributions, and assistance from labor agencies and United Way.

Outside the context of credit counseling, individual counseling has, in a number of instances, been held to be a tax-exempt charitable activity. Rev. Rul. 78-99, 1978-1 C.B. 152 (free individual and group counseling of widows); Rev. Rul. 76-205, 1976-1 C.B. 154 (free counseling and English instruction for immigrants); Rev. Rul. 73-569, 1973-2 C.B. 179 (free counseling to pregnant women); Rev. Rul. 70-590, 1970-2 C.B. 116 (clinic to help users of mind-altering drugs); Rev. Rul. 70-640, 1970-2 C.B. 117 (free marriage counseling); Rev. Rul. 68-71, 1968-1 C.B. 249 (career planning education through free vocational counseling and publications sold at a nominal charge). Overwhelmingly, the counseling activities described in these rulings were provided free, and the organizations were supported by contributions from the public.

Internal Revenue Code section 501(c)(3) specifies that an exempt organization described therein is one in which "no part of the net of earnings inures to the benefit of any private shareholder or individual." The words "private shareholder or individual" in section 501 refers to persons having a personal and private interest in the activities of the organization. Treas. Reg. § 1.501(a)-1(c). The inurement prohibition provision "is

designed to prevent the siphoning of charitable receipts to insiders of the charity. . . ." United Cancer Council v. Commissioner, 165 F.3d 1173 (7th Cir. 1999). Reasonable compensation does not constitute inurement. Birmingham Business College v. Commissioner, 276 F.2d 476, 480 (5th Cir. 1960).

Where an organization provided a source of credit to companies of which a private shareholder was either an employee or an owner, the court found that a portion of the organization's net earnings inured to the benefit of that private shareholder. Easter House v. United States, 12 Cl. Ct. 476 (1987). That such loans were made showed that the companies controlled by the private shareholder had a "source of loan credit" in the organization.

The Credit Repair Organizations Act (CROA), 15 U.S.C. § 1679 et seq., effective April 1, 1997, imposes restrictions on credit repair organizations, including forbidding the making of untrue or misleading statements and forbidding advance payment, before services are fully performed. 15 U.S.C. § 1679b. Significantly, section 501(c)(3) organizations are excluded from regulation under the CROA.

The CROA defines a credit repair organization as:

> (A) any person who uses any instrumentality of interstate commerce or the mails to sell, provide, or perform (or represent that such person can or will sell, provide, or perform) any service, in return for the payment of money or other valuable consideration, for the express or implied purpose of-
>
> > (i) improving any consumer's credit record, credit history, or credit rating, or
> >
> > (ii) providing advice or assistance to any consumer with regard to any activity or service described in clause (i).

15 U.S.C. § 1679a(3). The courts have interpreted this definition broadly to apply to credit counseling agencies. The Federal Trade Commission's policy is that if an entity communicates with consumers in any way about the consumers' credit situation, it is providing a service covered by the CROA. In Re National Credit Management Group, LLC, 21 F. Supp. 2d 424, 458 (N.D.N.J. 1998).

Businesses are prohibited from cold-calling consumers who have put their phone numbers on the National Do-Not-Call Registry, which is maintained by the Federal Trade Commission. 16 C.F.R. § 310.4(b)(1)(iii)(B); 47 C.F.R. § 64.1200(c)(2). Section 501(c)(3) organizations are not subject to this rule against cold-calling. Because 501(c)(3) organizations are exempt from regulation under the CROA and the cold-calling restrictions, organizations that are involved in credit repair have

added incentives to be recognized as section 501(c)(3) organizations even if they do not intend to operate primarily for exempt purposes.

GOVERNMENT POSITION

Exempt Purpose

The purpose of ORG's activities differs substantially from those of the organizations in Rev. Rul. 65-299, Rev. Rul. 69-441, and Consumer Credit Counseling Service of Alabama, Inc. v. U.S. In this case, ORG engages in minimal activities which further an exempt purpose. ORG behaves more like a for-profit corporation rather than a non-profit corporation. ORG functions internally like a profit-driven company. Its "counseling" activity is nothing more than a sales activity. Its "counselors" are the salesmen whose goals were to sell as many DMPs as possible to drive up revenues, thereby, benefiting its directors, BM-1 and BM-2. Consumers who were not current on their bills did not qualify for a DMP and were not offered educational counseling. Instead, they were told to call back when they got their bills in order. Later in XXXX, these individuals were told that they could access the Website website if they had internet access. There was no evidence of any meaningful, educational face-to-face counseling. The "counselors" were judged, evaluated and compensated in large part on their current week or months production of new DMP account revenues. ORG markets and sells DMPs to any consumer who can afford the payments. There was no waiver of fees for persons who were unable to afford its services. There was no actual counseling provided to consumers who contacted or were contacted by ORG. The compensation structure of employees rewarded volume of enrollment of consumers in DMPs, and did not did not allow any meaningful credit counseling to take place.

The taxpayer did not engage in any meaningful educational outreach during the years under examination. Other than providing a quarterly newsletter or directing an individual to its website, there was no evidence of any other meaningful educational activity. All phone calls focused on analyzing whether or not the consumer would qualify for a DMP. This was the primary focus of the "counselor."

Substantial Non-Exempt Purpose

In addition, ORG had a substantial non-exempt purpose of selling a product, the DMP, and of providing substantial business to the related for-profit entities. ORG was not furthering any charitable or educational purpose by mass marketing a DMP. ORG advertises and purchases leads in order to increase its business. Its employees were compensated partly based on the amount of business they brought in. Employees were not encouraged to provide educational counseling during their training.

The reason ORG is organized as an exempt organization under section 501(c)(3) of the Internal Revenue Code is to avoid the regulatory scheme of the Credit Repair Organizations Act (CROA), 15 U.S.C. section 1679, et. Seq. CROA was enacted to protect consumers by banning certain deceptive practices in the credit counseling industry. If ORG was a for-profit company, the CROA would prohibit it from charging fees in advance of fully providing services. In addition, if ORG were for-profit, federal law would prohibit it from purchasing leads and making cold calls to potential customers. Because section 501(c)(3) organizations are exempted from the provisions of CROA, ORG is able to engage in deceptive business practices that Congress intended to prohibit when it passed the CROA law. As such, ORG is operated for a substantial non-exempt purpose, that of carrying on a business while avoiding federal regulations. In addition, ORG could not collect "fair share" payments from creditors if it did not have tax-exempt status. The entire DMP business depends on an organization having tax-exempt status.

Private Benefit Rather Than Public

ORG was formed for the private benefit of BM-1 and BM-2 and its related for-profit entities. Once a client was enrolled in a DMP, all of the processing was turned over to CO-2 of State, the FOUNDERS for-profit back office processor. In order to generate the DMP clients, "leads" were purchased from CO-6, another for-profit corporation owned by BM-1 and BM-2. Advertising and marketing services were purchased from CO-12 and Promotions, Inc., also owned by the FOUNDERS. ORG provided a steady stream of business to these organizations. In fact, a substantial portion of each of the for-profits revenues were generated through service contracts with ORG. In addition, BM-1 and BM-2 had complete control over the non-profit ORG and the related for-profits mentioned above. It also appears that ORG did not solicit any companies other than their own for-profit corporations to process its DMPs, provide "leads", or provide advertising and marketing. ORG, in effect, acted as a debt collection service for the creditors.

Inurement

A review of the ORG balance sheet on form 990 for tax year ending showed Prepaid Expense asset balance of $. A review of the forms 11205 for CO-2 for tax years ending **and** showed ordinary income for the two years totaling approximately $ dollars. BM-1 and BM-2, as equal partners, took equal distributions in tax years ending **and** totaling approximately $ dollars. CO-2 was supposed to be providing services to ORG "st cost", yet the forms 11205 were showing ordinary income.

In a memorandum dated from BM-5, CFO of ORG, it was decided based upon discussions with CO-11 that a Management Fee would be charged by CO-2 to ORG at $ per client, per month. The fee was charged retroactive to . This fee effectively eliminated the Prepaid Expense and

created an additional billing from CO-2 to ORG in the amount of $. In reviewing the memorandum from BM-5, CFO, it is apparent that CO-2 was no longer providing the processing services to ORG "at cost", as stated in the Fulfillment Agreement. This additional Management fee was recognized as income by CO-2 and had flowed to the FOUNDERS as distributions on their and Forms 1120S. In referring to the additional Management Fee, the memorandum stated, "this fee will provide CO-2 of State with the necessary funding for it to continue to provide its services to ORG and ORG/CO-2 Budget Planning (a related corporation with a 1023 application pending)." Three months later, CO-2 of State became inactive and a new processor named CO-2 took over the processing for ORG.

The taxpayer purchased the intangible assets of CO-1. and CO-2, two for-profit entities owned by BM-1 and BM-2 for $, as valued by the firm CO-3. The FOUNDERS received payments of interest and principal from ORG for its purchase of their MOTTO business assets, including "goodwill" and "know how". The $ dollar purchase price was paid down to $ in only five years. Thus the not-for-profit ORG transferred to CO-1. and CO-2 approximately $ over the course of five years, although ORG had 50 years under the terms of the agreement to repay the two for-profit entities.

ORG's Forms 990 states that both BM-1 and BM-2 worked an average of hours per week during XXXX and XXXX. In the tax year ending , BM-1 and BM-2 each received in compensation, benefits and deferred compensation from ORG in their positions as President/Director and Vice President/Director. In the tax year ending , ORG paid them each $ in compensation. BM-1 and BM-2 also drew salaries from their related for-profit entities, CO-2 of State and CO-6. It is highly unlikely that their hours of service per week was exclusively for the benefit of ORG and not their related for-profits.

The transactions and activities cited above constitute inurement to insiders of ORG, notably, BM-1 and BM-2 due to the "complete control" that these individuals had over the operations and assets of ORG, the section 501(c)(3) organization, and the related for-profit service organizations also owned by these two individuals.

CONCLUSION

In summary, ORG was not operated exclusively for exempt purposes because it did not engage primarily in activities which accomplish an exempt purpose. More than an insubstantial part of ORG's activities are in

furtherance of a non-exempt purpose and ORG was operated for the purpose of serving a private benefit rather than public interests. Also, part of the net earnings of ORG inured to the benefit of private shareholders or individuals. Accordingly, it is determined that ORG is not an organization described in section 501(c)(3), and is not exempt from income tax under section 501 of the Internal Revenue Code, effective .