

Credit Counseling Compliance Project Frequently Asked Questions

September 30, 2006

1. What is the credit counseling compliance project?

The credit counseling compliance project is a comprehensive, multi-faceted strategy that includes a widespread outreach program to alert the industry and public to problems in the sector. It includes both an aggressive examination program to halt abuses within the credit counseling industry and a rigorous determination process to prevent abusive organizations from receiving tax exemption. This project involves coordination with other federal and state agencies and oversight organizations to combat abuses, provides the public and the industry with several guidance and educational documents describing the hallmarks of an acceptable credit counseling program, and maintains continuous oversight of the tax-exempt credit counseling industry.

2. Why is the IRS focusing on credit counseling?

In recent years, the IRS has seen an increase in abuses in the credit counseling industry. Many organizations have moved away from their approved tax-exempt purpose of offering counseling and education to help individuals understand and address their financial problems. Instead, their focus is debt management services including promises to restore favorable credit ratings or to provide commercial debt consolidation services.

3. How does the IRS decide whether a credit counseling organization qualifies for tax-exempt status under section 501(c)(3)?

When examining a credit counseling organization or reviewing a credit counseling organization's application for tax-exemption, the IRS looks at the facts and circumstances to see if the organization's objective is to help clients gain a better understanding of their financial problems and develop the necessary skills to address those problems. We look at whether the organization provides each debtor with options tailored to fit his or her specific circumstances, rather than offering counseling as a mechanism to enroll individuals in debt management plans without considering the individual's best interest. In evaluating the organization's objective, we consider factors such as, how the organization markets its services, interviews clients, develops recommendations, and trains its counselors. In addition, founders, officers, directors, or for-profit companies cannot personally benefit from the credit counseling organizations operations.

4. What guidance does IRS provide to help credit counseling organizations determine whether their educational purpose is sufficient to obtain or preserve tax exemption under section 501(c)(3)?

The IRS has made available, and encourages credit counseling organizations to use, Chief Counsel Advice (CCA 20062001, May 9, 2006) and the Core Analysis Tool (CAT) and instructions to help an organization evaluate whether it operates for tax-exempt educational purposes. Using the criteria in these documents, a credit counseling organization can make changes to its operations to ensure it complies with the tax laws.

The Advice provides the legal framework to determine whether a credit counseling organization that offers counseling and debt management plans to the public operates in furtherance of educational purposes consistent with section 501(c)(3). The CAT and its instructions, designed to help agents and tax law specialists evaluate whether a credit counseling organization operates in a tax-exempt manner, lists characteristics that demonstrate whether an organization is furthering an educational purpose that is sufficient to obtain or preserve tax exemption.

5. How many credit counseling organizations has the IRS examined?

We have examined 63 credit counseling organizations, representing 56% of the revenue in the credit counseling industry, based on information from the latest available IRS filing data. In addition, we are conducting compliance checks on more than 700 credit counseling organizations to determine whether they are operating compliant credit counseling programs.

6. What has the IRS found during its investigation of the credit counseling industry?

The examinations completed thus far have uncovered abuses involving organizations that: fail to provide education; operate as commercial businesses; and serve the private interests of directors, officers, and related entities.

7. What has the IRS done to stop abuses in the credit counseling industry?

The IRS has revoked, terminated or proposed revocation of more than half of the organizations examined, representing 41% of revenue in the industry, based on latest available IRS filing data. By rigorously reviewing new applications, we were able to prevent abusive organizations from receiving tax exemption. Out of 110 recently reviewed applications, only three met the requirements for tax-exempt status; 95 were not approved and the remaining 12 are pending. Working with other IRS divisions, we developed a process to evaluate entities related to credit counseling organizations, such as related

for-profit businesses, preparers and individuals. In addition, we are coordinating our efforts closely with state enforcement officials and the Federal Trade Commission. To help identify organizations that began offering credit counseling services after they received tax exemption, we added questions to Form 990 that require organizations to disclose whether they provide credit counseling, debt management, or debt negotiation services.

8. Is the IRS still giving tax-exempt status to credit counseling organizations? If so, what steps is it taking to ensure that a credit counseling organization meets all the requirements for tax exemption?

If a credit counseling organization meets all the requirements of section 501(c)(3), the IRS will approve its application for tax-exempt status.

Realizing the need to prevent additional abusive organizations from receiving tax exemption, we implemented a rigorous front-end review process to target applications for exemption from organizations conducting credit counseling activities. We added new questions to Form 1023 (application for tax-exempt status) to help us identify organizations that have a relationship with a for-profit service provider. A trained group of determination agents carefully reviews all applications for tax-exempt status that may involve credit counseling activities to differentiate compliant organizations from those that are abusive. Because of the careful scrutiny applied to new applications for tax exemption, the IRS has effectively stopped the proliferation of new abusive credit counseling organizations receiving tax-exempt status.

9. What is the IRS doing to increase the public's awareness of abusive credit counseling organizations?

Because of the serious abuses in the credit counseling industry, the IRS continues to take steps to ensure that the public is not misled by organization that are incorrectly labeled as tax exempt. The public can identify credit counseling or other organizations that are no longer eligible to receive tax deductible contributions by going to our website at www.irs.gov/charities and clicking on "Search for Charities".

The IRS, partnering with other stakeholders (e.g., FTC, Department of Justice's Executive Office of the U.S. Trustee), unveiled a website designed to help consumers decide whether to use and how to chose a credit counseling organization. While consumer education is generally outside the IRS responsibilities, in this case, the IRS believes it is advisable given that its enforcement activities are reaching the entire industry.

10. Can a credit counseling organization that receives fair share payments from credit card companies also qualify for tax-exempt status?

Yes, a credit counseling organization that otherwise meets the requirements under section 501(c)(3) and 501(q) will be tax exempt, even if it receives “fair share” payments. However, the Pension Protection Act of 2006 contains limits on the amount of revenue a credit counseling organization may receive from its customers’ creditors which are attributable to DMP services.

Fair share payments are payments made by some credit card companies to credit counseling organizations based on the amount the organization collects from the consumer.

11. How do IRS criteria for recognizing credit counseling organizations as exempt differ from the certification requirements under the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005?

The laws have different statutory requirements and are administered by different agencies. The Bankruptcy Act does not require an organization to be exempt under section 501(c)(3) to qualify as a nonprofit budget and credit counseling agency. Likewise, bankruptcy certification is not a requirement for tax exemption. The Bankruptcy Act certification requirements are available on the U.S. Department of Justice’s website at www.usdoj.gov/ust.