

**Internal Revenue Service**  
Appeals Office

Release Number: **201417023**  
Release Date: 4/25/2014  
Date: January 29, 2014

**Department of the Treasury**

**Employer Identification Number:**

**Person to Contact:**

Employee ID Number:  
Tel:  
Fax:

**UIL: 501.03-00**

**Certified Mail**

Dear:

This is a final adverse determination regarding your exempt status under section 501(c)(3) of the Internal Revenue Code (the "Code"). It is determined that you do not qualify as exempt from Federal income tax under section 501(c)(3) of the Code effective July 1, 2005.

Our revocation was made for the following reason(s):

You are not operated exclusively for charitable, educational, or other exempt purposes as required in § 501(c)(3) of the Code. You did not engage primarily in activities which accomplish one or more of the exempt purposes specified in § 501(c)(3) of the Code. Treasury Regulation § 1.501(c)(3)-1(c)(1). More than an insubstantial part of your activities were in furtherance of a non-exempt purpose.

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

You are required to file Federal income tax returns on Forms 1120. File your return with the appropriate Internal Revenue Service Center per the instructions of the return. For further instructions, forms, and information please visit [www.irs.gov](http://www.irs.gov).

If you were a private foundation as of the effective date of the adverse determination, you are considered to be taxable private foundation until you terminate your private foundation status under section 507 of the Code. In addition to your income tax return, you must also continue to file Form 990-PF by the 15th Day of the fifth month after the end of your annual accounting period.

Processing of income tax returns and assessments of any taxes due will not be delayed should a petition for declaratory judgment be filed under section 7428 of the Code.

We will make this letter and the proposed adverse determination letter available for public inspection under Code section 6110 after deleting certain identifying information. We have provided to you, in a separate mailing, Notice 437, *Notice of Intention to Disclose*. Please review the Notice 437 and the documents attached that show our proposed deletions. If you disagree with our proposed deletions, follow the instructions in Notice 437.

If you decide to contest this determination, you may file an action for declaratory judgment under the provisions of section 7428 of the Code in one of the following three venues: 1) United States Tax Court, 2) the United States Court of Federal Claims, or 3) the United States District Court for the District of Columbia. A petition or complaint in one of these three courts must be filed within 90 days from the date this determination letter was mailed to you. Please 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. See also Publication 892.

You also 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 matters that may not have been resolved through normal channels get prompt and proper handling. If you want Taxpayer Advocate assistance, please contact the Taxpayer Advocate for the IRS office that issued this letter. You may call toll-free, 1-877-777-4778, for the Taxpayer Advocate or visit [www.irs.gov/advocate](http://www.irs.gov/advocate) for more information.

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

Sincerely Yours,

Appeals Team Manager

Enclosure: Publication 892 and/or 556



TAX EXEMPT AND  
GOVERNMENT ENTITIES  
DIVISION

DEPARTMENT OF THE TREASURY  
Internal Revenue Service  
TE/GE:EO Examinations  
1100 Commerce Street, MS 4900-DAL  
Dallas, TX 75242-1027

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.

Letter 3618 (04-2002)  
Catalog Number 34809F

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,

Sunita B. Lough  
Director, EO Examinations

Enclosures:  
Publication 892  
Publication 3498  
Report of Examination

Form <b>886A</b>	Department of the Treasury - Internal Revenue Service <b>Explanation of Items</b>	Schedule No. or Exhibit
<b>Name of Taxpayer</b>	<b>ORG-1</b> <b>d.b.a. ORG-2</b>	<b>Year/Period Ended</b> June 30, 20XX thru June 30, 20XX

**LEGEND**

ORG - Organization name      ORG-1 - 1<sup>st</sup> Organization name      XX - Date  
Address - address      City - city      State - state      Country - country  
program - program      FDN-1 & FDN-2 = 1<sup>st</sup> & 2<sup>nd</sup> Founders      Secretary -  
secretary      ED/OM - ED/OM      BM-1, BM-2, BM-3 & BM-4 = 1<sup>st</sup>, 2<sup>nd</sup>, 3<sup>d</sup> & 4<sup>th</sup> BM  
EVENT-1, EVENT-2, EVENT-3 & EVENT-4 = 1<sup>st</sup>, 2<sup>nd</sup>, 3<sup>d</sup> & 4<sup>th</sup> EVENT      RA-1 THROUGH  
RA-8 = 1<sup>st</sup> THROUGH 8<sup>th</sup> RA      CO-1 THROUGH CO-28 = 1<sup>st</sup> THROUGH 28<sup>th</sup> COMPANIES

**ISSUES**

1. Should ORG-2's Federal tax exempt status under IRC section 501(c)(3) be revoked for failure to operate for exempt purposes as described under such section?
2. Whether compensation paid by ORG-2. to FDN-1 and FDN-2, the founders of ORG-2, was excessive. As such, should the excessive compensation constitute inurement?

**FACTS**

**Background of ORG-2**

ORG-2 was founded by FDN-1 and FDN-2. FDN-1 and FDN-2 are licensed psychologists in the field of family and marriage counseling for the past 25 years and have been performing family and marriage counseling out of CO-1, d.b.a. CO-2, an organization exempt from Federal income tax under IRC section 501(c)(3). In the course of performing family and marriage counseling to couples, FDN-1 and FDN-2 discovered that finance, sex and communication are the top three problems for most couples. Often times, financial issues keep couples from completing the counseling sessions. From 19XX to 19XX, FDN-1 and FDN-2 also hosted a radio program "PROGRAM" on CO-3 FM and CO-4. "PROGRAM" aired daily Monday through Friday. On several occasions, guests participating in the radio program suggested that FDN-1 and FDN-2 should look into financial counseling and debt management programs (DMP) as a way to help individuals, couples, and families with their financial issues. FDN-1 and FDN-2 looked into the suggestions and in 19XX they founded ORG-2. In 19XX, ORG-2 applied for Federal tax exempt status and was subsequently recognized as an organization exempt from Federal income tax under IRC sections 501(c)(3) and 509(a)(2).

The specific purpose of ORG-2, as stated in its Articles of Incorporation, is "to meet the needs of persons experiencing financial difficulties by offering Biblical based financial counseling, education, encouragement and empowerment." ORG-2 disclosed in its Form 1023 Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code that it plans to conduct the following activities:

Form <b>886A</b>	Department of the Treasury - Internal Revenue Service <b>Explanation of Items</b>	Schedule No. or Exhibit
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- Telephone Counseling – ORG-2 will provide telephone counseling for those individuals who are unable to physically assess our ORG-2 facilities.
- Face-to-Face Counseling – ORG-2 will provide face-to-face financial counseling for those individuals who are seeking assistance with restoration of credit, financial management, debt management, and debt elimination. This will be accomplished within the context and with the partnership of the local church.
- Seminars – ORG-2 will provide seminars and workshops, primarily through the local church, that disseminate information about financial management, budgeting, stewardship and Biblical financial principles.
- Resource Support – ORG-2 will produce and make available to our clients, resources that support our efforts to fulfill our mission. These products will be made available to our clients as they interface with our programs.
- Media Ministry – It is ORG-2's desire to produce and broadcast various media programs such as radio, television, and Internet communications that fulfill our mission and purpose.

### Board of Directors and Key Employee

In the tax year ending June 30, 20XX, ORG-2's Board of Directors included:

- FDN-1, President, Chairman of the Board
- BM-1, Board Member
- BM-2, Board Member
- BM-3, Board Member
- BM-4, Board Member

FDN-2 served as ORG-2's Secretary. He resigned from this position on December 29, 20XX. The key employee included ED/OM, Executive Director and Office Manager. ORG-2 had 8 employees, 6 counselors and 2 administrators during the tax year ending June 30, 20XX.

### Educational Background of FDN-1 and FDN-2

FDN-1 has a B.A. in psychology, a M.A in theory with emphasis in marriage and family ministry, and a Ph. D. in clinical psychology. He is a licensed marriage and family counselor and a clinical psychologist. FDN-1 also has a real estate broker's license and is studying for his certification in financial planning.

FDN-2 has a B.A. in Biblical Studies, a M.A in theory with an emphasis in marriage and family ministry, and a Ph. D. in clinical psychology. FDN-2 is a licensed marriage and family counselor and a clinical psychologist.

### Related Entities and Other Programs

Form <b>886A</b>	Department of the Treasury - Internal Revenue Service <b>Explanation of Items</b>	Schedule No. or Exhibit
Name of Taxpayer	ORG-1 d.b.a. ORG-2	Year/Period Ended June 30, 20XX thru June 30, 20XX

**CO-1 (CO-1) d.b.a. CO-2** – An organization exempt from Federal income tax under IRC section 501(c)(3) founded by FDN-1 and FDN-2. CO-1 provides family, marriage and Christian counseling to couples and families.

**CO-5 (CO-5)** – A Christian based State mortgage company co-founded by FDN-1 in 20XX. FDN-1 also serves as CEO for CO-5. Per FDN-1, due to the slow down in the housing market, CO-5 is currently inactive.

**CO-6 (CO-6)** – A pilot program of ORG-2. CO-6 provides cash tracking and bill paying services to clients who do not need DMP services offered by ORG-2. This program is headed by RA-1, one of ORG-2's certified counselors. Under this program, clients would send their bills to RA-1. RA-1 would, in turn, pay bills for the clients and provide them with a summary at the end of the year. During the field visit on January 23, 20XX, FDN-2 disclosed that ORG-2 charges a fee for this service

In a written response titled, "IRS Information Request 02" received by the Service on June 24, 20XX, ORG-2 disclosed that this program is no longer being pursued. No clients were admitted into this program during tax year June 30, 20XX. Four clients were admitted into the program during tax year June 30, 20XX. Currently, there are no clients in this program. ORG-2 responded "n/a" to the question, "Are fees charged in connection with providing the services."

According to the Minutes of Directors' Meetings dated September 5, 20XX, CO-6 introduced the Cash Management Program in July 20XX. The Cash Management Program includes three stages:

1. Stage I-electronic bill paying service.
2. Stage II-cash and debit tracking/planning service.
3. Stage III-comprehensive and simple progress reporting and monitoring

The minute goes on to describe that CO-6 will use ORG-2's phone counseling department as the feeder for CO-6 advisors. ORG-2 eventually planed to establish a launch point to evolve CO-6 into a for-profit company.

Together, ORG-2, CO-1, CO-5, and CO-6 make up the CO-2 Group. Both ORG-2 and CO-1 employ the same fiscal year end date of June 30. ORG-2 and CO-1 occupy a building located in City, State. The building is leased by CO-7 (CO-7), a for-profit metal stamping company in which FDN-1 and FDN-2 co-own. CO-7 allows ORG-2 to occupy the space on the 2<sup>nd</sup> floor at no charge. The space occupied by ORG-2 is approximately 5,000 square feet.

### Compensation of FDN-1 and FDN-2

Form <b>886A</b>	Department of the Treasury - Internal Revenue Service <b>Explanation of Items</b>	Schedule No. or Exhibit
Name of Taxpayer  ORG-1 d.b.a. ORG-2		Year/Period Ended June 30, 20XX thru June 30, 20XX

In the original Bylaws adopted on October 22, 19XX, ORG-2 set forth, *"The salaries of the officers, if any, shall be fixed from time to time by resolution of the Board of Directors, and no officers shall be prevented from receiving such salaries by reason of the fact that he or she is also a director of the corporation. In all cases, any salaries received by officers of this corporation shall be reasonable and given in return for services actually rendered the corporation which related to the performance of the religious purposes of this corporation."*

The Bylaws did not set forth the criteria for reasonable compensation or the maximum that the officers are allowed to receive. FDN-1 and FDN-2 received the following compensation from ORG-2 (ORG) and CO-1:

	30-Jun-XX			30-Jun-XX		
	ORG	CO-1	TOTAL	ORG	CO-1	TOTAL
FDN-2						
FDN-1						

	30-Jun-XX			30-Jun-XX		
	ORG	CO-1	TOTAL	ORG	CO-1	TOTAL
FDN-2						
FDN-1						

	30-Jun-XX			30-Jun-XX		
	ORG	CO-1	TOTAL	ORG	CO-1	TOTAL
FDN-2						
FDN-1						

	30-Jun-XX			30-Jun-XX		
	ORG	CO-1	TOTAL	ORG	CO-1	TOTAL
FDN-2						
FDN-1						

For tax year ending June 30, 20XX, FDN-1 and FDN-2 also received bonuses of \$ and \$ respectively, from ORG-2. The bonuses were recorded outside of the regular payroll system and were not included in the \$ above.

In a response dated September 10, 20XX, ORG-2 disclosed that it relied on the advice of CPA Firm CO-8 and the compensation study conducted by American Association of Debt Management Organizations (AADMO) to set compensation for its officers. The Revenue Agent (Agent) requested all communications and correspondence along with the study and research conducted by CPA Firm CO-8 regarding the determination of the officers' compensation. ORG-2 did not provide the requested documentation.



Form <b>886A</b>	Department of the Treasury - Internal Revenue Service	Schedule No. or Exhibit
<b>Explanation of Items</b>		
Name of Taxpayer		Year/Period Ended
ORG-1 d.b.a. ORG-2		June 30, 20XX thru June 30, 20XX

On October 20, 20XX, subsequent to the Service issuing a preliminary report proposing revocation of ORG-2's exempt status, ORG-2 provided the Service with a letter dated January 6, 20XX written by RA-2, Managing Director of CO-8. In the letter, RA-2 describes his role in the ORG-2 Board of Director's approval of FDN-1 and FDN-2's salary increases. The following is a summary of the letter dated January 6, 20XX.

- a. During the period under examination, CO-8 has provided tax and accounting services to ORG-1.
- b. ORG-1's Board of Directors contacted CO-8 in December 20XX when it considered increasing FDN-1 and FDN-2's salary to approximately \$ each.
- c. ORG-1 provided CO-8 with a copy of the AADMO compensation study which was used to compare the contemplated salaries of FDN-1 and FDN-2.
- d. After a brief review of the information provided, RA-2 noted that compared to the other organizations listed in the AADMO compensation report, the contemplated salaries were on the higher end of the scale though they were not the highest salaries in the report. As such, and taking into account his understanding of other relevant factors, RA-2 verbally indicated that, in his opinion, the ORG-1 salaries were reasonable.
- e. RA-2 based his determination on the following factors:
  - a. The AADMO study provided by ORG-1 demonstrated that the contemplated salaries, though higher than those paid to some individuals, were not the highest salaries paid to officers of credit counseling organizations.
  - b. The additional responsibilities assumed by FDN-1 and FDN-2 in performing their roles as ORG-1 director/officers were significantly greater than those of strictly Exempt Organization Directors. Unlike other exempt organization's directors, FDN-1 and FDN-2 actively performed each of the organization's responsibilities tasks from directors to counselors. As FDN-1 and FDN-2 assumed more responsibilities than other directors, it was not unreasonable that their salaries should be higher given the expanded roles performed.
  - c. Lastly, RA-2 was aware of the substantial amount of time that FDN-1 and FDN-2 devoted on behalf of ORG-1 in taking care of their clients. FDN-1 and FDN-2 worked very long hours as they assumed the responsibilities of several positions. They would frequently work extremely late evening hours and on weekends to accommodate their financially burdened clientele. It would not be unreasonable to estimate that each of them worked for ORG-1 for at least 50 hours per week during 20XX and 20XX in multiple capacities.

The AADMO Credit Counseling Industry Compensation Study that ORG-2 provided to the Agent is a one-page table that lists executive compensation paid by credit counseling agencies shown as follow:

CREDIT COUNSELING INDUSTRY EXECUTIVE COMPENSATION					
Organization	Tax Year	Title	Compensation	Total Revenue	% of Total Rev.

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76	20XX	CEO
54	20XX	President
50	20XX	Exc. Dir.
87	20XX	Pres/Ex. Dir.
48	20XX	Pres./CEO
34	20XX	President
88	20XX	Pres./CEO
150	20XX	Pres./Dir.
90	20XX	General Mmgr
54	20XX	Exc. VP
147	20XX	Pres/Ex. Dir.
90	20XX	Treasurer
90	20XX	Vice President
156	20XX	Treas./Dir.
156	20XX	Pres./Dir.
8	20XX	President
177	20XX	President
26	20XX	Exe. Dir.
2	20XX	Pres./Chairman
20	20XX	COO

No explanation, footnotes, instructions, etc. accompanied the above table. On January 6, 20XX (after the Service issued a preliminary report), ORG-2 provided the Service with a completed copy of the AADMO compensation study. The AADMO study was commissioned to compare executive compensation in the credit counseling industry to executive compensation in the general non-profit (i.e. tax-exempt) organization sector. In the AADMO study, an executive from more than 500 individual salaried positions in the general non-profit industry and Form 990 returns for more than 150 separate non-profit organizations were evaluated. The AADMO warned the readers that its report was for informational purposes only. The AADMO further disclaimed any attempt to directly or indirectly suggest appropriate compensation levels or amounts for industry members.

During the examination, ORG-2 provided the Agent with the Minutes of Directors' Meetings dated December 29, 20XX. The minutes disclosed that three newly elected Board Members were present at the meeting; RA-3, BM-1 and BM-4, which are vendors that provide various services to ORG-2. The following is a portion of the minutes and is hereby quoted,

**"II. ORG-1 Financial & Statistics**

*FDN-1 noted that he and Mr. FDN-2 were currently receiving a salary of \$\$ per month. Due to changes in the income tax structure of the two, it is proper time to give them an increase in their salaries."*

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<b>Name of Taxpayer</b>  ORG-1 d.b.a. ORG-2		<b>Year/Period Ended</b> June 30, 20XX thru June 30, 20XX

The Board of Directors subsequently approved a salary increase of \$\$ per month from \$\$ per month to \$\$/month, commencing March 1, 20XX.

The Agent inquired about documentation of the board's discussion regarding the approval of the salary increases and was informed that, "*Any documentation, while not exhaustive or comprehensive, of these discussions are recorded in the minutes of this minutes.*" ORG provided no further explanation or documentation on this inquiry. ORG-2 further disclosed that the board did not have or use any report, study, analysis, etc. in making the decision to approve the salary increases.

ORG-2 also provided the Agent with the Minutes of Directors' Meetings dated September 5, 20XX. A portion of the minutes is hereby quoted, "*... A question arose over the level of officer compensation if it was too high in raw dollars or as a percentage of Gross Revenue. It was agreed to contact RA-2 to confirm the appropriate level.*"

FDN-1 and FDN-2 continued to receive a monthly salary of \$\$ until April 20XX. They then received a monthly salary of \$ for the remainder of the fiscal year ending June 30, 20XX.

#### **Duties and Responsibilities of FDN-1 and FDN-2**

In a written response received by the Agent on March 5, 20XX, ORG-2 disclosed that FDN-1 and FDN-2 are employees at will. There are no written employment agreements. In a written response dated September 10, 20XX, ORG-2 disclosed that FDN-1, and FDN-2, V.P. of Business Development and Church Relations, have the following duties and responsibilities.

- a. President (FDN-1): 40+ hours per week
  - i. Administration
  - ii. Public Relations
  - iii. Human Resource
  
- b. V.P. of Business Development (FDN-2): 40 plus hours
  - i. Fund Raising
  - ii. Provides direct individual counseling for individuals and families for financial and relational issues.

ORG-2 maintains that FDN-1 and FDN-2 performed the duties and responsibilities as described above.

#### **Time Devoted to ORG-2's Activities by FDN-1 and FDN-2**

ORG-2 and CO-1 disclosed on Part V-A, Current Officers, Directors, Trustees, and Key Employees, of Form 990 that the average weekly hours that FDN-1 and FDN-2 devoted to their respective position were as follows:

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	30-Jun-XX		30-Jun-XX		30-Jun-XX	
	ORG	CO-1	ORG	CO-1	ORG	CO-1
FDN-2	30 hrs.	20 hrs.	20 hrs.	20 hrs.	P/T	P/T
FDN-1	30 hrs.	20 hrs.	20 hrs.	20 hrs.	P/T	P/T

In a partial written response to IDR 02 received by the Agent on June 24, 20XX, ORG-2 disclosed that *it is not* difficult to determine on a day-to-day basis the numbers of hours spent by FDN-1 and FDN-2, nor are they required by the board, to account for their time on an hourly basis. In a subsequent follow-up telephone inquiry, ORG-2's Secretary, Secretary, orally corrected that *it is* difficult to determine on a day-to-day basis the numbers of hours spent by FDN-1 and FDN-2.

In a written response to IDR02 received by the Agent on March 5, 20XX, BM-1, a Board Member, provided the following explanation regarding FDN-1 and FDN-2's compensation, *"FDN-1 and FDN-2's salaries have averaged less than \$ per year since ORG-1 opened its doors to the public. Please note that their current salaries are considerably lower in comparison to the year you are evaluating. We also think that it was appropriate that some monies were given back to CO-1 for the years of free rent and financial support it gave in the form of loaning FDN-1 and FDN-2 to help found ORG-1..."*

**FDN-1 and FDN-2's Duties and Responsibilities at CO-1**  
**(CO-1)**

CO-1's Form 990 disclosed that FDN-2 was the President of CO-1 and FDN-1 was the Executive Director of CO-1.

The Agent inquired about FDN-2's actual duties and responsibilities at CO-1 and was informed that FDN-2 is responsible for Administration, Public Relations, Human Resources and other duties that the company may need from time to time to keep it as a going concern.

According to CO-1's web site, FDN-1 is the CEO of CO-1. The Agent inquired about FDN-1's duties and responsibilities at CO-1 and was informed that,

- The CEO of CO-1 is FDN-2, not FDN-1.
- FDN-1 assists FDN-2 in the day-to-day operation of CO-1.
- FDN-1' estimated work hours devoted to CO-1 is about 30 to 40 hours depending on the situation the company is in.

ORG-2 also disclosed that FDN-1 is the CEO of CO-7. However, he is not directly involved in the day-to-day operations of the company. He is informed of the company's status on a weekly basis, monthly basis, quarterly basis, semi-annual basis and on an

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annual basis. There are knowledgeable personnel in place to run the company. FDN-1' estimated hours per week is 1-2.

**Employment Agreement Between ORG-2 and ED/OM**

ED/OM joined ORG-2 on January 14, 20XX and was released on July 31, 20XX. ORG-2 provided the Agent with an Employment Agreement dated March 17, 20XX, between ED/OM and ORG-2. On average, ED/OM devoted 40 hours per week to his position. According to the Employment Agreement, ED/OM's duties and responsibilities included, but were not limited to, developing a strategic plan, providing annual budget plan and forecasting to founders, overseeing company operations, meeting with founders weekly, monthly and as needed, etc.

For the tax years ending June 30, 20XX and June 30, 20XX, ED/OM received compensation of \$ and from ORG-2 respectively.

On July 24, 20XX, the Service contacted ED/OM to obtain information regarding his title, duties, and responsibilities in his position at ORG-2. Also inquired was his knowledge of FDN-1 and FDN-2's duties, responsibilities and time devoted to their positions at ORG-2. In a letter dated August 15, 20XX, ED/OM responded to the Service's request for information. The following is a summary of ED/OM's responses.

- ED/OM's duties and responsibilities for the period beginning July 1, 20XX through June 30, 20XX are best described in the enclosed Employment Agreement dated March 17, 20XX under "1. Description of Duties".
- ED/OM cannot say how many hours per day FDN-2 devoted to his position at ORG-2 during the period beginning July 1, 20XX through June 30, 20XX. ED/OM's office was not on the same floor of the building as FDN-1 and FDN-2's so he did not observe FDN-1 and FDN-2's ongoing work activity.
- ED/OM cannot say what FDN-1 and FDN-2's actual duties and responsibilities were at ORG-2 during the period beginning July 1, 20XX through June 30, 20XX.
- ED/OM reported to FDN-1 as he was his boss.
- ED/OM cannot recall what title and position FDN-2 held at ORG-2 during the period beginning July 1, 20XX through June 30, 20XX.

In a letter dated July 7, 20XX from FDN-1 to the staff regarding the termination of ED/OM's employment with ORG-2, FDN-1 stated, "... Effective August 1, FDN-1 will assume daily operational oversight of the ministry. His time working directly with and in the ministry will increase from this point forward and into the months ahead. Please make sure to utilize FDN-1 as your first point of contact for matters concerning or impacting the ministry starting August 1. It's been a little under six years since FDN-1 has been at the helm and will welcome your support and encouragement as he makes this important transition."

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Refer to Exhibit 1 for the letter from ED/OM.

### **20XX Business Plan Summary**

During the examination, ORG-2 provided the Agent the 20XX Business Plan Summary. The following was discussed in the business plan.

- **Market opportunity is large and growing.** 900,000 hits per month on web for "debt consolidation".
- **Growing openness in Christian community to face financial realities.** This means a greater willingness to face debt problems and seek help.
- **Creditor choices for collections.** Be so effective with debt repayment results that creditors want to use us. Be a competitive, viable alternative to other channels.
- **Aggressive growth possible in 20XX,** however, must move quickly in first quarter to build remaining infrastructure to generate revenue growth of 60%.
- **Increase number and quality of applications.** Search engine changes for ORG and CO-15 long application will be completed in December. Sustain radio and magazine advertising. Expand word-of-mouth referrals.
- **Launch an educational initiative** in first quarter to meet compliance requirements and ministry goals. Core of initiative is a team of volunteers (financial coaches) who can respond to current customer demand. Another element is to offer public financial seminars as an outreach effort.
- **Minimal education efforts for both compliance and ministry needs.**

Action: Establish an Educational strategy for 20XX. Key part of effort to be a team of volunteers to provide ongoing education on all financial topics. Link with CO-9 ministries for staffing, structure and process concepts.

### **20XX Business Plan**

ORG-2 provided the Agent with a 20XX Business Plan and XX/XX Operational Update. In the 20XX Business Plan, ORG-2 set the following goals:

- Increase revenue by 6% to \$ and increase net income by \$\$.
- Gross revenue is targeted to be above 55% for the year and the client base will be grown to 4,000.

ORG-2 proposed the following strategy to achieve the goals set above.

- increase its reach to debt management program clients by offering additional financial resources, both in-house through bill paying programs and our sister mortgage operation.
- Refer candidates to outside partners that provide additional financial resources in return for referral fees.

### **Counseling and Debt Management Program**

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ORG-2 tailors its services to Christian clients nationwide. ORG-2 also serves walk-in clients. Appointments would be scheduled for those who are able to physically come to ORG-2's office after the initial call in. According to the training manual, ORG-2 classifies a person who had contacted ORG-2 for the first time as a *Suspect*. The Suspect then becomes a *Prospect*. Once the Prospect signed up for a DMP, the Prospect becomes a *Client*.

During the field visit on September 26, 20XX, the Agent asked FDN-1 to describe the counseling process. FDN-1 informed the Agent that he and FDN-2 do not get involved in the counseling process. In a subsequent correspondence, ORG-2 disclosed that FDN-1 and FDN-2 oversee the counseling process. According to the three Phone Counselors the Agent interviewed, the counseling activities began with a suspect calling in and involve the following steps:

**Step 1 – Getting to Know the Suspect and Gathering Information**

All counseling activities began with the counselor getting to know the suspect. The Phone Counselor would listen to their story and ask questions such as,

- Reason for calling, family problems, medical issues, lost of employment, etc
- The financial issues, credit card debts, repossession, mortgage, car loans, student loans, medical debts, problems with obtaining prescription drugs, etc
- How long their accounts have been past due
- If the accounts are in collection
- If their income is stable, etc.

At the same time, the Phone Counselor either directs the suspect to the ORG-2 web site or faxes or emails the suspect the budget form and creditor form. The purpose of the forms were to allow the suspect to list all sources of income and expenses and identify all creditors. On occasion, the suspect would call ORG-2 because they wanted a loan. ORG-2 does not offer loans.

**Step 2 – Budget Analysis**

Upon receiving the forms back from the suspect, the Phone Counselor would perform an analysis of the income and expenses to determine the appropriate actions. The counselor would review the information looking for items such as spending too much on food given the size of the family, eating out too often, etc.

**Step 3 – What Are the Options**

Based on the result of the budget analysis, the Phone Counselor would present the prospect with several options.

1. DMP – if the suspects have money after paying all necessary expenses, the counselor would offer a DMP. The Phone Counselor would go over the benefits of the DMP such

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as the reduced interest rate and payment, the time it takes to pay off the debts, one easy monthly payment, the reduction or elimination of harassing calls, etc.

2. Bankruptcy – Except for extreme circumstances, ORG-2 does not advise the suspect to file bankruptcy. It's against Christian values to file bankruptcy. The debtors should attempt to pay off their debts.
3. Refinancing – Per FDN-1, he is against the refinancing option because refinancing would convert one form of debt to another without paying off the debt.
4. Budgeting – this option involves the counselor advising the suspect to cut down unnecessary expenses so they have more money to pay debts.
5. Referral – If the DMP is not appropriate or if the suspect is not qualified for a DMP, the Phone Counselor would direct the suspect to the ORG-2's web site for the list of entities and organizations that provide assistance such as employment, free prescription drugs, etc.
6. Referral to CO-6 (CO-6) – If the clients did not want a DMP but wanted to better manage their finances or simply wanted someone to take care of the bill paying chores, the counselors would offer them cash tracking and bill pay through CO-6.
7. Other Option – This option focuses on paying off one debt, usually the biggest debt, at a time. FDN-2 referred to this option as the "Snowball Effect".

**Step 4 – The Suspect does Not Qualified for a DMP**

If the suspect did not want a DMP or did not qualify for a DMP, the Phone Counselor would refer the suspect to other organizations for assistance. After making the referrals and after the questions were answered, the counselor would end the call. The Phone Counselor would not call the suspect to follow up on their situation. If the suspect calls back with more questions, the Phone Counselor would respond accordingly.

**Step 5 – Prospect decided to Participate in a DMP**

If the prospect qualified and decided to sign up for the DMP, the Phone Counselor would sign the prospect up for the DMP. The Phone Counselor would send the DMP agreement and notification to the prospect. The prospect would fill out the application and sign the agreement to participate in the DMP. During the tax year ending June 30, 20XX, ORG-2 did not charge an initial set up fee. Currently the initial fee is \$. ORG-2 requires the clients to make a monthly suggested donation of \$. The monthly suggested donation is one condition stipulated into the DMP agreement that the clients must agree to.

**Step 6 – Processing DMP Clients**

ORG-2 does not process the DMP applications in house. After receiving the signed DMP agreement from the clients, the Phone Counselor reviews the application package for missing information and statements. If the package is completed, the Phone Counselor forwards the package to the in-house Administrator for final processing. The Administrator reviews the submitted application package for accuracy and completeness before



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submitting it to the outside back office for processing. ORG-2 engages CO-10 (CO-10) as its back office for processing DMP clients.

**Step 7 – Receiving Payment from Clients and Disbursing Payments to creditors**

DMP clients make payments directly to CO-10. CO-10 disburses payments to creditors. On a weekly basis, CO-10 pays ORG-2 for its share of the fair share and monthly DMP client's suggested donation that the clients agreed to.

Per FDN-1, after the application package is sent to CO-10, ORG-2 keeps the DMP client's files for one year and then shreds them. Each DMP client file contains a Trace Note. The Trace Note contains all communications between ORG-2 and prospective clients before and after they signed up for DMP (defined by the date the fund is withdrawn from the client's bank account for repayment to the creditors). During the examination, ORG-2 provided the Agent with copies of 10 DMP client files and 4 separate client's Trace Notes. The following is a representative communication between the Phone Counselor and a suspect.

A client from City, State (signed onto the program on 10/23/20XX)

*8/21/20XX: Email – Other Email – Email sent to prospective client about her friend RA-4 needing help as well. Emailed Budget and Creditor list to RA-5 to give to her friend*

*8/22/20XX: Follow Up – Need more info pending follow up from RA-4 and or RA-5*

*9/18/20XX: Follow Up – Need more info per RA-5. they both came back from a missions trip in Country (sic) and are serious about getting out of debt to support the family there.*

*She is currently out of town but will contact me when she returns*

*9/19/20XX: Email – Other SEM t contact and budget/creditor list*

*9/26/20XX: Prospect Reply – My name is RA-4. I recently received your information from my dearest friend RA-5. She was telling me how wonderful you are and what a blessing it was that you came into her life. I have found myself going down the wrong financial path, and in need of help and guidance. I would love to speak to you about my financial situation. I feel like the more I try sometimes, I just can't get it all worked out. I have been praying for a way to work this all out, and then RA-5 told me about you. I know that you are very busy, but I would love your advice in this arena of my life. Thank so much for your time, I really appreciate it. Have a blessed day.*

*9/26/20XX: Prospect Reply – Thank you sooooo much for your guidance. I am running around today, but should be back by 2:00pm (State time). I will be giving you a call when I get home. I have printed out the forms and will have them to you today. "How God Speaks", is something that I am going to read every morning. You are blessing and I cannot wait to speak with you!*

*9/26/20XX: Follow Up – Need/Waiting for Credit information SEM 1<sup>st</sup> contact and budget/creditor list*

*9/27/20XX: Follow Up – Notification sent Sent 1 time(s). SEM AR and statement request*

*9/27/20XX: Prospect Reply – DMA Agreed*

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9/27/20XX: Prospect Reply – CRA Agreed  
 9/27/20XX: Prospect Reply – ACA Agreed  
 9/27/20XX: Follow Up – Need/Waiting for Statements Faxing today wants to get started right away.  
 9/27/20XX: Fax – Received Statements  
 9/27/20XX: Follow Up – Need more info Act # for CO-11 and the bal on CO-12  
 9/27/20XX: Email – To confirm program  
 9/27/20XX: Phone Call – Incoming call CO-12 balance \$  
 9/27/20XX: Packet sent to Admin – Packet sent to Admin  
 9/28/20XX: Others – Welcome sent RA-6  
 10/8/20XX: Others – 364 + 61 = 425 RA-6  
 10/10/20XX: Others Update sent RA-6  
 12/12/20XX: Others – returned clients rang then went to busy sig. RA-6  
 12/12/20XX: Others – sent email and notified to call to ck status of accounts. RA-6  
 1/15/20XX: Others – Sent another email to see what is going on with accounts CO-13 and CO-14 not accepted / CO-14 needs increase but do not see that anyone has followed up. RA-6

### Counseling Sessions Listening-In

Prior to the Agent listening in during a counseling session, ORG-2 obtained a Core Analysis Tool (CAT). FDN-2 converted the CAT into a check sheet for use by the Phone Counselors during the counseling sessions. In one of the live telephone counseling sessions that the Agent listened to, the Phone Counselor used the converted CAT check sheet and went through each element in the CAT. At the end of the call, FDN-2 performed an evaluation on the Phone Counselor using the guidelines in the CAT. FDN-2 also provided the Agent with 3 recorded counseling sessions dated January 23, 20XX. The Phone Counselors also utilized the CAT and were evaluated based on the CAT. ORG-2 did not provide the Agent with recorded counseling sessions whereby the Phone Counselors followed the CAT and were evaluated based on the criteria set forth in the CAT for the years under audit. Per FDN-2, in the years under audit, ORG-2 did not have the CAT and did not use the CAT in its counseling sessions.

### Phone Counselors Hiring and Training

With respect to hiring practices, Phone Counselor's qualifications, certification and training, ORG-2 employs the following procedures: The minimum education requirement for a Phone Counselor is a high school diploma. A Bachelor's degree is preferred. All prospects seeking employment with ORG-2 must be Christian and willing to work with Christians. The prospects must be emotionally stable. Prior experience in working with the public and phone experiences are a plus. All employees wishing to become a Phone Counselors must study and pass the exam and be certified by the National Institute for Financial Education (NIFE). ORG-2 provides employees with a training manual. FDN-2

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recommends a couple of books, 'The Automatic Millionaire' by David Bach and Suzie Orman's '8 Steps to Financial Freedom', to the Phone Counselors for reading. The reading of these books is not mandatory.

In the initial field audit on September 26, 20XX, the Agent interviewed 3 Phone Counselors. Of the three, two were certified and one was in the process of studying for the certification examination. All Phone Counselors self studied for the NIFE exam. According to the Phone Counselors, they did not receive further classroom training from ORG-2 after passing the NIFE exam. According to the Phone Counselors, during the tax years under examination the officer manager ED/OM held monthly meetings and training with the Phone Counselors to discuss updates from credit card companies, new requirements, situational training, real life experience training, etc. On occasions, FDN-2 provided some psychology training to the Phone Counselors.

The Phone Counselors and Administrators, utilize ORG-2's training manual (also known as E-Myth) in performing the daily duties. ORG training manual is divided into two sections, Phone Counselor Department and Administrative Department. The following is the table of contents for the Phone Counselor training manual.

#### **ORG-1 Phone Counselor Department Table of Content**

1. DAILY TIME LINE
2. WORK STATION
3. TAKING APPLICATION
4. RECEIVING FORMS
5. RECEIVING STATEMENTS
6. WORKING APPLICATION
7. SUBMITTING APPLICATION
8. DE-SUBMITTED APPLICATION
9. FOLLOW UP WITH PROSPECT
10. DEPARTMENT CONDUCT
11. FORMS, LIST AND SPECIFICATIONS

The following are the instructions for taking application (#3 above).

#### **Taking Application**

*Taking applications from suspects can be done either by telephone or through the internet. Each has its own way of being handled, but the end result is the same, to lead the suspect to a prospect to a client status and on to a better stewardship.*

#### **Telephone (suspect prepared)**

1. *When a call comes in to you, it is important to be upbeat, businesslike and positive. These people are looking for the answers that will give them hope.*

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2. Follow the script that you have been given. This allows you to keep the telephone conversation within a specified time frame and will help you to get all the information required. This is also important to do since it will allow you to accept more calls.  
**REMEMBER: WE BUILD RELATIONSHIPS.**
3. Get at least the suspect's name, telephone number and email address. This allows for future contact from the ministry.
4. Ask suspect the qualifying questions:  
Are your accounts in collections?  
Is your income stable?
5. Get the suspect credit card information and enter into the system. Balance, monthly payment, interest rate and due date. If the suspect does not know the interest rate, use 20% as a default.
6. If the creditor is not in the system, refer to the **Non-Creditor List** or **Dmis**.
7. Get the information on their monthly budget and enter into the system. This is critical for developing a plan for success.
8. Once you have gathered the information, put suspect on hold.
9. Make sure to add cushion to the new monthly payment as stated in **WORKING APPLICATION** on page 10 concerning Monthly Payment Cushion.
10. When complete, you will discuss the program with the suspect.
11. Now you need to send the application to the suspect via email, mail or fax for their approval if they agree.
12. Enter any notes necessary for that now prospect in the Trace page in the system.
13. You will need to indicate that it is a phone call. You can enter as "Phone".

#### **Telephone (suspect unprepared)**

1. When a call comes in to you, it is important to be upbeat, businesslike and positive. These people are looking for the answers that will give them hope.
2. Follow the script that you have been given. This allows you to keep the telephone conversation within a specified time frame and will help you to get all the information required. This is also important to do since it will allow you to accept more calls.  
**REMEMBER: WE BUILD RELATIONSHIPS.**
3. Get at least the suspects name, telephone number and email address. This allows for future contact from the ministry.
4. Ask suspect the qualifying questions:  
Are your accounts in collections?  
Is your income stable?
5. If they do not have their information ready, inform them that you will send them via email the information you need. (Form #7)
6. If they do not have email, explain to them what you need and have them write it down. Ask them to repeat it back to you.
7. Enter any and all notes in the Trace page in the system.

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8. When the suspect sends or calls you back with the information, you will enter the information into the system.
9. If the creditor is not in the system, refer to the **Non-Creditor List** or **Dmis**.
10. If the suspect calls, put them on hold
11. Make sure to add cushion to the new monthly payment as stated in **WORKING APPLICATION** on page 10 concerning **Monthly Payment Cushion**.
12. When complete, you will discuss the program with the suspect.
13. Now you need to send the application to the suspect via email, mail or fax for their approval if they agree.
14. Enter any notes necessary for that now prospect in the Trace page in the system.

**ORG and CO-15 Application**

These are internet applications that are submitted by suspects. ORG is ORG-2 and CO-15 is CO-15. Some will be completed and others will not. You will use the same approach on each application you take.

**Follow-Up with Prospects**

According to the training manual, the Phone Counselors are required to follow up with the callers after the first contact was made – the sooner, the better. Follow up is to be made in the following priority: (1) cell phone, (2) work phone, (3) home phone, and (4) email. The following is a representative follow up message.

*"Hello \_\_\_\_\_, this is \_\_\_\_\_ from ORG. I am your personal counselor. I am BLESSED that God lead you to contact our ministry-that took A LOT of courage. It must be a real challenge to live with \_\_\_\_\_ (what they checked or comments). To be most helpful to you, I need about 10 minutes of your time to review your situation." In the meantime, I am emailing you our program forms for your review. The subject line says "Welcome Package from RA-7". Please look in your Inbox, Junk and Spam folders for this email as it gets rerouted at times. You may contact me by phone at \_\_\_\_\_. I am in the office from 8-5 PST. I will also leave my contact info on your (work phone or home phone or by email, whatever they have) to make it easier for you to reach me. I look forward to helping you \_\_\_\_\_. God bless you again for contacting ORG."*

Follow ups are to be made every business day for a one-week cycle. ORG-2 classifies the applicants as either *Tactical Applicant* or *Relational Applicant*. The following is ORG-2 Applicant Follow-up Procedure-1 Week Cycle:

<b>Application Aging by Days</b>	<b>How to proceed with tools for a Tactical Applicant</b>	<b>How to proceed with tools for a Relational Applicant</b>
<b>Day 0-App in day</b>	Use ORG Applicant Follow Up Script	Use ORG Applicant Follow Up Script

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<b>Day 1-Business Days</b>	Call Top 1-Visit Pain, Give Info, Ask for Contact	Call Top 1-Visit Pain, Give Encouragement, Ask for Contact
<b>Day 2-Business Days</b>	Email-Push using facts/data	Email-Push using Scripture, encouragement
<b>Day 3-Business Days</b>	Call Top 1&2 - Visit Pain, Give Info, Ask for Contact	Call Top 1&2 - Visit Pain, Give Encouragement, Ask for Contact
<b>Day 4-Business Days</b>	Email-Inactive Letter	Email-Inactive Letter
<b>Day 5-Business Days</b>	De-Prospect applicant in database	De-Prospect applicant in database
<b>Day 10-Business Days</b>	Email-What did you end up doing?	Email-What did you end up doing?

**Follow up Procedure for Relational Applicant**

**Call script for applicants with creditor information:**

"Hello \_\_\_\_\_, this is \_\_\_\_\_ from ORG. I was blessed by the fact you took the big step to contact us.

*It must be tough dealing with \_\_\_\_\_ (emotional drain of debt, spiritual bondage-anything feeling).*

*Our program can be a real blessing to you and free you from the bondage of this debt in a few short years.*

*\_\_\_\_\_, please take a few minutes and email me or call me at \_\_\_\_\_. In the meantime I will pray for your situation and that God will continue to encourage you to move forward in becoming debt free."*

**Call script for applicants without creditor information:**

"Hello \_\_\_\_\_, this is \_\_\_\_\_ from ORG. I was blessed by the fact you took the big step to contact us.

*It must be tough dealing with \_\_\_\_\_ (emotional drain of debt, spiritual bondage-anything feeling).*

*Our services can be a real blessing to you and your current situation.*

*\_\_\_\_\_, please take a few minutes and email me or call me at \_\_\_\_\_. In the meantime I will pray for your situation and that God will continue to encourage you to move forward in becoming debt free."*

**Follow Up Procedure for Tactical Applicant**

**Call script for applicants with creditor information:**

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"Hello \_\_\_\_\_, this is \_\_\_\_\_ from ORG. You were on my mind so I thought I'd try to contact you. It must be tough dealing with \_\_\_\_\_ (higher rates, creditor pressure, anything concrete).

Our program can save you thousands of dollars and many years of bondage to this debt. \_\_\_\_\_, please take a few minutes and email me or call me at \_\_\_\_\_. I look forward to hearing from you."

**Call script for applicants without creditor information:**

"Hello \_\_\_\_\_, this is \_\_\_\_\_ from ORG. You were on my mind so I thought I'd try to contact you. It must be tough dealing with \_\_\_\_\_ (higher rates, creditor pressure, anything concrete).

I am certain you can really be helped by the services we offer. \_\_\_\_\_, please take a few minutes and email me or call me at \_\_\_\_\_. I look forward to hearing from you."

**ORG Phone Script Checklist**

When engaging the suspects, the Phone Counselors follow the "ORG Phone Script Checklist" provided by ORG-2. The ORG-2's Debt Free Phone Script Checklist provides a framework, sets goal and time limit (in minute) for each goal

- Introduction Goal: To establish relationship & to gain authority (2-3 minutes)
- Program Detail/Mechanics Goal: 5-8 (minutes)
- Summary of Benefits: Give benefit(s) client desires and insure acceptance (2-3 minutes)
- Action Required & Closing Goal: To give direction and have client take action (2-3 minutes)
- Challenging Calls
  1. Did you establish yourself as an expert?
  2. Are you debating different points of financial stewardship?
  3. Are you trying to convince the caller of the right way to go?
  4. Are you focusing on the larger, more important spiritual issues of debt?
  5. Do you need to wrap up the call and move on to others who are waiting for your help?

**Phone Counselors Evaluation**

Each Phone Counselor is required to keep a Daily Call Tracking log. The purpose of the log is to record the number of calls received during the week and the number of callers that signed up for DMPs. One Senior Phone Counselor was evaluated as follow:

A. Accomplishments

- a. Continued to meet call goals per week in the quarter

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- b. Trained new employees (RA-8, )
- c. Increased time management discipline in daily activities
- B. Personal Development
  - a. Ensure client acceptance of program before sending them a packet
  - b. Investigate thoroughly why a prospect did not sign on the program
- C. Next Quarter Goals
  - a. April sign-on total must be 40 or more to stay at the same pay rate.
  - b. Bring May sign-on total to 45 or more.
  - c. Bring June sign-on total to 50 or more.

The Terms of Agreement of the above Senior Phone Counselor were as follows:  
Compensation

- A. First 90 Days of Employment
  - Base pay per hour: \$
  - Standard workweek: 40 hours, Monday-Friday 8:00 am to 8:00 pm
  - Weekly stipend: \$
- B. After 90-Day Review
  - Review of all compensation components: base pay, stipend, and sign-on fee.
  - Commission structure may begin to offset stipend.
  - Additional duties may be included that can affect compensation make-up.

Another Phone Counselor was evaluated as follows:

- A. Accomplishments
  - a. Allowed personal enthusiasm to come through to callers.
  - b. Stopped presenting a victim attitude to callers and self.
  - c. Sign-on (20%) and sent packet percentage (68%) at good levels.
- B. Personal Development
  - a. Take a little less time in conversation to increase new calls/day.
  - b. Do not allow a unique call to knock you off daily course.
- C. Next Quarter Goals
  - a. Increase average new calls per day from 10 to 12.
  - b. Stay focused doing work in both PC and CR department.

#### Advertising Practices

ORG-2 spent \$ and \$ on advertising in the tax year ending June 30, 20XX and June 30, 20XX, respectively.

#### Printing Advertising (Magazine and Flyers)

Magazine included CO-16, CO-17, and CO-18. Magazine advertising has been discontinued. ORG-2 does not engage in TV and newspaper advertising.



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Flyers appears to promote DMPs based on visual prominence and relative amount of time and space devoted.

The 8 ½ x 11 flyer is printed on both sizes contains phrases and message such as:

- *Get the burden of debt off your back, fast!*
- *Save time, make one easy payment*
- *Reduce your interest rate*
- *Protect your credit*
- *Stop harassing calls*
- *Compassionate & competent financial counselors*
- *Solutions designed for your personal needs*
- *Bring harmony & peace to your home.*

ORG-2 also has flyers in Spanish. The following is a translation Spanish flyer.

*"Each year, millions of people find themselves burdened with debt. But today there is help. ORG-1 is a Christian Ministry with the vision and goal in helping you liberate yourself from your debts. Our program of Debt Consolidation, Financial Counseling and Educational seminars offer help and sanction for families with debt problems throughout the nation. We teach financial responsibility from a Biblical perspective."*

#### Internet Advertising

Internet advertising expense for the tax years ending June 30, 20XX and June 30, 20XX, totaled \$ and \$ or 47% and 54% of total advertising expenses respectively. ORG-2 engages an internet advertising company located in City to handle its internet advertising. The search engine will direct internet users to ORG-2's web site when they entered search words such as *ORG-2, debt consolidation, debt free*, etc into the search engine. The following is the result of Google search when the phrase "ORG-2" was entered into the search engine. The link to ORG-2's web site is listed first after the sponsored links. ORG-2's link is **by ORG-2**.

PICTURE DELETED

The web site usage can be tracked to determine the effectiveness. According to ORG-2's statistic, Internet advertising accounts for 80% of all calls and 75%-80% of all applications. The following is a representative web page used prior to September 20XX. The contents of web pages remained fairly the same from one year to another.

PICTURE DELETED

#### Radio Advertising:

ORG-2 engages CO-19 to handle its radio advertising. For the tax years ending June 30, 20XX and June 30, 20XX, radio advertising accounted for \$ and \$ or % and % of total

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advertising expenses respectively. The primary radio station that ORG-2 advertises on is CO-20 in the City area and City on CO-20. CO-20 is a Christian preaching network. The 60-second ads were aired during the AM Drive (5am-10am), Prime (5am-7pm). The following is a representative radio ad aired in tax year June 30, 20XX.

*RA-8: "We had a bankruptcy and about a year later my husband passed away. He left me with credit card debt that I hadn't known about. When I was late on my payment my interest jumped to 29%. The interest charges were more than my minimum payment. There was no way for me to get ahead. Plus there were late fees too."*

*FDN-2: "RA-8 was in the tough spot when she called ORG-2."*

*RA-8: "They were able to drop my interest rate to 8%. And get rid the extra fees too. Can you imagine?*

*Who wouldn't want to do that?*

*I'll be out of debt in two and a half years.*

*That is so do-able; I thought I'd always be in debt."*

*FDN-2: "Hello this is FDN-2 of ORG-2.*

*Within a few minutes of your call we'll tell you how much money you'll save and how quickly we can help you become debt free."*

*Call # That's #. Or log on at ORG-2."*

### **Educational Activities**

In a written response dated September 10, 20XX to the Service, ORG-2 stated that it did not conduct any educational seminars and events during the tax years under audit. During the initial audit interview on September 26, 20XX, FDN-1 also verbally informed the IRS Agent that ORG-2 did not conduct any educational seminars or workshops. Also on September 26, 20XX, FDN-1 informed the Agent that, during the course of performing family and marriage speeches for CO-2, FDN-1 also gave speeches on money management issues. The percentage of money management speeches accounted for 10-15 percent of the total. FDN-1 stated that all speeches were held at churches.

In another written response received on February 26, 20XX, ORG-2 informed the Agent that its employees conducted several speaking engagements on the subject of financial management at local churches and men's retreats. These events were either organized by local churches or in conjunction with ORG-2. During the tax years ending June 30, 20XX and June 30, 20XX, ORG-2's employees were invited to speak at the following events:

- 1-11-XX 'Becoming and Staying Financially Fit', Event-1 by ED/OM
- 1-13- XX 'How to Get Out of Debt' by ED/OM, Event-2 City, State
- 3-3- XX 'How to Get Out of Debt' by ED/OM, Event-3 City, State
- 5-6- XX

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by FDN-2 and FDN-1, Event-4 City, State

➤ 5-13- XX

by FDN-2 and FDN-1, Event-4 City, State

➤ 5-27- XX

by FDN-2 and FDN-1, Event-4 City, State

➤ 6-30- XX

by FDN-2 and FDN-1, Event-4 City, State

The length of these speaking engagements ranged from 2 hours to half-days. The Agent requested the agenda for these speaking engagements but none was provided. ORG-2 provided the Agent with Power Point presentations for these seminars. ORG-2 spent \$ and \$ on educational activities for the tax years ending June 30, 20XX and June 30, 20XX, respectively.

Prior to September 20XX, ORG-2's web site contained no educational materials. In September 20XX, ORG-2 implemented an educational section on its web site. Visitors can click on the educational link to listen to recorded Power Point presentations on subjects of money management and finding meaningful employment.

### Financial Information

For the tax years ending June 30, 20XX and June 30, 20XX, ORG-2's Form 990 disclosed the following income and expenses:

<u>Revenue</u>	<u>30-Jun-XX</u>	<u>30-Jun-XX</u>
Contributions, gifts, grants		
Program service revenue		
Interest income		
<b>Total Revenue</b>		
<b>Expense</b>		
Grants and allocation		
Compensation of officers & directors		
Salaries & other compensations		
Payroll taxes		
Accounting fees		
Legal fees		
Supplies		
Telephone		
Postage and shipping		
Equipment rental and maintenance		
Travel		
Conferences, conventions, meetings		
Interest		
Depreciation		

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- Insurance
- Advertising
- Credit report
- Licenses and fees
- Consultation fees
- Education
- SOS
- Stationary office expense
- Auto expense
- Bank charge
- Promotions
- Business development
- Meals & entertainment
- Utilities

**Total Expense** \_\_\_\_\_

**Excess or (deficit) for the year** \_\_\_\_\_

The program service revenue was made up of the following:

	30-Jun-XX	30-Jun-XX
Fees from CO-10		
Fees from CO-21		
Credit reports fees		
Processing fees		
Counseling fees		

The following is the percentage of program revenue to total revenue.

	30-Jun-XX	30-Jun-XX
Program revenue		
Total revenue		
<b>Program revenue to total</b>		

In the past, ORG-2 engaged CO-21 to process its DMP clients. When the credit card companies reduced the fair share payments to CO-21 suggested that ORG-2 start looking for another back office for processing DMP clients. CO-21 recommended CO-10 (CO-10). Consequently, ORG-2 and CO-10 entered into an agreement whereby CO-10 agrees to process DMP clients for ORG-2. ORG-2 and CO-10 will then share the DMP fees and fair shares. Although CO-21 were no longer processing DMP clients for ORG-2, it still made fair share payments to ORG-2 for DMP clients that

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were already in the program. The credit report fees represented fees that DMP clients paid to have their credit report pull analyzed.

The "contributions, gifts, grants" revenue were contributions from CO-7, the for-profit business owned by FDN-1 and FDN-2.

The "grant and allocation" expense of \$ was housing allowance payments made to the related entity CO-1. The housing allowance payments were subsequently terminated.

Employees health insurance and worker compensation insurance accounted for \$ of the \$ insurance expenses for the tax year ending June 30, 20XX and \$ of the \$ insurance expenses for the tax year ending June 30, 20XX.

### **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 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. Section 1.501(c)(3)-1(d)(2), Income Tax Regulations.

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. section 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).

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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)-1(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 purposes, 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. Cl. 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 non-exempt commercial purpose that was not incidental to the educational purpose and was not entitled to be regarded as exempt. 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.2d 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

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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.

In Solution Plus, Inc. v. Commissioner, T.C. Memo. 2008-21, the United States Tax Court held that an organization whose principal activity was to market and process consumer debt management plans was not entitled to exemption under section 501(c)(3) because the organization was not organized or operated exclusively for exempt purposes and failed to establish that it did not operate for a substantial non-exempt purpose.

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.

IRC 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."

Treasury Regulations section 1.501(a)-1(c) defines "private shareholder or individual" as persons having a personal and private interest in the activities of the organization.

Treasury Regulations section 1.501(c)(3)-1(d)(1)(ii) states that an organization is not organized or operated exclusively for one or more of the purposes specified in subdivision

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(i) of this subparagraph unless it serves a public rather than a private interest. Thus, to meet the requirement of this subdivision, it is necessary for an organization to establish 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.

IRC section 162(a) states that in general, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal service actually rendered.

In Revenue Ruling 69-383, 1969-2 C.B. 113, a tax exempt hospital entered into a contract with a radiologist after arm's length negotiations. The contract provided for the radiologist to be compensated by receiving a percentage of the gross receipts of the radiology department. The revenue ruling concluded that the agreement did not jeopardize the hospital's exempt status under IRC 501(c)(3). In supporting this conclusion, the following facts were noted: the agreement was negotiated on an arm's length basis, the radiologist did not control the hospital, the amount received under the contract was reasonable in terms of the responsibilities and duties assumed, and the amount received under the contract was not excessive when compared to the amounts received by other radiologists in comparable circumstances.

In John Marshall Law School and John Marshall University v. The United States, 81-2 USTC 9514 (Ct. Cl. 1981), the Tax Court noted that the term "net earning" in the inurement-of-benefit clause of section 501(c)(3) has been construed to permit an organization to incur ordinary and necessary expenses in the course of its operations without losing its tax-exempt status. The issue, therefore, is whether or not the expenditures John Marshall Law School paid to its founders and their family members were ordinary and necessary to John Marshall Law School operations. The Tax Court concluded that unordinary and unnecessary expenses incurred by John Marshall Law School for the benefits of the founders constituted inurement.

In Church of Transfiguring Spirit v. Commissioner, 76 T.C. 1, 5 (1951), the court ruled that an organization is not operated exclusively for exempt purposes unless it is operated for the benefit of the public rather than for the benefit of a private interest. Also see Bob Jones University v. United States, 461 U.S. - (1983)

In Mabee Petroleum Corporation v. U.S., 203 F.2d 872 (5<sup>th</sup> Cir. 1953), a former oil company executive continued to receive the \$4 annual salary he had earned as president of the oil company even after he had formed a charitable trust and transferred the stock in the oil company to the trust. The Fifth Circuit Court of Appeals ruled that the salary was excessive and constituted inurement of net earnings to the private individual.



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In Bubbling Well Church of Universal Love, Inc. v. Commissioner, 74 T.C. 531 (1980) the Tax Court found inurement from a church to its founders and their son, who were the church's only employees. The church received \$61,170 in income, and almost all of it was spent for the family member's "living allowance", parsonage allowance, medical expenses, travel and other items.

In Birmingham Business College, Inc. v. Commissioner, *supra*, the court found that excessive compensation paid to founders constituted inurement.

In Church By Mail, Inc. v. Commissioner, 765 F.2d 1387 (9<sup>th</sup> Cir. 1985), the two ministers devoted only 60% of their time to the organization, and yet received over \$160,000 in compensation, a figure the court found unreasonable under the circumstances. Also see Mabee Petroleum Corporation v. U.S., 203 F.2d 872 (5<sup>th</sup> Cir. 1953).

Other examples of cases in which excessive compensation was held to create inurement are Harding Hospital, Inc. v. U.S., 505 F.2d 1968 (6<sup>th</sup> Cir. 1974); Texas Trade School v. Commissioner, 30 T.C. 642 (1958), *aff'd* 277 F.2d 168 (5<sup>th</sup> Cir. 1959); and Northern Illinois College of Optometry v. Commissioner, 2 T.C.M (CCH) 664 (1943).

In Incorporated Trustees of Gospel Worker Society v. U.S., 510 F. Supp. 374, 379 (D.D.C. 1981), *aff'd*, 672 F.2d 894 (D.C. Cir. 1981), *cert. den.*, 456 U.S. 944 (1982), three executives of an organization had salaries in 1970 of \$25,000, \$16,153, and \$5,790. The salaries increased by 1978 to \$100,000, \$72,377, and \$42,896. The court held that the sharp increases and the large amounts were "...at least suggestive of a commercial rather than nonprofit operation." See also Founding Church of Scientology v. U.S., *Supra* and Church By Mail, Inc. v. Commissioner, 765 F.2d 1387 (9<sup>th</sup> Cir. 1985).

**GOVERNMENT'S POSITION:**

**Issue 1:**

Based on the facts and circumstances of this case, the Service determines that ORG-2 was not operated exclusively for exempt purposes as described within Internal Revenue Code section 501(c)(3). The primary activity of ORG-2 is offering DMP services for fees. ORG-2 generated \$ and \$ total revenue for the tax years ending June 30, 20XX and June 30, 20XX respectively. Of the \$ and \$ total revenue, DMP and DMP related revenues accounted for \$ and \$ or % and % of total revenue for the tax years June 30, 20XX and June 30, 20XX respectively. Operating DMPs as a primary activity was reflected in ORG-2's business plans, how ORG-2 deals with potential clients, how ORG-2 evaluates its Phone Counselors and its advertising practices.

**20XX and 20XX Business Plan**

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In the business plans, ORG-2 primarily focused and emphasized growing and expanding its DMP operations. In the Goal for 20XX, ORG-2 set a % sign-on rate during the 4<sup>th</sup> quarter of 20XX. To achieve this level, ORG-2 proposed to revamp all aspects of the business, including:

- Quality of leads/applications
- Enhancements to their web-based system
- Rapid responses to clients
- Increased competence and skills by all staff
- Improved processes for sign-ons by the Counselors and Admin Staff

In the 20XX business plan, ORG-1's goal was to *"increase revenue by 6% to \$ and increase net income by \$\$.* Gross revenue is targeted to be above 55% for the year and the client base will be grown to 4,000." To achieve this goal, ORG-2's strategy was to *"increase its reach to debt management program clients by offering additional resources, both in-house through bill paying programs and outside sister mortgage operation. At the same time, ORG-1 will refer candidates to outside partners that provide additional financial resources in return for referral fees."*

When the creditors changed the terms, which ORG-2 speculated would result in increases for debt management program demand, ORG-2 sought opportunities to grow its DMP operations by taking action such as *"continue holding marketing expenses at current levels and monitor demand growth."*

While ORG-2's business plan placed so much focus and emphasis on the DMP operations and increasing revenue, it devoted little attention to educational efforts. Of the entire 20XX business plan, one bullet point was devoted to educational efforts.

#### **Dealing with Potential Clients**

Operating DMP as the primary activity was also reflected in the way ORG-2 deals with potential clients. ORG-2 instructs its counselors to aggressively pursue potential clients. ORG-2's training manual instructs the counselors, when the call comes in, to *"follow the script that you have been given. This allows you to keep the telephone conversation within a specified time frame and will help you to get all the information required. This is also important to do since it will allow you to accept more calls."* ORG-2's training manual instructs the counselors to *"ask the suspect qualifying questions: Are your accounts in collections? Is your income stable?"* ORG-2's training manual instructs the counselors to *"put suspect on hold" to "discuss the program with the suspect" and to "send the application to the suspect via email, mail or fax for their approval if they agree."*

The training manual appears to instruct the counselors to do one thing: sell DMPs to the suspects.

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ORG-2 provides the Phone Counselors with a Phone Counselor Scripts Checklist for use in engaging the suspects. The scripts set goals and time limits (in minutes) for each goal.

- 2-3 minutes to establish a relationship and gain an authority.
- 5-8 minutes to inform the suspects about details and mechanics of the DMP.
- 2-3 minutes to go over the benefit(s) the client desires and ensure their acceptance.
- 2-3 minutes to close the deal.

The scripts suggests that the Phone Counselors only need to collect necessary information so that they can offer DMPs to the suspects.

If the prospects did not sign up for a DMP or were not sure if a DMP was the right option for them after the initial call, ORG-2 instructs its Phone Counselors to repeatedly follow up with the suspects by any means necessary.

When following up with the prospects, ORG-2 instructs its Phone Counselors to “*visit pain*”. Depending on the types of applicant, *Relational Applicants v. Tactical Applicants*, the Phone Counselors would use a different tactic to visit pain. For *Relational Applicants*, the counselors would remind the suspects of the emotional distress, “*it must be tough dealing with \_\_\_\_\_ (emotional drain of debt, spiritual bondage-anything feeling)*” or “*we know the enemy’s attack is the strongest right after we try to move forward in Christ*”. Once the Phone Counselors reminded the applicants of the emotional distress they are in, they promise the applicants with “*our program can free you from the bondage of debt in a few short years*” or “*our program is a way to find freedom from the bondage of debt in a few short years. I am excited to share with you the blessing it can be to your life.*”

For *Tactical Applicants*, ORG-2 instructs its Phone Counselors to also “*visit pain*”. However, unlike the *Relational Applicants*, the counselors visit pain using facts “*it must be tough dealing with \_\_\_\_\_ (higher interest rate, creditor pressure, anything concrete)*”. Once the counselors stirred up the applicant’s pain, they will offer one solution “*our program can save you thousands of dollars and many years of bondage to this debt*” or “*based on your data, the Debt Free program will drop your average interest rates on your credit cards from \_\_\_% to \_\_\_%. The interest savings will be \$ \_\_\_\_\_ on the program. Also, you will get out of debt in \_ years instead of decades it will take if you do not move forward.*”

Based on a review of the scripts, there is no evidence suggesting that ORG-2’s Phone Counselors offers the potential clients with options other than the DMP.

A review of the Trace Notes also disclosed no evidence of ORG-2’s Phone Counselors offering the suspects options other than DMP. There is also no evidence of the Phone Counselors contacting the clients to follow up on their situation after they signed onto the program. All communications were initiated by the clients because they had issues with

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their accounts. When the clients did not pay the processing fee, ORG-1's Phone Counselors and Administrator contacted the clients to remind them to pay the fee.

A review of ORG-2's training manual, including the telephone scripts and the follow-up procedures disclosed that ORG-2's Phone Counselors were instructed to do nothing more than selling DMPs to the prospects using whatever tactics necessary including, but not limited to, stirring up the pain the prospects were experiencing. Once the prospects signed up for DMPs, they are very much on their own.

### Phone Counselors Evaluation

ORG-2 set quarterly DMP sign-on goals for its Phone Counselors and evaluated them, in part, based on their achievement, or lack thereof, of these goals. One Senior Phone Counselor was evaluated as follow:

- A. Accomplishments
  - a. Continued to meet call goals per week in the quarter
  - b. Trained new employees (RA-8)
  - c. Increased time management discipline in daily activities
- B. Personal Development
  - a. Ensure client acceptance of program before sending them a packet
  - b. Investigate thoroughly why a prospect did not sign on the program
- C. Next Quarter Goals
  - a. April sign-on total must be 40 or more to stay at the same pay rate.
  - b. Bring May sign-on total to 45 or more.
  - c. Bring June sign-on total to 50 or more.

Taken into account the instructions provided in the training manual, the scripts, the follow-up procedures and the quarterly goals, the counselors did not appear to have any options other than selling the DMPs to the prospects. The evaluation suggests that the counselor's compensation partly depends on the number of DMP clients they sign up. If the Phone Counselors did not meet the goal, their compensation would be in jeopardy.

ORG-2 provided the Service with recordings of counseling sessions whereby the Phone Counselors followed the criteria set forth in the Core Analysis Tool and were evaluated on their effectiveness in presenting the options to the suspects. These counseling sessions were recorded after the Service had initiated an audit. For the years under examination, there were no recorded counseling sessions demonstrating that the Phone Counselors followed the Core Analysis Tool and were evaluated based on the effectiveness in presenting options to the suspects. Furthermore, a review of the Trace Notes (page 13) disclosed no evidence of the Phone Counselors offering options other than DMPs to the suspects.

### Advertising Practices

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ORG-1 d.b.a. ORG-2		June 30, 20XX thru June 30, 20XX

ORG-2's advertising practices also indicate that the DMP activity is their primary activity. ORG-2 spent \$ and \$ on advertising for the tax years ending June 30, 20XX and June 30, 20XX, respectively. The majority of the advertising expenses was devoted to Internet advertising which ORG-2 determined was the most effective accounting for % of all calls and % of all applicants. ORG-2 paid an Internet advertising company in City to handle Internet advertising. The search engine directs users to ORG-2's web site when they entered search phrases such as debt free, debt consolidation or ORG-2 into the search engines. Once the suspects got to ORG-2's web site, they would see nothing more than information enticing them to sign up for the DMP.

The contents of the Radio advertising strictly promotes DMPs. In each radio ad, ORG-2 promised to save the targeted audience money and quickly get the audience out of debt, *"within a few minutes of your phone call we'll show how much money you'll save and how quickly we can help you become debt free"* or *"they were able to drop my interest rate to %.* And get rid of the extra fees to. Can you imagine that? Who wouldn't want to do that? *I'll be out of debt in two and a half years. That is so do-able; I thought I'd always be in debt."*

While ORG-2 spent \$ and \$ on advertising to promote its DMP services, it spent \$ and \$ on educational activities for the tax years ending June 30, 20XX and June 30, 20XX, respectively. The amounts were deprived from ORG-2's Form 990. ORG-2's web site did not contain educational materials until September 20XX.

In summary, ORG-2 conducted no educational seminars or workshops in the years under audit. ORG-2's employees conducted seven speaking engagements and spent a total of \$ (\$ in tax year ending June 30, 20XX and \$ in tax year ending June 30, 20XX) on educational activities. A review of ORG-2's operations disclosed that its primary purpose was offering DMPs for fees. Operating DMPs is the primary activity is reflected in ORG-2's business plans, how ORG-2 deals with potential clients, its advertising practices and how ORG-2 evaluates its employees. Offering DMP service for fees served a commercial not an exempt purpose. Better Business Bureau of Washington D.C., Inc. v. United States, American Institute for Economic Research v. United States and Solution Plus, Inc. v. Commissioner.

Pursuant to IRC section 501(c)(3), an organization will be regarded as operated exclusively for one or more exempt purposes only if it engages primarily in activities which accomplish one or more exempt purposes specified in IRC section 501(c)(3). Offering DMPs for fees is neither educational nor charitable; it was commercial. Since ORG-2 did not operate exclusively for one or more exempt purposes, its Federal tax exempt status under IRC section 501(c)(3) should be revoked effective July 1, 20XX. Treasury Regulations sections 1.501(c)(3)-1(a)(1) and 1.501(c)(3)-1(c)(1), and Revenue Ruling 69-441, 1969-2 C.B. 115.

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Name of Taxpayer  ORG-1 d.b.a. ORG-2		Year/Period Ended June 30, 20XX thru June 30, 20XX

**Issue 2:**

The compensation paid by ORG-2 to its founders, FDN-1 and FDN-2 was excessive under the facts and circumstances. As such, the excessive compensation constituted inurement. In arriving at this conclusion, the Service considered the following facts and circumstances.

**A. FDN-1 and FDN-2's Relationship with ORG-2**

FDN-1 and FDN-2 (hereinafter referred to as Founders) are private individuals with respect to ORG-2. Treasury Regulations section 1.501(a)-1(c) defines private shareholder or individual as persons who have a personal and private interest in the payor organization. Generally, an organization's officers, directors, founders and their families are considered private shareholders or individuals. FDN-1 and FDN-2 are the founders of ORG-2. Subsequent to founding ORG-2, both served as officers and/or directors of ORG-2.

According to BM-1, a Board Member, when ORG-2 was first founded, the Founders *"volunteered their time for the first three years of the ministry – i.e. they were paid nothing. The monies they lived on were from CO-1 who also provided free rent to the new ORG-1.* The above explanation indicates that the Founders have made substantial investments in the creation of ORG-2. Accordingly, they should be justified and entitled to excessive compensation. Beginning in the second year of operations, the Founders began receiving compensation for their services to ORG-2. The amount of compensation steadily increased from \$ in the tax year ending June 30, 20XX to \$ by tax year ending June 30, 20XX. The increases total \$ in three years. By the tax year ending June 30, 20XX, each of the two Founders received \$ in compensation from ORG-2. While ORG-2 is not the sole source of income provider to the Founders, it has provided substantial amounts of compensation to the two Founders. As such, the compensation creates a financial interest and relationship between ORG-2 and its Founders.

Taken into account the time, efforts, and resources that the Founders devoted to ORG-2 and the returned financial benefits in the form of compensation, the Founders are private individuals who have a personal and private interest in the activities of ORG-2.

**B. Whether FDN-1 and FDN-2's Compensation Was Excessive**

In determining whether the Founders' compensation was excessive, the Service examined the following factors:

**1. Whether the Founders' Compensation Was Negotiated at Arm's Length**

Based on the review of ORG-2's hiring practices, the employment agreement is an instrument used to document the employee and the employer's understanding of the employment terms including, but not limited to, the employee's duties and responsibilities,

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performance goals, compensation amount, etc. When ORG-2 hired ED/OM for the Executive Director position, it executed an employment agreement detailing ED/OM's duties, responsibilities, performance goals, compensation terms, etc. When ORG-2 hired a Phone Counselor, it also set forth the base pay, weekly stipend, DMP clients sign-on, etc. The presence of a contemporaneous written employment agreement indicates that ORG-2 and the prospective employee engaged in a negotiation and both sides agreed to the employment terms. There are no contemporaneous written employment agreements for the Founders documenting the employment terms such as their duties, responsibilities, performance goals, compensation, etc. ORG-2's Bylaws allow the officers to receive reasonable compensation for the services performed. However, it does not provide any criteria for reasonableness. The Bylaws did not set the upper limit of the officers' compensation.

In the absence of documentation demonstrating an arm's length negotiation, it is concluded that the Founders' compensation was not negotiated at arm's length.

In Mabee, Supra at 616, the Court of Appeals cited the lack of an arm's length dealing in its of excessive compensation. As such, the excessive compensation constituted inurement. The Court of Appeals stated, "*We think it doubtful whether comparable services would have cost as much had they been acquired in an arms-length transaction from an outside source.*"

## **2. The Founders' Influence over ORG-2**

The only documentation that contained some discussions about FDN-1 and FDN-2's compensation was the Minutes of Directors' Meetings dated December 29, 20XX. Present at this meeting were:

- FDN-1, President, Chairperson of the Board
- FDN-2, Secretary
- BM-1, Board Member
- BM-4, Board Member
- RA-3, Board Member, and
- ED/OM (non-Board Member), Executive Director

Three of the individuals above, RA-3, BM-1 and BM-4, were newly elected to ORG-2's Board of Directors and are vendors for various services to ORG-2.

In this meeting, "*FDN-1 noted that he and FDN-2 were currently receiving a salary of \$\$ per month. Due to changes in the income tax structure of the two, it is proper time to give them an increase in their salaries.*"

The Board of Directors subsequently approved a salary increase of \$\$ per month bringing the monthly salary to \$\$ for each of the two Founders. The reason for the salary increase suggested that the Founders used their influence to demand the salary increases.

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Generally, when an employee proposes or asks for a salary increase, he or she must demonstrate to the employer that he or she deserves a raise. The employee must show the employer that he or she has significantly contributed to the success of the business. Therefore, the employee deserves a salary increase. In this case, the Founders' income tax structure changed and they wanted a salary increase. It did not appear that the two Founders even had to make a case or an argument that they deserved a salary increase. It was noted in the Minutes dated December 29, 20XX, that ORG-2's financial situation worsened from tax year June 30, 20XX to June 30, 20XX. ORG-2 had to borrow \$ to pay for its operations. ORG-2's accounts payable increased by \$ due to the sudden and dramatic drop in income from creditors.

When comparing ORG-2's total revenue for tax year ending June 30, 20XX to the tax year ending June 30, 20XX, total revenue for tax year June 30, 20XX dropped by \$ (\$ as compared \$). While net income increased by \$ (from negative \$ to \$), the increase was primarily due to the lower housing allowances that ORG-2 made to CO-1, a related entity that also paid compensation to the Founders, lower advertising expenses, and cutting of staff.

	<u>30-Jun-XX</u>	<u>30-Jun-XX</u>	<u>Change</u>
Total revenue			
Net income			
Other salaries and wages			
Grants & allocations to CO-1			
Advertising			

The three newly elected Directors who are vendors for services to ORG-2 simply approved the salary increases. There is no evidence in the minutes suggesting that the newly elected Directors questioned whether the two Founders' current salaries, \$\$ per month for each of the two, were already too high or whether the salary increases were appropriate given the financial situation that ORG-2 was in.

The Founders' compensation pattern also suggests their influence over ORG-2. The Founders' compensation mirrored each other although their duties and responsibilities differed. Every year, with the exception of tax year June 30, 20XX, when one Founder received a salary increase, the other also received the same salary increase.

The court in Bubbling Well Church, supra at 534-5 noted that domination of a church by its founders and their son provided "an obvious opportunity for abuse of the claimed tax-exempt status." As such, the excessive compensation constituted inurement.

### **3. Time Devoted to the Positions by the Founders**



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Name of Taxpayer	ORG-1 d.b.a. ORG-2	Year/Period Ended June 30, 20XX thru June 30, 20XX

ORG-2 produced no evidence to demonstrate the actual hours each Founder devoted to his position at ORG-2. Prior to the Service initiating an examination of ORG-2's Form 990, ORG-2 disclosed on its Form 990 that the two Founders devoted 20 hours per week to their respective positions during the tax year ending June 30, 20XX, and 30 hours per week during the tax year ending June 30, 20XX. In a written response dated September 10, 20XX to the Service's request for information necessary for the examination, ORG-2 disclosed that the two Founders devoted 40 hours per week to their respective position but provided no evidence to support this statement. Instead, ORG-2 offered that it is difficult to determine on a day-to-day basis the number of hours FDN-1 and FDN-2 devoted to their position at ORG-2.

The Agent inquired about FDN-1 and FDN-2's actual duties and responsibilities with CO-1 and was informed that FDN-2 is responsible for Administration, Public Relations, Human Resources and other duties that the company may need from time to time to keep it as a going concern and that FDN-1's estimated work hours devoted to CO-1 is about 30 to 40 hours depending on the situation the company is in."

In the absence of evidence demonstrating that the Founders devoted 40 hours per week the Service determined that the each of the two Founders devoted 20 hours to his respective position at ORG-2.

An employee devoting 20 hours per week to his/her position should not receive the same pay as the one devoting 40 hours per week conducting the same duties and holding the same responsibilities. In Church By Mail, Inc. v. Commissioner, 765 F.2d 1387 (9<sup>th</sup> Cir. 1985), the two ministers devoted only 60% of their time to the organization, and yet received over \$160,000 in compensation, a figure the court found unreasonable under the circumstances. The court stated that "...We believe that services comparable to those performed by ministers could be obtained from an outside source in an arm's length transaction at a more reasonable cost... It seems likely that a member of the clergy could be hired to perform the part-time duties for which the ministers are responsible at a salary of considerably less than \$160,000 per year."

In Mabee Petroleum Corporation v. U.S., 203 F.2d 872 (5<sup>th</sup> Cir. 1953), the Court of Appeals emphasized the fact that the foundation's president devoted only part of his time to the foundation in its ruling that the excessive compensation constituted inurement.

**4. History of the Founders' Salaries and the Salary Increases**

Since inception, the Founders received the following compensation from ORG-2.

	30-Jun-XX	30-Jun-XX	30-Jun-XX	30-Jun-XX
FDN-2				
FDN-1				

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30-Jun XX	30-Jun-XX	30-Jun-XX	30-Jun-XX
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FDN-2  
FDN-1

As the compensation history illustrates, the Founders' compensations have been sharply increased from \$ for tax year June 30, 20XX to \$ for tax year June 30, 20XX; increases of \$ for each of the Founders over a 7-year period. The patterns and the sizes of the increases reflect the Founders' influence over ORG-2, rather than any increase in their duties and hours worked.

In Founding Church of Scientology v. U.S., *supra*, the court cited the steady increase in the compensation paid to the organization's founders over a short period of time as an important factor in its ruling of inurement.

**5. Availability of Comparable Services from a Third Party and Salary Scale of Others in the Same Line of Business**

ORG-2 disclosed that it relied on the AADMO Compensation Study to set FDN-1 and FDN-2's compensation. The AADMO expressly stated that its compensation study was not intended for use as a guideline for industry members for the purpose of setting executive compensation level. The AADMO simply illustrate the executive compensation as a percentage of the total revenue. The total revenue of these credit counseling agencies ranges from \$ to over \$. The AADMO study does not provide sufficient data such as position descriptions, duties and responsibilities, working hours, geographical location, etc. to allow the readers to make an appropriate comparison. The following table compares FDN-1 and FDN-2's compensation to officers' compensation paid by credit counseling agencies with comparable revenue size.

	Title	Compensation	Total Revenue	% of Total Rev.
<b>AADMO COMPENSATION STUDY</b>	General Manager			
	Pres./Exec. Dir			
	President			
	Exe. Dir.			
	Treasurer			
	President			
	President			
	Treas./Dir.			
	Pres./Dir.			
	President			
	President			
	President			

Form <b>886A</b>	Department of the Treasury - Internal Revenue Service	Schedule No. or Exhibit
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Name of Taxpayer		Year/Period Ended
ORG-1 d.b.a. ORG-2		June 30, 20XX thru June 30, 20XX

<b>ORG-2 (Including bonus)</b>	<b>TAX YEAR ENDING JUNE 30, 20XX</b>	
	<b>FDN-1</b>	<b>FDN-2</b>
<b>TAX YEAR ENDING JUNE 30, 20XX</b>		
<b>ORG-2</b>	<b>FDN-1</b>	<b>FDN-2</b>

The AADMO compensation study is not the only report available. The Economic Research Institute (ERI) also conducts its own compensation study. The ERI was founded in 1987 to provide compensation, benefits, talent management and competencies research for private and public organizations in the form of published reports and software database products. The IRS is a subscribed member for ERI database software products and services. The following is the ERI's Compensation Comparables Assessor prepared for ORG-2's Founders using ERI's software database on March 17, 20XX. The comparables assessor was tailored specifically for financial counseling and money management industries. The comparable assessor was also based on United State average geographical location.

<b>PRESIDENT and EXECUTIVE DIRECTOR</b>			
Revenue	10th Percentile	Mean	90th Percentile

On October 4, 20XX, the Service also prepared another ERI's Compensation Comparables Assessor for FDN-1, as President of ORG-2, and FDN-2, as Executive Director of ORG-2. The location used for the compensation comparables assessor was City, State where ORG-2 is located.

<b>PRESIDENT and EXECUTIVE DIRECTOR</b>			
Revenue	10th Percentile	Mean	90th Percentile

The ERI's Compensation Comparables Assessor derives independent survey analyses for US IRC 4958 Intermediate Sanction analysis and reporting. Data is derived from 2 million Forms 990/PF/EZ/EOs. Derived from over millions of Form 990s and 12 years of 10,000 SEC proxies, this is the largest salary survey ever created (with all source data retrievable with an Internet connection.) The ERI compensation report discloses that credit counseling agencies with total revenue of approximately \$ paid their officers a high-end compensation of \$ per year.

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<b>Explanation of Items</b>		
Name of Taxpayer		Year/Period Ended
ORG-1		June 30, 20XX
d.b.a. ORG-2		thru June 30, 20XX

In response to ORG-2's position that the ERI compensation study did not contain credit counseling agencies located in comparable locations, the Service obtained additional officer compensation data from comparable credit counseling and financial education agencies located in comparable locations such as City, State; City, State; City, State; City, State; City, State; City, State; and City, State. These credit counseling agencies were selected from Website, a website listing Form 990 of tax exempt entities.

	CO-21 of City		CO-22	
Tax year	12/31/XX	12/31/XX	12/31/XX	12/31/XX
Gross receipts				
President's compensation				
CFO's compensation				
Weekly average hours				
Location	City, State		City, State	

	CO-23		CO-24	
Tax year	12/31/XX	12/31/XX	12/31/XX	12/31/XX
Gross receipts				
President/CFO's compensation				
Weekly average hours				
Location	City, State		City, State	

	CO-25		CO-26	
Tax year	12/31/XX	12/31/XX	03/31/XX	03/31/XX
Gross receipts				
President/Exec. Director				
Weekly average hours				
Location	City, State		City, State	

	CO-27		
Tax year	12/31/XX	12/31/XX	12/31/XX
Gross receipts			
President & CEO			
Vice president			
Weekly average hours			
Location	City, State		

Form <b>886A</b>	Department of the Treasury - Internal Revenue Service <b>Explanation of Items</b>	Schedule No. or Exhibit
Name of Taxpayer	ORG-1 d.b.a. ORG-2	Year/Period Ended June 30, 20XX thru June 30, 20XX

The tables above illustrate that other comparable credit counseling agencies comparable paid their officers compensations ranging from \$ to \$ per year.

ORG-2 employed an Executive Director, ED/OM, to oversee the operations. The following table compares ED/OM's duties responsibilities and working hours to those of the Founders.

DELETED TABLE

DELETED TABLE

DELETED TABLE

	30-Jun-XX			30-Jun-XX		
	FDN-2	FDN-1	ED/OM	FDN-2	FDN-1	ED/OM
Average Weekly Hours Worked	20 hrs	30 hrs	40 hrs	30 hrs	30 hrs	40 hrs
Compensation						

The comparison above indicates that ED/OM's duties and responsibilities were not much different to those of FDN-1 and more extensive than those of FDN-2. ED/OM was responsible for developing a strategic plan to advance and promote ORG-2's mission, revenue, profitability, and growth. ED/OM was also responsible for ORG-2's daily activities and operations to insure the success of his strategic plan. The Founders' involvement was to meet with ED/OM on a weekly, monthly or as needed for reports and updates. In return, ORG-2 compensated ED/OM \$ and \$ for the tax years ending June 30, 20XX and June 30, 20XX respectively.

Taken into account all the relevant facts and circumstances, the Service determines that the compensation paid by ORG-2 to its Founders, FDN-1 and FDN-2 was excessive.

Determination of FDN-1' reasonable compensation

In determining the reasonable compensation for FDN-1, the Service looks at executive compensation paid by credit counseling agencies with comparable revenue size as well as the compensation ORG-2 paid to its executive director to manage and oversee the operations

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- Credit counseling with comparable revenue size listed in the AADMO compensation study paid their officers compensation ranging from \$ to \$ per year.
- Credit counseling agencies in the ERI compensation studies paid their officers high-end compensation of \$ per year (ERI compensation study prepared on March 17, 20XX).
- Other comparable credit counseling agencies located in similar markets such as City, State; City, State; City, State; City, State; City, State; and City, State, paid their officers (president/CFO) compensation ranging from \$ to \$ per year.
- ORG-2 paid ED/OM \$ and \$ for the two years in questions to manage and oversee the operations. ED/OM's compensation was in line with compensation paid by other comparable credit counseling agencies.

The officer compensation data above discloses that credit counseling agencies with total revenue ranging from \$ to \$ paid their officers compensation ranging from \$ to \$. Based on the compensation data, the Service determines that reasonable compensation for FDN-1 was \$ per year. The \$ also reflects additional duties that FDN-1 might have taken on as claimed by RA-2 of CO-8.

An employee working less than 40 hours per week should not be paid the same compensation as those who devote 40 or more hours per week. While the officers of credit counseling agencies listed in the AADMO, ERI and other comparable credit counseling agencies devoted 40 or more hours per week to their position, FDN-1 devoted 20 hours per week to his position. Therefore, FDN-1's compensation must be adjusted to reflect the actual hours worked.

For the duties, responsibilities and time devoted to his respective position, FDN-1 should be paid \$ (half of the \$ reasonable compensation) per year for the tax years ending June 30, 20XX and June 30, 20XX, respectively.

In addition to the salary, FDN-1 was also entitled to compensation for allowing ORG-2 to use the space leased and paid for by CO-7.

ORG-2 is located at Address, City, State. The property is leased by CO-7, a for-profit manufacturing corporation co-owned by FDN-1 and FDN-2. CO-7 is located in industrial area occupied by warehouses, distribution centers and manufacturing companies. According to CO-28, the property size is approximately 62,290 square feet. CO-7's administrative department, ORG-2, and CO-1 share a 2-story office building whereby ORG-2 occupies the space on the 2<sup>nd</sup> floor. The size of the space that ORG-2 occupies is approximately 5,000 square feet.

To obtain the fair market rental rate of the space, the Service visited loopnet.com, an online commercial real estate company. The Service then searched for comparable

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ORG-1 d.b.a. ORG-2		June 30, 20XX thru June 30, 20XX

properties that can be used by manufacturing companies within one mile of CO-7's location. The result discloses 6 manufacturing properties for lease. 4 of the 6 properties are located in close by city . The size of these properties varies from 19,850 to 67,350 square feet. The fair market rental rates vary from \$/SF per year to \$/SF per year. The Service then selected a similar size property located in City and is closest to CO-7. The refined search yields a 59,000 square foot-property located at Address, City. According to loopnet.com this property is approximately 0.77 mile from CO-7. The fair market value rental rate for this property is \$/SF per year. The Service then multiply the rate of \$/SF per year by the number of square feet used by ORG-2. The result is a annual rental rate of \$. The Service then estimated annual utilities cost of \$. The \$ is then added to the \$ to arrived at the fair market value of the use of the space provided by CO-7.

The \$ (\$ + \$) is then allocated evenly between FDN-1 and FDN-2. FDN-1' share is \$ (\$/2).

Taking into account the duties, responsibilities and the working hours as well as FDN-1' share of the fair value of ORG-2's use of the space provided by CO-7, the Service determined that compensation of \$ (\$ compensation + \$0 of the fair value of the space provided to ORG-2) was reasonable. The excessive amounts were \$ (\$ - \$) and \$( \$ - \$) for FDN-1 for the tax years June 30, 20XX and June 30, 20XX, respectively.

Determination of FDN-2's reasonable compensation

FDN-2's duties and responsibilities did not appear to be as extensive as FDN-1's and those of ED/OM. ORG-2 stated that FDN-1's duties included Administration, Public Relations and Human Resources. A review of ED/OM's employment agreement disclosed that ED/OM was responsible for managing and overseeing ORG-2's entire operations. FDN-2's duties included fund raising (it must be noted that % of ORG-2's total revenue came from fair share and DMP fees) and counseling. In determining the reasonable compensation for FDN-2, the Service looked at what other comparable credit counseling agencies paid to employees holding similar positions.

Tax Year	CO-22		CO-25	
	Consultants		of	County
	12/31/XX	12/31/XX	12/31/XX	12/31/XX
Gross receipts				
Director of Finance				
Director of IT	N/A	N/A	65,866	N/A
Human Res/Sec.	85,624	84,599	N/A	N/A
Weekly average hours	60	60	50	50
Location	City, State		City, State	

Form <b>886A</b>	Department of the Treasury - Internal Revenue Service	Schedule No. or Exhibit
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Name of Taxpayer		Year/Period Ended
ORG-1 d.b.a. ORG-2		June 30, 20XX thru June 30, 20XX

	12/31/XX	CO-27 12/31/XX	12/31/XX
Gross receipts			
Vice president			
Weekly average hours	40	40	40
Location	City, State		

For the duties and responsibilities that FDN-2 held, the Service determined that a salary of \$ per year for the tax years ending June 30, 20XX and June 30, 20XX was reasonable. The \$ also reflects any additional duties that FDN-2 might have taken on as claimed by RA-2 of CO-8. FDN-2's compensation of \$ is then adjusted to reflect the 20-hour work week. Based on the 20-hour work week, the Service determined that compensation of \$ per year is reasonable.

FDN-2 was also entitled to be compensated in the amount of \$ (see page 58 of this report) for allowing ORG-2 to use the space leased and paid for by CO-7. The total annual reasonable compensation was \$ (\$ + \$). The excessive amounts were \$ (\$ - \$) and \$ (\$ - \$) for FDN-2 for the tax years June 30, 20XX and June 30, 20XX, respectively.

The excessive compensation constituted inurement. Treasury Regulations section 1.501(c)(3)-(c)(2) states, "an organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private individuals." Therefore, in accordance with Treasury Regulations section 1.501(c)(3)-(c)(2), ORG-2's federal tax exempt status under IRC section 501(c)(3) should be revoked effective July 1, 20XX.

#### **TAXPAYER'S POSITION:**

On October 20, 20XX, the Service issued a preliminary report of examination proposing revocation of ORG-2's Federal tax exempt status under IRC section 501(c)(3) effective July 1, 20XX. In January 20XX, ORG-2 responded to the Service's preliminary report of examination disagreeing with the proposed action. In summary, ORG-2 maintains that (i) all of its activities have furthered its charitable and educational purposes; and (ii) none of its earnings have inured to the benefit of a private individual or shareholder.

#### **GOVERNMENT'S RESPONSE TO ORG-2'S POSITION THAT ITS ACTIVITIES HAVE FURTHERED EDUCATIONAL PURPOSES**

##### Source of Income



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Name of Taxpayer		Year/Period Ended
ORG-1 d.b.a. ORG-2		June 30, 20XX thru June 30, 20XX

On page 21 of your Letter, you stated, "As indicated on the Forms 990, the organization's expenses and activities are much broader than DMP administration, even though the sources of revenue may suggest otherwise. As such, an analysis of ORG-1's activities in relation to the amount of revenue generated by each activity provides a distorted view of the organization's activities. While it may be true that during the period under examination substantially all of ORG-1's revenue was generated from the administration of DMPs, it is not true that all of ORG-1's activities conducted in the administration of DMP's generated revenue.

As only one of the multiple activities in which ORG-1 engages produces revenue, it stands to reason that substantially all of ORG-1's revenue would be attributable to the sole revenue producing activity regardless of the amount of time spent on other activities. Therefore, any conclusion made about the proportion of ORG-1's activities based solely on ORG-1's revenue sources is inherently flawed."

#### Government's Response

The source of income is an indication that ORG-2's primary activity is promoting and selling DMPs. Primarily promoting and selling DMPs does not further a purpose set forth in IRC section 501(c)(3). As such, Congress enacted new laws limiting the amount of fair share received by credit counseling agencies.

#### Sale Tactic

On page 32 of your Letter, you stated, "In addition to reviewing the manual, the Service reviewed the counselor scripts and checklists. Upon reviewing this information, the Service concluded that the sole purpose of such information was to provide counselors with the tools necessary to engage in ruthless sale tactics such as "stirring up the pain the prospects were experiencing." The Service based its conclusion on the follow-up scripts available to the counselors during the period under examination.

ORG-1 acknowledges that the scripts do encourage counselors to "visit pain" during the counseling follow-up process. However, the Service appears to have defined the term differently than the manner in which it is used by ORG-1. As discussed above, FDN-1 and FDN-2 each have a Ph. D. in clinical psychology and have experience treating individuals dealing with addictions. When treating such individuals, it is common to use the term "visit the pain" to describe the process of dealing directly with the addiction issues so that the individual can begin the recovery process. Recognizing the psychological similarities between treating drug addictions and treating the financial troubles that, in some sense, are attributable to an addiction to easy credit, FDN-1 and FDN-2 developed their counseling model to help individuals address the psychological as well as the financial strains of excessive debt. Thus the term "visit pain" is not intended to be a sale tactic; it is intended to enable individuals to address their financial issues in a direct and honest manner so that they can effectively and permanently address their financial issues."

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Government's Response

ORG-2's intention in "visiting the pain" as a sales tactic is reflected in what ORG-2's counselors offer to the applicants after they "visited the pain". For relational applicants, the counselors focus is on the emotional drain of debt or spiritual bondage and offers a program that can free the applicants from debt and bondage. For tactical applicants, the counselors will offer a program that "can save you thousands of dollars and years of bondage to this debt." As the follow-ups continue on, the savings the counselors describe in the follow up messages become more detailed, "the Debt Free program will drop your average interest rates on your credit cards from \_\_\_% to \_\_\_%. The interest savings will be \$\_\_\_\_\_ on the program. Also, you will get out of debt in \_\_\_ years instead of the decades it will take you if you do not move forward." There is nothing in the follow up messages that suggest ORG-2 will do anything other than enrolling the potential applicants in DMPs.

Counselors Evaluation

On page 37 of your Letter, you stated, "...Also notable, during 20XX, RA-7 did not enroll a single individual on a DMP though she received a raise and bonus that year."

Government's Response

According RA-7's evaluation dated June 21, 20XX, from June 20XX to June 20XX, RA-7 signed on 281 clients.

Use of the Core Analysis Tool (CAT)

On page 39 of your Letter, you stated, "The Service appears to have taken the position that, more so than any other factor, counseling sessions are indicative of whether a credit counseling organization is engaged in an educational activity. The Service demonstrates this position through the CAT, which is substantially focused on an evaluation of the counseling session.

The CAT is divided into two parts, the second of which is only reviewed if the organization fails to demonstrate the positive factors provided in the first part. Part I of the CAT provides a process for reviewing the organization's counseling sessions, counselor education and training, and outreach/advertising. Part I of the CAT provides eleven factors to be evaluated during the examination, with the first five factors being related to the counseling session. Moreover, the instructions for the CAT provide that during an examination "the most detailed and probative information will come from tapes or transcripts of the actual sessions."

In the light of the obvious weight that the Service attributes to its review of counseling sessions during the course of an examination of a credit counseling organization, it is peculiar that, despite the fact that Agent listened to live counseling sessions and

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*reviewed recorded sessions, the Service did not use its analysis of these counseling sessions to shape its opinion of ORG-1's activities. In fact, in the entire 76-page Report, the Service uses only two paragraphs to describe the counseling sessions that it reviewed."*

Government's Response

Per FDN-2, in the years under audit, ORG-2 did not have the CAT tool and did not use the CAT in its counseling sessions. The recorded counseling sessions provided to the Agent were dated January 23, 20XX.

**GOVERNMENT'S RESPONSE TO ORG-2'S POSITION THAT ITS ACTIVITIES HAVE FURTHERED CHARITABLE PURPOSES**

You also have raised the argument that you satisfy the requirements of section 501(c)(3) because you serve a charitable purpose of relief of the financially distressed. Financially distressed individuals are not a charitable class. See Revenue Rulings 69-441, 1969-2 CB 115 and 65-299, 1965-2 CB 165.

**GOVERNMENT'S RESPONSE TO ORG-2'S POSITION THAT THE COMPENSATION PAID TO THE FOUNDERS DID NOT CONSTITUTE PRIVATE INUREMENT**

Reasonable Compensation

On page 50 of your Letter, you stated, *"The first glaring weakness in the Service's compensation report is that it treats all salaries as equal regardless of each organization's location. This is a flawed assumption. As ORG-1 is located in the City area, one of the most expensive locations in the country, a dollar-for-dollar comparison of the compensation paid by ORG-1 to that of an organization located in City, State, City State, or City, State will provide inaccurate results even if the organizations have similar revenue amounts. In the Service's study, of the 13 organizations listed in the Service's comparability report, only three are located in CO-14es with populations greater than 500,000."*

Government's Response

The Service prepared two ERI's Compensation Comparables Assessor reports. One was prepared on October 4, 20XX and the other on March 17, 20XX. The same information such as officers' position, revenue and asset size and industry code was used to prepare both reports. The October 4, 20XX report was prepared specifically for City, State where ORG-2 is located. The March 8, 20XX report was based upon the United States average. In addition to the ERI compensation reports, the Service also looked at officer compensation paid by tax exempt credit counseling agencies with comparable revenue size in similar markets. Refer to page 41 of this report for the

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Service's explanation and the factors considered in the determination of FDN-1 and FDN-2's reasonable compensation.

On page 54 of your Letter, you made references to the letter dated January 6, 20XX from CO-8. In that letter, RA-2 described his involvement in the determination of FDN-1 and FDN-2's salaries, the factors he considered and his conclusion regarding the reasonableness of FDN-1 and FDN-2's salaries.

#### Government's Response

When considering whether the compensation paid by ORG-2 to FDN-1 and FDN-2 was reasonable given the services rendered, only the actual services rendered and time FDN-1 spent on fulfilling his position at ORG-2 should be considered.

ORG-2 produced no records to support the claim that FDN-1 and FDN-2 worked for at least 50 hours per week during years under examination.

During the years under audit, FDN-1 held multiple positions with multiple organizations. ORG-2 disclosed that FDN-1 was the President of ORG-2 and was responsible for administration, public relations and human resource functions. In addition, FDN-1 was also the Co-Founder, Owner and CEO of CO-5 and the CEO of CO-7. FDN-1 also assisted FDN-2 in the day-to-day operations of CO-1 and the estimated time he devoted to CO-1 activities was 30-40 hours depending on the situation the company is in. For the years June 30, 20XX and June 30, 20XX, FDN-1 received \$ and \$ in compensation from CO-1 respectively for the services rendered.

According to the employment agreement between ORG-2 and ED/OM and the statement provided by ED/OM, it appeared that ED/OM was the employee responsible for the smooth operation of ORG-2. ED/OM then met with FDN-1 on a weekly, monthly and as needed basis for reports and update. Only after August 20XX, when ORG-2 terminated ED/OM's employment, did FDN-1 begin to take over the duties performed by ED/OM and devoted more time to his position at ORG-2.

FDN-2 served as V.P. of Business Development and was responsible for fund raising and providing counseling to individuals and families on financial and relationship issues. ORG-2 further disclosed that FDN-2 also served as CEO for CO-1 and was responsible for the administration, public relations, human resources and other duties that CO-1 may need from time to time. For the years ending June 30, 20XX and June 30, 20XX, FDN-2 received compensation of \$ and \$ from CO-1 respectively for the services rendered. The information ORG-2 disclosed indicates that FDN-2 was primarily responsible for the operations of CO-1 not ORG-2. ED/OM disclosed that he only reported to FDN-1 as his boss. ED/OM did not mention anything about reporting to

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FDN-2. ED/OM was not aware of FDN-2's actual duties and responsibilities at ORG-2. It should be noted that ORG-2 received \$0 from fundraising activity.

Given the duties, responsibilities and the time devoted to their positions, the Service determined that FDN-1 and FDN-2's compensation of \$ and \$ per year was not reasonable.

On page 54 of your Letter, you stated, "*Further, the Service appeared to base its conclusion on its belief that the presence of a Manager, ED/OM, there was no need for additional oversight or services provided by other ORG-1 officers. Further, as the Service was of the opinion that this additional oversight was not necessary, ORG-1's officers would not have actually engaged in such services. In making a determination regarding how an organization should be run by limiting the numbers of hours or the amount of oversight permissible, the Service is moving beyond its role of regulator and making business decisions on behalf of the organizations that it is examining. Such an approach goes well beyond the scope of the Service's regulatory powers.*"

Government's Response

Refer to IRC section 162(a) and John Marshall Law School and John Marshall University v. The United States, 81-2 USTC 9514 (Ct. Cl. 1981).

CONCLUSION:

1. Since ORG-2. was not operated exclusively for one or more exempt purposes under IRC section 501(c)(3), its Federal tax exempt status should be revoked effective July 1, 20XX.
2. Since ORG-2. was operated to serve a private interest of its Founders rather than the interest of the public, its Federal tax exempt status under IRC section 501(c)(3) should be revoked effective July 1, 20XX.

ORG-2 is responsible for filing Form 1120 U.S. Corporation Income Tax Return for the tax year ending June 30, 20XX and all years thereafter.