Mr. Chairman, Mr. Rangel, members of the Committee, I am pleased to testify today on the tax-exempt sector. I first provide a brief overview of the size and growth of the exempt sector, discuss some of the reasons why organizations have been granted tax-exempt status, and describe some common tax law features of exempt organizations. I conclude my testimony by focusing on charitable organizations, the largest category by far of exempt organizations. I summarize the requirements for exempt status as a charitable organization and review selected current issues relating to those organizations.

A. Overview of Organizations Exempt from Federal Income Tax

Size and growth of the exempt sector generally

Since the inception of the Federal income tax, the Congress has exempted certain types of entities from income taxation. Many exempt entities, such as charitable organizations, are familiar. Yet charitable organizations are but one type of exempt entity. The benefit of tax exemption is extended to groups as diverse as social welfare organizations, title holding companies, fraternal organizations, small insurance companies, credit unions, cooperative organizations, and cemetery companies. The statistics reported in this document do not include churches, which are not required to file returns with the Internal Revenue Service (“IRS”), and are not recorded in the IRS Master File of Exempt Organizations.

There are now 28 different types of organizations listed in the main exemption section of the Code (section 501), and numerous other exemptions provided elsewhere. The number and financial holdings of these organizations are large and have grown significantly since record-keeping began in 1975. The revenue reported to the IRS by such organizations has increased from approximately $0.3 trillion (in 2001 dollars) in 1975 to about $1.2 trillion in 2001. The

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1 In general, my testimony does not discuss entities that are exempt under section 401 of the Code, which are subject to a completely different regulatory apparatus than those exempt under section 501.
2001 revenue represented approximately 12.2 percent of gross domestic product in that year. The assets reported by the organizations have similarly increased, from approximately $0.5 trillion (in 2001 dollars) in 1975 to almost $2.9 trillion in 2001.

While a large majority of exempt entities fall into familiar categories, such as charitable organizations, there are also a fair number of organizations that fall into more obscure categories. Eight categories have fewer than 150 qualifying entities each, with four categories having fewer than five entities each.

**Size and growth of the charitable sector**

Charitable organizations described in section 501(c)(3) represent by far the largest category of exempt organizations, comprising about two-thirds of all exempt organizations. The 2004 IRS Master File of Exempt Organizations shows 1,010,365 charitable organizations. In terms of asset size and revenues, the share of charitable organizations in the exempt sector is similar. In 2001, the total revenue of charitable organizations (including private foundations but not including churches and other organizations not required to file) was about 9.3 percent of gross domestic product.

Among charitable organizations not including churches, the largest categories of organizations are hospitals and post-secondary educational organizations. In 2001, hospitals held 29 percent of total assets and collected 42 percent of total revenues in the exempt sector. Colleges and universities held 21 percent of the total assets and collected 11 percent of total revenue.

There has been significant recent growth in the number and size of charitable organizations. The number of such organizations has increased from 259,523 in 1976 to 1,010,365 in 2004, an increase of 289 percent. The total asset value and revenues (in 2001 dollars) reported to the IRS by charitable organizations similarly increased from about $360 billion and $155 billion, respectively, in 1975, to over $2 trillion and about $942 billion, respectively, in 2001.

The growth in the number and size of charitable organizations has been accompanied by growth in the amount of charitable deductions. In 1975, the total amount claimed as charitable deductions was about $43.7 billion whereas in 2002, the total was about $145 billion (both numbers in constant 2000 dollars).

**B. Reasons for Tax Exemption**

There is no unifying theme or singular principle that explains tax exemption for the many diverse organizations in the exempt sector, although there are some factors that may help to explain the exemption for certain of them.

Over the years, Congress has granted tax exemption only to certain types of organizations. As an initial matter, not all “nonprofit” organizations are afforded tax exemption, and not all tax-exempt organizations have the typical characteristics of a “nonprofit” organization. The term “nonprofit” generally refers to an organization’s form under State law, not its Federal tax status. State law generally does not prohibit “nonprofits” from earning a
profit, as one might expect. Instead, State law typically prohibits the distribution of earnings by nonprofit corporations (but not necessarily by other forms of entities) to their members.

The Federal exemption is extended in some instances to organizations that are not subject to a State-law constraint on distributions, as some entities are not required for exemption purposes to be organized in corporate form. Therefore, exemption may be obtained by some organizations that do not fit the classic definition of “nonprofit.” However, the Federal tax laws applicable to certain types of exempt organizations (though not all) contain prohibitions, such as the “no private inurement” and “no private benefit” doctrines, that are in some respects similar to the State-law constraint.

For some organizations, exemption from tax may be explained based on the nature of its activities. For example, charitable activities or activities that provide a public benefit may be viewed as governmental in nature and therefore not appropriate subjects of taxation. This may explain the exemption for charitable organizations, social welfare organizations, U.S. instrumentalities, and State and local governments. Promotion of certain activities may also be viewed as desirable policy, and therefore tax exemption is intended to encourage the activity. This may explain the tax exemption for arrangements to provide employee benefits, arrangements for individuals to save for health, retirement, and education, and the exemption for small or rural commercial organizations that engage in certain activities, such as farming, provision of financial services, insurance, electricity, or other public good.

Exempt status may also be attributable to the structure of an organization. Some organizations are funded exclusively by their members and expend all funds exclusively for members. If such an organization collects more in membership dues than its expenses, the excess is reinvested in the organization for the benefit of the members. Under general tax principles, the organization may not be considered as having any income because there has not been a shifting of benefit from the member to the organization – the organization merely facilitates a joint activity of its members. Thus, in some cases, the Code adopts a result that might occur even in the absence of statutory law, e.g., social clubs, fraternal organizations, voluntary employees’ beneficiary associations, cemetery companies, and homeowners associations.

Another factor that may explain some cases of tax exemption is the nature of the legislative process. As noted, Congress did not provide exemption for all organizations that are not organized for profit; rather, the general rule is that an organization is subject to tax absent a specific exemption. Such a rule means that once broad categories of exemption are codified, there will be specific classes of organizations that do not fit within the broad category and that seek and receive exempt status. Social welfare organizations, business leagues, labor, agricultural, and horticultural organizations and other organizations may be examples.

Another factor to consider is simple expediency, in that taxing certain small organizations was viewed at the time the exemption was granted as too costly to administer, especially when often little or no tax would be due. This appears partially to explain the reason for exempting single-parent title holding companies from tax as well as social clubs. As stated in 1916 legislative history: “the securing of returns from them has been a source of annoyance and
expense and has resulted in the collection of either no tax or an amount which is practically negligible.”

C. Common Tax Law Features of Exempt Organizations

In general

Despite varying standards regarding qualification for exempt status, different categories of exempt organizations share some common characteristics. For example, many types of exempt organizations are subject to a prohibition against “private inurement,” and most exempt organizations are subject to the general rules regarding the taxation of unrelated business income. Contributions to a limited number of exempt organizations are deductible as charitable contributions, while contributions to others may be deductible as a business expense but not as a charitable contribution. Most exempt organizations also are subject to rules regarding lobbying and political campaign activities and are required to file annual information returns.

Private inurement prohibition

The doctrine of private inurement generally prohibits an exempt organization from using its assets for the benefit of a person or entity with a close relationship to the organization. For example, section 501(c)(3) provides that an organization will qualify for charitable exempt status only if “no part of the net earnings [of the organization] inures to the benefit of any private shareholder or individual.” The regulations under section 501(a), which generally apply to organizations subject to the inurement proscription, define “private shareholder or individual” as “persons having a personal and private interest in the activities of the organization.” Inurement thus applies to transactions between applicable exempt organizations and persons sometimes deemed “insiders” of the organization, such as directors, officers, and key employees. The issue of private inurement often arises where an organization pays unreasonable compensation (i.e., more than the value of the services) to such an insider. However, the inurement prohibition is designed to reach any transaction through which an insider is unduly benefited by an organization, either directly or indirectly.

There is no “de minimis” exception under the inurement prohibition, and an organization that engages in an inurement transaction may face revocation of its exempt status. Until 1996, there was no sanction short of revocation of exempt status in the event of an inurement transaction. In 1996, however, Congress imposed excise taxes, frequently referred to as “intermediate sanctions,” on “excess benefit transactions” between certain exempt organizations and “disqualified persons.” The intermediate sanctions rules, which apply only to transactions involving organizations exempt under sections 501(c)(3) and 501(c)(4), impose excise taxes on a disqualified person who receives an excess benefit and, under certain circumstances, on organization managers who approved the transaction. No such sanctions are presently imposed against the organization itself.

Section 501(c)(3) organizations (but not other organizations) also are subject to a prohibition against conferring more than incidental “private benefit.” The private benefit prohibition applies to non-fair market value transactions with individuals or entities, not merely with insiders, and thus is in some respects broader than the private inurement prohibition.
Unrelated business income tax

In general, an exempt organization may have revenue from four sources: contributions, gifts, and grants; trade or business income that is related to exempt activities (e.g., program service revenue); investment income; and trade or business income that is not related to exempt activities. In general, the Federal income tax exemption extends to the first three categories, and does not extend to an organization’s unrelated trade or business income. In some cases, however, the investment income of an organization is taxed as if it were unrelated trade or business income.

The unrelated business income tax was introduced in 1950 to address the problem of unfair competition between for profit companies and non profit organizations conducting an unrelated for profit activity. The unrelated business income tax generally applies to income derived from a trade or business regularly carried on by the organization that is not substantially related to the performance of the organization’s tax-exempt functions. Most exempt organizations are subject to the tax.

Most exempt organizations generally may operate an unrelated trade or business so long as it is not a primary purpose of the organization. Therefore, engaging in a substantial amount of unrelated business activity before jeopardizing exempt status is permitted. By contrast, a charitable organization may not operate an unrelated trade or business as a substantial part of its activities.

Certain types of income are specifically exempt from the unrelated business income tax, such as dividends, interest, royalties, and certain rents, unless derived from debt-financed property or from certain 50-percent controlled subsidiaries.

For the tax year 2001, 35,540 organizations filed unrelated business income tax returns, reporting a total of $7.9 billion of gross unrelated business income. This translated into unrelated business taxable income (after taking into account allowable deductions) of approximately $792 million and total tax of approximately $226 million.

Contributions

Another feature of a minority of tax-exempt organizations is that contributions to such organizations may be deductible by the donor as charitable contributions for income, estate, and gift tax purposes. Contributions to charitable organizations, for example, generally are deductible for income, estate, and gift tax purposes, although the amount of deduction may be affected by such factors as the recipient organization’s classification as a public charity or private foundation and the type of property contributed. Other types of organizations that are eligible recipients of charitable contributions include: certain Federal, State, and local government entities, if the contribution is exclusively for public purposes; certain fraternal beneficiary societies, if the contributions are used for charitable purposes; cemetery companies, if the contributions are used for certain purposes; and certain organizations of war veterans.

Contributions to other types of exempt organizations generally are not deductible as charitable contributions. Under certain circumstances, however, contributions to a membership organization, such as a social welfare organization or trade association, may be deductible as a
business expense under section 162. In addition, contributions to tax-exempt employee benefit arrangements (e.g., qualified retirement plans) or individual savings arrangements (such as individual retirement accounts) may be deductible.

**Lobbying and political activities**

Tax-exempt organizations are also subject to rules regarding the permissible level of lobbying and political campaign activities. In general, the lobbying and political activity rules applicable to charitable organizations are more severe than the rules applicable to other types of exempt organizations.

**Information returns**

Exempt organizations are required to file an annual information return, stating specifically the items of gross income, receipts, disbursements, and such other information as the Secretary may prescribe. The requirement that an exempt organization file an annual information return does not apply to certain exempt organizations, including organizations (other than private foundations) the gross receipts of which in each taxable year normally are not more than $25,000. Also exempt from the requirement are churches, their integrated auxiliaries, and conventions or associations of churches; the exclusively religious activities of any religious order; certain state institutions whose income is excluded from gross income under section 115; an interchurch organization of local units of a church; certain mission societies; certain church-affiliated elementary and high schools; and certain other organizations, including some that the IRS has relieved from the filing requirement pursuant to its statutory discretionary authority.

**D. Summary of Requirements of Exempt Status of Charitable Organizations and Selected Issues Relating to Such Organizations**

**In general**

In general, the requirements for exempt status of an organization under section 501(c)(3) of the Code are that (1) the organization must be organized and operated exclusively for certain purposes; (2) there must not be private inurement to organization insiders; (3) there must be no more than an incidental private benefit to private persons who are not organization insiders; (4) no substantial part of the organization’s activities may be lobbying; and (5) the organization may not participate or intervene in political activities. Permitted purposes are religious, charitable, scientific, testing for public safety, literary, educational, the fostering of national or international amateur sports competition, or the prevention of cruelty to children or animals. Failure to satisfy any of these requirements should result in an organization not qualifying for exempt status under section 501(c)(3), or should result in a loss of such status once a violation is detected by the IRS. Most of the Federal law of charitable organizations is designed around ensuring that each of the requirements is satisfied by an organization initially and on an ongoing basis. Each of the requirements is simple to state, but none are simple, as each carries with it a significant body of statutory, common, and administrative law.

If an organization satisfies each of the requirements, there is a further question of what type of charitable organization it is. A section 501(c)(3) organization is either a public charity or a private foundation. In general, the basis for distinguishing between public charities and private
foundations is the level of public support an organization receives over time. Organizations with widespread public support tend to qualify as public charities; organizations funded by just a few donors tend to be classified as private foundations. There is a substantial body of law detailing how to determine whether an organization is publicly supported. Certain organizations also may qualify as public charities as a matter of law (e.g., churches, hospitals). The classification matters because private foundations generally are subject to more restrictions on their activities than are public charities, are subject to tax on their net investment income, and contributions to private foundations generally do not receive as favorable treatment as do contributions to public charities for purposes of the charitable contribution deduction.

Satisfaction of the requirements for exemption, classification of an organization as a public charity or private foundation, plus the resulting benefit that contributions to charitable organizations generally are tax deductible provides the simplest snapshot of the law of charitable organizations.

**Exempt purposes of section 501(c)(3) organizations**

**The meaning of charity – present law**

In general, there are two approaches to the meaning of the term charitable -- the legal sense and the ordinary and popular sense. The legal definition is derived from the law of charitable trusts and is broader than the ordinary sense of the term, which generally means the relief of the poor and distressed. Since 1959, Treasury regulations have defined the term “charitable” in the legal sense, to include:

- Relief of the poor and distressed or of the underprivileged; advancement of religion; advancement of education or science; erection or maintenance of public buildings, monuments, or works; lessening of the burdens of Government; and promotion of social welfare by organizations designed to accomplish any of the above purposes, or (i) to lessen neighborhood tensions; (ii) to eliminate prejudice and discrimination; (iii) to defend human and civil rights secured by law; or (iv) to combat community deterioration and juvenile delinquency.

This definition is broad, encompassing several ideas that would not generally be considered as charitable in the ordinary sense. In addition to meeting the regulatory definition of charitable, an organization described in section 501(c)(3) is not organized and operated for exempt purposes if a purpose of the organization is against public policy or is illegal.

In addition to the public policy requirement, certain common law principles inform the Federal tax law definition of charity. The charitable class requirement provides that an organization be organized to benefit a sufficiently large or indefinite class of people. The community benefit doctrine permits exemption as a charitable organization if the result of an activity inures to the benefit of the community, even though a private person is the immediate beneficiary of the activity.
The meaning of charity and the rationale for tax exemption and charitable deductions

There is no agreed upon explanation of the rationale behind the charitable tax exemption and tax deduction. Some of the basic rationales that have been offered, described in greater detail in Part II.C of this pamphlet, may be summarized as follows: (1) charitable organizations serve the public and therefore should be supported through provision of tax benefits; (2) charitable organizations provide goods and services that otherwise would have to be provided by the Government and therefore should be supported by the Government; (3) it is difficult to measure the net income of charitable organizations, and therefore they should be exempt from tax; (4) charitable organizations promote pluralism; (5) charitable organizations are efficient providers of services but have inherent limits on their ability to raise capital compared to for-profit entities and therefore need government support in the form of tax exemption (and charitable contributions); and (6) exemption is afforded to those organizations that can prove their worth through sustained donations.

Educational purposes

Tax exemption for educational organizations was provided in the Tariff Act of 1894, and has been replicated in each subsequent income tax act. Educational organizations have been eligible to receive tax deductible contributions since 1917. Like the term charitable, the term educational has no precise meaning. The Treasury regulations set forth the basic definition as relating to the “instruction or training of the individual for the purpose of improving or developing his capabilities.” This definition is consistent with provision of exemption for organizations that fit within the common conception of an educational organization, such as schools, colleges, and universities. Yet educational organizations are not limited to such traditional forms. The “instruction of the individual standard” may be met by many other types of organization. The Treasury regulations also provide that educational means the “instruction of the public on subjects useful to the individual and beneficial to the community.” The IRS and the courts have permitted a broad array of organizations to be considered educational under this standard.

A primary issue in determining whether something is educational is not the content of the information but the method the organization uses to convey information, irrespective of content. In general, the analytical exercise is to determine whether an organization’s presentation of information is objective and balanced, or whether the organization instead is an advocate or a mouthpiece for propaganda.

Religious purposes

The Federal tax exemption for organizations operated for religious purposes was, along with charitable and educational purposes, provided for originally in the Tariff Act of 1894, and religious organizations were designated as eligible for charitable contributions in 1917. There is no definition of “religious” provided by regulation. The manifest reason is the constitutional law framework that limits Federal involvement in religion. The IRS has developed a multi-factor list of characteristics that inform whether an organization may be considered a church (which is a kind of religious organization), and the IRS is careful to point out that this list is not comprehensive and that in each case, the facts and circumstances will be considered. In many
cases in which a religious organization’s claim to exempt status is questioned, the issue of whether the organization serves religious purposes often is not addressed because exempt status may be denied on other grounds, for example, private benefit or private inurement, commerciality, or violation of the political activities prohibition.

The Constitutional concerns regarding Federal involvement in religious organizations extend to the application of regulatory requirements. For example, certain religious organizations are exempted from the requirement to apply for tax exempt status, from annual information return requirements, and special audit procedures apply to churches. As a result, although religious organizations, particularly churches, constitute a significant part of the charitable sector, information about such organizations is scarce.

**Scientific purposes**

Scientific purposes were the first addition to the original three exempt charitable purposes and were added in 1913. Charitable contributions to scientific organizations were made deductible in 1917. A tax exempt scientific purpose hinges on the performance of basic or fundamental research in the public interest. Scientific research that is “applied” or “practical” may be subject to the unrelated business income tax, but generally is not inconsistent with exempt purposes. There is no precise definition of scientific research, and, in general, courts and the IRS have determined whether an organization is engaged in scientific research on a case-by-case basis. Scientific research must be in the public interest. Scientific research does not include activities of a type ordinarily carried on as incidental to commercial or industrial operations.

**Selected issues involving charitable organizations**

**Selected issues relating to the public charity – private foundation distinction**

In 2005, thirty-six years after Congress first drew a meaningful legal distinction between publicly supported organizations and private foundations, it may not be as clear, given the growth and diversity of publicly supported organizations, why some of the private foundation rules are not relevant for certain public charities, or whether some of the private foundation rules are performing their intended purpose. For example, the retention of substantial holdings in a commercial business, the making of investments or expenditures that jeopardize or are inconsistent with exempt purposes, or the maintenance of large endowment funds raise some of the same concerns whether conducted by a public charity or a private foundation.

In defining a private foundation, the 1969 Act provided that an organization that provides support to a public charity (a “supporting organization”) is considered a public charity and not a private foundation. Thus, supporting organizations receive the benefit of the favorable charitable contribution deduction rules and avoid the excise tax regime applicable to private foundations. Donors to supporting organizations may take a fair market value deduction for contributions of capital gain property such as closely held stock, which would not be permitted for gifts to private foundations. As a public charity, supporting organizations also are not subject to the private foundation self-dealing rules (e.g., barring loans and other transactions with insiders), limitations on business holdings, or subject to the private foundation payout rules. However, unlike other
public charities but like private foundations, supporting organizations generally do not have broadly based support, and may resemble private foundations in other respects.

Community foundations and donor advised funds, which generally qualify as public charities, offer limited ways for donors to exercise post-transfer control or direction over the use of funds or other property transferred to a charity for which the donor is entitled to a deduction in the year of transfer. Contributors to community foundations and donor advised funds receive the benefit of the favorable public charity rules and some elements of the control over distributions without being subject to the legal constraints placed on a private foundation. Thus, a donor can fund an account in a community foundation or donor advised fund with cash or capital gain property, take a fair market value deduction, accumulate income in the fund, and from time to time recommend that amounts be paid out of the fund for charitable purposes. Community foundations and donor advised funds, like supporting organizations, resemble private foundations in many ways, but are considered public charities.

Selected issues relating to the unrelated business income tax

In general, exempt organizations have greater discretion than taxable organizations in determining whether to report income as taxable or not, through the questions of whether income is from a regularly conducted trade or business, and whether the conduct of such a trade or business is “substantially related” to exempt purposes. In addition, even if an exempt organization treats income as unrelated and therefore as subject to tax, an exempt organization might allocate expenses for an exempt activity to an unrelated activity in order to minimize or eliminate the tax.

Issues often arise regarding whether certain types of receipts constitute royalties, which generally are excluded in determining an organization’s unrelated business taxable income. Two issues that have been the source of considerable debate in this area are: (1) whether income from an affinity credit card program constitutes a royalty and (2) whether income from a mailing list rental constitutes a royalty. Notwithstanding several court decisions, a taxpayer that provides more than a small amount of clerical services may risk having payments received in exchange for a license classified as payments for services rather than as excludable royalties.

Charitable hospitals

In general

The Code does not provide a per se charitable exemption for hospitals. Rather, a hospital qualifies for exemption if it is organized and operated for a charitable purpose and meets additional requirements of section 501(c)(3). The promotion of health has long been recognized as a charitable purpose that is beneficial to the community as a whole. It includes not only the establishment or maintenance of charitable hospitals, but clinics, homes for the aged, and other providers of health care.

Medical care generally is provided by government-owned, for-profit, and tax-exempt organizations. In the hospital sector, tax-exempt organizations dominate, with approximately 60 percent of the nation’s hospitals operating as charitable institutions. Historically, charitable hospitals were characterized as voluntary because they generally were supported by
philanthropy, staffed by doctors who worked without compensation, and served, almost exclusively, the sick poor. However, the character of the charitable hospital sector has changed significantly over the past several decades due to the growth of such resources as employer-provided health insurance and governmental programs such as Medicare (for the elderly and disabled) and Medicaid (for the poor). Today, charitable hospitals generally provide medical and other health-related services in a manner similar to their for-profit counterparts. They operate under the same healthcare regulations, compete for the same patients and doctors, and derive funding from many of the same sources as other types of hospitals.

Evolution of the legal standard

Financial Ability Standard.–Much like the nature of the health-care industry itself, the definition of the term charitable as applied to hospitals has not been static. In 1956, the IRS adopted the “financial ability standard,” requiring that a charitable hospital be “operated to the extent of its financial ability for those not able to pay for the services rendered and not exclusively for those who are able and expected to pay.” This standard effectively meant that a charitable hospital could not refuse to accept patients in need of hospital care who could not pay for such services. However, the IRS acknowledged that hospitals normally charge patients who are able to pay for services in order to meet the hospital’s operating expenses and stated that the “fact that the hospital’s charity record is relatively low is not conclusive that a hospital is not operated for charitable purposes to the full extent of its financial ability.” The ruling’s requirement that charitable hospitals provide some amount of free or reduced-rate care reflected the view that hospitals and other health care institutions were only charitable if they both provided relief to the poor and promoted health.

Community Benefit Standard.–The financial ability standard governed charitable hospitals until 1969. Congress had criticized the financial ability standard as imprecise concerning the extent to which a hospital must accept patients who are unable to pay. In addition, the creation of Medicare and Medicaid in 1965 had a fundamental effect on hospitals; a substantial portion of the free care previously subsidized by charitable hospitals now was reimbursed through these governmental programs. In response to these developments, the IRS adopted the “community benefit standard,” which remains the test applied by the IRS for determining whether a hospital is charitable. Under the community benefit standard, the promotion of health care is “one of the purposes in the general law of charity that is deemed beneficial to the community as a whole even though the class of beneficiaries eligible to receive a direct benefit from its activities does not include all members of the community, such as indigent members, provided that the class is not so small that its relief is not of benefit to the community.” Applying this community benefit standard, the IRS found that a hospital’s operation of a generally accessible emergency room open to all persons, regardless of ability to pay, provided a benefit to a sufficiently broad class of persons in the community. The requirement of the financial ability standard that charitable hospitals provide care to patients without charge or at rates below cost was removed. The community benefit standard applies not only to traditional hospitals, but also other health care provider organizations, such as clinics or health maintenance organizations (HMOs).
Credit counseling organizations

In a 1969 ruling, the IRS concluded that a credit counseling organization was exempt as a charitable or educational organization described in section 501(c)(3) by virtue of aiding low-income people who had financial problems and providing education to the public. The organization had two functions: (1) educating the public on personal money management, such as budgeting, buying practices, and the sound use of consumer credit through the use of films, speakers, and publications; and (2) providing individual counseling to low-income individuals and families without charge. As part of its counseling activities, the organization established debt management plans for clients who required such services, at no charge to the clients. The organization was supported by contributions primarily from creditors, and its board of directors was comprised of representatives from religious organizations, civic groups, labor unions, business groups, and educational institutions. In 1978, a court held that the law did not require that an organization must perform its exempt functions solely for the benefit of low-income individuals to be considered charitable. The court found the debt management plans of the agency at issue were an integral part of its counseling function.

During the period from 1994 to late 2003, 1,215 credit counseling organizations applied to the IRS for tax exempt status under section 501(c)(3), including 810 from 2000 to 2003. As of late 2003, the IRS has recognized more than 850 credit counseling organizations as tax exempt under section 501(c)(3). A number of new credit counseling entities have engaged in aggressive marketing and advertising while providing very little legitimate credit counseling or financial training. In addition, many of today’s credit counseling organizations conduct as their primary activity, and derive most of their revenues from, debt management planning and other activities. Because of these changes in the industry, Congress and the IRS have expressed concern that tax-exempt credit counseling organizations are not fulfilling their exempt purpose. The IRS has commenced a broad examination and compliance program with respect to the credit counseling industry. The IRS concluded in a recent legal memorandum that many credit counseling organizations may not qualify for exemption under section 501(c)(3) because of operation for a substantial nonexempt purpose, substantial private benefit, and private inurement.

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Thank you for the opportunity to testify. I would be pleased to answer any questions.