Summary of Pension Protection Act of 2006 and the IRS Internal Revenue Code Section 501(q) Issues Affecting Nonprofit Counseling Organizations

The nearly 400-page Pension Protection Act was passed in mid-2006 and was largely aimed at reforming pension and retirement plan disclosure and funding practices. Title XII of the Act focuses on 'Provisions Relating to Exempt Organizations' which primarily addresses charitable giving and record-keeping issues. However Section 1220 within Title XII entitled 'Additional Standards for Credit Counseling Organizations' contains strict new requirements for agencies that provide credit counseling services as a 'substantial purpose.'

The provisions of Section 501(q) have only recently come to light though the requirements went into effect as early as August 2006. New counseling organizations were required to comply by 2007 and existing counseling organizations (as of August 2006) were required to comply by 2008.

Though many nonprofit housing counselors may not equate their activities with "credit counseling", the Internal Revenue Service definition of credit counseling services clearly encompasses the typical services offered by the bulk of nonprofit housing counseling organizations in the NeighborWorks Network today. Credit counseling services are defined as:

> *(a) The provision of educational information to the general public on budgeting, personal finance, financial literacy, saving and spending practices, and the sound use of consumer credit;*
> *(b) The assisting of individuals and families with financial problems by providing them with counseling; or*
> *(c) Any combination of such activities.*

The Pension Protection Act places certain types of restrictions on the activities of those credit counseling organizations that maintain a Section 501(c)(3) income tax exemption. In order to continue to qualify for the exemption, eligible nonprofits must also now meet the following 10 provisions of Section 501(q):

1. The organization provides credit counseling services tailored to the specific needs and circumstances of the consumer;

2. The organization makes no loans to debtors (other than loans with no fees or interest) and does not negotiate the making of loans on behalf of debtors;

3. The organization provides services for the purpose of improving a consumer's credit record, credit history, or credit rating only to the extent that such services are incidental to providing credit counseling services and does not charge any separately stated fee for any such services;

4. The organization does not refuse to provide credit counseling services to a consumer due to inability of the consumer to pay, the ineligibility of the consumer for debt management plan enrollment, or the unwillingness of a consumer to enroll in a debt management plan;

5. The organization establishes and implements a fee policy to require that any fees charged to a consumer for its services are reasonable, allows for the waiver of fees if the consumer is unable to pay, and except to the extent allowed by State law prohibits charging any fee based in whole or in part on a percentage of the consumer's debt, the consumer's payments to be made pursuant to a debt management plan, or on the projected or actual savings to the consumer resulting from enrolling in a debt management plan;

6. The organization at all times has a board of directors or other governing body (a) that is controlled by persons who represent the broad interests of the public, such as public officials acting in their capacities as such, persons having special knowledge or expertise in credit or financial education, and community leaders; (b) not more than 20 percent of the voting power of which is vested in persons who are employed by the organization or who will benefit financially, directly or indirectly, from the organization's activities (other than through the receipt of reasonable directors' fees or the repayment of consumer debt to creditors other than the credit counseling organization or its affiliates) and (c) not more than 49 percent of the voting power of which is vested in persons who are employed by the organization or who will benefit financially, directly or indirectly, from the organization's activities (other than through the receipt of reasonable directors' fees);

7. The organization does not own (except with respect to a Section 501(c)(3) organization) more than 35 percent of the total combined voting power of a corporation (or profits or beneficial interest in the case of a partnership or trust or estate) that is in the trade or business of lending money, repairing credit, or providing debt management plan services, payment processing, and similar services;

8. The organization receives no amount for providing referrals to others for debt management plan services, and pays no amount to others for obtaining referrals of consumers;

9. The organization is organized and operated such that the organization does not solicit contributions from consumers during the initial counseling process or while the consumer is receiving services from the organization; and

10. The aggregate revenues of the organization that are from payments of creditors of consumers of the organization and that are attributable to debt management plan services do not exceed the applicable percentage of the total revenues of the organization. For credit counseling organizations in existence on the date of enactment (8/17/06), the applicable percentage is 80 percent for the first taxable year of the organization beginning after the date which is one year after the date of enactment, 70 percent for the second such taxable year beginning after such date, 60 percent for the third such taxable year beginning after such date, and 50 percent thereafter. For new credit counseling organizations, the applicable percentage is 50 percent for taxable years beginning after the date of enactment.

Most of these provisions (Items 1, 3, 4, 5, 8, 9 and 10) are an integral or incidental part of regular activities and are already codified practices at nonprofit counseling agencies, including most if not all NeighborWorks organizations. Some of these seven items are specifically related to formal debt management plan services or credit repair services and therefore are most likely outside the scope of services provided by the typical NeighborWorks organization.

Debt management services are also broadly defined and may include loan modification, foreclosure counseling and budget management services to the extent that the counselor is actively involved in these activities.

Debt management plan services are defined as: '*Services related to the repayment, consolidation, or restructuring of a consumer's debt, and includes the negotiation with creditors of lower interest rates, the waiver or reduction of fees, and the marketing and processing of debt management plans.'*

The IRS also closely scrutinizes Board membership when evaluating Section 501(c)(3) exemptions. Item #6 could present a challenge for those organizations whose Board of Directors composition does not meet the percentage thresholds spelled out in this provision.

The most challenging aspect of compliance with Section 501(q) is related to Items 2 & 7, since a considerable number of organizations provide mortgage lending services in addition to counseling services. Many of them may inadvertently be in violation of Section 501(q) unless their programs are structured correctly or meet the limitations placed on direct lending activities in Item #2.

However, even those organizations that meet the primary requirements of Item #2 and offer only zero rate & zero fee loans or grants etc. may still be in violation if they are involved in the 'negotiation' of a loan. The IRS defines negotiation within the context of Section 501(q) as follows:

"In general, negotiation of a loan involves negotiation of the terms of a loan, rather than the processing of a loan. Organizations that provide assistance to consumers to obtain a loan from the Department of Housing and Urban Development, for example, are not necessarily negotiating a loan for a consumer."

The IRS does not consider a loan modification of an existing loan to be 'negotiation of a loan'. Housing counseling that includes *'attempts to renegotiate the terms of the borrower's mortgage, for instance, by requesting a reduction in the interest rate, the amortization of the amount in default, and/or a modification of the time period for paying off the loans'* does not violate the requirements of Item #2.

However, loan modification related activities are considered debt management plan services and organizational revenue from these activities must be considered under the provisions of Item #10. Other organizational activities may also trigger debt management plan definitions and should be included in Item #10 calculations if applicable.

Organizations that only offer subordinate loans with zero rate & zero fee terms in connection with lender partner first mortgages do not appear to be in violation of Item #2 provisions since they would most likely only be providing general guidance on established first mortgage products offered by partners and not actually negotiating loan terms.

Compliance with Section 501(q) is more troublesome for those organizations that have interest-bearing amortizing or non-amortizing loan programs and/or fee income structures related to those in-house products. This is a clear violation of Item #2 if done under the parent nonprofit entity and therefore jeopardizes the organization's Section 501(c)(3) income tax exemption.

Even organizations that have created separate mortgage lending subsidiaries may not be protected. A wholly-owned lending subsidiary is in violation of the 35% ownership limit in Item #7 unless that subsidiary also has a separate Section 501(c)(3) exemption.

Many organizations have established nonprofit lending subsidiaries but may not have sought a separate 501(c)(3) exemption for the lending entity. Few, if any, NeighborWorks organizations have established jointly-owned lending units that limit their ownership percentage to 35% or less or have set up complete standalone lending affiliates.

RECOMMENDATIONS

Determine Applicability and Exposure

There are three possible exceptions that could eliminate exposure in this area. First, lending activities are exclusively related to programs that are offered at a zero percent rate with no loan-related fees charged to the customer. This is an eligible activity under Section 501(q) and many nonprofits are only doing this type of lending with HOME Funds, CDBG funds or other federal, state, municipal or private sector funds.

Second, the nonprofit has already set up a wholly-owned separate mortgage lending entity and has secured or applied for a 501(c)(3) exemption from the IRS. This ensures compliance with Section 501(q) since the 501(c)(3) nonprofit is allowed to have full ownership of another 501(c)(3) organization.

The third, and perhaps least attractive option, evaluate whether credit counseling is truly a 'substantial purpose' of the organization. Managers should examine the Articles of Incorporation, by-laws and other organizational formation documents as well as 'Form 1023 - Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code' and 'Form 990 - Return of Organization Exempt From Income Tax' to determine how the organization portrays its activities to the IRS.

Management may also wish to evaluate the percentage of time the organization spends on credit counseling activities to determine if are negligible in relation to other activities and can therefore justify that they are not a substantial purpose of the organization.

Corrective Action Options

If the above analysis results in a determination that the organization confronts 501(q) exposure there are three possible corrective options:

1. Create a wholly-owned subsidiary with a separate 501(c)(3) designation. This may be the most appealing option since the nonprofit can retain full control of the entity. The organization can usually seek a 501(c)(3) exemption and continue to lend until a decision has been rendered by the IRS. If approved, in most cases the IRS will recognize the exemption from the date of filing the 1023 application.

The challenge with this option is that the organization may already have secured mortgage licensing under the parent entity's name and will most likely need to forfeit the license and start over. Some states and surety bond companies require a minimum net worth so sufficient organizational assets must be transferred to the new lending entity. In addition, most states require that 'responsible individuals', loan originators, processors and underwriters work for the lending entity so payroll transfers will also need to implemented. Finally, existing contracts

(HOME Funds, municipal etc.) and certifications (CDFI etc.) must be evaluated for transferability options.

2. Create a separate mortgage lending entity and retain no more than 35% ownership. This may be an option for organizations that cannot or do not want to pursue the first option. It may also be practical for a group of organizations in the same geographic location to pool their resources and create an entity where each organization has some limited percentage of ownership. A Section 501(c)(3) exemption would not be required for the new entity although founders might wish to secure the exemption for other purposes.

The challenge with this option is similar to the first option although the expenses related to lending law and SAFE Act compliance would be distributed amongst the owners and therefore less of a burden on any single organization. However, having multiple layers of ownership could introduce complicated management and decision-making challenges.

3. Create a standalone affiliate mortgage lending entity. This may be the least attractive option since ownership and oversight would be completely separate from the parent nonprofit. However it would comply with Section 501(q) in the strictest sense. The entity would not need to seek a Section 501(c)(3) exemption but disclosure requirements related to affiliates must be properly followed.

The challenges associated with this option are similar to the others. There also may be additional federal, state or local requirements associated with an affiliate entity.