Several months ago, the Internal Revenue Service took the position with some lawyer referral services in California that a return of fees to the service by a panel member constituted taxable unrelated business income to the service. In what appears to be a change in that position, the Chief, Exempt Organizations Technical Branch of the Internal Revenue Service, has issued a technical advice memorandum to the Bar Association of San Francisco holding that "...surcharge fees, forwarding fees and case fees received by the Bar Association of San Francisco, relating to (that Bar's) operation of a Lawyer Referral Service, do not constitute unrelated business income under Section 512 (a) (1) of the Code and are not subject to tax under Section 511." The Alameda County Bar Association received a similar technical memorandum from the I.R.S. Though a technical advice memorandum is not binding on the Internal Revenue Service in other cases similarly situated, it should be of some value in answering questions as to whether the income tax should be imposed on such fees.

Because of this conclusion, pending legislation, introduced by the Honorable Fortney H. (Pete) Stark (CA) in the House of Representatives, is being allowed to lie dormant. That legislation (H.R. 3097) was initially introduced to amend the Internal Revenue Code of 1954 to provide that the operation of a lawyer referral service by a state or local bar association shall not be treated as an unrelated trade or business. In his introduction of the bill, Mr. Stark stressed the universality of the underlying issue, which would affect all bar associations throughout the country. At the urging of the American Bar Association Standing Committee on Lawyer Referral and Information Service, the ABA's Board of Governors gave its support to the principle that the income of bar sponsored referral services should not be treated as taxable unrelated business income.
In both the legislative approach and the technical memorandum, the main issue being considered was whether surcharge, forwarding and case fees payable to the lawyer referral service(s) of a state or local bar association constitute unrelated business taxable income to the sponsoring bar association. Of particular concern was the payment of a contingent fee through the arrangement by the lawyer referral service and the participating attorney. This contingent fee is based on either a fixed dollar amount or as a percentage of the earned fee(s) generated by the lawyer's providing legal services to a referred client.

A 1979 IRS National Office Technical Advice Memorandum (LTR 7952002, August 3, 1979), concluded that such forwarding fees were taxable, in part, because any attorney services rendered after the initial consultation constituted a business relationship for the private benefit of the attorney and the client with which the sponsoring bar association was not involved. The IRS found that this relationship did not contribute importantly to the bar association's exempt purpose and was unrelated to it. In the case of the San Francisco program, the IRS found that the exempt function services of the San Francisco LRIS continued well beyond the initial consultation. These exempt function services included:

1. LRIS rules which govern the relationship between the attorney and client beyond the initial consultation.
2. Staff follow-up (including client surveys) to make sure referrals are properly handled under the LRIS rules.
3. Staff attempts to resolve informally disputes which arise between referred clients and participating attorneys.
4. The requirement that participating attorneys submit all fee disputes to a committee for arbitration and all other disputes to a client-relations committee.

By reaching the favorable conclusion, the Internal Revenue Service applied Section 1513 - (d)(2) of the Regulations, which provides that a trade or business is "substantially related" to exempt purposes only if the performance of services or other activity from which a particular amount of gross income is derived "contributes importantly" to the accomplishment of these purposes. The determination also relied on the fact that programs and services offered to the general public by the lawyer referral services comprise a means of providing the best services to the community and its members, regardless of their economic circumstances, and therefore these programs and services tend to promote the purposes of the sponsoring bar associations, which themselves are business leagues organized within the meaning of Section 501(c)(6) of the Internal Revenue Code (1954). In short, the public service nature of the Lawyer Referral and Information Service's programs was crucial to the IRS finding.
The rationale stated in the technical memorandum closely followed the language used by Representative Stark in his introduction of H.R. 3097. A touchstone for the Internal Revenue Service's decision on the case at hand, and the reasoning behind the proposed legislation, seems to be the specific performance of a public service by the lawyer referral service(s).

Referral services apparently should maintain these public service elements in their general operations in order to prevent questioning of their fee and funding sources by the Internal Revenue Service. They also should avoid any activity that would even marginally indicate any seeming impropriety pursuant to normal operations. It would seem that the performance of low or reduced fee services to the general public by lawyer referral services' panel attorneys would help justify the use of contingency fee arrangements. Apparently, it is assumed that such income would tend to defray the costs of maintaining other non-fee generating programs for the benefit of the public. Among such activity sponsored by the bar association would be a pro bono publico program. A Lawyer Referral and Information Service should obtain advice of its own Counsel to obtain proper interpretation of the foregoing commentary.

For the benefit of our readers, a full text copy of the Technical Advice Memorandum is available, without cost, from the American Bar Association. Interested individuals and lawyer referral services may obtain their copies by writing to the Standing Committee on Lawyer Referral and Information Service, American Bar Center, 750 North Lake Shore Drive, Chicago, Illinois, 60611, or by calling Ms. Connie Berg, Committee Liaison, at (312) 988-5760. (C. Berg and E. Peters, ABA Staff).

PROGRAM OF ASSISTANCE AND REVIEW (PAR)

At the National LRS Workshop in Orlando, the American Bar Association Standing Committee unveiled its new program to assist local and state LRSs and their sponsoring organizations in refining their operations and making them even more effective.

PAR is designed to accomplish two objectives: (1) to assist your LRS in improving management and operational functions through the assistance of a team of experts in the areas in which a LRS requests assistance, and (2) to offer suggestions through telephone communications, exchanging and sharing of materials, and on-site visits.

PAR experts are people like you, who understand your operation. They are lawyers and professional staff from large and small programs throughout the country. They have successfully established and operated their own programs and are now available to share their own knowledge and expertise with you.