LTR 7952002, August 3, 1979

Symbol: None given

NATIONAL OFFICE TECHNICAL
ADVICE MEMORANDUM

[Code Secs. 501 and 513]

Exemption from tax on corporations, certain trusts, etc.; Exempt v. not exempt; Business leagues, chambers of commerce, real estate boards, or boards of trade; Performance of particular services for members; Unrelated v. related trade or business; Bar association's referral service. — CCH.

ISSUES

(1) Whether the operation of a lawyer-referral service by a local bar association constitutes particular services in contravention of section 1.501(c)(6)-1 of the Income Tax Regulations.

(2) If exempt status is not denied on the grounds set forth in (1), is the income received from the operation of that service subject to the tax imposed on unrelated business income by section 511 of the Internal Revenue Code?

FACTS

A is a local bar association that was organized under the non-profit laws of the State of B. A is exempt from federal income tax under section 501(c)(6) of the Code.

One of the purposes of A is to ensure that the community receives competent legal services, regardless of the ability of individuals to pay.

As one of its activities, A sponsors a lawyer-referral service (hereafter, "referral service"), which operates with the assistance of one full-time secretary and one part-time secretary. Any member of A may apply to have his/her name placed on the organization's referral list. Each participating member must maintain minimum malpractice insurance and provide a half-hour consultation for a minimal fee to referral clients. An advertisement in the Yellow Pages of the local telephone directory is maintained by A. Individuals are referred to participating lawyers specializing in the area of law relevant to the particular matter on a rotational basis. Once an individual has been referred to a lawyer, that lawyer's name drops to the bottom of the list. A mutually convenient appointment between the participating attorney and the person is then arranged.

A set fee of $10 was charged for the first one-half hour meeting. The consultation fee is frequently waived for low-income cases. The fees charged are very modest in comparison to normal fees charged by lawyers. (Since January 1, 1976, the participating attorney has charged $20 for the initial consultation and remitted $10 of it to A.)

Clients are not obligated to return after their initial appointment. Additional time spent on a matter is negotiated between the inquiring person and the participating attorney, without any involvement by A.

Each participating member who is listed with the referral service pays an annual charge, which is $50, to A. In addition, A received ten percent of all additional fees collected by the participating members that are in excess of $100 and less than $5,000. Thus, A received between $10 and $500 from each participating member who has a client referred by A who continues to be a paying client of the participating member. (Since January 1, 1978, A has not received a percentage of any fees collected by the participating attorney for services provided after the initial consultation. In addition to the $50 registration fee, A now receives $10 of the $20 charge for the initial visit.) A uses the income to defray the expenses incurred in operating the referral service.

The primary purpose of the referral service is to provide a method whereby any individual who can afford to pay a reasonable fee for legal advice and who does not have or know a lawyer may be referred to a participating lawyer who is available to give a brief consultation for a fixed fee. Another purpose is to provide legal service to individuals who are unable to pay for such services.

Approximately 150 members of A or 15 percent of the total membership were listed as participating members of the lawyer-referral service during the years under examination.

During the fiscal year ending May 1974, A received $26,978 in gross receipts, of which $4,655 were in registration fees and $7,889 were in additional assessments. During the fiscal year ending May 1975, A received $54,951 in gross receipts, of which $3,888 were in registration fees and $6,917 were in additional assessments.

APPLICABLE LAW

Section 501(c)(6) of the Code provides for the exemption from Federal income tax of business leagues which are not operated for profit and that no part of the net earnings of which inures to the benefit of any private shareholding or individual.

Section 1.501(c)(6)-1 of the regulations defines a business league as an association of persons having a common business interest, the purpose of which is to promote such common interest and not to engage in a regular business of a kind ordinarily carried on for profit. Also, a business league's activities should be directed to the improvement of business conditions of one or more lines of business as distinguished from the performance of particular services for individual persons.

Section 511 of the Code imposes a tax on the unrelated business taxable income of certain tax-exempt organizations, including business leagues described in section 501(c)(6).

The term "unrelated business taxable income" is defined in section 512(a) of the Code, with certain modifications, as the gross income derived by any organization from any unrelated trade or business regularly carried on by it, less allowable deductions directly connected with the carrying on of such trade or business.

Section 513(a) of the Code defines the term "unrelated trade or business" as any trade or business the conduct of which is not substantially related (aside from the need of such organization for the income of funds or the use that it makes of the profits derived) to the exercise or performance by such organization of its exempt functions.

Section 513(e) of the Code provides that a "trade or business" includes any activity which is carried on for the
production of income from the performance of services. An activity does not lose identity as a trade or business merely because it is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the organization.

Section 1.513-1(d)(2) of the regulations 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.

Section 1.513-1(d)(4)(iv) of the regulations provides that, in certain cases, activities carried on by an organization in the performance of exempt functions may generate goodwill or other intangibles which are capable of being exploited in commercial endeavors. Where any organization exploits such an intangible in commercial activities, the mere fact that the resultant income depends in part upon an exempt function of the organization does not make it gross income from related trade or business. In such cases, unless the commercial activities themselves contribute importantly to the accomplishment of an exempt purpose, the income which they produce is gross income from the conduct of unrelated trade or business.

Revenue Ruling 61-170, 1961-2 C.B. 112, denied exemption under section 501(c)(6) of the Code to a nurses' registry because it functioned essentially as an employment agency for the members.

Revenue Ruling 74-306, 1974-2 C.B. 168, denied exemption under section 501(c)(6) of the Code to a countrywide tow truck referral service.

RATIONALE

The primary purpose of the referral service is to ensure that the legal profession is meeting its obligation to the community at large; that is, making available competent legal services to all who need or believe they need legal advice. This purpose is carried out through the referral service which is a means for extending legal services to those who do not know or have a lawyer. The half-hour consultation provides an opportunity for referral clients to present their legal problems to a participating and competent lawyer who is listed as one who handles those types of cases and who will discuss their legal problems over a known, fixed fee for the first and, frequently, only consultation. Furthermore, the referral service reduces public criticism of the profession generally when the public is made aware, in advance, of the initial cost of legal services.

The individual pays a nominal consultation fee that is substantially below the normal commercial rate for a half-hour consultation. The fact that participating lawyers receive and keep a fee of $10 for the initial one-half hour consultation does not, under these circumstances, violate the provisions of section 501(c)(6) of the Code.

In response to the first issue, we conclude that the referral and initial consultation are designed to improve the conditions within the legal profession as distinguished from the performance of particular services for individual persons within the meaning of the regulations.

Educating the public on the availability and fixed cost of half-hour consultations with competent members of the bar association results in substantial public benefit through the knowledge that such program exists, through its availability to persons regardless of income status.

Furthermore, the referral service program builds goodwill for the legal profession. In general persons of all income levels who do not have or know a local lawyer have the opportunity to present their legal problems in a setting where they will receive proper legal attention from a competent lawyer for a modest, fixed consultation fee.

Revenue Ruling 61-170 and Revenue Ruling 74-308 are distinguishable from the instant case in that the purpose of those organizations was to provide customers who would pay normal fees for the services rendered by the organization's members and were not primarily to acquaint potential customers with the services provided by the members.

Therefore, the referral service and the initial consultation promote the common business interests of the entire profession within the meaning of section 1.501(c)(6)-1 of the regulations.

By detailing a portion of its overall activities to the lawyer-referral service, A is promoting one of its principal purposes, that of ensuring that the community receives competent legal services, regardless of the ability of the individuals to pay. The offering of a referral service which leads to an initial consultation according to the terms described above, contributes importantly within the meaning of section 1.513-1(d)(2) of the regulations, to the accomplishment of exempt purposes, which includes making legal services available to individuals who do not have or know a lawyer in their immediate community.

Therefore, the income of A from the annual registration fees (and now from the initial consultation fees) is income from an activity that is substantially related to A's exempt purpose. Because the referral service is not an unrelated trade or business, the income derived from the registration (and initial consultation fee) is not subject to the tax imposed on unrelated business income by section 511 of the Code.

However, any relationship that develops between the participating attorney and the client subsequent to the initial consultation is not a business relationship but a continuing attorney-client relationship. A is not involved with this continuing attorney-client relationship. And, this continuing relationship does not contribute importantly to the exempt purpose of A, as the referral and initial consultation do.

The regulations provide that "the mere fact that the resultant income depends in part upon an exempt function of the organization does not, make it gross income from related trade or business." The income that A received as a percentage of the fees charged to the client was an indirect result of the exempt-referral activity. But the continued attorney-client relationships does not itself further any exempt purpose. Because this business relationship does not substantially contribute to the exempt purpose of A, any income derived from the relationship subsequent to the initial consultation is subject to tax on unrelated business income imposed by section 511 of the Code.

CONCLUSIONS

(1) A's operation of a lawyer-referral service does not result in the performance of particular services for members in contravention of section 1.501(c)(6)-1 of the regulations.
Further, the operation of a lawyer-referral service in the manner described above is an exempt activity under section 501(c)(6) of the Code.

(2) The income from the operation of the referral service, which includes the registration fees (and now charges from the initial consultation), is not subject to the tax imposed on unrelated business income by section 511 of the Code. However, the additional assessment received pursuant to the business relationship that developed between the attorney and client subsequent to the initial consultation is subject to the tax imposed on unrelated business income by section 511 of the Code.