



# Fee-for-Service Activities: Tax Law and Other Considerations for Legal Services Programs

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## Summary

Legal services programs ("programs") are searching for new revenue sources in light of the proposed reductions in grant funds from the Legal Services Corporation ("LSC"). A few programs have already tried fee-for-service activities with some success -- that is, rendering legal services for a fee paid by non-LSC-eligible individual or organizational clients. More programs are likely to consider this option in the weeks ahead. In addition to the typical business and practical considerations which individual lawyers face when beginning a law practice, legal services programs must consider the restrictions imposed by their Internal Revenue Code ("IRC") Section 501(c)(3) tax-exempt status (and corresponding status under state income tax laws) and their LSC grant.

This article will review the tax law and other considerations involved in establishing a fee-for-service practice within the legal services program; by an affiliated nonprofit, §501(c)(3) tax-exempt corporation; or by employees or former employees of the program in their private practice, under contract with the program. This article will not describe the existing or past fee-for-service efforts of legal services programs, nor will it discuss all the business and practical issues involved in creating a law practice. Information on the business of practicing law is available and should be consulted prior to initiating fee-for-service activities.

Finally, this article will not discuss proposed changes to the Legal Services Corporation Act. A bargain sale is a transfer to an Internal Revenue Code (IRC) Section 501(c)(3) tax-exempt organization (a "charity") for a sales price less than the fair market value of the property.

## Fee-for-Service within the Legal Services Program

### Federal Income Tax Law Considerations

To maintain its IRC §501(c)(3) tax-exempt status, the program must be operated primarily for charitable or educational purposes. The term "charitable" includes relief of the poor and distressed or of the underprivileged, the elimination of prejudice and discrimination, and the defense of human and civil rights secured by law.<sup>1</sup> The term "educational" includes the instruction of the public on subjects useful to the individual and beneficial to the community.<sup>2</sup> This includes instruction on legal rights and obligations. Tax-exempt status could be jeopardized if more than an insubstantial part of the program's activities is not in furtherance of these purposes.<sup>3</sup>

The Internal Revenue Service ("IRS") has not stated precisely how much non-charitable or non-educational activity is more-than-insubstantial. Court decisions adopt a case-by-case-approach, and have revoked or denied tax-exempt status even though the purpose of non-exempt activities is to generate income to support charitable or educational activities. The nature of the activity, rather than the use of its proceeds, determines whether it is exempt or non-exempt.

The following sections describe the circumstances under which a §501(c)(3) tax-exempt legal services program can charge fees in furtherance of its exempt purposes. State income tax laws are not discussed, since most state tax agencies follow the IRS rulings and federal court decisions in such matters. Programs are advised to review these issues with local tax counsel.

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<sup>1</sup> Treas. Reg. §1.501(c)(3)-1(d)(2).

<sup>2</sup> Treas. Reg. §1.501(c)(3)-1(d)(3).

<sup>3</sup> Treas. Reg. §1.501(c)(3)-1(c)(1).

## Serving the Indigent

The provision of free legal services to persons otherwise financially incapable of obtaining such services is recognized as the charitable relief of the poor and distressed.<sup>4</sup> However, no inherent inconsistency exists between IRC §501(c)(3) tax-exempt status and charging fees. Many kinds of tax-exempt entities charge fees -- universities, hospitals, symphonies, and museums, to name just a few. Moreover, an IRS ruling approved charging fees for legal services.<sup>5</sup>

In this ruling, an organization formed and operated to provide legal services to indigent persons otherwise financially incapable of obtaining such services was supported in part by fees paid by its indigent clients. For each hour of legal assistance received, a client was expected to pay a nominal hourly fee determined by reference to the client's own hourly income. Fees charged were thus based on an indigent's ability to pay rather than the type of service rendered, and did not negate or significantly detract from the substantial economic relief provided by the organization to the poor and distressed.

In a special ruling,<sup>6</sup> the IRS upheld the continuing eligibility for §501(c)(3) tax-exempt status of University Legal Services, Inc. of Washington, D.C. The IRS noted that the organization had been providing legal assistance to indigent persons otherwise incapable of obtaining it. The organization's original tax-exempt ruling letter was based in part on the organization's statement that it would not charge fees for its services. The IRS approved the organization's plan for charging fees equal to each client's hourly income plus an additional 25%.

The IRS has not defined indigent. A client who meets LSC income eligibility guidelines certainly qualifies. Recently, the IRS adopted the income limits of the Department of Housing and Urban Development (HUD) for "low-income" and "very low-income" (80 and 50 percent, respectively, of an area's median income, adjusted for family size) in determining which organizations that provide low-income housing will be considered charitable because they relieve the poor and distressed.<sup>7</sup> In the special ruling described above, the IRS accepted the organization's use of HUD's very low-income limits for determining eligibility for services.

Basing fees on client income creates administrative burdens, such as the need for individual client billing rates and documentation justifying the fee charged. The program should consider other fee structures that do not negate or significantly detract from the substantial economic relief provided to the poor.

## Serving Other Members of a Charitable Class

### *Below Cost Services*

The program may also provide legal assistance,<sup>8</sup> in defense of human and civil rights,<sup>9</sup> to the elderly or disabled, to other §501(c)(3) organizations, or to other members of a "charitable class". These clients need not be indigent, and can be required to pay fees. In fact, they can be members of a charitable class even though they can afford to pay the market rate for legal assistance.

However, it is not enough to serve a member of a charitable class. The program must do so in a manner that demonstrates a charitable, rather than a commercial, purpose. As in the case of indigents, limiting

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<sup>4</sup> Rev. Rul. 69-161, 1969-1 Cum. Bull. 149.

<sup>5</sup> Rev. Rul. 78-428, 1978-2 Cum. Bull. 177.

<sup>6</sup> Special Ruling, January 1978, CCH ¶6418.

<sup>7</sup> Announcement 95-37, 1995-20 I.R.B. 18 (May 1, 1995).

<sup>8</sup> Rev. Rul. 72-228, 1972-1 Cum. Bull. 148; Rev. Rul. 75-285, 1975-2 Cum. Bull. 203; and Rev. Rul. 68-655, 1968-2 Cum. Bull. 213.

<sup>9</sup> National Right to Work Legal Defense and Education Found. v. United States, 487 F.Supp. 801 (E.D.N.C. 1979); Rev. Rul. 73-285, 1973-2 Cum. Bull. 174; Rev. Rul. 68-438, 1969-2 Cum. Bull. 209.

fees based on a client's ability to pay is one means of demonstrating charity. For example, in providing low-income housing, one required element of charity is a limitation on rents so that the housing is "affordable".<sup>10</sup>

Another means of demonstrating charity is charging less than the cost of providing the assistance, resulting in a fee not ordinarily accepted by private attorneys in the area. The IRS has ruled that an organization providing at-cost managerial and consulting services for improving the performance of tax-exempt organizations did not qualify for §501(c)(3) exemption; furnishing at-cost services fell short of the donative element necessary to classify the activities as charitable.<sup>11</sup> The Tax Court denied §501(c)(3) tax-exempt status to an organization selling consulting services to §501(c)(3) organizations at cost plus an administrative charge.<sup>12</sup>

On the other hand, an organization that provided investment, management, and other services to tax-exempt organizations for a charge substantially less than cost qualified for §501(c)(3) tax-exempt status.<sup>13</sup> The IRS has ruled that charging below-cost fees for mediation services is charitable.<sup>14</sup>

By charging less than cost and below the fee ordinarily accepted by private attorneys in the area, the program distinguishes its fee-charging activities from those of private law firms. However, if fee charging is intended to offset lost grant revenue, does charging less than cost make economic sense?

For example, if the cost of an attorney is \$80,000 per year, and the attorney, working full-time on fee matters, can generate \$70,000 in fees, does the program benefit if it must raise \$10,000 in grant funds to maintain that attorney? Presumably, the attorney's expertise is made available to the program's other activities despite the full-time fee work. Someday, the program's funding situation might improve, enabling the attorney to reduce the time spent on fee-charging matters. The program will have retained the attorney's expertise for a fraction of the cost of hiring and training a new attorney when the funding situation improves.

In determining whether the program should charge less than cost for its staff time, remember to include all costs, including the allocable cost of bookkeeping, supervising the staff person, and similar costs. Because some of these costs might in fact be covered by program grants, even charging less than cost can be "profitable", and it reduces the program's reliance on grant funds.

### **At-Cost Services**

It is not always necessary to charge less than cost, however. Sometimes, charity is based not on the amount of the charge but on the provision of assistance not available from the private sector. In one ruling, an organization provided funds to businesses unable to obtain funds from conventional commercial sources because of the risk involved in conducting business in urban areas inhabited mainly by low-income minority or other disadvantaged groups. The organization withdrew its assistance once the success of the business was reasonably assured and conventional commercial funds were available. The IRS held that this assistance relieved poverty, lessened neighborhood tensions, and combated community deterioration, all charitable purposes, and it did not require that the organization charge less than cost for its assistance.<sup>15</sup>

In order to rely on this means of determining charity, a program must demonstrate that by accepting certain cases, it seeks to further its charitable purposes such as the elimination of prejudice and

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<sup>10</sup> Announcement 95-37, *supra*.

<sup>11</sup> Rev. Rul. 72-369, 1972-2 Cum. Bull. 245.

<sup>12</sup> B.S.W. Group, Inc., 70 T.C. 352 (1978).

<sup>13</sup> Rev. Rul. 71-529, 1971-2 Cum. Bull. 234.

<sup>14</sup> Rev. Rul. 80-279, 1980-2 Cum. Bull. 176.

<sup>15</sup> Rev. Rul. 74-587, 1974-2 Cum. Bull. 162.

discrimination or the defense of human and civil rights, and that the private bar would not accept these cases. The program would need a referral procedure, and could accept only those cases that could not be referred. It could then charge a reasonable fee, given the services rendered and the ability of the client to pay.

In most cases, the "reasonable fee" will be limited to the program's cost of providing the service. The IRS has found charitable the provision of services to members of a charitable class at "lowest feasible cost," that is, an amount equal to cost. In one ruling, an organization rented office space to §501(c)(3) tax-exempt organizations at below commercial rates and at no more than the rent needed to meet operating expenses. The charitable programs of the tenants were enhanced by their close proximity to supportive and related programs and services and by the below-market rent.<sup>16</sup>

In another ruling, an organization operated a home for the aged, charging the least amount necessary to pay for all items of expense, including indebtedness and reserves, and agreeing not to discharge persons once admitted because they can no longer afford to pay.<sup>17</sup> Similar rulings exist for organizations that provide specially designed housing to physically handicapped persons,<sup>18</sup> and for organizations that provide housing for the elderly.<sup>19</sup>

In each of these rulings, the provision of services was charitable both because the organization limited its charges and the special needs of a charitable class were met. In each case, the private sector provides the same service - rental of office space, operation of nursing homes, rental of housing to the elderly or disabled - without, however, limiting the charges or agreeing not to discharge a non-paying resident.

These rulings can be distinguished from those in which at-cost services to charitable organizations were held not to be charitable, because of the added requirement that services continue despite the inability of the recipient to pay for them. Also, in the adverse rulings and cases, all of the revenue was derived from at-cost fees. The organizations involved did not provide any grant-funded free or below-cost services.

While the IRS will permit a certain amount of "at-cost" services to members of a charitable class, it generally regards the provision of legal services as an inherently commercial activity, unlike the promotion of health, which is an inherently charitable activity (such as in the nursing home and special needs housing rulings above). A program that primarily engages in at-cost services appears to be operating a private law practice. It is not enough to limit fees so as not to produce a profit, since private law firms can also operate at a loss, just as any other business.

The IRS addressed this issue in revising its treatment of public interest law firms, which are also eligible for §501(c)(3) tax-exempt status. Such firms provide legal representation for the resolution of issues of broad public importance where private law firms do not ordinarily provide such representation because the cases are not economically feasible. Thus, public interest law firms do not provide direct representation of litigants in actions between private persons where the financial interests at stake would warrant representation from private legal sources.

Until 1992, public interest law firms could not accept client-paid fees. Now they can, but only up to the actual cost incurred in each case. Once having undertaken a representation, such firms may not withdraw from the case because the litigant is unable to pay the fee. Furthermore, the total of all fees,

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<sup>16</sup> Rev. Rul. 69-572, 1969-2 Cum. Bull. 119.

<sup>17</sup> Rev. Rul. 72-124, 1972-1 Cum. Bull. 145.

<sup>18</sup> Rev. Rul. 79-19, 1979-1 Cum. Bull. 195.

<sup>19</sup> Rev. Rul. 79-18, 1979-1 Cum. Bull. 194.

both court awarded and from clients, may not exceed 50% of the total cost of the firm's legal operations, averaged over a five-year period, unless an exception is granted.<sup>20</sup>

Therefore, in addition to the provision of free or low-cost services to indigents pursuant to LSC or other grants, a program can provide legal services to the non-indigent elderly, disabled, charitable organizations, or other members of a charitable class, if charges are limited to cost and the program agrees to continue representation after the client is no longer able to pay. Private law firms provide the same service but without limiting the charges, limiting the amount of revenue from such cases, or agreeing to continue representation regardless of ability to pay.

### **Above Cost Services/Sliding Fee Scale**

In limiting charges to cost, the program can charge more than cost to a limited number of non-indigent members of a charitable class if the excess revenue is used to provide free or below-cost services to other members of a charitable class. Thus, some clients pay more than cost, and others pay less. Since balancing the amount of above-cost and below-cost fees in any one year is difficult, the excess revenue from above-cost fees can be carried over to a succeeding fiscal year.

In two cases, the courts upheld the §501(c)(3) tax-exempt status of credit counseling centers supported in part by grant funds and in part by fees. The centers used the above-cost counseling fees charged to middle and upper income clients to offset some of the cost of providing free or below-cost services to low-income clients. Overall, the fees did not support the full cost of operations, with grants making up the difference.<sup>21</sup>

Similarly, in the provision of low-income housing, only 75% of the housing units must be occupied by low-income persons in order for the project to be considered charitable. Up to 25% of the units may be provided at market rates to persons who have incomes in excess of the low-income limit. Organizations can use the revenues from their market rate tenants to support the provision of affordable housing to the poor.<sup>22</sup>

However, if the housing project consists of multiple buildings, they must share the same grounds. Thus, market rate housing is not charitable when located on a separate site from low-income housing, even though the surplus income from the market rate housing is used to support the low-income housing. This is consistent with the general principle, stated above, that the nature of the activity, rather than the use of its proceeds, determines whether it is exempt or non-exempt.

In the credit counseling cases, it was not necessary to distinguish among the counseling services provided. The excess revenue from any above-cost service to any client could be applied to offset the cost of any free or below-cost service to any other client. Similarly, legal services programs should not have to separately account for above-cost services by type of service or client, as long as all of the excess revenue is used to provide free or below-cost services to other members of a charitable class.

### **Serving the General Public**

Can a program provide legal assistance to anyone at any charge, as long as it uses all the excess revenue, plus grant funds, to provide free or below-cost services to indigents or other members of a charitable class? In the credit counseling cases, the counseling centers received their tax-exemption because their counseling and educational services were made available to, and benefited, the community as a whole. Their limited fee charging did not detract from the charitable and educational nature of their activities, and did not inhibit accomplishment of their desired results.

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<sup>20</sup> Rev. Proc. 92-59, 1992-29 I.R.B. 11 (July 20, 1992).

<sup>21</sup> *Consumer Credit Counseling Service of Alabama, Inc. v. U.S.*, 78-2 U.S.T.C. ¶9660 (D.D.C.1978); *Credit Counseling Centers of Oklahoma, Inc. v. U.S.*, 79-2 U.S.T.C. ¶9468 (D.D.C. 1979).

<sup>22</sup> Announcement 95-37, *supra*.

In contrast, the provision of legal services is not inherently charitable or educational. Instead, it is a commercial activity made charitable when services are provided to a member of a charitable class for a limited fee. The provision of legal assistance to the general public is an unrelated business activity, and, despite the charitable use of the excess revenue, could result in loss of tax-exempt status. Also, federal income tax must be paid on the net income from the unrelated activity.

### Example of Fee-Charging Guidelines

In conclusion, programs can provide low-cost services to the poor, below-cost services and some at-cost services to other members of a charitable class, and some above-cost services to members of a charitable class when the excess revenue is used to provide free or below-cost services. The following is an example of client and fee acceptance guidelines approved by the IRS for providers of legal assistance:

1. Clients are limited to organizations that have or are seeking §501(c)(3) status; individuals within a charitable class; cooperatives or other non-charitable organizations engaged in charitable activities; and government agencies engaged in activities or services on behalf of a charitable class.
2. Client cases consistent with the charitable purposes and priorities of the program are accepted on a first-come, first-served basis, whether or not a fee is charged.
3. A client whose income is below federal poverty guidelines receives assistance without charge.
4. Other individuals and organizations are charged cost or less, depending on ability to pay, and must pay out-of-pocket expenses. If the program receives a subsequent third-party payment, such as an attorney fee award, it will refund the fees and expenses collected in excess of its cost in that case.
5. Revenue from fees is paid to the program, not to individual staff. Staff salaries are based on comparable salaries of government or nonprofit law corporation staff.
6. At least 60% of the assistance will be provided free or at below cost. The program will accept only that number of fee cases the income from which is projected as 40% of the program's annual budget.
7. Any unexpended fee revenue will be included in the program's unrestricted fund, up to an amount equal to the program's projected annual budget. While at this ceiling, the program will not accept fee cases. Thus, fees are charged only when needed to supplement other funds and meet operating costs. The limited accumulation of fee revenue in one year may be used to meet operating expenses in a subsequent year.
8. The program's board of directors or executive committee will supervise and monitor operation of the fee schedule and guidelines.

A program can adopt other guidelines consistent with the preceding discussion, and can undertake a limited amount of fee work that is not in furtherance of its exempt purposes.

### Seeking An IRS Ruling

The preceding guidelines were drawn from proposals submitted to the IRS by organizations already §501(c)(3) tax-exempt and organizations first applying for such tax exemption. The latter organizations knew that they had to charge fees for some services, and thus addressed this issue in their tax exemption application. In approving the exemption, the IRS approved the plan to charge fees. The former organizations had only provided free assistance, consistent with limitations in the purposes clause of their

articles of incorporation or statements made to the IRS during the tax exemption application process. Funding cuts necessitated that they begin to charge fees for certain services.

Programs should first review their articles of incorporation and tax exemption application to determine whether they limit or restrict fee charging. If necessary, the program should amend its articles, and notify the IRS that it intends to begin charging for certain services, describing the nature of the services, the clients, how fees will be determined, and why it considers this fee-charging to be consistent with its exempt purposes. Notification can be by letter or by formal ruling request.

A letter puts the IRS on notice, but does not provide assurance that the IRS accepts the proposed activities as charitable. A ruling request provides assurance of IRS acceptance or rejection, but only if the program's actual fee-charging activities are consistent with those described in its ruling request. There is a fee required for a ruling, and it will take several months for the IRS to respond.

If a program's articles of incorporation and tax exemption application do not limit or restrict fee charging, the program has another alternative -- to engage in fee-charging without first notifying the IRS by letter or ruling request. The program must still disclose its fee-charging activities on its annual IRS Form 990 information return.

## Practice of Law Considerations

The practice of law in the corporate form used to be prohibited. Most states now have a professional law corporation statute that permits attorneys to form a corporation authorized to engage in the practice of law. Typically, such statutes require that all directors, officers, and shareholders of the corporation must be attorneys. Legal services programs cannot meet this requirement, since LSC regulations require that at least one-third of the governing body of a recipient must be eligible clients.<sup>23</sup>

Professional law corporation statutes contemplate the for-profit practice of law. Only a few states provide statutory recognition of nonprofit, charitable law corporations. In these states, the courts have held that assistance need not be restricted to the indigent. However, it is generally unclear whether charitable law corporations can charge fees.

In states without statutory recognition of nonprofit, charitable law corporations, the courts have permitted the corporate practice of law by legal services programs. Sometimes, explicit reference is made to the provision of legal services at no charge to the client. Other times, free services are assumed.

### Example: California

At one time, California had no statute that permitted the practice of law by nonprofit legal services programs, and programs did not comply with the state's professional law corporation statute. In permitting programs to continue their operations, a California Attorney General Opinion adopted the "administrative body" or "conduit" approach taken in other states, holding that a legal aid society, operated for the purpose of defending the rights of the indigent and oppressed, acts merely as a conduit or intermediary to bring an attorney and disadvantaged client together, and neither controls nor exploits the manner in which the attorney represents the client nor benefits from the arrangement.<sup>24</sup> The Opinion assumed that clients were not charged fees.

In 1981, California enacted an Interest On Lawyers Trust Account (IOLTA) statute.<sup>25</sup> Eligible IOLTA fund recipients include nonprofit legal services programs incorporated in California which provide as their

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<sup>23</sup> 45 C.F.R. §1607.3(c).

<sup>24</sup> 55 Opinions California Attorney General 39 (January 20, 1972).

<sup>25</sup> California Business and Professions Code §6210 et seq.

primary purpose legal services without charge to indigent persons.<sup>26</sup> Thus, the statute explicitly permits the practice of law by nonprofit legal services programs.

The statute does not require programs to engage exclusively in the provision of free services to indigents. Clearly, programs can serve non-indigent persons. It is not clear whether a program must provide these services free of charge. The statute does prohibit the provision of legal assistance with respect to any fee generating case,<sup>27</sup> but defines this as a case or matter undertaken on behalf of an indigent person.<sup>28</sup> The regulations implementing the statute shed no light on the permissibility of charging fees to non-indigents, although they do permit a \$10 charge to indigent clients. California programs have charged fees to non-indigent clients with the knowledge and approval of the California State Bar.

Then, in 1992, the California Attorney General ruled that an unincorporated organization that charged reduced fees for legal services to low-income persons who do not meet the IOLTA statute definition of indigent, could not incorporate as a nonprofit corporation. Instead, it had to comply with the professional law corporation statute.<sup>29</sup> California law was changed in 1993 to permit the organization to incorporate as a nonprofit corporation.<sup>30</sup> Thus, California law now permits fee charging of non-indigents by nonprofit law corporations that meet certain requirements.

### Other States

Legal services programs in states other than California have charged client fees without objection from their state bar, despite the lack of clear statutory authority for this practice. Therefore, this issue may not arise as additional programs engage in fee charging.

If this issue is raised, however, several arguments can be made in defense of permitting fee charging by nonprofit legal services programs that do not comply with the state's professional law corporation statute. First, as a charitable tax-exempt corporation, the program is supervised by the IRS, the corresponding state tax agency, and by the state agency, typically the attorney general's office, charged with overseeing the operations of charitable corporations to ensure that they operate in a charitable manner. This ongoing supervision is in addition to the supervision by the courts or other state agency that regulates the practice of law. The tax laws limit the amount and scope of fee-charging activities, as discussed above. Furthermore, tax-exempt charitable corporations must provide that no part of their income or assets may inure to the benefit of any individual, and must dedicate their assets on dissolution to other charitable organizations.

Second, programs already accept attorney fee awards made by a court or agency and paid by opposing parties or from public funds. As with the new IRS ruling which allows public interest law firms to accept client-paid in addition to court-awarded fees, it is only one more step to allow programs to do the same. The IRS concluded that safeguards such as the following are sufficient to distinguish a public interest law firm's practice from the private practice of law:

- Cases in which a client-paid fee is possible may not be accepted if the organization believes that the party can retain a private law firm;
- All fees are paid to the organization, rather than to individual staff attorneys, who are compensated on a straight and reasonable salary basis not established by reference to fees received in connection with cases they have handled; and

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<sup>26</sup> §6213(a)(1).

<sup>27</sup> §6223(a).

<sup>28</sup> §6213(e).

<sup>29</sup> 75 Opinions California Attorney General 92 (May 13, 1992).

<sup>30</sup> California Corporations Code §13406(b), as added by Chapter 955 (Senate Bill 312).

- The policies and programs of the organization are the responsibility of a board representative of the public interest, not controlled by employees.

A program can point to the same safeguards in its operations, especially since a majority of its board must be attorney members appointed by the governing body of one or more bar associations.<sup>31</sup> Regardless of the source of the fees, a program uses them to offset costs, including fixed salary obligations, in the same manner as grant funds are used to meet such costs. Staff are not paid more as a result of the award or fee, which is paid to the program and not to individual staff attorneys. A program does not have the same incentives as does a private law firm in accepting client fee cases.

Finally, a program can argue that despite the ethical obligation of attorneys to provide free legal services, the efforts of individual lawyers are not enough to meet the need. Legal services programs are an important addition to this individual obligation. The program must charge client fees in some cases in order to support its provision of free services in many others.

## Restrictions Imposed By the Legal Services Corporation Act and Regulations

Legal services programs may provide legal assistance to clients whose annual income makes them ineligible for free legal assistance, if the assistance is supported by non-LSC funds.<sup>32</sup> Organizations are ineligible for free legal assistance if they have funds to retain legal counsel.<sup>33</sup> Therefore, as long as LSC funds are not used, programs may charge fees to clients, including organizational clients, who are not eligible for free legal assistance.

This conclusion is not altered by the restrictions on the acceptance of fee-generating cases. Programs may not use LSC funds to provide legal assistance in a fee-generating case unless other adequate representation is unavailable.<sup>34</sup> Non-public funds are similarly restricted.<sup>35</sup> However, a fee-generating case is defined as a case or matter undertaken on behalf of a client eligible for free legal assistance that reasonably may be expected to result in a fee from an award, public funds, or the opposing party.<sup>36</sup> This does not include fees paid by clients ineligible for free legal assistance.

### Operational Considerations

#### Cash Flow

As stated above, a program cannot use LSC funds to support its fee-for-service cases. Thus, LSC funds cannot be used to pay staff salaries and other expenses prior to collection of client fees. Possible sources of needed up-front working capital include the program's unrestricted funds and client retainers. Since LSC funds cannot subsidize fee-for-service cases, if the program fails to collect, or charges less than its full cost, it will need another source of funds to make up the difference.

#### Risk

Sound business judgment will be needed in deciding whether to accept a fee-for-service case, how much to charge, how to define the scope of services, the timing of payment, and other similar matters. As stated above, LSC funds cannot be used to cover the program's uncollected bad debts or cost of services in excess of the amount collected from client fees. Scarce unrestricted or grant funds, or excess revenue

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<sup>31</sup> 45 C.F.R. §1607.3(b)(1).

<sup>32</sup> 45 C.F.R. §1611.3(e); Proposed 45 C.F.R. §§1611.4(d) and 1611.7(b), 60 Federal Register 3805-3806 (January 19, 1995).

<sup>33</sup> 45 C.F.R. §1611.5(c); Proposed 45 C.F.R. §1611.7(a), 60 Federal Register 3806 (January 19, 1995).

<sup>34</sup> 45 C.F.R. §1609.3.

<sup>35</sup> 45 C.F.R. Part 1610.

<sup>36</sup> 45 C.F.R. §1609.2.

from other fee-for-service cases, must be used instead. Program staff might not have experience in exercising this case selection judgment.

### ***Time Accounting and Cost Allocation***

Accurate time accounting and cost allocation systems will be needed to prove that LSC funds are not subsidizing the fee-for-service cases, and, if necessary, to demonstrate to the IRS the relationship between the program's costs and its charges. Staff engaged in both LSC-funded and fee-for-service work must keep detailed time records. All this increases a program's operating costs and adds administrative complexity.

### ***Billing, Accounting, and Collection Systems***

The program must invoice and account for client retainers and payment for services rendered and costs advanced on a client's behalf, send follow-up notices for amounts unpaid, and develop and implement collection procedures. Program systems designed to account for LSC and other grants and court-awarded fees may not be adequate for individual client billing and collection.

### ***Malpractice Insurance***

Until recently, malpractice insurance sponsored by the National Legal Aid and Defender Association (NLADA) arguably excluded coverage for fee-for-service cases, so a separate policy was needed. Often, these policies were expensive relative to the fee revenue received. The current NLADA-sponsored policy does not exclude coverage for such cases. Programs insured through other policies should check their coverage. The risk of liability on some fee-for-service work can extend many years into the future, thus necessitating the continued purchase of insurance even if the program discontinues its fee-for-service work.

### ***Ethical Considerations***

Programs will face issues such as

- How to allocate scarce resources (computer availability, staff time, etc.) at times when it is not possible to meet deadlines for, or otherwise assist, both fee-paying and LSC-eligible clients;
- How staff can balance both fee-paying and free assistance so that high-quality services are provided regardless of whether a client pays;
- How to determine the order in which clients are assisted by staff who assist both fee-paying and LSC-eligible clients;
- Whether an organization can afford to pay for assistance on a particular matter, rendering it ineligible for free assistance on that matter, whether to provide free assistance on other matters simultaneously or at other times because the organization cannot afford to pay for assistance on those matters at those times, and how to determine when an organization no longer can afford to pay; and
- Whether an individual meets the program's requirements for free assistance when s/he might otherwise have the means to pay something, and how to determine when the individual no longer can afford to pay.

Other issues resulting from the addition of a fee-for-service practice within the program also are likely to arise.

## Fee-for-Service by an Affiliated Nonprofit, §501(c)(3) Tax-exempt Corporation

Instead of establishing an internal fee-for-service practice, a program could form an affiliated (controlled) nonprofit, §501(c)(3) tax-exempt corporation to undertake fee-for-service assistance,<sup>37</sup> and transfer to it some of the program's unrestricted and/or non-LSC grant funds. The affiliate will need funds to pay staff, rent space, equipment, and library usage from the program or others, and meet other office-opening expenses. The affiliate could employ former program staff, or could contract with the program for a portion of its staff time. All agreements between the program and the affiliate should be at "arms-length" fair market value, or at least equal to the program's costs, in order to demonstrate that LSC funds are not subsidizing the affiliate.

### Advantages of Forming an Affiliate

- The assets of the program are protected from malpractice and other risks of fee-for-service assistance;
- Separating free from fee assistance is less confusing and presents a clearer image to the community and funders;
- Time accounting, cost allocation, and other operational matters may be simplified, unless the two corporations share staff; and
- Income received by the affiliate might not be subject to the same restrictions as are imposed on the program's use of private funds.

### Disadvantages of an Affiliate

- It takes a considerable expenditure of time and money to form a new corporation -- the steps include reserving a name; preparing and filing articles of incorporation; preparing bylaws; selecting directors and holding an organizing meeting to elect officers, establish a bank account, and take other appropriate corporate actions; preparing federal and state income tax exemption applications (generally, it will be 3-4 months before approval is received); and obtaining other licensing, such as a local business license, or registering with the courts or other agency which regulates the corporate practice of law;
- Ongoing efforts are needed to maintain the legal separateness of the two corporations -- separate bank accounts, books and records, stationery, tax returns and other governmental filings, and

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<sup>37</sup> The program instead could form an affiliated nonprofit, non-tax-exempt corporation or an unaffiliated corporation to undertake fee-for-service assistance. A non-tax-exempt corporation would pay income tax on net revenues, if any, but would not be subject to the federal tax law limitations described previously on the number of fee cases and the amount of revenue derived from them; it would still have practice of law and operational considerations, and might be subject to LSC restrictions because of the program's control. The unaffiliated corporation might not be subject to LSC restrictions, but the program, without control over the corporation, could not be sure that its activities always would be acceptable. Finally, the program could establish both an internal fee-for-service practice and an affiliated corporation to undertake certain matters that the program did not want to undertake.

Whatever the form of the new entity, program staff time probably should not be spent in its formation. LSC regulations prohibit the use of LSC or private funds to initiate the formation of any association, although staff may provide legal assistance to an eligible client organization. 45 C.F.R. §1612.10. If the affiliate is not an eligible client organization (see 45 C.F.R. §1611.5(c)), staff may provide legal assistance in its formation outside of normal working hours by following the LSC regulations on uncompensated outside practice of law, 45 C.F.R. §1604.5 (the program director must determine that the work is not inconsistent with the attorney's full time responsibilities; the affiliate must be a charitable organization). Proposed 45 C.F.R. §1604.6(b), 60 Federal Register 3370 (January 17, 1995), allows program attorneys to use limited amounts of program resources to act on behalf of a charitable group.

board meetings and minutes, with agreements between the corporations for the sharing or transfer of funds, staff, space, equipment, supplies, library usage, or other services;

- The IRS will scrutinize the proposed fee-for-service assistance, since the affiliate must disclose its plans in its federal income tax exemption application;
- It is more likely that the nonprofit practice of law will be questioned, depending on whether the affiliate's revenues will be derived predominantly from fees, or whether it will also receive significant grant funds to provide free services; and
- If program staff are transferred to the affiliate, there may be unionization issues, and the affiliate will need to adopt a personnel manual and internal operating policies; obtain employee fringe benefits; purchase malpractice, fiduciary responsibility, and board liability insurance; and address issues involving the transfer of accrued vacation leave, sick leave, compensatory time and other benefits (the program may have to cash-out the accrued vacation leave of transferring staff, thus draining its cash reserves). Also, there may be issues of completing cases begun at the program prior to staff transfer.

## Referrals from the Program to the Affiliate

The program may refer to the affiliate persons ineligible for free legal assistance that have the means to pay (fee-for-service cases, as distinguished from fee-generating cases). LSC regulations do not address referral of over-income individuals or organizations with the ability to pay. In other contexts, the program would be advised to establish a system for referrals that does not unduly favor particular attorneys. In this context, the program will want to make its referrals first to the affiliate. It is advisable to inform the local bar of the reasons why the affiliate was formed, the goals that hopefully will be achieved, and the nature and type of referrals to be made. The support and encouragement of the bar may prove important to attaining these goals.

## Fee-for-Service by Employees or Former Employees of the Program

### Part-Time Employee, Part-Time Fee-For-Service Practice

A program not willing to assume the risks or up-front costs of a fee-for-service practice, and an employee willing to do so, can agree to a part-time employment arrangement. The employee can establish the part-time private practice at the program offices or elsewhere. The employee should pay to the program the fair market value of its space, support services, or other resources used.

If the part-time private practice is successful, the attorney might earn more than s/he was paid as a full-time program staff person. As a private practitioner, the attorney has more flexibility than the program or its affiliate would have in selecting cases and setting fees, since the tax law and grant restrictions described above would not apply.<sup>38</sup> On the other hand, the attorney is at risk, and must address such issues as collection, purchase of malpractice insurance, and cash flow.

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<sup>38</sup> LSC regulations restrict the activities of part-time program staff as follows:

Certain activities may not be undertaken at any time. For example, 45 C.F.R. §1608.4(a) prohibits program employees from intentionally identifying LSC or the program with any partisan or nonpartisan political activity, or with the campaign of any candidate for public or party office.

Certain activities may not be undertaken with LSC funds. For example, 45 C.F.R. §1613.3 prohibits the use of LSC funds to provide legal assistance with respect to a criminal proceeding.

Issues might arise concerning the completion of cases begun while the attorney was a full-time program employee. The program cannot pay the attorney with private attorney involvement funds, since LSC regulations<sup>39</sup> prohibit such payment to any attorney who for any portion of the previous two years has been a staff attorney as defined in the regulations.<sup>40</sup> Since the client also cannot be asked to pay, the attorney should complete these cases on program time.

However, the attorney might want to transfer to his/her private practice a case that may involve an award of attorneys' fees. The program would receive payment for work done while the attorney was its employee, pursuant to LSC regulations that permit a program to act as co-counsel with a private lawyer and share the fee.<sup>41</sup> The client must consent to the arrangement after a full disclosure that a division of fees will be made, and the division must be made in proportion to the services performed.

Also, issues might arise concerning referrals by the program to the private practice of those persons ineligible for free legal assistance who have the means to pay (fee-for-service cases, as distinguished from fee-generating cases). See the discussion above regarding referrals from the program to an affiliate. Finally, if the program intends to engage in some fee-for-service activity, it will need a policy to determine which matters it will undertake, and whether the program or the private practice has the first opportunity to accept or reject a potential fee-for-service matter.

## Program Contracts with Former Employee

In order to assist a former employee in the transition to private practice, a program could contract for the provision of certain services on an as-needed basis. As an early example, a General Accounting Office (GAO) report described in favorable terms the establishment in 1981 of Downeast Law Offices by former staff of Pine Tree Legal Assistance, the LSC grant recipient in Maine.<sup>42</sup>

Pine Tree contracted with this private firm to complete their ongoing cases, in an amount that Pine Tree would have spent on salaries and overhead had the employees not transferred to Downeast. Pine Tree also leased space and equipment to Downeast, with the two organizations maintaining separate entrances and phone numbers. These agreements provided Downeast with the cases, capital, and support to begin the private practice.

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Certain activities may not be undertaken while carrying out "legal assistance activities", that is, activities carried out during working hours using resources provided by the program, or that provide legal advice or representation to an eligible client. For example, 45 C.F.R. §1608.6 prohibits attorneys from engaging in political activity, any activity to provide voters with transportation to the polls, or any voter registration activity.

Certain activities may not be undertaken by "staff attorneys", defined in 45 C.F.R. §1600.1 as an attorney more than one half of whose annual professional income is received from the program. For example, 45 C.F.R. §1608.5(c) prohibits staff attorneys from being a candidate for partisan elective public office.

Part-time program attorneys are not subject to the provisions of 45 C.F.R. Part 1604, regarding the outside practice of law (the provision of legal assistance to a client not entitled to receive legal assistance from the program). These provisions are only applicable to attorneys employed full time in legal assistance activities supported in major part by LSC funds. Proposed 45 C.F.R. Part 1604, 60 Federal Register 3370 (January 17, 1995), similarly applies only to attorneys employed full-time by the program.

<sup>39</sup> 45 C.F.R. §1614.1(e).

<sup>40</sup> 45 C.F.R. §1600.1.

<sup>41</sup> 45 C.F.R. §1609.8(c).

<sup>42</sup> "The Establishment of Alternative Corporations By Selected Legal Services Corporation Grant Recipients," GAO/HRD-85-51 (August 22, 1985).

According to the GAO report, after the original agreement, Pine Tree did not pay Downeast to handle additional cases, and Pine Tree was no more likely to refer clients to Downeast than to other law firms. Pine Tree did not renew the office lease because the shared space arrangements were difficult to monitor, and billing and collection were administrative burdens.

Subsequent to the formation of Downeast, new LSC regulations were adopted. Now, a contract with a private law firm or attorney representing a program's clients involving more than \$25,000 must be submitted in writing to LSC for prior, written approval.<sup>43</sup>

## Conclusion

Proposed reductions in LSC funds have stimulated a discussion of alternative funding sources for legal services programs. This article explores some of the issues involved in one approach -- engaging in fee-for-service activities directly, through an affiliated corporation, or by supporting employees or former employees engaged in private practice. Hopefully, this article will help focus the discussion of this approach. Since it only scratches the surface, considerations crucial to some program's decision might be mentioned only briefly or not at all. For further information or discussion, please contact the Law Center.

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<sup>43</sup> 45 C.F.R. Part 1627.