

Audit Technique Guide for Public Interest Law Firms

Introduction

This guide provides audit guidelines for cases involving organizations directly engaged in litigation as a substantial part of its activities. It's not intended to be an in-depth, technical resource. For more information on public interest law firms, read the following:

- Rev. Proc. 92-59, 1992-2 C.B. 411
- Rev. Rul. 76-5, 1976-1 C.B. 146

Organizational Requirements for Public Interest Law Firms

To qualify for exemption, public interest law firms must:

- Be organized and operated as described in IRC Section 501(c)(3).
- Not participate in or intervene in any political campaign on behalf of (or in opposition to) any candidate for public office.
- Have none of its net earnings inure to the benefit of any private shareholder or individual, and no substantial part of its activities may carry on propaganda or otherwise attempt to influence legislation, (except as otherwise permitted in IRC Section 501(h)).
- Be designed to present a position on behalf of the public at large on matters of public interest, such as:
 - Class actions in which the resolution of the dispute is in the public interest;
 - Suits for injunction against action by government or private interests broadly affecting the public;
 - Freedom of information requests;
 - Urban renewal;
 - Prison reform;
 - "Test" cases of significance to the public, where private interest is small.
- Not attempt to achieve its objectives by illegal activity or through a program of disruption of the judicial system.
- Not violate any canons of legal ethics.

Pre-audit Procedures for Public Interest Law Firms

See [IRM 4.75.10](#), Exempt Organizations Pre-Audit Procedures to:

- Determine the statute of limitations
- Request the determination case file
- Review IDRS information
- Review referrals and/or check sheets
- Research the organizational requirements
- Review the return/form

In addition to verifying compliance with the usual requirements of IRC Section 501(c)(3) organizations, when you audit public interest law firms, you must fully analyze the organization's litigation activities to determine whether these activities serve a public rather than a private interest.

Rev. Proc. 92-59, 1992-2 C.B. 411 requires the organization to file an attachment to its annual information form listing all the cases in litigation or litigated during the year. The attachment must provide the following for each case:

- Description of the matter in dispute.
- Explanation of how the litigation will benefit the public generally.
- The fees sought and recovered.
- The attorney fees sought and recovered.

Initial Information Document Request (IDR) for Public Interest Law Firms

The procedures below supplement [IRM 4.75.10](#), Exempt Organizations Pre-Audit Procedures. Consider requesting these items in the initial Information Document Request (IDR), not limited to:

- Bylaws
- Minutes
- Internal policies
- Copies of briefs filed with the court
- Contracts/Agreements
- Attorney fees paid by opposing parties
- Attorney fees received directly from clients
- Out-of-pocket costs include filing fees, travel expenses, and expert witness fees

Operational Requirements for Public Interest Law Firms

A public interest law firm recognized as tax-exempt under IRC Section 501(c)(3) must present a program designed to serve the public interest through litigation. Review the following documents to determine if the organization's litigation serves a public interest:

- Internal memoranda
- Minutes of board meetings
- Internal documents that discuss the firm's activities
- Copies of briefs filed with the courts
- Newspaper or magazine articles concerning the litigation
- Copies of newsletters
- Transcripts of radio and television broadcasts of attorneys working with the organization

Review all policies and programs to ensure that policies and programs:

- Are created by a board or committee that is representative of the public interest and is not controlled by employees or persons who litigate for the organization. Nor is the board or committee controlled by any organization that is not itself an organization described in [IRC Section 501\(c\)\(3\)](#).
- Don't exist to provide directly or indirectly, litigation cost deductions for a donor's private benefit.

Tour the facility. The firm should NOT operate in a way that creates identification or confusion with a private law firm by sharing office space. Refer to [IRM 4.75.11](#), On- Site Examination Guidelines.

Compensation Arrangements for Public Interest Law Firms

The public interest law firm must meet the fee guidelines in Rev. Proc. 92-59, 1992-2 C.B. 411. To ensure fees that the firm receives satisfy issued guidance and are accurately reported, always perform a sample analysis of the organization's source documents. Ensure these fee standards are met:

- The firm may accept:
 - reimbursement from clients or from opposing parties for direct out-of-pocket expenses incurred in the litigation. Out-of-pocket costs include filing fees, travel expenses and expert witness fees.
 - attorney fees if the fees are paid by the opposing parties and are awarded by a court or administrative agency or approved in a settlement agreement.
 - attorney fees if they're paid directly by clients and the fees don't exceed the actual case costs. Costs may be charged against a retainer and any remaining balance refunded to the litigant. Once they agree to undertake a representation, an organization may not withdraw from the case because the litigant is unable to pay the contemplated fee.
- The organization may not:
 - consider the likelihood of a fee in the case selections.
 - accept cases in which a court awarded or client paid fee is possible and the organization believes the litigants have a sufficient commercial or financial interest in the outcome of the litigation to justify retention of a private law firm. The organization may, (for sufficient broad public interest cases) represent the public interest as amicus curiae or intervenor.
- The total court awarded and client attorney fees must NOT exceed 50 percent of legal function operations' total cost. This percentage is calculated over a five year period including the taxable year in which the fees are received and the four preceding taxable years or lesser period of existence. The costs of the legal function include attorney salaries, nonprofessional salaries, overhead and other direct costs. An organization may submit a ruling request if an exception to the 50 percent limitation appears warranted.
- The organization doesn't seek or accept attorney fees that result in a conflict with state statutes or professional canons of ethics.
- Attorney fees must be paid to the organization, not to individual staff attorneys. Staff attorneys and employees must be compensated by a straight salary that doesn't exceed reasonable amounts and isn't set based on case fees received for cases handled.

Other Concerns Regarding Public Interest Law Firms

- Review litigation in which litigants made payments to the firm.
- Analyze and review corporate minutes, correspondence and contracts to determine if any direct or indirect arrangements allow a charitable contribution deduction for the litigation cost that is for a donor's private benefit. If you find this arrangement, consider making a discrepancy adjustment to the donor's income tax return or making a referral to the Small Business/Self-Employed (SB/SE)

division or the Large Business and International (LB&I) division on Form 5666, TE/GE Referral Information Report.

- Review financial records for evidence of fee splitting with private law firms. See Rev. Rul. 76-5, 1976-1 C.B. 146.
- Review financial records for potential unrelated business income (UBI). Legal work or litigation performed for a fee that is not performed for a public interest does not further IRC Section 501(c)(3) purposes, even if done for another exempt organization. This type of fee income is subject to unrelated business income tax.