

2015

Post-Graduate Legal Training: The Case for Tax-Exempt Programs

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POST-GRADUATE LEGAL TRAINING: THE CASE FOR TAX-EXEMPT PROGRAMS

*Adam Chodorow**

*Philip Hackney***

The challenging job market for recent law school graduates has highlighted a fact well known to those familiar with legal education: A significant gap exists between what students learn in law school and what they need to be practice-ready lawyers. Legal employers historically assumed the task of providing real-world training, but they have become much less willing to do so. At the same time, a large numbers of Americans – and not just those living at or below the poverty line – are simply unable to afford lawyers. In this Article, we argue that post-graduate legal training, similar to post-graduate medical training, is a good way to address these market failures and reduce the gap in both skills and legal services.

We consider a number of questions regarding how best to structure post-graduate legal training programs, including whether law schools should take the lead in developing them, and, if so, whether to locate such programs within law schools. We then turn to the important tax issues such programs raise. Programs operated within law schools should generally not affect those schools' tax-exempt status. Tax exemption for stand-alone programs is more complicated, but we conclude that properly structured programs should be granted tax-exempt status, both as a policy matter and under current IRS guidance. We offer suggestions about how best to design programs to come within that guidance and call on the IRS to issue clear guidance for these kinds of programs.

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I. INTRODUCTION

The challenging job market for recent law school graduates has highlighted a fact well known to those familiar with legal education: a significant gap exists between what students learn in law school and what they need to be practice-ready lawyers.¹ Until recently, legal employers took on the task of training graduates, whether through formal programs or one-on-one mentoring. However, market pressures and budget constraints have caused many legal employers to eliminate or significantly reduce the training they used to supply.² The resulting skills gap affects the ability of young lawyers to secure employment and advance in their careers as well as the quality of representation clients receive.

At the same time, many Americans simply cannot afford to hire attorneys.³ The unmet need for high-quality, affordable legal services affects not only the destitute and near destitute but also many in the middle class. The scope of the problem is difficult to gauge, but by some estimates poor people's legal needs go unmet up to 80 percent of the time and middle class people's legal needs go unmet up to 60 percent of the time.⁴ Insufficient access to affordable legal services is bad not just for those who must do without, but also for society as a

¹ See, e.g., ALFRED Z. REED, TRAINING FOR THE PUBLIC PROFESSION OF THE LAW: HISTORICAL DEVELOPMENTS AND PRINCIPAL CONTEMPORARY PROBLEMS OF LEGAL EDUCATION IN THE UNITED STATES WITH SOME ACCOUNT OF CONDITIONS IN ENGLAND AND CANADA 281 (1921) (stating, "the failure of modern American law school to make any adequate provision in its curriculum for practical training constitutes a remarkable educational anomaly"); Jerome Frank, *Why Not A Clinical Lawyer School?*, 81 U. PENN. L. REV. 1907 (1933); ALBERT J. HARNO, LEGAL EDUCATION IN THE UNITED STATES, 137 (1953) ("all [law schools] can be grouped under one heading, that the schools do not adequately prepare students for the tasks they will have to perform in the practice."). As described more fully below, law schools have made significant strides in this regard over the past 50 years, but critics remain dissatisfied. See, *infra*, sources cited in note 12.

The training gap is distinct from the question of whether law schools are producing too many lawyers. Even if the number of graduates were perfectly matched to available jobs, legal employers would complain that the graduates lacked the practical skills necessary to be a lawyer. Addressing the supply and demand question is beyond the scope of this Article.

² Neil J. Dilloff, *Law School Training: Bridging the Gap Between Legal Education and the Practice of Law*, 24 STAN. L. & POL'Y REV. 425, 431-33 (2013).

³ We focus here on civil representation and do not comment on the quantity or quality of public defender services.

⁴ See Emily A. Spieler, *The Paradox of Access to Civil Justice: The "Glut" of New Lawyers and the Persistence of Unmet Need*, 44 U. TOL. L. REV. 365, 369-376 (2013) (assessing the extent to which we can measure unmet legal needs).

whole. Among other things, lack of access to legal advice undermines the rule of law and floods the courts with pro se litigants who do not understand how the system works.

Over the past several years, a number of law schools have begun to experiment with post-graduate training programs designed to address these twin market failures.⁵ Such programs take many forms, but they typically involve new lawyers working for paying clients at below-market rates under the supervision of more-seasoned attorneys.⁶ In this way, new lawyers can gain needed training and experience while providing legal services to those currently unable to afford lawyers. However, funding issues and tax law considerations may stymie these training programs unless they are carefully structured.

In this Article, we consider a number of questions regarding how best to structure post-graduate legal training programs to achieve these dual purposes. In Parts II and III, we make the case for post-graduate legal training as a good way to address the skills and legal services gaps, and we consider program design issues, such as (1) whether law schools should take the lead in developing these programs, (2) whether programs should operate as incubators for solo practitioners or more like medical residency programs, and (3)

⁵ For a listing of the schools that have implemented some form of post-graduate legal training, see http://www.americanbar.org/groups/delivery_legal_services/initiatives_awards/program_main.html.

The idea of law school affiliated post-graduate training is not new. Rutgers considered creating such a program in the late 1990s, but it never got off the ground. For a discussion of that proposal, see Andrew J. Rothman, *Preparing Law School Graduates for Practices: A Blueprint for Professional Education Following the Medical Profession Example*, 51 RUTGERS L. REV. 875 (1999). See also Steven K. Berenson, *A Family Law Residency Program?: A Modest Proposal in Response to the Burdens Created by Self-Represented Litigants in Family Court*, 33 RUTGERS L.J. 105 (2001) (focusing on providing legal services to pro se litigants, but recognizing the training opportunities). For a more recent exposition of this idea, see Bradley T. Borden & Robert J. Rhee, *The Law School Firm*, 63 S. C. L. REV. 1 (2011).

⁶ Some law schools are paying recent graduates to do post-graduate internships at public-interest employers. See, e.g., Liza Dee And Cory Weinberg, *In dim job market, law school pays more graduates to work* (Feb 7, 2013), THE GW HATCHET, available at [http://www.gwhatchet.com/2013/02/07/in-dim-job-market-law-school-pays-more-graduates-to-work/Should you say which law schools or at least give examples? Does this work?](http://www.gwhatchet.com/2013/02/07/in-dim-job-market-law-school-pays-more-graduates-to-work/Should_you_say_which_law_schools_or_at_least_give_examples?Does_this_work?) Participants get work experience and can build networks that might lead to jobs down the road. Such programs are not self-sustaining and we do not address them here.

whether they should be housed within a law school or operated as separate entities.

We argue that, while other organizations could create such programs, law schools should take the lead because they are in the best position to do so. Law schools have significant experience with clinical education that bears directly on the training mission. Incubator programs require far fewer resources than do full-blown residency programs, and schools must determine for themselves which kind of program they prefer. Incubators fit better within a law school setting, while residency programs should probably be established as stand-alone entities.

In Part IV, we turn to the important tax issues post-graduate training programs raise. We begin by positing that tax exemption is important because it will facilitate fund raising, may help attract clients, and could mollify the local bar, which might view such programs as a threat. We then tackle the normative question of whether such programs *should* qualify as charitable organizations eligible for tax exemption under Section 501(c)(3). We do so because there is no authority directly on point, and understanding the policy will shape the way in which relevant authorities should be construed. We conclude that, while post-graduate legal training programs may not look like traditional schools or charities, they nonetheless are worthy of tax exemption because they address the market failures that lead to the skills and legal services gaps.

We consider next whether such programs qualify for exemption under current guidance. Programs operated within law schools will partake of their host institutions' tax-exempt status and should not affect it, except in extreme and unlikely circumstances. Stand-alone programs are more complicated because they must apply for tax-exemption in their own right. Properly designed post-graduate training programs should qualify under two different lines of authority. First, law school affiliated programs can be granted an exemption because they support the educational mission of their affiliated law school. Second, programs should receive an exemption in their own right, whether or not affiliated with a law school, because they serve an educational purpose. The key issue is whether providing legal services to paying clients constitutes an impermissible, non-exempt purpose.⁷ We argue that such activities are permitted under

⁷ Legal aid organizations that serve the poor are allowed to charge nominal fees based on ability to pay, Rev. Rul. 78-248, 1978-2 C.B. 177, and this could arguably be a basis on which tax exemption could be granted. However, given the need of most programs to charge more than nominal fees, we do not believe that

both general guidance and the specific guidance addressing on-the-job training. We offer a model program that should fit within existing guidance and call on the IRS to issue specific guidance setting forth the parameters under which these programs will qualify as charitable organizations.

II. THE NEED FOR POST-GRADUATE TRAINING PROGRAMS

This Part briefly sets forth the challenges facing legal education and the difficulties that arise from the lack of affordable legal services before explaining why post-graduate legal education should be considered a serious contender to address these problems. These challenges support the case we make in Part IV on why these programs are worthy of tax exemption. Those already convinced may wish to skip ahead to Part III, which addresses design considerations or Part IV, which focuses on the tax issues.

A. The Skills Gap

Legal education in America was originally provided through an apprenticeship system, where would-be lawyers worked for established lawyers until they gained sufficient knowledge and skills to be called to the bar.⁸ The first law schools appeared in the early 1800s⁹ and quickly displaced apprenticeship as the primary path to becoming a lawyer.¹⁰ The modern law school curriculum was developed in the 1890's, and it focused on legal theory, as opposed to practice.¹¹ Not surprisingly, newly minted lawyers coming from the law schools lacked the experience and many of the practical skills typical of those who had gone through years of apprenticeship. This change did not go unnoticed, and from the very beginning, critics complained that law

relief of the poor and distressed is likely to be an independent basis to make a claim for exemption in most cases. Reaching out to underserved communities may help distinguish the program from for-profit organizations, but pursuing that as the basis is likely to fail in most cases under current law. Whether low-bono services should warrant a tax exemption is beyond the scope of this article.

⁸ For a history of legal education in America, see Robert Stevens, *LAW SCHOOL: LEGAL EDUCATION IN AMERICA FROM THE 1850S TO THE 1980S* (1983). See also Lawrence M. Friedman, *A HISTORY OF AMERICAN LAW*, 2nd ed. (1985) (discussing the organization of the bar and how lawyers were educated during different periods).

⁹ See Stevens, *supra* note 6, at 5.

¹⁰ *Id.* at 7.

¹¹ See, e.g., A. Benjamin Spencer, *The Law School Critique in Historical Perspective*, 69 WASH & LEE L. REV. 1949, 1973 (2012).

schools failed to produce “practice ready” lawyers.¹² Initially, legal employers provided on-the-job training, but as market conditions have changed, they have steadily reduced the amount of training they provide, leaving a skill-training vacuum.¹³

Over the past 30 years, law schools have increased their practical training by setting up a wide range of legal clinics, creating professionally-staffed legal writing programs, expanding externship opportunities, and developing professional skills and simulation courses in topics ranging from trial advocacy to business planning. The number of client contact hours and amount of experiential learning that graduates now have is staggering when compared to just 20 years ago. Despite these advances, critics remain unsatisfied with the amount of practical training law students receive and are pushing for even greater skills training within law schools.¹⁴

¹² See *supra*, sources cited in note 1. Of significant recent note are the two American Bar Association (ABA) studies on this issue, the so-called Cramton and MacCrate Reports, and the more recent Carnegie Foundation Report. AMERICAN BAR ASSOCIATION, SECTION OF LEGAL EDUC. AND ADMISSIONS TO THE BAR, REPORT AND RECOMMENDATIONS OF THE TASK FORCE ON LAWYER COMPETENCY: THE ROLE OF LAW SCHOOLS (1979); AMERICAN BAR ASSOCIATION, SECTION OF LEGAL EDUCATION AND ADMISSIONS TO THE BAR, REPORT OF THE TASK FORCE ON LAW SCHOOLS AND THE PROFESSION: NARROWING THE GAP, LEGAL EDUCATION AND PROFESSIONAL DEVELOPMENT – AN EDUCATIONAL CONTINUUM (1992); William M. Sullivan et al., EDUCATING LAWYERS: PREPARATION FOR THE PRACTICE OF LAW (2007).

¹³ See Dilloff *supra* note 2; see also, Daniel Thies, *Rethinking Legal Education in Hard Times: The Recession, Practical Legal Education, and the New Job Market*, 59 J. LEGAL EDUC. 598, 605-06 (2010); STATE BAR OF WISCONSIN BOARD OF GOVERNOR’S CHALLENGES TO THE PROFESSION COMMITTEE, THE CHALLENGES FACING THE LEGAL PROFESSION (2011) (<http://www.reinhartlaw.com/services/buslaw/corpgovern/documents/art1111%20t e.pdf>).

¹⁴ See, e.g., Roy Stuckey et al, BEST PRACTICES FOR LEGAL EDUCATION: A VISION AND A ROADMAP (2007) and Deborah Maranville; Lisa Radtke Bliss; Carolyn Wilkes Kaas; Antoinette Sedillo López, BUILDING ON BEST PRACTICES: Transforming Legal Education in a Changing World (2015), both projects of the Clinical Legal Education Association.

Over the last few years, both the ABA and a number of state bar associations have moved to increase skills requirements. The ABA has done so as part of its accreditation powers, requiring students to take at least 6 hours of experiential learning. See 2015-2016 Standards and Rules of Procedure for Approval of Law Schools, Standard 303(a)(3), available at http://www.americanbar.org/content/dam/aba/publications/misc/legal_education/Standards/2015_2016_chapter_3.authcheckdam.pdf. The New York and California bar associations are considering adopting practical skills requirements for

Unfortunately, increasing skills training within the existing law school curriculum would require either a significant increase in tuition to pay for such training,¹⁵ or a radical reworking of the current system to focus on skills training. Regardless of the merits of such suggestions, such a restructuring seems unlikely in the short run.

Asking legal employers to train young lawyers also appears to be a non-starter. Small firms often lack the capacity to train young lawyers, while pressure to maintain the all-important profits per partner number creates strong incentives for larger firms to reduce or eliminate training.¹⁶ Clients are increasingly unwilling to pay for

applicants to their respective bars. *See, e.g.*, Staff Memorandum of the New York State Bar Association, December 30, 2013 (discussing the need for greater skills training for new lawyers and contemplating requiring bar applicants to have 12 hours of such training, whether through clinics, externships or simulation courses, before being admitted to the bar), available at <https://www.nysba.org/WorkArea/DownloadAsset.aspx?id=46440>; State Bar of California TASK FORCE ON ADMISSIONS REGULATION REFORM: PHASE I FINAL REPORT, June 11, 2013 (recommending that applicants to the California State Bar be required to take 15 credit hours of experiential learning while in law school), available at <http://board.calbar.ca.gov/docs/agendaItem/Public/agendaitem1000010717.pdf>.

¹⁵ While one professor can easily teach 100 students in a core doctrinal course, clinical training and writing classes require much smaller ratios. Robert Kuehn asserts that 84% of all law schools already have the capacity to provide a clinical experience to every student and that no differences in tuition exist between those schools that can provide such experiences to all students and those that cannot. *See* Robert R. Kuehn, *Pricing Clinical Legal Education*, 92 DENV. L. REV. 1 (2014). However, the cost of additional resources necessary to produce practice-ready lawyers would be prohibitive. One might think that schools could use adjuncts for this purpose, both because they are less expensive than regular faculty and have ongoing practice experience. However, these courses are often so labor intensive that adjuncts may be unwilling to commit the time necessary. In addition, not every law school is located near a large pool of adjuncts.

¹⁶ Indeed, there is significant economic pressure not to hire recent graduates, with the common wisdom being that law firms lose money on associates until their third year. Debra L. Bruce, *A Law Firm Associate's Primer on Law Firm Economics*, Lawyer Coach, (June 10, 2013) available at <http://www.lawyer-coach.com/index.php/2013/06/10/a-law-firm-associates-primer-on-law-firm-economics/> (indicating that large firms she surveyed claimed that they needed to collect \$350,000 per associate to break even and associates were not profitable for such firms until around the fourth year); Law Career Blog, *Big Firm Economics 101: Why Are Associate Salaries So High?* (Feb. 7, 2006), available at <http://law-career.blogspot.com/2006/02/big-firm-economics-101-why-are.html>. (suggesting that most firms don't break even on associates until their third year of practice); *But see*, Ed Wesserman, *Why Aren't Associates More Profitable?* (May 25, 2009), available at

associate training,¹⁷ leading large firms to hire fewer first year associates.¹⁸ High lawyer mobility also creates disincentives for legal employers to train because such training will only benefit future employers. Nor does the future offer much hope.¹⁹

B. The Legal Services Gap

Law faculties are also well aware of the shortage of high-quality, affordable legal services. Legal fees have risen so high that a large number of Americans simply can't afford to hire a lawyer. A recent survey by the National Law Journal showed median firm-wide billing rates of respondents for 2012 to be \$425/hour. Even outside the major metropolitan areas, rates are quite high. A 2013 survey in

[associates-more-profitable/](#) (arguing that the purported lack of profitability may derive from simplistic accounting practices that improperly assign overhead to associates).

¹⁷ Ashby Jones & Joseph Palozzolo, *What's A First Year Lawyer Worth?*, Wall St. J., Oct. 17, 2011, available at http://online.wsj.com/news/articles/SB10001424052970204774604576631360989675324?mod=ITP_marketplace_0&mg=reno64-wsj&url=http%3A%2F%2Fonline.wsj.com%2Farticle%2FSB10001424052970204774604576631360989675324.html%3Fmod%3DITP_marketplace_0 (noting that many general counsel are now unwilling to pay for first year associate time).

¹⁸ In 2008, 19% of all attorneys found jobs at firms with over 251 lawyers. In 2011, that number dropped to 10.5%. Christopher J. Gearon, *Reality Check for Law Firm Associates*, U.S. NEWS AND WORLD REPORT, Nov. 1, 2012, available at <http://www.usnews.com/news/articles/2012/11/01/reality-check-for-law-firm-associates>.

¹⁹ Technology and the ability to outsource legal work to other countries is likely to reduce the number of associates needed. See, e.g., Michael G. Owen, *Legal Outsourcing to India: The Demise of New Lawyers and Junior Associates*, 21 PAC. MCGEORGE GLOBAL BUS. & DEV. L. J. 175 (2008). Moreover, firms may be shifting from the well-known pyramid structure to a new "diamond" structure, in which firms are populated primarily by mid-level lawyers, with a small group of equity owners and young associates on either side. See William Henderson & Evan Parker, *The Diamond Law Firm, A New Model or the Pyramid Unraveling?*, LAWYER METRICS (Dec. 3, 2013), available at <http://lawyermetrics.com/2013/12/03/the-diamond-law-firm-a-new-model-or-the-pyramid-unraveling/>. Worse yet, from a training perspective, is the predicted rise of virtual firms, where individual lawyers with different skills sets will come together to create ad hoc firms for individual cases or transactions. RICHARD SUSSKIND, *TOMORROW'S LAWYERS: AN INTRODUCTION TO YOUR FUTURE* (2013). Such "firms" are anticipated to be highly competitive and indeed may supplant traditional firms because they will likely have low overhead and the flexibility to add or cut members as needed. Because they will only employ those essential to the case or transaction in question, the impetus to train young lawyers will be greatly diminished.

Arizona revealed that the median hourly rate was \$255/hour, with the average at \$280.²⁰ The rates vary by practice area, years of experience, firm size, and location within the state, but rates at the 25th percentile rarely fall below \$200. This means that 20 hours of work typically costs around \$5,000, a significant amount for someone who earns \$50,000 per year.²¹

For the very poorest, free legal services are nominally available through the Legal Services Corporation and the organizations they fund. However, such organizations have restrictions on the types of cases they can take,²² and the income levels at which people lose eligibility are so low that only a small number qualify.²³ Even with these limitations, the funding for these types of services is nowhere near adequate to cover the needs of those who qualify.²⁴ Indeed,

²⁰ STATE BAR OF ARIZONA, 2013, *ECONOMICS OF LAW PRACTICE IN ARIZONA*, (Editor Information and Date).

²¹ The reasons for the market's failure to produce lawyers willing and able to provide legal services in the range between \$100 and \$200 per hour are puzzling. In a recent report, the Committee On Legal Education And Admission To The Bar Association Of The Bar Of The City Of New York suggested that rising student debt precludes lawyers from entering public service or entering practices where they can charge affordable rates, <http://www.nycbar.org/pdf/report/lawSchoolDebt.pdf>, but the lack of reasonably priced legal services predates the recent rise in law school debt.

²² See, e.g., Legal Service Corporation Office of Inspector General Audit Guide for Recipients and Auditors, Appendix A, Compliance Supplement (<http://www.oig.lsc.gov/aud/audguide/agmenu.htm>).

²³ The Federal Poverty Guidelines for 2013 set the poverty level for individuals at \$11,770 and for a family of four at \$24,250. U.S. DEPARTMENT OF HEALTH AND HUMAN SERVICES, 2015 POVERTY GUIDELINES (2015), available at <http://aspe.hhs.gov/2015-poverty-guidelines#thresholds>. Legal services organizations predominately provide free services to those who are at or lower than 125% of the federal poverty level. See *About LSC*, LEGAL SERVICES CORPORATION, <http://www.lsc.gov/about/what-is-lsc> (last visited Feb. 13, 2015); Consumer's Guide to Legal Help: Finding Free Help, AMERICAN BAR ASSOCIATION, http://apps.americanbar.org/legalservices/findlegalhelp/faq_freehelp.cfm (last visited Feb. 5, 2015).

²⁴ See, e.g., LEGAL SERVICES CORPORATION, *DOCUMENTING THE JUSTICE GAP IN AMERICA: THE CURRENT UNMET CIVIL LEGAL NEEDS OF LOW-INCOME AMERICANS*, (Sept. 2009), available at http://www.lsc.gov/sites/default/files/LSC/pdfs/documenting_the_justice_gap_in_america_2009.pdf

government funding for legal services to the poor is constantly under attack and unlikely to be increased in the near future.²⁵

Many state bar organizations have implemented “modest means” programs, where lawyers agree to represent customers up to 250% of the federal poverty level for \$75/hour.²⁶ However, this barely puts a dent into the demand. By some accounts, up to 60 percent of middle class legal needs go unmet.²⁷ Self-help solutions exist, such as Legal Zoom²⁸ and Nolo Press,²⁹ but such aids are no substitute for a trained attorney, especially when matters stray beyond the routine.

The sad state of affairs was perhaps best captured by the ABA in its 2013 draft report on potential changes to legal education:

the services of these highly trained professionals may not be cost-effective for many actual or potential clients, and some communities and constituencies lack realistic access to essential legal services....The current misdistribution of legal services and common lack of access to legal advice of any kind requires innovative and aggressive remediation.³⁰

The lack of legal representation not only harms those who cannot afford lawyers, but it also imposes significant costs on society, writ large. For instance, pro se litigants impose significant costs on the legal system. As Chief Justice Chase Rogers of the Connecticut Supreme Court, has noted, pro se litigants “clog up the court system. Cases are delayed and lengthened, creating frustration for everybody.”³¹ This problem is especially acute in family law courts,³² though it is

²⁵ See, e.g., House Spending Bill Cuts LSC Budget By 20%, LEGAL SERVICES CORPORATION (Jun 3, 2015) available at <http://www.lsc.gov/media-center/press-releases/2015/house-spending-bill-cuts-lsc-budget-20>.

²⁶ See, e.g., MODEST MEANS PROGRAM, <http://www.azflse.org/modestmeans/> (last visited Feb. 12, 2015).

²⁷ See Spieler, *supra* note 4.

²⁸ <http://www.legalzoom.com/index-new-c.html>.

²⁹ <http://www.nolo.com>.

³⁰ See ABA Draft Report, *supra* note 14, at 3.

³¹ <http://www.ctlawtribune.com/id=1202603921219/Editorial-Coping-With-Pro-Se-Litigants#ixzz3Po1vYXNd>.

³² A 1990 survey found that in 52% of Arizona divorces, neither party was represented, while in approximately 88% one party was not represented. Bruce D. Sales et al., Self-Representation in Divorce Cases (American Bar Association 1993). Other states reported similar statistics. See Berenson, *supra* note 5, at 109.

One solution to this problem could be to allow paralegals or others with limited training to handle these types of disputes. Washington State has recently issuing limited licenses to legal technicians in this area. See

experienced elsewhere. Pro se litigants need assistance in filling out forms and help from judges during hearings and trials.³³ Cases that should settle go to trial; trials can take a lot longer than necessary.

Equally troubling is the fact that justice may not be served. Pro se litigants with good cases may lose because they do not understand the rules of evidence or fail to introduce necessary evidence because they do not understand the legal standard.³⁴ In addition, judges may be inclined to help those without lawyers, thus abandoning their neutral position; or they may sit back and watch pro se litigants with winning cases lose.³⁵ Neither outcome is good.

Pro se representation can also lead to the law developing in unfortunate ways. In our adversarial system, we rely on the parties to brief the issues so that the judges can make good decisions on both the facts (in bench trials) and the law. Pro se litigants do not always make the best arguments, depriving judges of the opportunity to see all sides of a legal issue, which can lead to bad law.³⁶

III. POST-GRADUATE TRAINING DESIGN CONSIDERATIONS

So, how might we tackle these twin problems? Post-graduate legal training programs can help new lawyers gain the skills and experience they need to be successful lawyers, while addressing the legal services gap. Given the scope of the problems, such programs are

<http://www.wsba.org/Legal-Community/Committees-Boards-and-Other-Groups/Limited-License-Legal-Technician-Board>. While this approach may help some clients, it is also fraught because client needs may go beyond the scope of permissible practice, and those with limited training may miss important legal issues. Moreover, it does not address the lawyer training issues focused on here.

³³ *Id.* at 112–117.

³⁴ Studies have shown that, in the low-income context, represented parties in the U.S. Tax Court do roughly twice as well as those who litigate pro se. See OFFICE OF THE TAXPAYER ADVOCATE, LOW INCOME TAXPAYER CLINIC PROGRAM REPORT 8 (2007), available at <http://www.irs.gov/pub/irs-pdf/p5066.pdf>. While some of the difference may stem from the fact that represented parties may settle more losing cases, it likely does not account for the entire difference.

³⁵ *Id.*

³⁶ For instance, in *In Re: the Shaheen Trust* u/a 1/12/1994, available at <http://caselaw.findlaw.com/az-court-of-appeals/1689940.html>, pro se beneficiaries alleged that a trustee had breached its trust. The trustee counterclaimed, arguing that the beneficiaries should forfeit their interests under a no-contest clause. The trial court and court of appeals both held that alleging a breach of trust was tantamount to challenging the validity of a disposition, triggering a forfeiture of their interests. Had the beneficiaries hired lawyers, this issue likely would have been decided differently. At the very least, it would have been squarely presented.

unlikely to solve them fully, but they are certainly a step in the right direction.

Once one accepts that post-graduate legal training programs are desirable, questions arise as to how best to structure them. The first question is whether law schools should take the lead in establishing and operating such programs. The next question focuses on whether programs should operate as incubators, with recent graduates operating their own law practices, or more like residency programs, where the program is responsible for generating work. The final question is whether the program should operate as part of the law school or as a stand-alone entity. In this Part, we focus on these design decisions.

A. Why Should Law Schools Create and Operate Post-Graduate Training Programs?

Acknowledging that there is a gap between legal training and the skills law graduates need for practice and that there are unmet needs for legal services is not the same as concluding that law schools should take the lead in addressing either problem. As noted above, neither law schools nor legal employers seem poised to act, leaving law schools and other non-profits. Traditional legal non-profits, such as state bar associations and the ABA, provide some training to their members and facilitate their members providing pro- and low-bono work, but it seems highly unlikely that they would create programs of the scope or size we are discussing. The same goes for governmental agencies. This leaves law schools, which are dedicated to teaching and to the success of their graduates and have an abiding interest in the legal system, writ large, including access to legal services. Moreover, they have experience with legal clinics that they can draw on in designing and running post-graduate programs.

This is not to suggest that only law schools should create such programs. Indeed, many lawyers would likely relish the opportunity to train young lawyers, while helping people who cannot otherwise afford legal representation. Rather, in the current environment, law schools may be in the best position to create such programs, in part because their students are directly affected by the skills gap, and it could be easier for law-school affiliated programs to obtain tax-exemption. Once the models in their various forms have been established and put through their paces, it would make sense to encourage others to step in and create their own post-graduate training programs.

B. Incubator v. Residency

Post-graduate training programs come in many forms, and law schools must decide whether the program should operate as an incubator or a residency program. Incubators are typically aimed at those interested in establishing their own law practices.³⁷ Law schools provide space, some infrastructure, and a mentor to help participants. Most incubators rely on the participants to generate their own work, obtain their own malpractice insurance, and establish their own IOLTA accounts,³⁸ among other things. In contrast, residency programs operate more like traditional firms in that they have practice areas run by seasoned attorneys. The resident attorneys work for the program, which is responsible for setting up the infrastructure and generating the work.

Incubators generally require far less in the way of planning, infrastructure, or institutional commitment than do residency programs. They also pose far less risk.³⁹ Participants bear much of the economic risk if they cannot generate business, and the law schools are generally not seen to be engaged in the practice of law, with all the risk that entails. This perhaps explains why incubators are the most popular form of post-graduate training programs to date.⁴⁰

Incubators may not meet the needs or goals of every kind of law graduate. Not every graduate wants to establish a solo practice, especially right out of law school or has the capacity to generate sufficient business off of which to live. Residency programs can provide financial security by paying the new lawyers and assuming the responsibility of generating the work. They may also allow for a more controlled experience, one where trained lawyers educate and mentor new lawyers in a way that incubators cannot typically accomplish.

³⁷ See, e.g., the incubator programs operating at the California Western School of Law and the Thomas Jefferson School of Law, described at http://www.americanbar.org/groups/delivery_legal_services/initiatives_awards/program_main/program_profiles.html?cq_ck=1425594085817.

³⁸ Most lawyers must establish trust accounts, referred to as IOLTA accounts, to hold client money. For a discussion of such accounts in Arizona, see <http://www.azbar.org/media/50359/trustaccount.pdf>.

³⁹ Obviously, the law school could be subjected to vicarious liability for its connection to the incubator, but it is unlikely that incubators present the same type of malpractice problems as does a residency-style post-graduate legal training program.

⁴⁰ See http://www.americanbar.org/groups/delivery_legal_services/initiatives_awards/program_main/program_profiles.html?cq_ck=1425594085817 for a description of law-school affiliated post-graduate training programs.

However, residency programs are far more expensive and complicated than simple incubators and may encounter greater resistance from the practicing bar because of concerns over competition. Nonetheless, on balance, we believe that residency-like programs can provide a better training environment, have the potential to train a significantly larger number of lawyers, and can provide more legal services to those who currently go without. Accordingly, these programs deserve serious consideration.

C. Should Programs Be Established Within Or Outside Of Law Schools?

Another important decision is whether programs should be housed within law schools or created as stand-alone entities. Internal programs could be operated as a law school activity, like moot court, or through a separate legal entity, such as a single member LLC or a non-profit corporation.⁴¹ Stand-alone programs would be established as a new legal entity. This decision involves a number of different considerations, many of which push in different directions.

Locating the program within a law school or as part of the broader university offers a number of benefits. First and foremost, schools can maintain control over personnel, direction, selection of participants, etc. Moreover, law school programs may have access to university resources, including facilities, human resources, and personnel, including the general counsel's office. They may also be able to offer university benefits to employees. Locating programs within law schools may also make it easier to get faculty involved and to ensure that any knowledge the program generates is passed along to those responsible for designing and implementing the law school curriculum. Finally, locating programs within law schools may also help brand the program and promote the school. In particular, it may highlight the ways in which the school is embedded in the local community and engaged in addressing community concerns, needs, and issues.⁴² It may also help attract clients who might otherwise distrust lawyers.

⁴¹ In some cases, this approach may not be possible because of state law. *See, e.g.*, ARIZ. CONST., ART IX, § 7 (precluding state agencies from owning other organizations). Other issues with corporate documents or state charters may arise, but they are beyond the scope of this article.

⁴² For an example of this approach, see Arizona State University, whose design aspirations include social embeddedness and transforming society. *See* A NEW AMERICAN UNIVERSITY, <http://newamericanuniversity.asu.edu/#1> (last visited Feb. 12, 2015).

However, locating a post-graduate program within a law school or university also entails a number of risks. For instance, it may subject the university to legal liability should there be malpractice.⁴³ While these risks already exist with clinics and can be offset with insurance, post-graduate programs may increase the risk. Even absent malpractice, the practice of law can be quite contentious, and both the client and lawyer on the other side may harbor ill-will toward the institution. Clients also may develop unrealistic expectations and blame their lawyers if things go wrong. Disgruntled individuals could engage in a wide range of activities, including suing the university, posting derogatory comments on line, or even complaining to local politicians. Such complaints could create problems, especially for state universities.

Post-graduate training programs also run the risk of alienating law school alumni, who might perceive them as competition. Unlike clinics, which represent pro-bono clients, most post-graduate programs, or the lawyers participating in them, will represent at least some paying clients. Schools need to be wary of competing against their own graduates or otherwise antagonizing them.⁴⁴

To the extent that incubator programs simply provide infrastructure and some mentoring to new lawyers who are setting up their own practices, the risks seem fairly low, and housing such programs within a law school makes sense. In contrast, residency programs likely are best created as stand-alone entities. While the law school might be seen as the creative force behind such programs, the diminished control and management shield schools from at least some of the financial and political fallout, if any.

IV. TAX EXEMPTION AND THE POST-GRADUATE LEGAL TRAINING PROGRAM

Any post-graduate legal training program will likely want to take advantage of the benefits of operating as a tax-exempt charitable organization. As described below, post-graduate legal training programs located within law schools will generally not need to seek tax-exempt status. Most ABA-accredited law schools are either tax-

⁴³ The university could create the program as a separate legal entity within the university's corporate family, but there is always the concern that the corporate or LLC veil could be pierced or some agency relationship be found.

⁴⁴ In some cases, state law prohibits state actors from competing in areas where the private market functions. See, e.g., Ariz. Rev. Stat. Ann. § 41-2753.

exempt organizations under Code § 501(c)(3) or operated by a state,⁴⁵ and under most circumstances programs located within such schools will be automatically be considered tax exempt. The question in this situation is whether a program's activity could jeopardize the law school's tax-exempt status or subject the school to the unrelated business income tax (UBIT). In contrast, stand-alone programs must consider whether to seek tax-exempt status, and, if so, whether they would qualify for such status under current law and IRS guidance. This Part explores these important questions.

Professor Colombo has written a thoughtful article on this topic, focusing primarily on programs operated within law schools.⁴⁶ We generally agree with his assessment that such programs should not create any tax problems for law schools that establish them. Colombo's brief discussion of stand-alone firms focuses on "commerciality" and the cases that involve charitable organizations operating for-profit businesses. He concludes that it is unclear whether they could obtain tax exemption. We argue that a properly designed post-graduate training program should qualify for exempt status under a different line of authority, which addresses charitable organizations that provide on-the-job training. Moreover, its income, if any, should not be subject to UBIT.

A. Why Tax Exemption?

Before turning to the existing law and guidance, we discuss the benefits of tax exemption as well as the normative question of whether such programs should qualify for tax exemption. As discussed below, especially in the context of stand-alone programs, the authorities are not directly on point, and tax authorities will have some discretion on how to apply them. Considering the question from a theoretical perspective first provides guidance as to how they should exercise it.

1. The Benefits of Tax-Exempt Status

Most programs will not generate significant income, raising the question of why tax exemption matters. Charitable status under Code § 501(c)(3) would provide post-graduate training programs a number of benefits, the most important of which may be the ability to raise money from donors. Creating and maintaining a post-graduate legal

⁴⁵ For a list of ABA-accredited law schools, see http://www.americanbar.org/groups/legal_education/resources/aba_approved_law_schools/in_alphabetical_order.html.

⁴⁶ John D. Colombo, *The Federal Tax Exemption Aspects of Law Schools Running Their Own Law Firms*, 72 Exempt Org. Tax Rev. 153 (2013).

training program could be quite expensive. While most programs will likely charge fees, the fees may not be sufficient to cover all costs. Even if a program can break even, it seems highly unlikely that any program would be self-sustaining for the first several years. Fundraising may be critical to getting stand-alone programs up and running and could permit them to offer additional pro bono and low bono services, thus increasing the demand for services and the opportunities for participating attorneys to receive training.

While programs could certainly solicit tax-free gifts,⁴⁷ charitable status under Code § 501(c)(3) would permit donors to deduct such gifts as charitable contributions under Code § 170.⁴⁸ Moreover, it would significantly increase the likelihood that private foundations and governments would be willing to make grants. Private foundation rules require foundations to make significant grants each year⁴⁹ to accomplish charitable purposes.⁵⁰ While foundations can give to taxable entities, they risk a significant penalty and potentially their tax exempt status if (1) they do not annually pay enough out to support charitable activity⁵¹ or (2) they do not closely scrutinize the use of money provided to non-charitable organizations to ensure it is used for charitable purposes.⁵² As a result, foundations rarely make grants to organizations that are not public charities.⁵³ Additionally,

⁴⁷ I.R.C. § 102.

⁴⁸ Charitable contributions to government entities, their political subdivisions, and some organizations whose income is exempt from tax under Code § 115 are also deductible. For a brief discussion on the § 115 issue and deductibility see <http://www.irs.gov/Government-Entities/Federal,-State-&-Local-Governments/Governmental-Information-Letter>.

⁴⁹ I.R.C. § 4942(a), (d)–(e).

⁵⁰ The expenditures must be used to support the charitable purposes listed in Code § 170(c)(2), which include educational purposes. I.R.C. § 4942(g).

⁵¹ I.R.C. § 4942(g). Private foundations typically accomplish this by transferring funds directly to charitable organizations that qualify as public charities under section 509(a).

⁵² I.R.C. § 4945(d)(4). This is typically referred to as expenditure responsibility. Failure to monitor expenditures can result in an excise tax starting at twenty percent of the expenditure. See <http://www.irs.gov/Charities-&-Non-Profits/Private-Foundations/Grants-by-Private-Foundations:-Expenditure-Responsibility>.

⁵³ A public charity is an organization that qualifies as tax exempt under Code § 501(c)(3) and either operates a favored type of public institution such as a church or a hospital, or receives a substantial amount of support from the public or the government. While it might be possible to use a university's foundation (which in most cases actually qualifies as a public charity) as a conduit for donations and grants, doing so might create problems for the university foundation and donors whose money is directed to a for-profit entity.

government grants are often dependent upon the organization being a nonprofit organization.⁵⁴ Post-graduate legal training programs that want to seek grants from private foundations and the government are well advised to form a charitable organization and qualify for public charity status.

In addition, many states and local governments offer benefits to organizations exempt from tax under section 501(c)(3), such as exemptions from property and sales taxes.⁵⁵ Status as a charity may also permit resident attorneys to participate in loan forgiveness programs, which could act as a salary supplement.⁵⁶ Under certain narrow circumstances, tax-exempt organizations may be able to also take advantage of private activity tax-exempt bonds,⁵⁷ which could provide a program a cheaper way to raise funds for its facilities.

Finally, tax-exempt status may send a signal to both clients and the local bar. Many potential clients distrust lawyers and assume that they are only out to line their own pockets. Tax-exempt status would make clear that a post-graduate legal training program is not driven by a profit motive. The local bar may also feel less threatened if a program is tax exempt.⁵⁸ Admittedly, establishing the program as a non-profit corporation provides many of these same benefits. However, because most people expect nonprofits to be qualified as charitable organizations by the IRS, some may be confused if the program does not obtain tax-exempt status.

⁵⁴ See, e.g., Legal Services Corporation Basic Grants requires its grant recipients to be nonprofit organizations with legal aid services as a charitable purpose. <http://www.lsc.gov/grants-grantee-resources/our-grant-programs/basic-field-grant>.

⁵⁵ For some benefits provided by states, see BAZIL FACCHINA, EVAN SHOWELL, & JAN E. STONE, *Privileges & Exemptions Enjoyed By Nonprofit Organizations: A Catalog And Some Thoughts on Nonprofit Policymaking*, 28 U.S.F. L. REV. 85 (1993-1994).

⁵⁶ See, e.g., <https://studentaid.ed.gov/repay-loans/forgiveness-cancellation/charts/public-service> (describing federal loan forgiveness programs for those engaged in public service). These programs often have a length of service requirement. Given that the typical post-graduate law firm would only allow a student to stay 2-3 years, the post-graduate law firm is likely only a partial answer to this loan forgiveness question.

⁵⁷ I.R.C. § 145. Admittedly, obtaining a bond for these organizations would present some substantial challenges.

⁵⁸ Establishing the program as a tax-exempt entity could arguably give such programs an advantage vis-à-vis for-profit firms, so care must be taken to ensure that the programs focus on their educational mission and on those who are currently locked out of the market.

Before turning to consider whether post-graduate legal training programs should be considered charitable organizations, it is worthwhile to consider whether one of the new hybrid entities, such as low-profit limited liability companies, benefit corporations, and flexible purpose corporations, might be appropriate.⁵⁹ After all, these programs operate like normal businesses in that they charge clients, but they are tempered by strong social policy objectives of training new lawyers and creating greater access to legal services. Unfortunately, hybrid entities will not provide the benefits of tax-exemption. First, these organizations cannot generally qualify as tax-exempt charitable organizations.⁶⁰ Nor will investments in such organizations by foundations automatically qualify as program-related investments that count toward their qualified distribution requirement.⁶¹ Thus, hybrid entities would have no better chance of receiving grants from a private foundation than a for-profit business. They also might not be able to access governmental grants. Second, even if the tax issues were resolved favorably, it is not clear that clients or the local bar would accept hybrid entities to the same degree they would accept a charitable tax-exempt organization. Profits from hybrids can be distributed, undercutting much of the messaging and assurances that non-profit and tax-exempt status provides.

2. Post-Graduate Legal Training Programs Should Qualify For Tax Exemption As A Theoretical Matter

Before delving into the current guidance, it helps to consider more generally whether post-graduate programs are the type of activity for which tax exemption should be allowed. Answering that question may affect how strictly or narrowly authorities should read existing authority, none of which is directly on point. The scholarly debate over why the government should afford some organizations tax-exempt

⁵⁹ See Lloyd Hitoshi Mayer & Joseph R. Ganahl, *Taxing Social Enterprise*, 66 STAN. L. REV. 387 (2014). The statutes authorizing such entities appear aimed at the shareholder wealth maximization norm, which constrains managers' ability to consider benefits to other constituents in their decision-making. Presumably though an L3C that adopted the 12 requirements needed for an LLC to seek exemption described below in footnote 97 could qualify under those circumstances.

⁶⁰ While some have pushed to extend tax-exempt status to hybrids, they lack many of the characteristics, such as the non-distribution constraint, that traditional tax-exempt entities possess, making it difficult to determine whether and to what extent they serve the public good. For a discussion of the reasons why such organizations should not receive tax-exempt status, see *id.*, at 421–441.

⁶¹ *Id.* at 396.

status began in earnest with an article by Boris Bittker and George Rahdert, in which the authors argued that an exemption from income tax for donation-receiving organizations was warranted on the grounds that charitable organizations do not have income in the same sense as for-profit firms.⁶² Funds must be used for charitable purposes and, if such expenditures are considered deductible, by definition expenses will equal income, leading to no net income for tax purposes.⁶³

In response, Henry B. Hansmann argued that tax-exemption should be viewed as a subsidy to organizations that produce public or quasi-public goods.⁶⁴ Under this theory, producers of such goods will fail to produce at optimal levels because they are unable to capture the benefits their activities produce.⁶⁵ The government can overcome this the free-rider problem and consequent market failure by using its taxing power to force everyone to contribute to the production of such goods. Alternately, the government can subsidize public good production by affording tax-exemption to private organizations and

⁶² Boris Bittker & George Rahdert, *The Exemption of Nonprofit Organizations from Federal Income Taxation*, 85 YALE L.J. 299 (1976).

⁶³ For more recent analyses of whether income taxation of non-profit organizations is appropriate on income measurement grounds, see Daniel Halperin, *Is Income Tax Exemption for Charities a Subsidy*, 64 TAX L. REV. 283 (2011). See also Philip T. Hackney, *What We Talk About When We Talk About Tax Exemption*, 33 VA. TAX REV. 115 (2013) (providing a related justification, namely that under the shareholder theory of corporate law, we have no justification for taxing charitable organizations because they have no shareholders).

William D. Andrews offered a related justification for the charitable contribution deduction, arguing that the individuals who contribute income to public benefit organizations should get a deduction because they dedicated their funds to public, rather than private, consumption. William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309, 360 (1972).

⁶⁴ See Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835 (1980); Henry B. Hansmann, *The Rationale for Exempting Nonprofit Organizations from Corporate Income Taxation*, 91 YALE L.J. 54, 58 (1981). In addition to pointing out the free-rider problems associated with public good production, Hansmann also noted that non-profit status, and in particular the non-distribution constraint, served an important signal in cases where the market cannot adequately monitor behavior.

⁶⁵ A true public good is nonrival and non-excludable, meaning that the consumption by one person does not diminish the ability of others to consume, and the producer cannot exclude people from consuming it. True public goods are quite rare, but similar market failure problems arise with private goods that have positive externalities, often referred to as quasi-public goods. For ease of reference, we will use the term public goods to describe both public and quasi-public goods.

creating tax incentives for others to provide the necessary funds.⁶⁶ Although Hansmann's argument was not focused on the charitable contribution deduction, the deduction can be seen a device to direct additional funds to organizations producing public goods, either by lowering the cost of private giving or allowing taxpayers to designate where their tax dollars should go.⁶⁷

Although others have advanced other theories,⁶⁸ we believe that Hansmann offers the best justification for tax exemption. Thus, we examine post-graduate legal training programs under his market failure theory. The IRS itself has adopted a market failure justification in its guidance regarding public interest law firms, leading us to believe that such a theoretical basis should be persuasive to the IRS.⁶⁹

We note that not every market failure deserves to be corrected through a public subsidy. For instance, there is likely a market failure associated with car repair. Car owners do not trust car mechanics because of an information asymmetry problem. However, we do not argue that the IRS should allow car mechanics to operate as tax-exempt charitable organizations. Rather, the extent to which the public, writ large, is affected by the failure must be taken into account. We are not able to identify the exact point at which public harm or public good rises to the level where subsidy is justified, but we believe on the job training and the provision of legal services to those who cannot afford them fall well within the traditional ambit of public benefit to qualify.

⁶⁶ The latter option is especially appealing if one believes that the government is likely to fail to set public good production at the appropriate level. For a discussion of why the government might fail to set the right mix or level, see Adam Chodorow, *Charity with Chinese Characteristics*, 30 UCLA PAC. BASIN L. J. 1 (2012).

⁶⁷ These alternate visions of the charitable deduction can be seen in Paul R. McDaniel, *Federal Matching Grants for Charitable Contributions: A Substitute for the Income Tax Deduction*, 27 TAX L. REV. 377 (1972).

⁶⁸ Rob Atkinson, *Altruism in Nonprofit Organizations*, 31 B.C. L. REV. 501 (1990); Rob Atkinson, *Theories of the Federal Tax Exemption for Charities: Thesis, Antithesis, and Syntheses*, 27 STETSON L. REV. 395 (1997); Evelyn Brody, *Of Sovereignty and Subsidy: Conceptualizing the Charity Tax Exemption*, 23 J. CORP. L. 585 (1998); Nina J. Crimm, *An Explanation of the Federal Income Tax Exemption for Charitable Organizations: A Theory of Risk Compensation*, 50 FLA. L. REV. 419 (1998); Mark A. Hall & John D. Colombo, *The Charitable Status of Nonprofit Hospitals: Toward a Donative Theory of Tax Exemption*, 66 WASH. L. REV. 307 (1991). For a discussion of those theories, see Chodorow, *supra* note 66.

⁶⁹ Rev. Rul. 75-74 and 75-75 (reasoning that public interest law firms can be exempt where the market would not otherwise provide a particular service).

We contend that two different market failures warrant government subsidy for post-graduate legal training programs. The first is the failure of law schools and legal employers to provide meaningful educational training opportunities to new lawyers. The second is the lack of affordable legal services for the vast majority of Americans, which causes a significant number of people to forego lawyers. Either alone warrants tax exemption and the subsidy it entails. Together, they make an even stronger case.

Education has traditionally been seen as a quasi-public good, benefiting not only those who acquire it, but also society generally. Recognition of education's status as a quasi-public good can be seen in the long history of public education in the United States,⁷⁰ as well as in its prominent role in the creation of the charitable deduction nearly 100 years ago.⁷¹ Economic theory suggests that people will underinvest in education from a societal perspective because they will not be compensated for the value it provides to the community at large. This is precisely what we have seen.

Given the benefits that flow to lawyers, some may question whether legal education – as opposed to secondary or college education – is a public or private good. As a recent ABA report of the future of legal education noted, it has characteristics of both:

On the one hand, the training of lawyers is a public good. Society has a deep interest in the competence of lawyers, in their availability to serve society and clients, and in their values. This concern reflects the centrality of lawyers in the effective functioning of ordered society. Society also has a deep interest in the system that trains lawyers. This is because the system directly affects the competence, availability, and values of

⁷⁰ See, e.g., National Center for Education Statistics, *120 Years of American Education: A Statistical Portrait*, National Center for Educational Statistics (Thomas D. Snyder ed.), available at <http://nces.ed.gov/pubs93/93442.pdf>. Indeed, Thomas Jefferson repeatedly argued that an educated populace was central the country's success. See, e.g., Thomas Jefferson: Diffusion of Knowledge Bill, 1779. FE 2:221, Papers 2:526 (“The most effectual means of preventing [the perversion of power into tyranny are] to illuminate, as far as practicable, the minds of the people at large, and more especially to give them knowledge of those facts which history exhibits, that possessed thereby of the experience of other ages and countries, they may be enabled to know ambition under all its shapes, and prompt to exert their natural powers to defeat its purposes.”).

⁷¹ See 55 Cong. Rec. 6728 (1917) (indicating that a key reason for enacting the charitable deduction was a fear that wealthy individuals would not otherwise donate to institutions of higher education).

lawyers.... The fact that the training of lawyers is a public good is a reason there is much more concern today with problems in law schools and legal education than with problems in education in other disciplines, like business schools and business education.

But the training of lawyers is not only a public good. The training of lawyers is also a private good. Legal education provides those who pursue it with skills, knowledge, and credentials that will enable them to earn a livelihood....⁷²

The question isn't whether lawyers benefit from their training but rather whether the market fails to produce the optimal level of training. That point seems unassailable, at least if you ask legal employers. Finally, we note that this objection is not unique to training lawyers; all education includes a component of private benefit, and we support it regardless of whether the learner is young or old, rich or poor, engaged in highly practical or deeply theoretical work.

The second market failure is the lack of affordable, high-quality legal services for large numbers of Americans. As described above in Part II.B, up to 60 percent of legal needs for the middle class are going unmet.⁷³ This affects not only those who cannot afford lawyers, but also society at large. Pro se litigants slow down the operation of the courts, people's rights go unprotected, and parties enter into suboptimal deals. In a society like ours, where virtually every activity is touched by the law, the lack of legal resources can undermine the rule of law itself.⁷⁴

Finally from a practical standpoint, we believe society has already made a favorable judgment regarding subsidizing a highly similar training arrangement. Post-graduate legal training looks a lot like post-graduate medical training, which we willingly subsidize. Despite two years of clinical training in medical school, newly graduated doctors must undertake a one-year internship and then a residency under the close supervision of experienced physicians with a mandate to train

⁷² See AMERICAN BAR ASSOCIATION TASK FORCE ON THE FUTURE OF LEGAL EDUCATION, DRAFT REPORT AND RECOMMENDATIONS 6 (Sep. 20, 2013), available at http://www.americanbar.org/content/dam/aba/administrative/professional_responsibility/taskforcecomments/task_force_on_legaleducation_draft_report_september2013.authcheckdam.pdf.

⁷³ Spieler, *supra* note 4, at 369-376.

⁷⁴ Berenson, *supra* note 5.

new doctors. Only after they have completed such programs are new doctors viewed as fully qualified to practice on their own. In all, this post-graduate training typically takes 3-5 years. As with the post-graduate legal training program described here, the new doctors are paid for their services, though below market rates, and hospitals charge clients for the services rendered.

According to a recent report, the government contributes approximately \$15 billion to subsidize post-graduate medical training through Medicare and Medicaid,⁷⁵ in addition to funding other agencies, such as the National Institutes of Health and the Department of Veterans Affairs and the states. This funding supports approximately 115,000 residents each year at a cost of about \$100,000 per resident per year, or about \$500,000 per each new physician. Millions of Americans, otherwise unable to afford medical services, benefit from these subsidies, which can be justified based on the positive externalities associated with a healthy populace.⁷⁶

Medicine and law clearly differ, and one could argue that the failure to train doctors adequately within the medical school setting is greater than the failure to train lawyers, because the consequences of a market failure in medicine are more significant than in law. After all, a shortage of trained doctors could lead to loss of life, while the lack of trained lawyers typically has only monetary consequences. However, not all medical issues are life threatening, and bad lawyering could lead to loss of liberty and even life in the criminal context. Lawyers help establish and protect individual rights, act as transaction cost engineers,⁷⁷ and aid with the smooth functioning of the legal system. While private parties capture many of these benefits, society as a whole benefits when people are well represented.

Moreover, the proposal regarding post-graduate legal education does not require direct investment. Nor is it likely to involve anywhere near the amount of government subsidy as is seen in medicine. Given the anticipated lack of profits at post-graduate legal training programs, the subsidy will likely be limited to the taxes that would have been paid on amounts donated to such organizations.

Given the positive externalities associated with legal education and the negative externalities that arise when people are not well

⁷⁵ Catherine Dower, *Health Policy Brief*, HEALTH AFFAIRS, (Aug. 16, 2012), http://healthaffairs.org/healthpolicybriefs/brief_pdfs/healthpolicybrief_73.pdf.

⁷⁶ Miranda Perry Fleischer, *Libertarianism and the Charitable Tax Subsidies*, 56 B.C. L. REV. 1345, 1389 (2015).

⁷⁷ See Ronald J. Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 YALE L.J. 239 (1984); Symposium, *Forward: Business Lawyers and Value Creation For Clients*, 95 OR. L. REV. 1 (1995).

represented, we believe post-graduate legal training programs are worthy of a subsidy in the form of tax exemption and the ability to receive tax-deductible donations.

B. Post-Graduate Legal Training Programs Within the University Setting

A program operating within the university setting would either operate as an activity of the law school or as a separate legal entity owned by the law school or university, such as a single-member Limited Liability Company (LLC) or a controlled non-profit corporation. How such programs are treated and the impact on the sponsoring law school depends on whether the law school is public or private and how the program is organized.

1. Public Law Schools

State entities, including universities, generally do not need to qualify for tax-exemption under section 501(c)(3).⁷⁸ Instead, they are exempt from federal income tax because of sovereign immunity or because the Code does not identify government entities as taxpayers.⁷⁹ If a post-graduate training program is operated without separate legal form, it would be considered an activity of the law school and would partake of the law school's tax exemption and factor into decisions about whether exemption was appropriate, in the first place.

If the program is organized as a separate legal entity,⁸⁰ perhaps to protect the school against liability, the path to exemption depends on the type of entity formed. One option would be to organize the program as a single-member LLC, with the law school acting as the sole member. Single-member LLCs are generally ignored for tax

⁷⁸ See Ellen P. Aprill, *Excluding the Income of State and Local Governments: The Need for Congressional Action*, 26 GA. L. REV. 421 (1992) (hereinafter Aprill GA).

⁷⁹ See I.R.S. Gen. Couns. Mem. 14,407 (Jan. 28, 1935). See Rev. Rul. 71-131 and 71-132; see also Ellen P. Aprill, *The Integral, the Essential, and the Instrumental: Federal Income Tax Treatment of Governmental Affiliates*, 23 J. CORP. L. 803 (1998) (hereinafter Aprill IA). Most state schools are probably not considered the state or a political subdivision thereof because schools do not exercise one of the three sovereign powers of a state: (1) power to tax, (2) power of eminent domain, or (3) the police power. See *Shamberg's Estate v. Comm'r*, 3 T.C. 131, (1944), aff'd, 144 F.2d 998 (2d Cir. 1944), cert. denied, 323 U.S. 792 (1945). Instead, they are probably considered an integral part of the state.

⁸⁰ In some cases, this may not be possible. See, e.g., ARIZ. CONST., art. IX, § 7 (banning state entities from owning stock in or otherwise owning companies).

purposes,⁸¹ and any activity carried out by such a program would simply be considered the activity of the school and automatically exempt, though potentially subject to UBIT.⁸²

Alternately, the law school could create a controlled non-profit corporation. Such entities might be granted tax-exempt status under a number of different theories. First, the corporation could apply for 501(c)(3) status, discussed below in Part IV.C. Second, it could be considered exempt as an “integral part” of the law school or university. The IRS treats an organization as an integral part of a state or political subdivision when the state or political subdivision controls the organization’s operation without an independent organizational structure,⁸³ though in some cases such structures are permitted.⁸⁴ Unfortunately, as Professor Aprill has noted,⁸⁵ the IRS has been inconsistent in how it applies these rulings, and any school taking this path would probably need to seek a private letter. While we believe that tax-exempt status should be allowed for the policy reasons noted above, it is not clear how the IRS would actually rule.

Third, a public school could attempt to fit the program within Code § 115.⁸⁶ Section 115 does not technically exempt the entity from

⁸¹ Organizations typically treat single member LLCs as partnerships for tax purposes. In such cases, LLCs are ignored for tax purposes.. Treas. Reg. 301.7701-3(a). However, members may elect to treat LLCs as corporations for tax purposes. In such cases, activities at the LLC would no longer be considered an activity of the law school.

⁸² Contributions to LLCs wholly owned by a section 501(c)(3) parent are deductible as charitable contributions if the contribution meets the requirements of I.R.C. § 170. See I.R.S. Notice 2011-52, I.R.B. 2011-30 (Jun. 25, 2011).

⁸³ See Rev. Rul. 60-384, 1960-2 C.B. 172; Rev. Rul. 87-2, 1987-1 C.B. 18; See also Aprill IA *supra* note 66, at 810.

⁸⁴ *Id.*, citing to I.R.S. Priv. Ltr. Rul. 97-33-003 (May 9, 1997); I.R.S. Priv. Ltr. Rul. 97-06-006 (Nov. 8, 1996); I.R.S. Priv. Ltr. Rul. 96-27-016 (Apr. 5, 1996); I.R.S. Priv. Ltr. Rul. 96-22-019 (Feb. 28, 1996). The IRS has suggested that, where the state is “substantially involved” in an organization’s activities, it can be considered an integral part. Joseph O’Malley, Elizabeth Mayer, and Marvin Friedlander, *State Institutions – Instrumentalities*, IRS Continuing Professional Education Text, (1996). <http://www.irs.gov/pub/irs-tege/eotopicf96.pdf>. The following factors are important in determining involvement: (1) creation of the organization by executive order of the governor of a state, (2) creation of the organization by executive order of the governor of a state as an official state agency, (3) a state or a state agency having the power to appoint and remove the organization's board, (4) a state or a state agency having the power to abolish the organization, (5) a state or a state agency monitoring the organization's activities, and (6) the organization using government employees to conduct its activities.

⁸⁵ See Aprill IA, *supra* note 66.

⁸⁶ Rev. Rul. 60-384, 1960-2 C.B. 172.

taxation; instead, it excuses from tax any income derived from the exercise of an “essential governmental function” that accrues to a state or political subdivision.⁸⁷ Integral part and Code § 115 are similar, but important differences exist. In particular, Code § 115 requires less day-to-day control. The IRS tends to be quite lenient in construing both the “essential governmental function” and “accruing” elements,⁸⁸ while courts have taken a more stringent view, leaving legal advice on the matter somewhat challenging. The primary reasons for seeking exclusion under either the integral part doctrine or Code § 115 over Code § 501(c)(3) would be to eliminate the Form 990 filing requirement and escape general supervision by the IRS under provisions such as Code § 4958 (excess benefit transactions).

From a tax perspective, it would be much easier for a school to run the program as an activity or through an LLC. The other approaches only make sense if non-tax considerations precluded doing so. Regardless of the legal theory for exemption or how the program is organized, the primary tax-related danger for a public law school is whether any income the program generates would be subject to UBIT, which is discussed below in Part IV.C.4.⁸⁹

2. Private Law Schools

Unlike public law schools, private law schools typically obtain tax-exempt status by qualifying as charitable organizations under Code § 501(c)(3). To qualify under that section, entities must be organized and operated exclusively for one or more exempt purposes. Education is one of the approved exempt purposes.⁹⁰ Having a substantial non-exempt purpose is fatal to an organization’s application or continuing exempt status, even if an organization has several exempt purposes.⁹¹ Thus, unlike with public schools, whose tax exemption is secure, operating a post-graduate training program within a private school could potentially put the school’s tax exemption at risk, in addition to raising UBIT questions.⁹²

⁸⁷ I.R.C. § 115. Under this provision, the program would be able to receive tax-deductible donations and grant funding from private foundations, just like organizations granted tax-exempt status under Code § 501(c)(3).

⁸⁸ See Aprill (GA), *supra* note 65.

⁸⁹ Any law school considering operating a program within the law school that has issued tax-exempt bonds should also examine whether the operation of such a firm could cause problems for its tax-exempt bond status under Code § 145.

⁹⁰ I.R.C. § 501(c)(3).

⁹¹ See *Better Business Bureau v. United States*, 326 U.S. 279 (1945).

⁹² *C.f.* Rev. Rul. 2004-51, 2004-1 C.B. 974 (2004) (reviewing both exempt status and UBIT questions as a result of a joint venture conducted by a university).

As before, a program operated without any separate legal structure or as a single-member LLC is simply considered a law school activity,⁹³ and the program would derive its tax exemption directly from the law school because it is the law school. As Professor Colombo has noted, it seems highly unlikely that a program's activities would threaten a law school's tax-exempt status.⁹⁴ To do so, the program would have to constitute a substantial non-exempt purpose. Assuming the program is designed with training lawyers as its primary goal, it seems unlikely that the program would be deemed a separate, non-exempt purpose. In contrast, a program designed to benefit individuals, such as the supervising attorneys, could be deemed a non-exempt purpose. However, it seems unlikely that such a program would be deemed substantial given the relative size of most law schools, whether measured by revenue, assets, employees, or hours worked. For the post-graduate training program to endanger a law school's tax exemption, the program would have to grow to a mammoth size, such that revenue from the sale of legal services exceeded that of the law school on a regular basis.⁹⁵

More likely is that program profits could be subject to UBIT. Professor Colombo concludes that if conducted within the law school, it is highly likely that the activity would be considered substantially related to the law school's exempt purpose and thus not an unrelated business activity. However, we caution that, if the program were conducted without sufficient regard to the educational mission, the activity could be deemed unrelated to the school's educational mission. The prudent law school should adopt clear rules to ensure that the educational mission dominates, as discussed below in our recommendations in Part IV.C.4. Even if the IRS were to determine

⁹³ The school could also consider entering into a joint venture with a for profit organization in the form of an LLC. The LLC would not obtain exemption, but its activity would be attributed to the law school. This could affect its exempt status if too much private benefit accrues to the for-profit partner or create an obligation to pay UBIT on the venture's income. The IRS has approved this structure under certain conditions. *See* Rev. Rul. 98-15 and Rev. Rul. 2004-51. Among other things, the charity needs to exercise control over matters that would affect the venture's exempt purpose. *See* Rev. Rul. 98-15 and Rev. Rul. 2004-51. We do not consider the joint venture option further because we believe it presents unnecessary complications. For a thorough analysis of the issues raised by joint ventures of nonprofit organizations, *see* MICHAEL I. SANDERS, JOINT VENTURES INVOLVING TAX-EXEMPT ORGANIZATIONS, (3rd Ed. 2007).

⁹⁴ Colombo, *supra* note 64, at ____.

⁹⁵ We discuss the legal standard and its application in greater detail in the context of stand-alone programs, where the fee-for-service aspect of programs looms much larger.

UBIT applied, the ruling would not have a significant financial impact because such programs are unlikely to turn a profit and consequently should owe little if any in tax.

C. Stand-Alone Post-Graduate Training Programs

1. Qualify for 501(c)(3) Status Under Current Guidance

Qualifying a stand-alone program as a tax-exempt charity depends on the type of entity formed. One possibility is to create the program as a single member LLC owned by an existing tax-exempt organization, such as a free-standing alumni organization or university foundation. As noted above, the LLC would generally be disregarded for tax purposes, unless it elected to be taxed as a corporation. However, the affiliation could pose a number of tax issues for the sponsoring organization. At the very least, the sponsoring organization would be required to notify the IRS on its Form 990, but it may also want to seek clarification from the IRS on its status to ensure that the change does not threaten its exempt status.⁹⁶ Multi-member LLCs present significant difficulties and may not be worth the effort.⁹⁷ This leaves non-profit corporations as the best choice if tax-exemption is to be sought. Such organizations must qualify in their own right.

Post-graduate legal training programs that provide legal services to paying clients do not fit easily within categories of legal service organizations for which tax exemption is readily available. Nonetheless, a path does exist that is consistent with both the letter

⁹⁶ Tax exemption letters from the IRS provide certainty regarding the activities disclosed to the IRS in the application. An organization that significantly changes its activities must provide notice to the IRS on its Form 990. However, such notice does not provide the organization any assurance from the IRS that it remains in compliance with the exempt requirements. Before beginning to operate the program, the organization may want to seek a private letter ruling from the IRS to ensure that the new activity will not jeopardize its exempt status. *See* IRS Pub. 4221-PC, Compliance Guide for 501(c)(3) Public Charities, 23, <http://www.irs.gov/pub/irs-pdf/p4221pc.pdf>. (last checked Sept. 13, 2015). The organization could also choose to have the LLC apply separately for exemption, but the LLC would no longer be disregarded, and we are back to our argument below in Part IV.C. *See* IRS Instructions for Limited Liability Company Reference Sheet, Part I, Q 1 & 2, http://www.irs.gov/pub/irs-tege/lc_guide_sheet_instructions.pdf.

⁹⁷ *See* note 93, *supra*. The Service allows LLCs to qualify as a charitable organization where they meet a 12-part test including that its only members are other charitable organizations or government entities. *See* Richard A. McCray & Ward L. Thomas, *Limited Liability Companies as Exempt Organizations – An Update*, 27 IRS Exempt Organization Continuing Professional Education (2001).

and spirit of current guidance. We believe the path is narrow and will require constant vigilance on the part of those that direct such programs. However, programs that have education as their primary purpose and use appropriately scaled on-the-job training in a commercial setting to accomplish this purpose should qualify under both the general guidance on tax exemption and the specific guidance directed to charitable organizations that provide on-the-job training.

a) False Starts

At first blush, one might think that stand-alone post-graduate legal training programs could qualify as tax exempt under Code § 501(c)(3) as a qualified legal services organization or by virtue of the low-cost services they provide to those who cannot afford lawyers.⁹⁸ If nothing else such programs seem quite similar to medical residency programs, and one might think that the rationale in the former context would work in the latter. Unfortunately, none of these approaches provides a clear path to exemption.

First, most programs would not qualify as public interest law firms. The IRS has defined public interest work to be the type of work that for-profit firms will not take, typically because the private interests are insufficient to warrant hiring a lawyer.⁹⁹ It has also generally limited public interest firms from receiving more than 50% of their support from fees charged to clients.¹⁰⁰ By design, most post-

⁹⁸ IRS guidance clearly creates a path for four different types of legal services organizations: (1) legal aid organizations providing assistance to low income individuals for free or a small fee, (2) human and civil rights defense organizations, (3) public interest law firms, and (4) organizations that attempt to achieve charitable goals through litigation itself. See *Litigation by 501(c)(3) Organizations*, IRS Exempt Organizations Continuing Professional Education (1984). <http://www.irs.gov/pub/irs-tege/eotopicd84.pdf>. Programs are not likely to fit under the second and fourth categories.

⁹⁹ The IRS explained in Rev. Rul. 75-74 and 75-75 that private interests sufficient to warrant hiring an attorney suggest that no public interest exists. More recently, the IRS has permitted public interest firms to charge fees, subject to limitations, suggesting a broader view of public interest. However, such firms must set their policies and programs through a committee representative of the public interest.

¹⁰⁰ Rev. Proc. 92-59 at §4.05. Initially firms were barred from seeking or accepting attorneys' fees from clients, Rev. Proc. 75-13 at §3.01, but they were allowed to accept fees paid by the opposing side or awarded by courts. *Id.* at §3.02. However, they could not consider the likelihood of fee recovery in their decision whether to take a particular case. *Id.* at §3.03; see also Rev. Rul. 75-76 ruling that neither the expectation nor possibility of a fee award could be a substantial motivating factor in the decision to take a case and requiring public

graduate training programs will seek to represent a mix of low-income and middle-income parties in private disputes, making it unlikely that the work done would count as public interest. In addition, most programs will depend primarily on fees for support, violating the 50% limit.¹⁰¹

Second, it seems unlikely that most programs will qualify as legal aid organizations. Organizations that provide legal services to the indigent for free or at a nominal fee can qualify for tax exemption,¹⁰² and some programs may have received tax-exempt status under this rule.¹⁰³ However, the IRS has also held that providing below-market goods or services to those simply unable to pay market rates is not a charitable purpose under Code § 501(c)(3) and could indeed defeat tax exemption.¹⁰⁴ In other contexts, the IRS has suggested that, where a service is not “inherently charitable,” the service must be provided at “substantially below cost” to obtain exemption.¹⁰⁵ Organizations that provide services to those beyond the poor or near poor or that must survive on the fees they charge clients seem unlikely to qualify.¹⁰⁶ It is

interest firms to stop handling cases with a strong possibility of a fee award if such cases become economically feasible for private litigants). The IRS liberalized the rules in 1992 and now permits firms to charge their clients. However, they cannot charge more than their actual costs. Rev. Proc. 92-59 at §5.01. Nor may they withdraw from a case if the client cannot pay. *Id.* at §5.02.

¹⁰¹ The 50% rule formally applies only to public interest law firms, and, if the IRS wished to promote low-bono firms, it could create a different rule for such firms and expand on the notion of what constitutes a legal aid organization.

¹⁰² Rev. Rul. 78-248, 1978-2 C.B. 177 (advising that legal organization that represented indigents and charged fees based upon the indigents' limited abilities to pay provided substantial economic relief to the poor and distressed considered exempt). *See also*, Rev. Rul. 72-559, 1972-2 C.B. 247 (advising that providing subsidies to recent law graduates to establish practices in economically depressed communities does not jeopardize tax-exempt status).

¹⁰³ Such organizations likely received private letter rulings from the IRS, which are only applicable to their particular facts and circumstances and have no precedential value.

¹⁰⁴ Rev. Rul. 73-127 (sale of groceries to the poor at below-market prices deemed not to be an exempt purpose); *Federation Pharmacy Services, Inc. v. Commissioner*, 72 T.C. 67 (1979), *aff'd* 625 F.2d 804 (8th Cir. 1980) (pharmacy that sold drugs at cost to the elderly and the handicapped did not qualify for exemption).

¹⁰⁵ *See* 1986 EO CPE Text, H. 501(c)(3), available at <http://www.irs.gov/pub/irs-tege/eotopich86.pdf>, and indicated that fifteen percent of cost qualifies as substantially below cost. Rev. Rul. 71-529, 1971-2 C.B. 234.

¹⁰⁶ We note that in both the medical and educational contexts, charitable organizations provide services at market rates to all comers, suggesting that there should be room for other types of organizations to do so without risking their tax

possible that the IRS has changed the norm for legal assistance organizations. However, it is not apparent from the published guidance.

Whether providing low bono services alone should qualify as an exempt purpose is beyond the scope of this Article. However, if the IRS is taking a broad view of what qualifies as a legal aid organization, it should publish guidance that clearly sets forth the requirements for qualifying as a legal aid organization, thereby clearing up any uncertainty or confusion.

Finally, the rationale covering non-profit hospitals and medical residency programs is not a clean fit because it is based on the provision of medical services. Much like legal training programs, medical residency programs train recent graduates, whom they pay, while providing services to a wide range of patients and charging market rates for the services they provide. However, the justification for exempting medical resident programs does not appear primarily to be the educational function served. Instead, the provision of medical services is charitable because operated for the benefit of the community.¹⁰⁷ As the IRS recognized in Revenue Ruling 69-545, promoting health for the benefit of the community has long been

exempt status. Indeed, in the housing context, the IRS has allowed the sale of services or goods to the poor and middle class combined, so long as substantially all of those receiving the housing are low-income individuals. Rev. Rul. 70-585, 1970-2 C.B. 115; Rev. Proc. 96-32, 1996-1 C.B. 717 (IRS provided safe harbor for low-income housing assistance organizations set up to assist low and moderate income residents if 75 percent of the units are occupied by families who are low-income (meaning 80% of the median local income)). However, cf. Rev. Rul. 2006-27, 2006-1 C.B. 915, in which the IRS appears concerned about whether significant private benefit is involved in these types of transactions.

¹⁰⁷ Rev. Rul. 69-545, 1969-2 C.B. 117 (a nonprofit hospital qualifies for exemption where it operates for the benefit of the community by (1) maintaining a community board, (2) providing services to all in the community who can pay, and (3) operating an emergency room open to all, including those who cannot pay) The primary distinction between a for-profit and a nonprofit, tax exempt hospital for some time has been the non-distribution constraint imposed on tax-exempt hospitals. Although Rev. Rul. 69-545 noted that an emergency room open to all was an important factor in justifying the exemption, the Emergency Medical and Labor Treatment Act in 1986 (Section 1867(a) of the Social Security Act) imposed that obligation on all hospitals. The Patient Protection and Affordable Care Act imposed new rules on tax-exempt hospitals that provide a bit more distinction between these two types of organizations. Code § 501(r) requires tax-exempt hospitals to perform a community health needs assessment, adopt a financial assistance, new billing, and collection policies, and limit charges to patients.

recognized a charitable purpose even when not necessarily strictly directed toward the interests of the poor. Whether right or not, providing legal assistance is simply not seen as an inherently charitable activity, and a training program for such an operation must take a different path to exemption.¹⁰⁸

b) Education With On-The-Job Training As The Path To Exemption

Despite the false starts described above, current guidance offers two paths to tax exemption for post-graduate legal training programs. One possibility is that law-school affiliated programs could be granted exemption because they advance the mission of their affiliated schools. The other is that such programs advance education in their own right, even if they don't look like traditional educational institutions. This latter approach paves the way for non-law-school affiliated programs.

1. Indirect Exemption

The IRS has held that organizations that provide commercially available services can receive tax exemption if they advance the interests of an exempt educational institution.¹⁰⁹ For instance, the IRS

¹⁰⁸ The closest analogue within the medical context for post-graduate legal training programs is faculty group practice organizations. See BNA Tax Management Portfolios - Estates, Gifts & Trusts Series EXEMPT ORGANIZATIONS/PRIVATE FOUNDATIONS 451-1ST T.M., TAX-EXEMPT ORGANIZATIONS: OPERATIONAL REQUIREMENTS, available at <http://www.bna.com/taxexempt-organizations-reporting-h2147483995/>. These are groups of medical school faculty employed in part by a hospital or higher education institution, but incorporated pursuant to a state law as a group of doctors engaged in private practice. The practice bills patients and pays the doctors an amount in addition to any base salary from the university or hospital. The doctors typically teach and train medical residents as part of their private practice. The IRS originally refused to grant these practice groups exemption because they believed the doctors received too much private benefit; but the IRS lost a series of cases in the 1980s, and it now generally recognizes such practices as exempt as long as they follow fairly strict guidelines. *University of Massachusetts Medical School Group Practice v. Comr.*, 74 T.C. 1299 (1980), acq., 1980-2 C.B. 2; *B.H.W. Anesthesia Foundation, Inc. v. Comm'r.*, 72 T.C. 681 (1979), nonacq., 1980-2 C.B. 2. The rationale for granting these programs tax-exempt status seems to be that they are an integral part of the exempt entity they are associated with and that they promote health. While not directly on point, these authorities suggest that commercial activities can be affiliated with charitable organizations, where the commercial activity is closely associated with the teaching mission.

¹⁰⁹ These rulings seem closely connected to the integral part doctrine discussed above in Part IV.B. For a discussion of this theory, see Roderick Darling & Marvin Friedlander, *Virtual Mergers Hospital Joint Operating Agreement*

has granted tax exemption to college bookstores,¹¹⁰ dorms,¹¹¹ cafeterias, and restaurants,¹¹² as well as to providers of scholarships and low-interest loans to college students.¹¹³ It has also found that a separately incorporated non-university controlled alumni association that raises funds for university programs, engages in public relations work on behalf of the university, publishes an alumni magazine, and supervises the sale of football tickets allotted to alumni is exempt from tax because substantially all of its activities aid education.¹¹⁴

Relatedly, the IRS has suggested that exempt organizations can create separate entities over which they have substantial control and seek exemption under the integral part theory, which is similar to that discussed above in the context of public schools.¹¹⁵ In a non-precedential statement, the IRS stated that an existing exempt organization must exercise “sufficient control and close supervision . . . to establish the equivalent of a parent and subsidiary relationship,” and that the organization seeking exemption “must perform essential services that if performed by the exempt organization itself would not be an unrelated trade or business.”¹¹⁶

None of the cases cited above involve an organization similar to the post-graduate legal training program described here. Nonetheless, post-graduate legal training programs will support their affiliated law schools and advance their goal of producing well-trained lawyers.

Affiliations, 1997 IRS Continuing Professional Education text. <http://www.irs.gov/pub/irs-tege/eotopicj97.pdf>. However, the rulings and holdings do seem to stand on their own, supporting the idea of an independent ground for allowing exemption.

¹¹⁰ *Squire v. Students Book Corp.*, 191 F.2d 1018 (9th Cir. 1951).

¹¹¹ Rev. Rul. 76-336, 1976-2 C.B. 143 (nonprofit corporation that provides housing to students at college where (1) neither the community nor the college are able to provide adequate housing, (2) the organization consults with the college and (3) the corporation locates the housing near to the college advances education and thus is operated for a charitable purpose under § 501(c)(3)).

¹¹² Rev. Rul. 58-194, 1958-1 C.B. 240 (corporation “organized for the purpose of operating a book and supply store and a cafeteria and restaurant on the campus of a State university primarily for the convenience of its student body and the members of its faculty . . . operated exclusively for educational purposes”).

¹¹³ Rev. Rul. 63-220.

¹¹⁴ Rev. Rul. 60-143, 1960-1 C.B. 192, (1960).

¹¹⁵ See, e.g., Rev. Rul. 78-41, 1978-1 C.B. 148, (Malpractice trust “serving as a repository for funds paid in by the hospital, and by making payments at the direction of the” operates as an integral part of the hospital and is therefore tax-exempt under Code § 501(c)(3)).

¹¹⁶ Roderick Darling & Marvin Friedlander, *Virtual Mergers Hospital Joint Operating Agreement Affiliations*, 1997 IRS Continuing Professional Education text. <http://www.irs.gov/pub/irs-tege/eotopicj97.pdf>.

Such activities would not likely be viewed as unrelated if carried on within the schools. Accordingly, despite commercial overtones, the IRS could use this line of authority to grant tax exemption to a post-graduate training program closely affiliated and supervised by a related law school.

2. Direct Exemption

The more direct approach focuses on the educational efforts of the programs themselves. A properly designed program should qualify under the general guidance for Code § 501(c)(3) and the specific guidance addressing charitable organizations that provide on-the-job training. The key to this approach is to ensure that any commercial activity is clearly “in furtherance of” the programs’ educational purpose and is properly scaled to that purpose. We start with the general rules before moving on to the more specific guidance.

a. General Guidance

Code § 501(c)(3) affords tax exemption to organizations that pursue educational purposes. Educational purposes include “[t]he instruction or training of the individual for the purpose of improving or developing his capabilities....”¹¹⁷ Code § 501(c)(3) also permits exemption for organizations that pursue charitable purposes. Advancement of education is included as a charitable purpose and therefore serves as a separate ground for exemption.¹¹⁸ Even though post-graduate training programs are not traditional schools, for which exemption is readily available,¹¹⁹ they clearly pursue educational purposes and advance education.¹²⁰ The question will be whether the

¹¹⁷ See I.R.C. § 501(c)(3) and T.R. § 1.501(c)(3)-1(d)(1)(iv)(2).

¹¹⁸ T.R. § 1.501(c)(3)-1(d).

¹¹⁹ Schools typically maintain a regular faculty, have a curriculum, and a regularly enrolled student body. See I.R.C. § 170(b)(A)(ii). They also typically charge tuition and award degrees. The examples provided in the Treasury regulations include “a primary or secondary school, a college, or a professional or trade school.” Treas. Reg. § 1.501(c)(3)-1(d)(3)(ii). To be clear, not all educational institutions are granted tax exemption. Organizations that violate public policy are not entitled to tax-exempt status. See *e.g.*, *Bob Jones University v. United States*, 461 U.S. 574 (1983). Moreover, where a school serves a private, as opposed to a public, interest, tax exemption is not permitted. Thus, if McDonald’s created McDonald’s U to train new employees, tax exemption would be inappropriate. John D. Colombo, *Why is Harvard Tax-Exempt? (and Other Mysteries of Tax Exemption for Private Educational Institutions)*, 35 ARIZ. L. REV. 841, 847 (1993).

¹²⁰ Although not precisely on point, the IRS has found that an organization providing funds for an on-the-job legal learning experience “advances education

commercial activity through which the on-the-job training is accomplished will somehow defeat exemption.

To qualify for charitable status, an organization must be organized and operated “exclusively” for charitable purposes.¹²¹ However, in construing the operational side of that test, the regulations interpret the term “exclusively” to require only that the organization be operated “primarily” for an exempt purpose.¹²² Under this standard, organizations are ineligible for tax-exempt status if a “more than insubstantial portion” of their activities is in pursuit of a non-exempt purpose.¹²³

Selling goods and services to paying customers, even at a discount, is not an exempt purpose, and therefore otherwise charitable organizations typically cannot be exempt if those activities are substantial. In such cases, the IRS will deny an organization exempt status because the organization has a “substantial commercial purpose.”¹²⁴ Two bits of related law and guidance complicate the

by supporting the training of individuals for the purpose of improving or developing their abilities.” Rev. Rul. 78-310, 1978-2 C.B. 173. This ruling supports a broad reading of educational purpose that should encompass providing training directly. Also, the IRS has approved an apprenticeship program established as a joint project of labor and management. Rev. Rul. 67-72, 1967-1 C.B. 125; *see also* Rev. Rul. 72-101, 1972-1 C.B. 144 (establishment of a school by labor and management to train employees).

¹²¹ I.R.C. § 501(c)(3).

¹²² T.R. § 1.501(c)(3)-1(c).

¹²³ T.R. § 1.501(c)(3)-1(c)(1). This interpretation likely comes from the Supreme Court’s interpretation in *Better Business Bureau of Washington, D.C., v. U.S.*, 326 U.S. 279 (1945) of a related statute found in the Social Security Act. *See* Philip Hackney, *A Response to Professor Leff’s Tax Planning “Olive Branch” for Marijuana Dealers*, 99 IOWA L. REV. BULL. (2014).

¹²⁴ *See, e.g., Living Faith, Inc. v. Comm’r*, 950 F.2d 365 (7th Cir. 1991) (affirming US Tax Court decision that Living Faith’s activities operating a health food restaurant demonstrated a “substantial commercial purpose” such that it did not qualify for tax exemption). *See also* JOINT COMMITTEE ON TAXATION, HISTORICAL DEVELOPMENT AND PRESENT LAW OF THE FEDERAL TAX EXEMPTION FOR CHARITIES AND OTHER TAX-EXEMPT ORGANIZATIONS (JCX-29-05) 51-52 (April 19, 2005). *See also* *Goldsboro Art League v. Comm’r*, 75 T.C. 337 (1980), in which the IRS informed the taxpayer, which ran a museum and provided art education in the community and also sold some of the art: “You are not operated for any exempt purpose within the meaning of Sections 501(c)(3) and 170(c)(2). You are operated in furtherance of a substantial commercial purpose. Further you serve private rather than public interests.” The court reversed the IRS because it found that the organization operated primarily for educational purposes. The sale of paintings did not rise to the level of primary purpose. The regulations do not

analysis. First, the regulations create an exception if the commercial activities are “in furtherance of” an organization’s exempt purpose. However, the organization cannot be organized primarily to carry on such activities.¹²⁵ Second, in 1950, Congress enacted the UBIT, which imposes a tax on a charitable organization’s unrelated business income. This implicitly allows organizations to carry on some quantum of an unrelated trade or business and to engage in any amount of a related trade or business, so long as it does not become a primary purpose.

To determine whether post-graduate training programs with significant on-the-job training aspects qualify for exempt status, we must first understand what “in furtherance of” means. One possibility, and one that would give the law coherence, is that the in furtherance requirement has the same definition as used in the UBIT context, that is, the activity must bear “causal relationship” and “contribute importantly” to the organization’s exempt purpose.¹²⁶

Another possible interpretation of “in furtherance of” is that the activity will be deemed in furtherance of exempt purposes if it generates revenues that are used to support such purposes.¹²⁷ This is often referred to as the “destination of income” test, and the inquiry focuses on whether the charitable support from an otherwise unrelated business activity is commensurate with the business activity.¹²⁸ We believe that Congress makes clear via the UBIT and Code § 502 that operating a business to generate revenue to support a charitable cause cannot be considered “in furtherance of” an exempt purpose. However, we offer it here for completeness.

describe what constitutes primary or substantial, which creates some uncertainty and puts significant pressure on the exceptions.

¹²⁵ T.R. § 1.501(c)(3)-1(e)(1). As the Tax Court noted in *Goldsboro, supra* note 124, “[a]n organization may engage in a trade or business as long as its operation furthers an exempt purpose and its primary objective is not the production of profits.”

¹²⁶ T.R. § 1.513-1(d)(2).

¹²⁷ The Supreme Court set this standard in *Trinidad v. Sagrada Orden*, 263 U.S. 578 (1924). See also, Rev. Rul. 64-182 (exemption granted to organization that operated a commercial real estate rental business to fund charitable activities).

¹²⁸ See, e.g., Rev. Rul. 64-182 (exempt org that operated a commercial real estate rental business to fund charitable activities granted exempt status). Under this theory, a business that generates significant revenues, only a small portion of which are used to support charity, will not be deemed in furtherance of charitable purposes. See, e.g., I.R.S. Gen. Couns. Mem. 34682, 1971 IRS GCM LEXIS 38, 18 (Nov. 17, 1971). Similarly, where a business fails to produce significant revenues to support charity, it will be deemed not to be in furtherance of charity, thus thwarting tax exemption. See, e.g., *Id.* at 23-24.

We must also determine when a business activity will be deemed an organization's "primary" purpose. Authorities have denied exemption where business interests dominate, sometimes referred to as the doctrine of "commerciality." For instance, a company organized to improve the quality of Sunday school texts, but which had expanded its offerings and accumulated over \$1.6 million in net earnings from the sale of books, lost its exemption because the authorities found that its primary purpose became the sale of books rather than the advancement of education or religion.¹²⁹ In other words, if the organization looks more like a commercial enterprise than a charity, and especially if the activity is loosely related to the exempt purpose, the organization will be deemed to be primarily engaged in commercial activity, thus precluding exemption.¹³⁰

Finally, there is the issue of "private benefit."¹³¹ Organizations that benefit private, as opposed to public, interests are typically denied exemption. For instance, in *Ginsberg v. Commissioner*, the Tax Court found an organization that dredged a private waterway for the sole benefit of the donors to the organization provided so much private benefit such that the organization was not operated primarily for an exempt purpose.¹³² More recently, the Tax Court found the American

¹²⁹ See, e.g., *Scripture Press Foundation v. U.S.*, 285 F.2d 800, 805 (Ct. Cl. 1961), cert. denied, 368 U.S. 985 (1962) (finding that based on evidence of significant growth of sales that the "sale of religious literature is its primary activity and that its instructional phase is incidental thereto."). But see *Presbyterian and Reformed Publ'g Co. v. Comm'r*, 743 F.2d 148 (3rd Cir. 1984) (upholding the exempt status of the Presbyterian and Reformed Publishing Co. in a seemingly similar situation).

¹³⁰ See, e.g., *B.S.W. Grp. Inc. v. Comm'r*, 70 T.C. 352 (1978) (finding that a purportedly non-profit consulting group looked too much like a for-profit consulting group to qualify as tax exempt).

¹³¹ The basis for this requirement appears to be Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii). Private benefit is similar to private inurement and often confused with it. Private inurement occurs where net earnings of an organization inure to a private shareholder or individual. I.R.C. § 501(c)(3). Private benefit is a broader concept that focuses on the beneficiaries of the organization's activities. Examples of private inurement include excessive salaries. Private inurement should not pose a problem for post-graduate training programs. For a discussion of private benefit, see Andrew Megosh, Mary Scollick, Mary Jo Salins and Cheryl Chasin, *Private Benefit under IRC 501(c)(3)*, 2001 EO CPE Text, available at <http://www.irs.gov/pub/irs-tege/eotopich01.pdf> and John D. Colombo, *Private Benefit: What Is It and What Do We Want It To Be*, National Center on Philanthropy and the Law Annual Conference Proceedings (2011) available at http://www1.law.nyu.edu/ncpl/resources/documents/JohnColomboFormattedNCP_LPaper2011.pdf.

¹³² 46 T.C. 47 (1966).

Campaign Academy, which trained individuals or candidates who intended to advocate only for Republicans, was not primarily operated for an exempt purpose.¹³³ Courts and the IRS recognize that all nonprofit organizations benefit some private interests. The question is whether the organization is operating more than “incidentally for the purpose of benefiting the private interests.”¹³⁴

Under these standards, post-graduate training programs should be granted exemption if properly designed. Certainly, the classroom and practical training aspects of stand-alone programs support a claim that their purpose is educational. The questions are (1) whether providing legal services to paying clients is “in furtherance of” the exempt educational purpose, (2) if not, whether it is a substantial non-exempt purpose, (3) whether it rises to the level of “primary” purpose, and (4) whether it creates a private, as opposed to public, benefit.

As noted above, there are two possible ways to construe “in furtherance of.” The first uses a definition similar to that used for UBIT, namely that the business activity must bear a “substantial relationship” to the organization’s exempt purpose.¹³⁵ The program’s exempt purpose is to train new lawyers. Providing legal services to fee-paying clients will contribute to this goal because it is the best way for new lawyers to gain the experiences necessary to develop their practice skills. Providing legal services is a necessary means, not an independent end,¹³⁶ and therefore should be viewed as in furtherance of that goal.

Post-graduate legal training programs would face greater difficulty under the destination of income test because they are not designed to generate income. The IRS has ruled that an organization

¹³³ American Campaign Acad. v. Comm’r, 92 T.C. 1053 (1989).

¹³⁴ See Rev. Rul. 98-15. For example, in *Goldsboro*, *supra* note 124, the court found that, even though the organization in question sold paintings and remitted 80% of the sale proceeds to the artists, the organization served a public purpose by primarily promoting art education and only incidentally served the artists’ private interests. *Goldsboro* at 345.

¹³⁵ T.R. § 1.513-1(d)(2).

¹³⁶ This contrasts sharply with cases where the IRS and courts have rejected claims that commercial activity was in furtherance of an exempt activity. For instance, in *Senior Citizen Stores, Inc. v. U.S.*, 602 F.2d 711 (5th Cir. 1979), the taxpayer operated a number of second hand stores and argued that they served the charitable purpose of aiding the elderly. The court held that the retail activity appeared to be an end in and of itself and not a means of accomplishing the charitable goal of assisting the elderly. In particular, the court noted that “less than half [the organization’s] employees were over the age of 55, and their training was restricted to the needs of plaintiff’s business. Plaintiff conducted no training program beyond the training of employees for its own shops.”

will fail this test if (1) the business activity does not generate funds to be used for exempt purposes or (2) it generates significant income, but only a small amount is used for charitable purposes.¹³⁷ Ironically, under this standard, a program focused on making money would be more likely to be considered “in furtherance of” an exempt purpose than one designed to provide training. We think this would be an odd reading of the statute, especially in a case like this one, where the business activity is so clearly linked to the exempt purpose.

If providing legal services to paying customers is deemed in furtherance of the exempt purpose, as we believe it should be, the activity should not be seen to be a primary purpose. If it is deemed not to further a program’s exempt purpose, in most cases that activity will be large enough to be considered a substantial non-exempt purpose, thus thwarting tax exemption.

Finally, post-graduate legal training programs do not appear to pose significant private benefit issues. The programs will not be preparing new attorneys for a specific firm, as would be the case of the hypothetical McDonald’s University, or the American Campaign Academy.¹³⁸ The IRS could assert that a given program is operated for the private benefit of the supervising attorneys members, as it did in the faculty medical practice group context.¹³⁹ To avoid this problem, care should be taken not to compensate attorneys based upon the return from the cases they bring in. The IRS could also assert that the programs operate for the benefit of the clients. However, on-the-job training cannot proceed without clients, and this would doom all such enterprises.

b. Specific Guidance – On-The-Job Training Programs

Post-graduate training programs need not rely on the general legal rules to support the claim that they deserve tax exemption. A number of authorities hold that organizations with on-the-job training in commercial settings can qualify for tax-exempt status so long as the training is in service, and appropriately scaled, to an exempt purpose. For instance, in Rev. Rul. 73-128, the IRS approved tax-exempt status for an organization that operated a toy-making business as a vehicle to train non-skilled persons who were unable to find good jobs.¹⁴⁰ The organization at issue operated a number of community programs, including remedial reading and language skills classes, general

¹³⁷ See *supra* note 128.

¹³⁸ *Supra* note 133.

¹³⁹ See *supra* note 108.

¹⁴⁰ Rev. Rul. 73-128.

counseling services, and a job-training program. Participants in the training program were paid to make toys, which were sold to the public via regular commercial channels. Some participants worked in management roles. The positions were not permanent. Rather, the goal was to place them in permanent jobs as soon as they were adequately trained. Income earned through the sale of the toys was used to fund other community services, and any shortfalls were covered by public contributions.

The IRS noted that the sale of products is not a charitable purpose, whereas the provision of vocational training to the unskilled and under-employed was, so long as the manner of doing so was otherwise charitable. The question was whether the business operation was an end in and of itself or instead the means by which the organization accomplished its charitable purpose. The IRS concluded that the toy making operation was a means to a charitable end based on the clear and distinct causal relationship between the activity and the training objective. Moreover, the scale of the toy making activity was appropriate to the level of training being provided.

In contrast, Rev. Rul. 73-127 involved an organization that operated a grocery store and spent only 4% of its revenues on training the “hard-core unemployed.” The rest of its operations were aimed at selling food at a discounted price to the poor. The IRS found that selling discounted food to the poor was not a charitable purpose, while helping the unemployed was. It also found that on-the-job training in commercial enterprises was an appropriate way to fulfill that purpose. However, because the grocery operation was substantially larger than necessary to carry out its charitable training mission, the IRS denied the organization tax-exempt status, finding that selling discounted groceries was a substantial non-exempt purpose.

Organizations that mix a charitable purpose with on-the-job training in commercial settings are becoming increasingly popular. For instance, Juma Ventures in San Francisco is dedicated to helping at-risk youth. It used to operate a number of Ben & Jerry franchises, which it uses to train its clientele in basic skills such as counting change, getting to work on time, etc., so that they can move on to jobs at for-profit organizations.¹⁴¹ It now has relationships with sports stadiums to do similar work.¹⁴² The Delancey Street Foundation in San

¹⁴¹ For more information about Juma Ventures, see <http://www.jumaventures.org/>.

¹⁴² See Juma Ventures Announces New Job Creation Program in New Orleans, Social Enterprise Alliance, (Dec. 4, 2012). <https://www.se-alliance.org/member-news/juma-ventures-announces-new-job-creation-program-in-new-orleans> (last checked Sept. 13, 2015).

Francisco is dedicated to helping the homeless. It operates a restaurant that it uses to train its clientele in the hopes that they will be able to find work elsewhere.¹⁴³ A number of partnerships between charities and for-profit businesses have also sprung up to create training opportunities for the disadvantaged.¹⁴⁴

We believe that a well-designed post-graduate legal training program fits within these authorities and examples. The fee-for-service aspect of the program is specifically designed to train the resident attorneys in the skills they will need. It will also be scaled to the educational purpose. If properly designed, resident attorneys will work on every matter handled. Every senior attorney in the program will supervise resident attorneys. Thus, such programs should fit easily within Rev. Rul. 73-128 and avoid the pitfall described in Rev. Rul. 73-127 and in *Senior Services, Inc.*¹⁴⁵

Some may believe that a training program for lawyers can be distinguished from those described in the precedents based on differences in the capabilities and salaries of lawyers, compared to those in the precedents. In particular, the exempt purposes served by the on-the-job training programs discussed in the guidance involve helping the poor. However, nothing in the precedents suggests that on-the-job training is *only* appropriate when helping the poor. Rather, they focus on the relationship between the training and the exempt purpose.¹⁴⁶ Organizations that train lawyers in practical skills, including law schools and continuing legal education providers, can be tax exempt because of their educational purpose.¹⁴⁷ It would be a strange rule that prohibited all on-the-job training in an educational context. We believe that same principle should hold here.

Before moving on to the UBIT analysis we make one more point about the clientele the program will serve. Were the program's exempt purpose to serve the poor, the fact that some clients will not be poor could be problematic. However, where the sale of services or goods is properly tailored to accomplish an exempt purpose, the IRS is willing

¹⁴³ For more information about the Delancey Street Foundation, see <http://www.delanceystreetfoundation.org/>.

¹⁴⁴ See Sussanah Camic Tahk, *Crossing the Tax Code's For Profit/Nonprofit Border*, 118 Penn St. L. Rev. (2014)489,. (Describing a number of partnerships between for profit companies and public charities).

¹⁴⁵ See *supra* note 136.

¹⁴⁶ A number of revenue rulings have held that apprenticeship programs, which typically involve work for clients, can be tax exempt. See, e.g., Rev. Rul. 77-272, 1877-2 C.B. 1919; Rev. Rul. 67-72.

¹⁴⁷ See, e.g., NATIONAL INSTITUTE FOR TRIAL ADVOCACY, <http://www.nita.org>.

to allow those services to be provided to the middle class, even at market rates. The most obvious examples are hospitals and educational institutions, but the IRS has accepted this possibility outside of those two narrow fields. This was certainly the case in Rev. Rul. 73-128, discussed above.

In Rev. Rul. 72-124, the IRS held that an organization that provided homes for the elderly could be exempt even where the provision of the services includes a majority of those who can pay for the services.¹⁴⁸ Similarly, the IRS has granted exemption to an organization that provided loans to business owners in high-density urban areas with significant poverty and neighborhood blight to stimulate economic development.¹⁴⁹ The IRS noted that although some of the recipients of the loans would not be members of a charitable class, the important thing was that these individuals were “merely the instruments by which the charitable purposes are sought to be accomplished.”

In the case of a post-graduate training program, serving the middle class is actually important to the exempt mission. Training new attorneys to advise businesses requires clients with businesses, which the poor by-and-large do not own or operate. Nor are they likely to have the resources to retain lawyers to perform this type of work, even at the reduced rates such programs will charge. Expanding the client base beyond the poor is critical to the training mission of producing practice-ready lawyers and can provide broad societal benefits, given the market’s failure to produce affordable legal services.

2. UBIT

Assuming a program is granted tax exemption, the question arises whether any income produced by on-the-job training can be considered “unrelated” to the charitable mission, such that it will be subject to UBIT. As noted above, the question of UBIT is important whether the program is conducted within law schools or outside, and whether the law school is public¹⁵⁰ or private. To qualify as an unrelated trade or business, an activity must meet three requirements: (1) it must be a trade or business, (2) regularly carried on, and (3) be not substantially related to the organization’s exempt purpose.¹⁵¹ The first two requirements are not in question for post-graduate training

¹⁴⁸ Rev. Rul. 72-124, 1972-1 I.R.B. 145 (1972). *See also*, Rev. Rul. 79-18, 1979-1 C.B. 194 (1979).

¹⁴⁹ Rev. Rul. 74-587, 1974-2 C.B. 162 (1974).

¹⁵⁰ I.R.C. § 513(a)(2).

¹⁵¹ I.R.C. § 513; T.R. § 1.513-1(a).

programs, leaving only the question whether the activity is substantially related to the programs' educational purpose.

While an organization's tax exemption is not in question for this analysis, an organization that engages primarily in substantially unrelated activities will not qualify as a tax exempt organization.¹⁵² The regulations under Code § 513 provide important guidance here, stating that "the size and extent of the activities involved must be considered in relation to the nature and extent of the exempt function which they purport to serve."¹⁵³ One example in the regulations is quite instructive and mirrors the authorities discussed above in the context of on-the-job training.¹⁵⁴ The example involves an organization that trains students for the performing arts and generates funds from the sale of tickets to performances. The example concludes that the performances contribute importantly to the accomplishment of the organization's exempt purpose. Accordingly, the income produced is from a substantially related trade or business and not subject to UBIT.

The IRS relied on this reasoning in Revenue Ruling 80-296, when it approved the sale of broadcast rights to collegiate sports games as a trade or business substantially related to the educational purpose of college athletics. It found that by exhibiting the game in front of a larger audience the organization promoted the school's educational purpose. In Revenue Ruling 76-94, the IRS considered a business run by an organization dedicated to helping emotionally disturbed adolescents. The organization operated a grocery store at which many of the youth worked. Working in the store was an integral part of the therapy and affected other aspects of life at the residential facility. Students were paid for their work and could use their salaries to defray the costs of their stay. The IRS held that the activity was scaled to the organization's exempt purpose and therefore was not an unrelated trade or business.¹⁵⁵

A post-graduate legal training program designed in accordance with the principles described below in Part IV.B.5 should readily qualify as a related business and thereby avoid UBIT.

3. Private Foundation or Public Charity Status

Although not a matter of tax-exemption, the post-graduate legal training program must also consider whether it will be treated as a

¹⁵² I.R.C. § 501(c)(3) and T.R. § 1.501(c)(3)-1(c).

¹⁵³ T.R. § 1.513-1(d)(3).

¹⁵⁴ T.R. § 1.513-1(d)(4), Ex. 1.

¹⁵⁵ I.R.C. § 513.

public charity or as a private foundation.¹⁵⁶ This issue is important because public charities are provided much more latitude under the Code than private foundations. As noted above, private foundations must distribute a certain percentage of their income or assets for charitable purposes each year.¹⁵⁷ The charitable contribution deduction under Code § 170 is much less generous for donations to private foundations than to public charities.¹⁵⁸ Additionally, private foundations face a bevy of excise taxes on behavior, such as self-dealing, excess business holdings, and a required demonstrated payout amount, that are costly to monitor and could restrict optimal functioning.¹⁵⁹

Public charities are given more latitude because they typically have a broad public constituency, and Congress trusts that their activities are more likely to be in the broad interests of the public. Schools, hospitals, churches, and organizations that receive broad public support from fundraising are considered public charities. Private foundations on the other hand typically receive their support from one family or a few families.

Schools (educational organizations in the Code) are considered public charities, but post-graduate legal training programs are unlikely to qualify under this provision because they will not operate with a full time faculty, a curriculum, and a regularly enrolled body of pupils or students.¹⁶⁰ Under some circumstances, programs may qualify as public charities because they receive a substantial part of their support from either a governmental unit or from contributions of the public.¹⁶¹ Most likely, programs will qualify because they receive more than one third of their support from a combination of contributions and grants and from the sale of its goods or services, where the sale of those goods or services qualify as part of its exempt purpose.¹⁶²

Alternately, they might attempt to qualify as a supporting organization under section 509(a)(3). An in-depth discussion of

¹⁵⁶ I.R.C. § 509.

¹⁵⁷ See Part IV.B.1, *supra*.

¹⁵⁸ I.R.C. § 170(b).

¹⁵⁹ I.R.C. § 4941 imposes a self-dealing excise tax on certain controlling persons of a private foundation; I.R.C. § 4942 imposes an excise tax on a failure to distribute income; I.R.C. § 4943 imposes an excise tax on excess business holdings.

¹⁶⁰ Named organizations include churches, hospitals, and schools. See I.R.C. § 170(b)(1)(A) via I.R.C. § 509(a).

¹⁶¹ I.R.C. § 170(b)(1)(A)(vi).

¹⁶² I.R.C. § 509(a)(2).

supporting organizations is beyond the scope of this article.¹⁶³ However, such organizations have very close ties to the public charities they support, such that they, too, can be considered public charities, much like organizations performing essential functions for tax-exempt organizations may be considered exempt. Support is generally established through interlocking boards and other provisions designed to show the close connection and alignment of interests between the public charity and its supporting organization.¹⁶⁴ Any program seeking tax exemption must consider how best to ensure that it falls on the public charity side of the line.

4. A Model Post-Graduate Training Program

Ideally, the IRS would issue clear guidance in the form of a revenue ruling making clear that post-graduate legal training programs can qualify for tax exemption and setting forth the parameters such programs must meet to qualify. Designing the specifics of such guidance is beyond the scope of this article. However, it would need to address both the scope of the educational activities required and the extent to which and at what price such programs could serve clients beyond those typically served by legal aid organizations.¹⁶⁵

In the interim, those creating post-graduate training programs must make do with the guidance that does exist. While the current guidance does not provide the certainty one might desire, at least the tax considerations are consistent with both the educational and legal

¹⁶³ For a discussion of supporting organizations, see <http://www.irs.gov/Charities-&-Non-Profits/Charitable-Organizations/Supporting-Organizations-Requirements-and-Types>. Some may think of the supporting organization route as a method to obtain exemption. However, exemption for a supporting organization must be independently established. Some may confuse the notion of integral part discussed above in Part IV.B.

¹⁶⁴ See IRS, Supporting Organizations – Requirements and Types, <http://www.irs.gov/Charities-&-Non-Profits/Charitable-Organizations/Supporting-Organizations-Requirements-and-Types>.

¹⁶⁵ With regard to the latter, one possibility might be to follow California Corporation's Code § 13406(b), which permits law firms to be non-profit public benefit corporations if they meet certain conditions, including that 70% of their clients must be lower income persons under the California Health and Safety Code, which is based on Housing and Urban Development (HUD) guidelines. Such an approach would allow for a significant range of eligible clients, while ensuring that the program was not simply competing in the regular legal market. Significant care would be needed to ensure that the rules created enough leeway for such firms to break even or at least come close. Otherwise, such firms may face unsustainable financial pressures.

access goals most programs will have. First and foremost, it is critical to establish an independent exempt purpose, which in most cases will be educational. The clearly stated mission of any such program should be to train young lawyers in the practical aspects of lawyering. To be clear, a by-product of this mission may be to provide free or low-cost legal services to those currently unable to afford lawyers. However, unless the program provides free or mostly free services to the poor, this is not the basis upon which we believe the post-graduate legal training program can acquire tax-exempt status under current guidance. Care must be taken to ensure that providing legal services to middle class individuals, even at reduced rates, does not rise to the level of a substantial non-exempt or the program's primary purpose.

While it is important from a training perspective that the program's on-the-job training be as similar to a for-profit operation as possible, from a tax perspective, care should be taken to distinguish the training activities from for-profit firms. The authorities taken as a whole reveal that organizations that look too much like for-profit entities will not be granted tax exemption, whatever the doctrinal justification may be.¹⁶⁶ Only where commercial activities serve an exempt purpose or are incidental to an exempt purpose is exemption allowed. The following suggestions should strengthen the case for granting stand-alone post-graduate training programs exempt status.

First, classroom education activities should be significantly greater than those found in for-profit firms. Resident attorneys should be trained on a wide variety of topics, including practical skills, such as how to take depositions, draft contracts, negotiate deals or settlements, and also cover the business of law, including how to price matters, bill clients, organize files and use technology. Programs should consider forming close relationships with other non-profit organizations, such as the sponsoring law school or state bar, to provide such training.

Second, care should be taken in the type of work selected. Work should not only be suitable to new lawyers, but it should also have significant pedagogical value. For instance, simple divorces often require negotiations (both with the client and the opposing side), limited discovery, and lead to short trials, all skills that young litigators need. Divorces can also often be completed within a year, thus giving the resident attorneys a good view of a case's life cycle. In contrast, programs should probably avoid practices that consist mainly of filling out forms, on the one hand, and overly complex matters requiring significant practice experience, such as reverse triangular mergers, on

¹⁶⁶ See, e.g., *B.S.W. Corp. Inc.*, *supra* note 130.

the other hand. Instead, they should focus on practice areas that young lawyers are likely to go into, such as family law, civil litigation, criminal defense, and transactional matters.

Third, the demands on the resident attorneys should be less than those found in for-profit firms. Associates in such firms are often required to bill 2000 hours, leaving little time for classroom learning or serious on-the-job mentoring. Resident attorneys should have billable expectations commensurate with their expanded classroom obligations and the expectation that they will be working closely with supervising attorneys who will treat each project as a teachable moment and learning opportunity. This will ensure that the on-the-job training element is truly focused on education and scaled to that task.

Fourth, resident attorneys should be allowed to stay for no more than three years, by which time they will have learned sufficient skills to be considered practice ready. This flips the for-profit model on its head¹⁶⁷ and mirrors the training program described in Rev. Rul. 73-128, where paid trainees moved on as soon as they developed sufficient skills to find private sector jobs. It also ensures that new positions will open each year and make these programs available to more new lawyers.

Fifth, the program should focus on areas or client groups that are not currently served by for-profit firms to minimize the extent to which the program competes with the private sector. While programs cannot focus exclusively on the poor absent outside funding, they could focus on the elderly,¹⁶⁸ minority groups, or veterans, all of whom have significant needs that are going unmet. Although not necessary,¹⁶⁹ the program should set rates below market to reach these clients. Doing so strengthens the claim that the program is not competing with for-profit businesses, but rather is serving clients the market has left behind. To be clear, we do not argue that providing low-cost legal services is a charitable purpose under current rules, though, if structured to serve a class of citizens whose legal rights are going undefended, maybe it should be. If such activities are disproportionate to the training needs of the educational purpose, the firm could fail to obtain tax-exempt status. Nonetheless, it is consistent with the idea discussed in the context of public interest law firms, that tax-exemption may be appropriate for organizations that fill market gaps.

¹⁶⁷ As noted above, most firms lose money on associates during the first few years and only reap the benefits of any training provided thereafter. *See supra* note **Error! Bookmark not defined.**

¹⁶⁸ *See, e.g.*, Rev. Rul. 72-124.

¹⁶⁹ *See, e.g.*, Rev. Rul. 73-128.

Sixth, the program should not be designed to turn a significant profit. Organizations that turn large profits seem far more commercial than charitable, even where the purpose of the activity is to advance an exempt purpose.¹⁷⁰

Seventh, although the authorities permit charitable organizations to pay market rate salaries,¹⁷¹ paying the resident and supervising attorneys salaries commensurate with what public sector lawyers make will further differentiate the program from for-profit firms.

Eighth, efforts should be taken to connect the program to other exempt organizations. For instance, it might be advisable to put leaders of legal focused non-profits, such as the state bar or community legal services, on the organization's board or use members of the school's alumni organization to provide the classroom training. Creating a tight connection between the program and other tax-exempt organizations will highlight the program's non-profit nature and may help it qualify as a supporting organization, for purposes of qualifying as a public charity, if necessary.

Programs should also consider creating a community board that includes individuals from the law school, the state bar, the court system, and important community leaders, who can ensure that the organization is thinking broadly about their mission and focused on the community in which they operate. It might also be advisable to conduct a regular community needs assessment to determine how well it is fulfilling the legal and educational needs of its community.¹⁷²

Finally, and perhaps most important, the scale of the practice must be proportional to the training need.¹⁷³ Getting the scaling correct will avoid the risk identified in Rev. Rul. 73-127 that the commercial activity through which on-the-job training occurs will be

¹⁷⁰ See *Scripture Press Foundation v. U.S.*, 285 F.2d 800, 805 (Ct. Cl. 1961), cert. denied, 368 U.S. 985 (1962). Earning profits would be permissible under the destination of funds definition of "in furtherance of," if the excess revenues were used to support an exempt purpose. Nonetheless, doing so might call into question the program's primary purpose.

¹⁷¹ Treas. Reg. § 53.4958-6.

¹⁷² Congress recently imposed such a requirement on hospitals in Code § 501(r). While not a requirement for any other organizations, Congress has indicated that they are important in demonstrating an organization is trying to meet community needs.

¹⁷³ See, e.g., Rev. Rul. 73-128 (toy-making business that trained workers and sold the output at market rates deemed a means to a charitable end because there was a clear and distinct causal relationship between the training and the charitable purpose). See also Rev. Rul. 76-94; T.R. § 1.513-1(d)(4), Ex. 1 (discussing this same issue in the context of UBIT).

considered a substantial non-exempt purpose.¹⁷⁴ The *raison d'être* for the program must be to train lawyers, not perform legal work for clients. To ensure that this remains so, post-graduate training programs should ensure that every experienced lawyer in the organization is deeply involved in training the resident attorneys and that the resident attorneys are involved in most, if not all, of the legal work being conducted.

V. CONCLUSION

Over the past several years, a number of actors have begun to explore different ways to provide the practical training necessary for new lawyers. While some are pushing for greater training within the law school curriculum, we believe that post-graduate legal training programs make the most sense. Such programs will provide a wide range of public benefits, from training new lawyers to helping address the lack of affordable legal services for a vast number of Americans.

In this Article, we explore a number of design concerns related to post-graduate legal training, including the relative merits of incubator and residency programs, whether such programs should be operated within law schools or as stand-alone entities, and whether they can and should qualify for tax-exempt status.

We conclude that a properly designed post-graduate legal training program operated within a school should pose no problems for a school's tax-exempt status. Moreover, a properly-designed stand-alone program should qualify for tax exemption under current guidance, even though it does not fit easily within any existing categories for which tax exemption has routinely been granted. That said, we believe that the IRS should issue specific guidance in this area in the form of a revenue procedure to provide much needed certainty and help facilitate the creation of such programs, an important step in addressing the gap between what students learn in law school and what they need to be practice-ready lawyers.

¹⁷⁴ The organization at issue in Rev. Rul. 73-127 only dedicated 4% of its revenues to training.