

PATENT COORDINATORS
CONTRACT AND GRANT OFFICERS
VICE CHANCELLORS - RESEARCH/ADMINISTRATION

SUBJECT: The Tax Reform Act of 1986 (Updated OTT Guidance)

Background

On March 24, 1993, the Office of Technology Transfer (OTT) issued Operating Guidance Memo No. 93-2 (The Tax Reform Act of 1986) discussing the impact of the Tax Reform Act of 1986 (86 Tax Act) on University negotiations of sponsored research agreements with private industry. Due to the imprecise language contained in the law and the lack of any implementing regulations, the guidance provided in Memo 93-2 was based upon congressional reports and the statute's legislative history. On January 16, 1997, the Internal Revenue Service (IRS) issued final regulations, 62 Fed. Reg. 2,275, for the 86 Tax Act, Public Law 99-514. The IRS regulations provide specific guidance regarding the use of tax-free bond-supported University facilities in the performance of sponsored research agreements with private sponsors. This Operating Guidance Memo supercedes and cancels Operating Guidance Memo No. 93-2, incorporating and extending its guidance based upon the recently issued IRS regulations. This Memo provides new information on the applicability of the 86 Tax Act to the University's basic research activities, the negotiation of sponsored research agreements and multi-party cooperative research agreements, and conditions under which the University is exempt from certain provisions of the 86 Tax Act.

The 86 Tax Act established new and more restrictive limitations on the extent to which facilities funded with tax-exempt financing can be used in or for the benefit of certain non-governmental business activities. This memo is intended to provide guidance to Patent Coordinators and Contract and Grant personnel engaged in the review and negotiation of sponsored research agreements. Because of the complexity of issues surrounding this topic, definitions of key terminology are provided in Enclosure 1. They contain the definition of "private activity" use as applied to tax-exempt bonds issued by state and local governments. So long as this so-called "private activity" use remains within certain specified limits, however, the related tax-exempt financing will be unaffected.

Included within the concept of the type of private activity use, which must be taken into account under these limitations, is the performance of sponsored research activities by an entity like the University of California. The final regulations reflect changes to the applicable law made by the Technical and Miscellaneous Revenue Act of 1988 that affect issuers of tax-exempt bonds. The regulations provide needed guidance for applying those bond restrictions pertaining to private activity use. All issuers of tax-exempt bonds are required to covenant in their bond indentures that the issuer will not permit the financed property or facilities to be used in any manner that would violate the rules surrounding private activity use or otherwise cause the interest to become taxable under IRS income tax provisions. Therefore, the final

regulations could impact the University's negotiation of corporate sponsored research agreements or multi-party cooperative research agreements (Sponsored Agreements) that utilize University facilities being financed by tax-exempt bonds.

The 86 Tax Act established new restrictions and limitations concerning permitted uses of facilities financed by tax-exempt bonds. Of importance to the University are provisions that relate to the circumstances under which a bond's tax-exempt status could be jeopardized as a result of the (1) use of bond-financed facilities for certain Sponsored Agreements, and (2) use of certain incentive-payment or management contracts with for-profit service providers. However, not all Sponsored Agreements are automatically considered to involve private business use. The IRS set forth specific rules for determining when Sponsored Agreements do not give rise to private business use. The application of the private activity use rules under the 86 Tax Act depends upon how a specific Sponsored Agreement treats the disposition of the intellectual property rights that might arise from the research activity supported under the agreement. The related tax-exempt financing will be unaffected so long as the private business use remains within certain specified limits.

The 86 Tax Act final regulations provide for a facts and circumstances rule and a private business use test, and in addition, the IRS has issued a separate revenue procedure that establishes safe harbors for Sponsored Agreements. These safe harbors, as defined under this revenue procedure, are only applicable to basic research agreements. The IRS regulations and revenue procedure were effective as of May 16, 1997. The IRS regulations apply to bonds issued on or after this date, while the revenue procedure applies to any Sponsored Agreements entered into on or after this date.

Shortly after the passage of the 86 Tax Act and the implementing IRS regulations, the Office of Technology Transfer (OTT), in collaboration with University Counsel, University-retained Bond Counsel, and the Research Administration Office, assessed the applicability and potential impact of the statute on the University's sponsored research function. In order to assure University compliance with its bond indenture obligations, the following operational guidance is provided to clarify the requirements of the 86 Tax Act. This guidance can also serve as an effective negotiating tool for use by Contract and Grant Officers and/or Patent Coordinators in support of the University's policy in the area of patent and licensing rights. Although the IRS regulations also apply to facility management and incentive-payment contracts, a discussion of these matters is beyond the scope of this memo.

Applicability of the Tax Reform Act

Generally speaking, under the 86 Tax Act, the tax-exempt status of financing used by the University or the State of California for buildings and capital improvements may be threatened when the University enters into any Sponsored Agreements. As a result, the University is required to covenant in its bond indentures that it will not permit the financed facilities to be used in any manner that would violate the private activity use rules or otherwise cause the interest to become taxable under IRS income tax provisions. Applicable scenarios include certain categories of Sponsored Agreements to be conducted using such facilities, and where the agreement conveys back to the sponsor certain intellectual property rights.

Definition of Private Business Use

The IRS regulations provide guidance on the general definition of private business use, exception for general public use, and de minimis exceptions in applying the private business use test. Private business use applies to any building or facility, whether owned or leased by the University, being financed by tax-exempt bonds issued by the University or by the State and which meets a 10% private business use test. Under the IRS regulations, sponsored research may be considered a private business use of the bond-financed facility as a result of (1) ownership of the property, (2) actual or beneficial use of it under a lease or a management or incentive-payment contract, or (3) certain other "similar arrangements." A bond may be considered a private activity bond if it satisfies the private business use test. The IRS regulations state:

"The private business use test relates to the use of the proceeds of an issue. The test is met if more than 10 percent¹ of the proceeds of an issue is used in a trade or business of a non-governmental person. For this purpose, the use of financed property is treated as the direct use of proceeds. Any activity carried on by a person other than a natural person is treated as a trade or business."

As such, a sponsored research agreement with the University could result in private business use of the property used for the research, based upon all of the facts and circumstances of the situation. University Counsel advises that the loss of tax-exempt debt status may be triggered when more than 10 percent of a building, facility, or other capital improvement funded by such debt is used for Sponsored Agreements which convey back to the sponsor rights to intellectual property arising out of the research. This situation also applies when more than 10 percent of the debt service is repaid from sources derived from such Sponsored Agreements.

The process for applying the private business use test is rigorous. Attempting to monitor compliance with the 10 percent private business use limitation presents a significant administrative burden, given the total number of facilities involved and the ever-changing mix of financing sources at individual campus facilities. Furthermore, complications arise in attempting to monitor the allocations of indirect costs and debt service repayment sources among the different sponsors. As a result, more than de minimis private business use of tax-exempt bond financed facilities could jeopardize the bonds' tax-exempt status retroactively. Fortunately, IRS Revenue Procedure 97-14 provides certain safe harbor provisions under which a Sponsored Agreement does not result in a private business use under the Internal Revenue Code of 1986. The need for performing the private business use test can be eliminated if the activities and intellectual property rights resulting from Sponsored Agreements are compliant with the safe harbor provisions of IRS Revenue Procedure 97-14 (Enclosure 2).

¹ 5 percent if bonds are issued for a private 501(c)(3) such as a private research foundation or private university.

IRS Revenue Procedure 97-14 Operating Guidelines

Overview

Revenue Procedure 97-14 sets out certain safe harbor provisions under which certain types of basic research agreements would not be considered private business use. It defines basic research as:

“...any original investigation for the advancement of scientific knowledge not having a specific commercial objective. For example, product testing supporting the trade or business of a specific nongovernmental person is not treated as basic research.”

The safe harbor provisions only apply to basic research agreements. These agreements are classified into two types: “corporate-sponsored research” or “cooperative research agreements.” Research agreements that do not satisfy the safe harbor requirements may still avoid private business use classification if they meet the facts and circumstances test. The 86 Tax Act provisions and requirements in this area are complex and detailed. The discussion and performance of such a test is beyond the scope of this memo.

Corporate Sponsored Research Agreements

A research agreement relating to a facility used for basic research supported or sponsored by a single corporate sponsor will not result in private business use if the following conditions are met:

- (1) The license or other use of any resulting technology by the sponsor is permitted only on the same terms as the University would permit that use by any unrelated, non-sponsoring party (that is, the sponsor must pay a competitive price for its use), and
- (2) The price paid for such use is determined at the time the license or other resulting technology is available for use.

In addition, the revenue procedure states:

“Although the recipient need not permit persons other than the sponsor to use any license or other resulting technology, the price paid by the sponsor must be no less than the price that would be paid by any non-sponsoring party for those same rights.”

Thus, the University can promise to grant exclusive licenses to a single corporate sponsor as long as the sponsor agrees to pay a fair, competitive price for it.

Chapter 11 of the Contract and Grant Manual gives specific guidance regarding a corporate sponsor's patent rights. The "Summary of Sponsor Patent Rights" (11-341) specifically states that a sponsor will only obtain an opportunity to negotiate a license. It further states that all licenses will:

- be royalty-bearing, rates negotiable and based on general industry practice for the types of invention involved;
- provide for diligent development, commercial marketing or use as one condition for retention of the license; and
- normally require a license issue fee and appropriate minimum annual royalties.

Chapter 11 of the Contract and Grant Manual (11-342) goes on to state that license agreements cannot be entered into until the subject invention has been made.

Therefore, for corporate-sponsored research agreements, University policies are consistent with the safe harbor provisions afforded the University under IRS Revenue Procedure 97-14 as long as the agreement involves basic research on the part of the University. The adherence to these policies in negotiating basic research agreements with corporate sponsors will minimize the risk of such agreements being classified as a private business use under the provisions of the 86 Tax Act.

Cooperative Research Agreements

A cooperative research agreement with multiple, unrelated corporate sponsors will not result in private business use if the University meets the following conditions:

- (1) Multiple, unrelated sponsors agree to fund basic research to be performed by the University;
- (2) The research to be performed and the manner in which it is to be performed (for example, selection of the personnel to perform the research) is determined by the University;
- (3) Title to any patent or other product incidentally resulting from the basic research lies exclusively with the University; and
- (4) Sponsors are entitled to no more than a nonexclusive, royalty-free license to use the product resulting from the research.

In addition to those University policies cited previously, the University Patent Policy, Copyright Policy, and employment practices are consistent with these safe harbor provisions as they require mandatory assignment of intellectual property to The Regents by employees and by those using University facilities. Further, it is University policy and practice to retain ownership to its intellectual property, including those produced under Sponsored Agreements. The adherence to these policies in negotiating Sponsored Agreements will minimize the risk of being classified as a private business use under the provisions of the 86 Tax Act.

Contract and Grant Negotiations

In the area of sponsorship, the 86 Tax Act applies to all corporate sponsors and collaborators. Since private colleges, universities, and research organizations or foundations exempt from income tax under Internal Revenue Code 501(c) (3) are deemed to be "non-governmental" for purposes of these private business use determinations, research agreements with such institutions must also be evaluated as to the intellectual property rights provisions. OTT and the Office of the General Counsel should be consulted if there are any questions about arrangements with 501(c) (3) entities with regard to the applicability of the 86 Tax Act. Questions regarding the tax-exempt bond status of a particular campus building or facility should be directed to:

Randall Young
Assistant Treasurer-External Financing
Phone: (510) 987-9660
e-mail: randall.young@ucop.edu

In conclusion, the Contract and Grant Officers and/or Patent Coordinators need to consider the implications of the Tax Reform Act of 1986 in their negotiation of corporate-sponsored and multi-party cooperative research agreements. The safe harbor provisions under the IRS implementing guidelines provide the University with a means to exclude such agreements from classification as a private business use. However, the safe harbor provisions restrict such agreements to only basic research activities, as defined in IRS Revenue Procedure 97-14. Deviation from University intellectual property policy positions could threaten the tax-exempt status of financing used by the University or the State. Care must be exercised in structuring Sponsored Agreements such that they fall within the safe harbor provisions of IRS Revenue Procedure 97-14 and avoid being classified as a private business use. Compliance with University policy in these areas can protect the University from the exposure to liability posed by such a threat.

As a secondary benefit, the 86 Tax Act can be used as a powerful tool in buttressing the University Patent Policy position:

- the 86 Tax Act adds strong support to the University's policy requiring retention of title to inventions made by UC employees;
- the 86 Tax Act bolsters the University position that the value of an invention be determined at the time the invention arises, not earlier or before an invention exists; and
- the 86 Tax Act requires a competitive price be paid for its use.

Enclosure 3 is a summary sheet on the 86 Tax Act. We are providing this sheet for your use during negotiations as one tool in persuading potential research sponsors of the appropriateness of the University position. The 86 Tax Act provisions and requirements are complex and detailed. The foregoing merely summarizes some important points to be considered in the negotiation of Sponsored Agreements. If you have any questions concerning this Operating Guidance Memo please contact Chuck Rzeszutko.

OTT Operating Memo No. 00-1


May 24, 2000

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This OTT Guidance Memo supercedes and cancels Operating Guidance Memo No. 93-2. Please make the appropriate administrative changes within your organization.

Refer questions to: Chuck Rzeszutko
(510) 587-6063
charles.rzeszutko@ucop.edu

Sincerely,



Joe Acanfora
Associate Director

Enclosures: 1. Definitions
2. IRS Revenue Procedure 97-14
3. 86 Tax Act Summary Sheet

cc: OTT Associate Directors and Managers
University Counsel Simpson
Assistant Treasurer Young

Definitions

Basic Research Agreement	As defined in IRS Revenue Procedure 97-14, any original investigation for the advancement of scientific knowledge not having a specific commercial objective. For example, product testing supporting the trade or business of a specific non-governmental person is not treated as basic research.
IRS Revenue Procedure	An official statement of a procedure that either affects the rights or duties of taxpayers or other members of the public under the Internal Revenue Code and related statutes and regulations.
Private Activity Use	86 Tax Act category of use that serves to identify arrangements that have the potential to transfer the benefits of tax-exempt financing, as well as arrangements that actually transfer these benefits, to non-governmental persons.
Private Business Use	The direct or indirect use of proceeds from an issued bond in a trade or business of a non-governmental person.
Private Business Use Test	An IRS-prescribed test to determine if the use of a bond's proceeds qualify as the private business use of a financed property.
Safe Harbors	Specific legal exemptions promulgated by the IRS under which an exemption is provided from specific rules and tests contained in the Code and IRS regulations, provided certain qualifications are met.

Rev. Proc. 97-14

SECTION 1. PURPOSE

The purpose of this revenue procedure is to set forth conditions under which a research agreement does not result in private business use under § 141(b) of the Internal Revenue Code of 1986. This revenue procedure also applies to determinations of whether a research agreement causes the test in § 145(a)(2)(B) of the 1986 Code to be met for qualified 501(c)(3) bonds.

SECTION 2. BACKGROUND

.01 Private Business Use.

(1) Under § 103(a) of the 1986 Code, gross income does not include interest on any state or local bond. Under § 103(b)(1) of the 1986 Code, however, § 103(a) of the 1986 Code does not apply to a private activity bond, unless it is a qualified bond under § 141(e) of the 1986 Code. Section 141(a)(1) of the 1986 Code defines "private activity bond" as any bond issued as part of an issue that meets both the private business use and the private security or payment tests. Under § 141(b)(1) of the 1986 Code, an issue generally meets the private business use test if more than 10 percent of the proceeds of the issue are to be used for any private business use. Under § 141(b)(6)(A) of the 1986 Code, private business use means direct or indirect use in a trade or business carried on by any person other than a governmental unit. Section 145(a) of the 1986 Code also applies the private business use test of § 141(b)(1) of the 1986 Code, with certain modifications.

(2) Corresponding provisions of the Internal Revenue Code of 1954 set forth the requirements for the exclusion from gross income of the interest on state or local bonds. For purposes of this

IRS Revenue Procedure 97-14

revenue procedure, any reference to a 1986 Code provision includes a reference to the corresponding provision, if any, under the 1954 Code.

.02 Section 1.141-3(b)(6)(i) of the Income Tax Regulations provides, in general, that an agreement by a nongovernmental person to sponsor research performed by a governmental person may result in private business use of the property used for the research, based on all of the facts and circumstances.

.03 Section 1.141-3(b)(6)(ii) provides in general that a research agreement with respect to financed property results in private business use of that property if the sponsor is treated as the lessee or owner of financed property for federal income tax purposes.

.04 Section 1.145-2(a) provides generally that §§ 1.141-0 through 1.141-15 apply to § 145(a) of the 1986 Code.

.05 Section 1.145-2(b)(1) provides that, in applying §§ 1.141-0 through 1.141-15 to § 145(a) of the 1986 Code, references to governmental persons include section 501(c)(3) organizations with respect to their activities that do not constitute unrelated trades or businesses under § 513(a) of the 1986 Code.

SECTION 3. DEFINITIONS

.01 *Basic research*, for purposes of § 141 of the 1986 Code, means any original investigation for the advancement of scientific knowledge not having a specific commercial objective. For example, product testing supporting the trade or business of a specific nongovernmental person is not treated as basic research.

.02 *Qualified user* means any state or local governmental unit as defined in § 1.103-1 or any instrumentality thereof.

The term also includes a section 501(c)(3) organization if the financed property is not used in an unrelated trade or business under § 513(a) of the 1986 Code. The term does not include the United States or any agency or instrumentality thereof.

.03 *Sponsor* means any person, other than a qualified user, that supports or sponsors research under a contract.

SECTION 4. SCOPE

This revenue procedure applies when, under a research agreement, a sponsor uses property financed with proceeds of an issue of state or local bonds subject to § 141 or § 145(a)(2)(B) of the 1986 Code.

SECTION 5. OPERATING GUIDELINES FOR RESEARCH AGREEMENTS

.01 *In general.* If a research agreement is described in either section 5.02 or 5.03 of this revenue procedure, the research agreement itself does not result in private business use.

.02 *Corporate-sponsored research.* A research agreement relating to property used for basic research supported or sponsored by a sponsor is described in this section 5.02 if any license or other use of resulting technology by the sponsor is permitted only on the same terms as the recipient would permit that use by any unrelated, non-sponsoring party (that is, the sponsor must pay a competitive price for its use), with the price paid for that use determined at the time the license or other resulting technology is available for use. Although the recipient need not permit persons other than the sponsor to use any license or other resulting technology, the price paid by the sponsor must be no less than

the price that would be paid by any non-sponsoring party for those same rights.

.03 Cooperative research agreements.

A research agreement relating to property used pursuant to a joint industry-governmental cooperative research arrangement is described in this section 5.03 if—

(1) Multiple, unrelated sponsors agree to fund governmentally performed basic research;

(2) The research to be performed and the manner in which it is to be performed (for example, selection of the personnel to perform the research) is determined by the qualified user;

(3) Title to any patent or other product incidentally resulting from the basic research lies exclusively with the qualified user; and

(4) Sponsors are entitled to no more than a nonexclusive, royalty-free license to use the product of any of that research.

SECTION 6. EFFECTIVE DATE

This revenue procedure is effective for any research agreement entered into on or after May 16, 1997. In addition, an issuer may apply this revenue procedure to any research agreement entered into prior to May 16, 1997.

DRAFTING INFORMATION

The principal author of this revenue procedure is Loretta J. Finger of the Office of Assistant Chief Counsel (Financial Institutions and Products). For further information regarding this revenue procedure contact Loretta J. Finger on (202) 622-3980 (not a toll-free call).

26 CFR 601.202: Closing agreements.

(Also Part I, §§ 57, 103, 141, 142, 144, 145, 147, 7121; 1.141-12, 1.142-2, 1.144-2, 1.145-2, 1.147-2.)

OTT Operating Memo No. 00-1
Enclosure 3
5/24/00

University of California Office of the President



Memo 00-1
Operating Requirement
May 24, 2000

TAX REFORM ACT OF 1986 (Public Law 99-514)

It is the conclusion of the University Office of Technology Transfer and Office of General Counsel that in order to protect the tax-exempt status of debt issued to finance University buildings, capital improvements and other facilities, that sponsored and cooperative research agreements for investigations to be conducted using University facilities must comply with limitations set forth below. Accordingly, University policy guidelines require all such agreements to provide for the following:

1. Title to intellectual property made by University employees or others using University facilities shall be retained exclusively by The Regents;
2. Future licensee shall pay a competitive price for any such technology. Funding support for a research project may not be considered as payment toward a license of future intellectual property; and
3. The value of any such technology shall be determined at the time the intellectual property arises and is available for licensing, and not at the earlier research agreement negotiation stage when said intellectual property does not yet exist.