



Tax-Related Tips to Ensure Compliance for Sponsored Research Agreements

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United States universities and research institutions that issue tax-exempt bonds must abide by federal tax rules adopted in 1986 to limit the use of government-subsidized financing for projects other than traditional government functions. To remain compliant, the institution *must not* exceed the limits on private business use of facilities that were financed with tax-exempt bonds. This private business use may include sponsored research. To ensure institution compliance while negotiating sponsored research agreements:

- Avoid sponsored research agreements that require the university to transfer patents on resulting inventions to the research sponsor. Such an agreement makes any use of institution facilities for that research a private business use.
- In most cases, avoid granting an automatic license to the research sponsor as part of the research agreement. However, it is acceptable to give the research sponsor a right of first negotiation to license any intellectual growing out of the sponsored research. In general, the license terms should not be determined at the time that the sponsored agreement is adopted, but negotiated later, when the nature of the invention is known.

Failure to follow the safe harbor does not necessarily result in private business use, but because of the vagueness of the all-of-the-facts-and-circumstances standard, departing from the safe harbor involves some peril, and should be done, if at all, only after consultation with tax counsel.

These rules are not absolute. The applicable regulations, enacted in 1997, state that a sponsored research agreement may result in private business use of

the property used for the research “based on all of the facts and circumstances.”¹ An “all the facts and circumstances” standard is nearly as vague as a standard could be. The statement prohibiting the negotiation of license terms with the sponsored research agreement was conspicuously absent from these final regulations, though it had been included both in the regulations originally proposed by the Internal Revenue Service (IRS) and in a General Explanation of the Tax Reform Act of 1986 prepared by the Staff of the Congressional Joint Committee on Taxation around the time the statute was enacted. Instead, the statements about separating the license and the sponsored research are included in IRS pronouncements that lay out a safe harbor—a set of standards one can follow to be sure a sponsored research agreement will not be treated as resulting in private business use (Revenue Procedures 97-14 and 2007-47).

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The safe harbor in the revenue procedures applies only to basic research agreements. *Basic research* for this purpose is defined as “an original investigation . . . not having a specific commercial objective.”² Basic research does not include “product testing supporting the trade or business of a specific nongovernmental person.”³ The IRS pronouncements also approve, as not private business, any cooperative basic research performed for multiple sponsors who are entitled to no more than non-exclusive, royalty-free licenses.



If an institution deliberately or inadvertently fails to avoid characterization of sponsored research as private business use, this will not be fatal to the tax exemption as long as:

- The percentage of the proceeds of the bond financing directed to private business uses does not exceed 10 percent (in the case of a state institution)³ or
- The percentage of the net proceeds directed to private business uses does not exceed 5 percent (in the case of a private institution).⁴

The IRS has accepted allocation of the exempt and nonexempt use of a facility by means of comparing the revenue from sponsored research that constitutes private business use with the revenue from government-funded research, as well as other allocation methods.⁵ But calculation of the percentage of private business use might not be so simple, and many universities prefer to avoid any private business use other than those that are *de minimis*. Hence, adherence to the guidelines of Revenue Procedures 97-14 and 2007-47 is the norm.

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As a result, the typical practice in sponsored research agreements in the United States is to give the corporate research sponsor no intellectual property rights beyond a right of first negotiation for a license on whatever inventions may arise from the research. This doesn't always please the sponsor. Corporate sponsors might believe that the party paying for the research should own the resulting technology. That is usually the practice in the commercial world and also is a model available in universities in Europe. This makes the process particularly tough for a U.S. university seeking funding from

a European corporation that is accustomed to European norms.

European corporations tend to argue that they are being asked to pay twice for the same technology: first with the sponsored research and second for a license to the technology resulting from the sponsored research. Even worse than paying twice, in their perspective, is the fact that they can't know the size of the second payment (the license fee) before committing to the first payment (the research sponsorship payment).

Approaches used by some universities to deal with this conundrum include:

- Specifying a range of possible royalties within a defined field of use in the sponsored research agreement. The actual royalty is still determined at the time the license is negotiated, after the invention has been made, but the negotiation is bounded by the two ends of the range. This is intended to assure the sponsor that a license will be available on reasonable terms. Whether this approach still falls within the safe harbor is uncertain. Technically, the exact royalty is negotiated at the time of licensing, as required. But with basic research, no one knows at the time of the research what the emerging invention might be. What if the fair market value of the invention is outside of the predesignated royalty range?
- If specifying a range of financial license terms in the sponsored research agreement does not ultimately qualify for the safe harbor, the particular agreement still might be able to qualify as not-private business use, based on the facts and circumstances test of the regulations, but this is quite uncertain.
- If the use is found to be private, analyze whether the private business use of the bond-financed facility exceeded the 5 percent limit (or 10 percent for a government entity).
- Giving the corporate sponsor a right to require a postinvention binding third-



party appraisal of the intellectual property, if the sponsor and the university are unable to agree on licensing terms. The appraised royalty rate would then become the license rate. This should fall within the safe harbor requirements that the fee be set postinvention and at market rates, but would not leave the sponsor vulnerable to an unexpected, unreasonably high royalty demand.

- Another approach, for corporate research sponsors that are especially sensitive to intellectual property ownership, when working with institutions that allow their researchers to spend a portion of their time on outside consulting, is to have research conducted by the university faculty but at facilities of the research sponsor, avoiding use of facilities that were financed with tax-exempt bonds. This will often not be practical, however, due to geographic constraints or availability of specialized equipment. To summarize, U.S. universities and

research institutions must be careful to remain compliant when negotiating sponsored research agreements. However, this does not need to be a deterrent to corporate research sponsors partnering with these institutions. ▽

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Notes

¹ 26 CFR 1.141.3 (b)(6). The regulations also state that “[a] research agreement with respect to financed property results in private business use of that property if the sponsor is treated as lessee or the owner of financed property for federal income tax purposes.” 26 CFR 1.141-3(g)(8).

²Rev. Proc. 97-14, Section 3.01.

³Internal Revenue Service Revenue Procedure 2007-47. One commentator has observed that “[f]or those universities and hospitals conducting industry-sponsored clinical research, the definition of basic research arguably causes all product-related, safety, and efficacy studies to be considered private business use.” Adam P. Rifkind, Esq. “A Challenge for Issuers of Tax-Exempt Bonds: IRS Revenue Procedure 2007-47,” *Teaching Hospitals and Academic Medical Centers*, Volume 5, Issue 3 (December 2007), p. 7.

⁴See Internal Revenue Code, § 145.

⁵Internal Revenue Service Private Letter Ruling 9125050 (March 29, 1991).

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