

NACUA Continuing Legal Education Workshop

*Legal Issues in Higher Education Sponsored Research, Compliance and
Technology Transfer*

Tax-Exempt Bond Financed Facilities

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I. BASIC LAW REGARDING PRIVATE USE.

- A. General Principles. Interest earned on revenue bonds issued by a conduit authority for the benefit of a corporation, fund or foundation, organized and operated exclusively for religious, charitable, scientific or educational purposes that qualifies as a charitable organization under Section 501(c)(3) of the Internal Revenue Code of 1986, as amended (the “Code”) (a “501(c)(3) Organization”), is exempt from federal income taxation, subject to compliance with a wide-range of federal tax law requirements, certain of which are summarized below. Because the interest is exempt from federal income taxation, the interest rate borne by such bonds (and therefore paid by the 501(c)(3) Organization) is lower than taxable bonds. Most common 501(c)(3) Organizations issuing debt are hospitals and health care systems, educational institutions and cultural institutions.

The general public policy advanced by such a financing structuring is the promotion of the charitable works of 501(c)(3) Organizations through the availability of lower cost of capital. In order to ensure such public policy is so advanced, the Code and the United States Treasury Regulations that relate to tax-exempt bonds (the “Regulations”) mandate compliance with various rules and regulations relating to the use of projects financed with tax-exempt bonds (the “Bond Financed Property”). These requirements include that the Bond Financed Property be used in the trade or business of the 501(c)(3) Organization. If a private entity other than the 501(c)(3) Organization uses or manages the bond financed property, the relationship between that private entity and the 501(c)(3) Organization needs to comply with certain federal tax law requirements.

- B. Statutory Requirement. Under the Code, not more than 5% of the net proceeds of the bonds may be used in a “Private Use” (as hereinafter defined). Net proceeds exclude bond proceeds used to fund a reasonably required reserve fund. However, costs of issuance funded with bond proceeds count towards this 5% limitation. As a result, if 2% of the net proceeds (the maximum amount permitted under the Code) of a bond issue are applied to pay costs of issuance, only 3% of the remaining net proceeds may be used in a “Private Use.” See generally Sections 141(b) and 145(a)(2)(B) of the Code and Section 1.141-3 of the Regulations.

- C. Key Definitions.

“Private Use” means any Use (as hereinafter defined) (i) by a person that is neither a state or local governmental unit nor a 501(c)(3) Organization or (ii) by a 501(c)(3) Organization (including the 501(c)(3) Organization for whom the bonds are being issued) in an activity that is, in whole or in part, an Unrelated Trade or Business (as hereinafter defined) of such 501(c)(3)

Organization. If property is used simultaneously in a Private Use and in a Use that is not a Private Use, such property is used in a Private Use.

“Use” includes any use as a result of (i) ownership, (ii) actual or beneficial use pursuant to a lease or a management, service, incentive payment, research or output contract, (iii) any other similar arrangement, agreement or understanding, whether written or oral, (iv) with respect to any portion of the Bond Financed Property available for use by the general public, any arrangement that conveys special legal entitlements to any person with respect to such portion of the Bond Financed Property or (v) with respect to any portion of the Bond Financed Property not available for use by the general public, any arrangement that conveys special economic benefits to any Person with respect to such portion of the Bond Financed Property.

“Unrelated Trade or Business” means an activity that constitutes an “unrelated trade or business” within the meaning of Section 513(a) of the Code, without regard to whether such activity results in unrelated trade or business income subject to taxation under Section 511 of the Code.

- D. Exceptions. The Code and Regulations provide that Use that complies with certain safe harbors may be excluded from the 5% limitation.

Sponsored Research. As more fully discussed below, Use pursuant to research agreements meeting the requirement of Rev. Proc. 97-14, 1997-1 C.B. 634 (“Rev Proc. 97-14”) or any applicable successor Revenue Procedure or Regulation does not constitute “Private Use.”

Limited Use. Use (including use in sponsored research activities) of Bond Financed Property or a portion thereof by Persons on a first-come, first-served basis under an agreement that does not provide for use of the Bond Financed Property or a portion thereof by any particular Person for more than 50 days does not result in “Private Use” so long as the 501(c)(3) Organization is not treated as being engaged in an unrelated trade or business as a result of such activities.

Management and Service Contracts. Although not relevant to sponsored research projects per se, but coming into play in research facilities where management or other services are provided by a third party, the Internal Revenue Service (the “IRS”) has identified certain contractual relationships that are generally not considered to create private business use issues. Those contracts include (i) contracts for services that are solely incidental to the primary function of the Bond Financed Property (such as contracts for janitorial, office equipment repair, vending or similar services) and (ii) contracts to provide for services if the only compensation is the reimbursement of the service provider for actual and direct expenses paid by the service provider to unrelated parties. Also contacts that relate to a use that

is functionally related and subordinate to a qualified management contract and the use is not, in substance, a separate contractual agreement (such use of a storage area by a manager for equipment that is necessary for the manager to perform its services under a qualified management contract) will not create private business use. In addition, management contracts that comply with certain term, termination and compensation provisions are excluded from the 5% limitation. See generally Rev. Proc. 93-19, 1993-1 C.B. 526 or Rev. Proc. 97-13, 1997-1 C.B. 632 (as modified by Rev. Proc. 2001-39, 2001-2 C.B. 38).

Employee Uses. Uses by a natural person as an employee (as an employee relationship is determined for federal income tax purposes) of the 501(c)(3) Organization, do not constitute “Private Use.”

Qualified Improvements. Use of Qualified Improvements (hereinafter described) by a Private User does not constitute “Private Use.” A “Qualified Improvement” is an improvement to a building (including its structural components and land functionally related and subordinate to the building) where the following requirements are satisfied.

- (i) The building was placed in service more than 1 year before the construction or acquisition of the improvement is begun;
- (ii) The improvement is not an enlargement of the building or an improvement of interior space occupied exclusively for any private business use;
- (iii) No portion of the improved building or any payments in respect of the improved building are taken into account under Section 141(b)(2)(A) of the Code (the private security test); and
- (iv) No more than 15 percent of the improved building is used for private business use.

II. MANAGEMENT CONTRACTS/RENTAL ACTIVITIES.

In the case of universities and colleges, issues relating to Private Use often arise in connection with contracts with outside vendors for the operation and management of (i) cafeteria, concession and other food areas, (ii) bookstores and similar retail facilities and (iii) parking facilities. Unless the term, termination and compensation provisions comply with the safe harbors of Rev. Proc. 93-19, such contracts would typically constitute Private Use. We mention only briefly the private use issues associated with management contracts and rental activities because, while they are not specific to the research context, they commonly arise and can impact your research facilities as they might any other facility on your campus.

In addition to the above, rental activities for summer camps, corporate conferences or the like should also be reviewed. Frequently, those activities meet the “50 day” exception discussed above.

Not only does the use of the Bond Financed Property raise Private Use questions, but the Use of the Bond Financed Property by the University in an “unrelated trade or business” also may constitute Private Use. For example, the lease of space by the University to another 501(c)(3) Organization, such as another affiliated research organization (*e.g.*, the Howard Hughes Medical Institute), would need to be closely examined by counsel to determine if such activity constituted a “related trade or business” of the University. This analysis involves the overlap of what is considered to be a scientific organization—*i.e.*, an organization engaged in fundamental or basic research or otherwise operated for the dissemination of such scientific knowledge—and a charitable or educational organization. For example, an organization engaged in research on human diseases, developing scientific methods for treatment and disseminating its results through physician seminars was determined to be both a scientific and educational organization. The federal income tax definition of the term charitable also includes advancement of science. Ultimately this determination is highly factual.

In all cases, the particular facts and circumstances need to be examined to determine whether the relationship gives rise to Private Use.

III. RESEARCH CONTRACTS.

- A. Federal Government Sponsored Research. One area of Private Use that in recent years has been the subject of much controversy relates to sponsored research. As noted above, research contracts are considered to be Private Use unless they comply with Rev. Proc. 97-14. Sponsored research includes research sponsored by a nongovernmental entity. It is clear that the federal government is a nongovernmental person for purposes of these private business use rules. This follows from Treas. Reg. § 1.141-1(b), which defines a “nongovernmental person” for purposes of the private business use rules as a person other than a “governmental person.” This same regulation, in defining a “governmental person,” excludes from such classification “the United States or any agency or instrumentality thereof.” Therefore, any determination as to whether the sponsorship by the federal government under a Bayh-Dole research agreement results in private business use will be made based on all of the facts and circumstances relating to the agreement between the research institution and the federal governmental agency sponsor.
- B. Bayh-Dole. Congress enacted the Bayh-Dole Act in 1980 to promote the utilization and public availability of inventions arising from Federally supported research. The Bayh-Dole Act applies to agreements for the performance of experimental, developmental or research work funded by the

federal government. The purposes of the Bayh-Dole Act are to promote inventions arising from federally sponsored research, further public-private collaboration and public availability of inventions arising from Federally sponsored research, ensure that inventions made by nonprofit organizations promote free competition, and protect the public from the nonuse or unreasonable use of inventions.

Under the Bayh-Dole Act, at the time that the federal agency enters into a research agreement with a research institution, the federal agency receives a nonexclusive and royalty-free license to use any patentable or otherwise protectable invention or discovery developed under the research agreement on behalf of the U.S. (See Bayh-Dole Act, 35 U.S.C. § 202(c)(4)).

- C. Rev Proc 97-14. In Rev. Proc. 97-14, the IRS established a safe harbor test under which nongovernmental-sponsored research agreements will not be treated as giving rise to private business use 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.” (Rev. Proc. 97-14, § 5.02).

While Rev. Proc. 97-14 confirmed the continued viability of the facts and circumstances test used in determining whether a research agreement should be treated as private business use, if a nongovernmental-sponsored research agreement fails the Rev. Proc. 97-14 safe harbor test, the IRS generally applies the facts and circumstances test more harshly and is more apt to find that the research agreement results in private business use. A literal and technical application of the Rev. Proc. 97-14 safe harbor test could lead to the conclusion that, should the research institution that entered into a Bayh-Dole research agreement with a federal agency subsequently enter into a third party, royalty-bearing license agreement with respect to the technology developed under the research agreement, the Research Agreement would fail the safe harbor test. This is because at the time that the federal agency entered into the research agreement, the federal government received a nonexclusive and royalty-free license to use any patentable or otherwise protectable invention or discovery developed under the research agreement on behalf of the U.S. Therefore, when the institution subsequently enters into a royalty-bearing license of this technology with an unrelated third party, the federal government, which is receiving the same technology on a royalty-free basis,

would arguably be paying less than the “competitive price” paid by the third party licensee. In addition, the research agreement arguably fails to the second component of the safe harbor test because the royalty-free license granted to the federal government is determined at the time the research agreement was entered into, not at the time that the technology is available for use.

The IRS could apply Rev. Proc. 97-14 to federally sponsored research agreements and conclude that all such agreements result in private business use. Alternatively, the IRS could disregard the Rev. Proc. 97-14 safe harbor test when analyzing federally-sponsored research agreements that are subject to the terms and conditions of the Bayh-Dole Act on the ground that the drafters of Rev. Proc. 97-14 were unaware of the Bayh-Dole Act and the potential negative impact of its provisions on private use determinations when it created this safe harbor test.

This alternative approach to the issue may be difficult to sustain given Priv. Ltr. Rul. 199914045 (Jan. 8, 1999) where the IRS applied the Rev. Proc. 97-14 safe harbor test to a federally-sponsored research agreement. In that case, the governmental person represented that it would only license the technology developed under the contract to third parties on the same nonexclusive, royalty-free basis as the license granted to the federal agency. In most other cases, however, the research institution clearly plans to enter into royalty-bearing license agreements with third parties. Thus, if the IRS were to take this approach to the issue, it would have to conclude that the conclusion set forth in PLR 199914045 was in error.

- D. Expected IRS Guidance. In August, 2006, the IRS included as part of its 2006-2007 Priority Guidance Plan the provision of guidance on private business use issues under Section 141 of the Code stemming from federal financing of research and the application of the Bayh-Dole Act. As such, it is expected that the IRS will provide additional guidance sometime within the next year.
- E. Other Sponsored Research. Although recent scrutiny is often focused upon federally sponsored research, the same issues arise with corporate sponsored research, such as research sponsored by pharmaceutical companies. Accordingly, if a sponsored research agreement with a commercial sponsor grants the sponsor a royalty-free license to make commercial use of resulting intellectual property, or if the agreement sets in advance a fee, royalty rate or other payment that the sponsor must pay for the use of the intellectual property before the intellectual property has been created and can be objectively valued, the sponsored research agreement needs to be closely scrutinized as a possible Private Use.

Clinical Trial Agreements. In the context of a sponsor-initiated clinical trial, the sponsor brings a proprietary drug, device or compound it owns to the University for further research or a clinical trial. Even though the University's personnel may create intellectual property as a result of this research, many Universities take the position that granting to the sponsor ownership of, or royalty-free rights to, any intellectual property that constitutes an improvement to or derivative work of the sponsor's intellectual property (in the strict patent and copyright meanings of those terms) is not a Private Use, because the University is not giving away something it owns because the University's rights to commercialize those improvements or derivative works are governed by the controlling patent or copyright already owned by the sponsor. Furthermore, in utilizing the drug, device or compound provided by the sponsor, the University is providing medical care to patients of the University, which obviously furthers the University's charitable function.

Material Transfer Agreements. Similarly, a material transfer agreement (MTA) that grants to a commercial provider of research materials ownership of or royalty-free rights in any inventions resulting from use of the materials, or (more commonly) ownership of or royalty-free rights in inventions resulting from uses of the materials that are outside the permitted uses provided for in the MTA, can create a Private Use.

IV. MEASUREMENT OF PRIVATE USE.

- A. Measurement Period. Once Private Use has been identified, in order to determine if the amount of Private Use fits within the 5% limitation or if it needs to be excluded from the Bond Financed Property, the Private Use needs to be measured. The amount of Private Use is determined according to the average percentage of Private Use of the Bond Financed Property during the measurement period. Except in the case of certain refundings, as a general rule, the measurement period begins on the later of the issue date of the bonds or the date the Bond Financed Property is placed in service and ends on the earlier of the last date of the reasonably expected economic life of the Bond Financed Property or the last maturity date of any of such bonds (determined without regard to any optional redemption dates). Section 1.141-3(g)(2) of the Regulations. In the case of bonds that are being refunded that were issued after the effective date of the 1997 private activity bond regulations (May 15, 1997), the measurement period begins on the later of the issue date of the refunded bonds or each component of the property financed with the refunded bonds was placed in service and ends on the maturity date of the refunding bonds. In the case of bonds that are being refunded that were issued prior to the effective date of the 1997 private activity bond regulations, the measurement period begins on the later of December 19, 2005 or the date each component of the property financed with the refunded bonds was placed in service and ends on the earlier of the last day of the reasonably expected

economic life of the Bond Financed Property or the last maturity date of the refunding bonds (determined without regard to any applicable optional redemption dates).

Private Use is typically considered to commence on the first date on which there is a substantial right to actual use by the Private User. However, if an arrangement is entered into prior to the date actual use commences and the arrangement transfers ownership or right to long term use (such as a lease arrangement), the Private Use is considered to commence on the date the arrangement is entered into. Section 1.141-3(g)(7) of the Regulations.

- B. Method of Allocation. Private Use may be allocated on the basis of a square footage or time allocation. Square footage allocation identifies by square footage the areas of a facility that will be used in a Private Use and compares that space to the total square footage of the facility, taking into account common space areas that benefit both Private Use space and non-Private Use space. A time allocation may also be used in cases where the same space is used in a Private Use and a governmental or “good use” but at different times. The average amount of Private Use is generally based upon the amount of time such space is used in a Private Use as a percentage of the total time for all actual use. Periods during which the space is not in use is disregarded. Section 1.141-3(g)(4) of the Regulations.

In late September, 2006, the IRS released proposed regulations that govern the measurement of Private Use for “mixed use” facilities or facilities that are simultaneous used in a Private Use and a “good use.” The proposed regulations are not yet effective but will become effective for bonds sold on or after the date that is 60 days after the date the regulations are finalized and published in the Federal Register.

Under the proposed regulations, bond proceeds and other sources of funds can be allocated to Private Use and non-Private Use under one of three methods: (1) a pro rata method; (2) a discrete physical method; or (3) an undivided portion method. The details of the proposed regulations are complicated and will likely change based upon comments received by the IRS.

V. ONGOING COMPLIANCE.

The tax documents executed in connection with a bond issue provide for a borrower’s reasonable expectations as of the time of issuance of the bonds. Compliance with the Private Use limitations, however, are based upon actual facts. Borrowers need to continue to monitor actual usage of the Bond Financed Property. Such monitoring includes reviewing compliance of research contracts entered into post bond issuance with Rev. Proc. 97-14, management contracts entered into post bond issuance (or amendments to

existing management contracts) with Rev. Proc. 97-13, ensuring that bond proceeds are properly allocated to “good use” space and being aware of how new arrangements and unanticipated use of Bond Financed Property may affect the Private Use allocations. An example of such change would be the unanticipated leasing, subsequent to the issuance of the bonds, of a portion of a student union to Starbucks or a similar entity.

Some Universities have adopted policies on Private Use reporting and monitoring. See, *e.g.*, <http://www.asu.edu/aad/manuals/fin/fin126.html>, a copy of which is attached to this outline.