

## Technology Transfer and the New Economy

by Milton Cerny

*Milton Cerny is a partner at Caplin & Drysdale, Washington.*

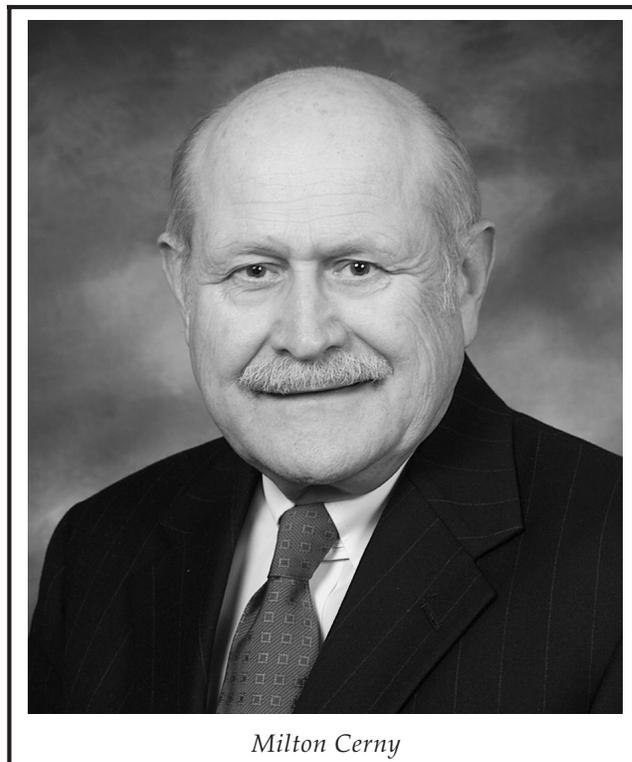
*The presidential debates put in sharp relief the challenges facing the United States economy regarding rising deficits, underfunded liabilities for Social Security, Medicare, and health care. Outsourcing of jobs has created dislocations and job losses and lessening of employment opportunities throughout the United States and particularly in the economically depressed areas that once were the engines of our economy that fueled our quality of life. It is clear we must find new paths to rebuild our economic base.*

*Both presidential candidates spoke about improving education as a means of raising living standards and the aspirations of those mired in low paying jobs or who have no work at all. What we need to focus on now is how do we combine the creative talents of the American people and America's institutions, both commercial and nonprofit, to develop the innovative products and technologies that make us competitive with the rising nations of China, India, and Europe. While we cannot compete on wages, we can compete in the development of new innovative technologies and productivity.*

*One of our greatest resources lies in our research institutes and universities, which are discovering new technologies like stem cell research but which are not being brought on line quickly enough in applied uses to provide the public with the benefit of these discoveries or the employment opportunities in the economically depressed areas of our country. Many of these institutions are nonprofit organizations whose creative talents need to be unleashed in creative joint ventures with commercial organizations to build the business for the new economy. Archaic tax laws need to be revised together with more enlightened tax administration to implement and encourage this result to bring about a rising economy of increased wages and corporate profits producing the income and tax revenues needed to reduce the deficits and meet the demands of our new economy.*

### Introduction

The rapidity of new discoveries made at research institutions of higher learning have presented new opportunities and challenges to universities, their faculty, staff, and undergraduate and graduate students. Commercialization of basic research has also presented universities operating under reduced state and federal support an opportunity to expand the horizons of science but also challenges in managing the coordination of basic research with the needs of the public and government regulation. A number of inde-



Milton Cerny

pendent supporting organizations have been created to support university research.

### I. Foundations That Support University Research

#### A. Background

Today, universities are aided in their efforts to further educational pursuits through supporting foundations. A supporting foundation (as defined in section 509(a)(3) of the code) is one that is organized and operates exclusively to support and benefit one or more public charities. In addition, the supporting organization must be party to a relationship with at least one of the beneficiary organizations that ensures that it will be responsive to that beneficiary's needs.

#### B. Supporting Organizations

Generally speaking, a supporting organization is one that operates exclusively for the benefit of one or more public charities. The Treasury regulations define

the supporting organization in terms of three basic concepts: the “organizational” requirement, the “operational” requirement, and, most importantly, the “relationship requirement.” As explained in more detail below, there are three subcategories of support organizations.

### C. Organizational Requirement

A supporting organization must be organized exclusively to benefit the supported organizations. That is, its articles of incorporation must specify the supported organization or organizations by name and state that the supporting organization’s exclusive purpose is to support and benefit the beneficiary organizations.<sup>1</sup>

### D. Operational Requirement

A supporting organization must also be operated exclusively to benefit the beneficiary organizations. That is, the supporting organization cannot make grants or conduct other activities that do not benefit the supported organizations. There is no requirement, however, that all beneficiary organizations receive grants every year or that they share the foundation’s income in any fixed proportion.<sup>2</sup>

### E. Relationship Requirement

Beyond the basic and fairly mechanical organizational and operational requirements, a supporting organization must stand in one of three prescribed relationships with its beneficiary organization. That is, a supporting organization must be

- operated, supervised, or controlled by its beneficiary organization;
- supervised or controlled in connection with its beneficiary organization; or
- operated in connection with its beneficiary organization.

**1. Operated, Supervised, or Controlled by One or More Public Charities.** If the supporting organization is controlled by the 509(a)(1) supported organizations, or is under some common control, then there is no further test that needs to be met. However, the third classification “operated in connection with” may be another option. The regulations provide certain tests for this option and describe certain limitations for entrance into this category that we believe the foundation could meet without unacceptable limitations on its freedom of action.

**2. Operated in Connection With.** Under the Treasury regulations, an organization is considered to be “operated in connection with” one or more public charities if “the supporting organization is *responsive to*, and *significantly involved* in the operations of, the

publicly supported organization. . . .”<sup>3</sup> [Emphasis added.] More specifically, the “operated in connection with” support organization must meet a “responsiveness test” and an “integral part test.”<sup>4</sup>

**a. Responsiveness Test.** Satisfaction of the responsiveness test involves two elements. First, the foundation’s articles would name one university official or their appointee to be a member or members of the foundation supported organization’s board of directors. This will take care of this requirement.<sup>5</sup> Second, the arrangement must be such as to give the university a significant voice in either the investment policies of the supporting organization, or the timing of and manner of making grants, the selection of grant recipients, and in otherwise directing the use of the income or assets of the 509(a)(3).

In order to reinforce the “voice” of the university, the by-laws might provide that the presence of the university representative be required for a quorum. Other similar provisions of the organizational documents could be used to add weight to its vote or votes.

**b. Integral Part Test.** The purpose of the integral part test is to ensure that at least one of the supported organizations is sufficiently dependent on the supporting organization to provide it with an incentive to monitor the supporting organization’s affairs. As with the responsiveness test, satisfying the integral part test is a two-step process.<sup>6</sup>

(1) The supporting organization must show that it pays “substantially all” of its income “to or for the use of” the supported organizations. The IRS has interpreted “substantially all” in this context as meaning 85 percent. Thus, on average, the supporting organization must pay 85 percent of its net income to or for the use of the supported organizations. Both grants to the supported organizations and reasonable administrative expenses incurred in making these grants should count toward this 85 percent of income payout requirement. Income not so expended may be accumulated.

(2) The university must have an interest in the amount of support it receives from the supporting organization to ensure that these supported organizations will be “attentive” to the supported university’s activities — that is, that the university will take an active interest in overseeing the supporting organization. It is important to note that not all of the supported organizations need satisfy this attentiveness test. Instead, the regulations state that “a

<sup>3</sup>Treas. reg. § 1.509(a)-4(f)(4).

<sup>4</sup>Treas. reg. § 1.509(a)-4(i)(1).

<sup>5</sup>This part of the test could be met, alternatively, by providing in the 509(a)(3)’s articles that its Board of Directors must at all times include one or more persons who are also members of the University Board of Directors or by showing that the officers and directors of foundations maintain a close and continuous working relationship with the officers or directors of the university. Treas. reg. § 1-509(a)-4(i)(2).

<sup>6</sup>Treas. reg. § 1.509(a)-4(i)(3).

<sup>1</sup>Treas. reg. § 1.509(a)-4(b).

<sup>2</sup>Treas. reg. § 1.509(a)-4(e).

substantial amount” of the total support provided by the supporting organization must go to an “attentive” grantee or grantees. The IRS has interpreted 15 to 30 percent to be substantial in this context. This could be limited to specific scholarships, scientific programs, or the production of services to assist the university in carrying out its educational and tax-exempt purposes.

(a) If the supporting organization’s grants account for a sufficiently large percentage of the beneficiary organization’s total funding, this fact alone will establish the required attentiveness. The IRS has ruled that providing 10 percent or more of the supported organization’s funds is sufficient for this purpose.

(b) If the 10 percent test is not met — fortunately that is not the case here — there is an alternative test. Thus, even if the supporting organization provides a relatively small percentage of total support, it can satisfy the attentiveness requirement if its grants are earmarked to support a substantial program or activity of the supported organization, and its grants account for a sufficiently large part of the funding of the program or activity that the grantee will take an active interest in continuation of this funding. The IRS has not stated what percentage of the total budget of the supported program or activity the supporting organization must provide. The regulations state simply that the attentiveness test will be met if it can be demonstrated that the beneficiary organization, in order to avoid interruption of the particular program, will be sufficiently attentive to the operations of the supporting organization. While not so stated in the regulations, there is obviously a quantitative aspect to this requirement.

(c) Finally, even if neither of the foregoing tests is met, a supporting organization may satisfy the attentiveness test by demonstrating, on the basis of all the “facts and circumstances,” that the supported organization will be attentive to its affairs. The regulations and IRS rulings suggest that several factors are particularly significant. Most important is evidence of actual attentiveness on the part of the supported organization. Thus, for example, if a principal officer of the university plays an active role in the supporting organization’s affairs, the IRS will almost certainly find the attentiveness test satisfied. Second, the IRS will give substantial weight to the dollar amount of the funding provided by the supporting organization, regardless of what percentage it represents of the supported organization’s total. For example, the IRS has ruled that if a supporting organization consistently provides \$200,000 to \$400,000 per year to a supported organization, the university will be attentive, notwithstanding that the grant comprises a small percentage of its total support. A third factor demonstrating attentiveness is that the support-

ing organization provides the supported organizations with a sufficiently detailed annual report to permit the supported organization to conduct a detailed analysis of its activities.

(d) Composition of Board. The legal requirement of significance is that a supporting organization cannot be controlled, directly or indirectly, by “disqualified persons.”<sup>7</sup> While persons associated with the 509(a)(3) will not be disqualified persons but most likely directors of the foundation, it is doubtful that the IRS would find “indirect” control of the 509(a)(3). We have recently obtained a ruling where the boards of the 509(a)(1) supported organization were the same as the 509(a)(3) organization. The new organization was held to be a 501(c)(3) and a public charity under section 509(a)(3).

## II. Scientific Research

A. The Service has a longstanding position that scientific research is a charitable activity under section 501(c)(3) whether conducted directly by an organization or through a supporting entity.

1. The Treasury regulations state that “scientific” as used in section 501(c)(3) “includes the carrying on of scientific research in the public interest,” that “research” is not synonymous with “scientific,” and that in order for research to be “scientific . . . it must be carried on in furtherance of a scientific purpose.” Although the regulations do not define “scientific,” they do provide that scientific research does not include activities ordinarily carried on as an incident to commercial or industrial operations, such as the ordinary testing or inspection of materials or products, or the designing or construction of equipment or buildings. The regulations further state that scientific research can be either “fundamental” or “basic” as contrasted with “applied” or “practical.”

2. The regulations further provide four examples of scientific research that are considered as directed toward benefiting the public in meeting the public interest test and have application to a university educational program. The four examples of scientific research regarded as carried on in the public interest include scientific research carried on for the purpose of:

- (a) aiding in the scientific education of college or university students;
- (b) obtaining scientific information published in a treatise, thesis, trade publication, or in any other form available to the interested public;
- (c) discovering a cure for a disease; or
- (d) aiding a community or geographical area by attracting new industry to or by encouraging

<sup>7</sup>Code § 509(a)(3)(C).

the development or retention of an industry in the community or area.

The regulations indicate that research described in these four examples will be regarded as carried on in the public interest even though the results are not made available to the public; the regulations state that the research described in these examples will be regarded as carried on in the public interest even though such research is performed pursuant to a contract or agreement under which the research's sponsor or sponsors have the right to obtain ownership or control of any patents, copyrights, processes, or formulas resulting from such research.

3. Commercially sponsored scientific research where the sponsor retains all rights to the research can also meet the public interest requirements if the results are published or they meet one of the four examples.

### III. Internal Revenue Service Policies and Rules

#### A. Royalties

##### 1. Sharing royalties with the inventor.

a. The IRS's favorable position regarding the appropriateness for an exempt organization to share royalties from the exploitation of an invention with the inventor has had a developing history. See Darling and Friedlander, *Intellectual Property, Internal Revenue Service Exempt Organizations Continuing Professional Education Text for FY 1999* (8110198) (hereafter "1999 CPE Text").

##### b. Cash royalties.

(1) In order to avoid potential private excess benefits or inurement issues, the IRS places principal reliance on comparability of a royalty sharing arrangement with those of other similar organizations. Typical employment agreements require the assignment to the exempt organization by the employee of inventions and other intellectual property in return for a share of the royalty, if any, received. For example, Northwestern University's current policy provides for 30 percent of the net income from royalties to go to the inventor. Patent and Invention Policy January 1, 1999, at <http://www.nwu.edu/ttp/policies/new-patent.html>. Harvard University provides 35 percent of the first \$50,000 of net income received and 25 percent of additional amounts to the inventor. Royalty Sharing Policy for Intellectual Property, at <http://www.techtransfer.harvard.edu/RoyaltySharing.html>.

(2) LTR 9316052 approved sharing of royalty and consulting income with employee and payment of a bonus to employees based on revenues from intellectual property.

(3) Congress has passed the Corporate Tax Bill (American Jobs Creation Act of 2004) and President Bush signed it. It contains a provision in section 882 for the treatment of charitable contributions of patents and similar property. A major issue surfaced regarding the valuation of donations of intellectual property. See IRS Notice 2004-7 released on Decem-

ber 21, 2003. Corporations reportedly gave patented and unpatented technology to universities in hopes that the grantees could expand the use of those inventions or discoveries. "A Gift Not of Cash, but of Opportunity," *The Chronicle of Higher Education* (March 3, 2000), at A-36. Most university patent policies do not appear to address the sharing of royalties in the event of commercially viable refinements or improvements of donated patent rights.

##### c. Equity Interests

Congress recognized the importance of university research and the transfer of technology into practical use in the Bayh-Dole Act, 35 U.S.C. § 200-212. The Federal Higher Education Act of 1965 recognized the university's long established mandate to educate and to engage in scientific research when it supported university efforts designed to assist in the solution of community problems and permitted researchers to share in the discoveries that resulted from their bank research at the university that was funded by a government grant.

(1) A tax-exempt organization can provide an inventor an equity interest in a taxable subsidiary without violating the inurement or private benefit prohibitions if such interest is based on the fair market value of the rendered services or the valuation of the discovery.

(2) LTR 9530009 approved the receipt by a 501(c)(3) organization of warrants to purchase stock in return for a license.

(3) In an interesting ruling, the IRS said that a 501(c)(3) will not be adversely affected by an employee buy-out of the taxable subsidiary, under certain circumstances. In LTR 9421006, the Service concluded that the 501(c)(3) status would not be adversely affected by a redemption by a taxable subsidiary of 80 percent of the 501(c)(3)'s stock holdings in the subsidiary and a subsequent sale of that stock to employees and employee benefit plans. It is important to negotiate the sale at arm's-length based on fair market value going concern value and that the redemption/sale was not planned when the subsidiary was created, that a consultant had determined that the employees were the only viable purchasers, and that the redemption price was based on an independent appraisal.

(4) In LTR 9316052 the Service also ruled that the sale by a section 501(c)(3)/509(a)(1) applied research organization of stock in a majority-owned business corporation to the officers, directors, and employees will not adversely affect exemption or result in unrelated business income (UBI) so long as the stock is sold at fair market value. Here the business corporation was formed and capitalized by the research organization to "commercialize" the inventions of the 501(c)(3)'s employees. Fair market value was determined by independent valuation.

*d.* When is a royalty-type equity interest valued to determine the amount of taxable income to the faculty member recipient?

(1) An item shall be included in gross income for the taxable year in which it is actually or constructively received by the taxpayer. Treas. reg. § 1.451-1.

(2) Income is “constructively received” in the taxable year in which it is credited to the taxpayer’s account, set apart or otherwise made available so that the taxpayer may draw on it at any time. Treas. reg. § 1.451-2.

2. Appropriate royalty share requires looking to industry norms and timing.

*a.* LTR 8204016 approved paying the inventor 15 percent of gross income or 50 percent of net income.

*b.* LTR 9316052, approved one-third share of revenue paid to inventor, 15 percent of revenue paid to evaluator of contributed intellectual property, and 50 percent of consulting revenue paid to employee.

*c.* In LTR 9311032, a 501(c)(3) organization sets up a taxable subsidiary and transfers a license it holds in exchange for 96 percent of Sub’s stock; 4 percent goes to an individual who runs a management services company servicing sub in order to give the company an incentive to effectively commercialize licensed technology. The IRS ruled that the organization may allow other investors the chance to invest in Subsidiary. Subsidiary may also do a public or private offering to finance future expansions through sale of its stock and will not result in UBIT to parent.

*d.* The IRS in its instructions to revenue agents specifically calls for comparison to published policies of comparable institutions.

## B. Exempt Status for Technology Transfer Organizations

1. It is important to gain recognition of proposed transactions from the IRS as tax-exempt transactions.

2. Consequences of the ownership of intellectual property.

*a.* Contrast Rev. Rul. 73-193, 1973-1 C.B. 262, with Rev. Rul. 76-297, 1976-2 C.B. 178. Ownership of both legal and beneficial interests in intellectual property by EO is essential to royalty treatment.

*b.* Compare LTR 8827017.

3. Integral part analysis.

*a.* LTR 9604019 found a for-profit subsidiary not to be an integral part but an investment; no adverse effect on exemption of parent. See also LTR 9705028.

*b.* LTR 9720031 is to the same effect, but with an FMV test imposed on the transfer of assets from the EO to the subsidiary.

4. Limits on “commercialization.”

## IV. Excess Benefits Issues. Section 4958 Major Concern of Universities and Related Research Organizations

A. The test of section 4958 is whether the “economic benefit provided” by the 501(c)(3) to the disqualified

person “exceeds the value of the consideration received” by the organization. Section 4958(c)(1).

## B. Inventor Could be Viewed as a Disqualified Person

1. The statutory test is whether individual is “in a position to exercise substantial influence over the affairs of the organization.” Section 4958(f)(1)(A).

2. The typical faculty member or medical investigator has no control over the EO or even its contracting activities but may be able to influence the terms of a particular license.

C. Treas. reg. § 53.4958-5(d) Example 3 provides that a university’s payment of revenue-based compensation to a faculty inventor does not constitute an excess benefit transaction “under the rule of this section.” “This section” refers to section 53.4958-5 addressing revenue sharing transactions. Thus, it appears that this example indicates only that the arrangement will not constitute an impermissible revenue sharing transaction and does not indicate whether the compensation will be deemed reasonable.

## D. Relevant Factors in Compensation

1. Reasonableness.
2. Comparability.
3. Documentation.

## V. Technology Transfer and Tax Exemption

In 1982, the IRS ruled that a nonprofit organization formed to assist technology transfer from research departments to universities and nonprofit research institutions to industry by obtaining patent, copyright, and rights from researchers and institutions and licensing them to third parties was not entitled to exemption as described under section 501(c)(3). This issue arose as a result of the adverse ruling issued to the Washington Research Foundation. That adverse ruling was upheld by the United States Tax Court in a decision dated November 21, 1985, in *Washington Research Foundation v. Commissioner*, 50 CCH TCM 1457 (1985). The foundation sought legislative relief in the Tax Reform Act of 1986.

Section 1605 of Public Law 99-514 was enacted to hold that relief solely to the Washington Research Foundation qualifies it for tax exemption as described under section 501(c)(3). The law provides that an organization incorporated after July 20, 1981, that transfers technology from universities and scientific research organizations (described in section 41(c)(6)(A) or (B)) to the private sector is treated as organized and operated exclusively for charitable purposes.

It would appear that this matter should have been settled, but in the General Explanation of the provision after enactment, the Joint Committee on Taxation said “no inference is intended as to whether such technology transfer or related purposes or functions of any other organization constitute purposes or functions described in section 501(c)(3) or section 170(c).” Accordingly, it remains an open question whether the IRS would challenge the tax-exempt status of other

technology transfer organizations. In order to obtain as much certainty as possible, it would be advisable to obtain a generic legislative exception for similarly situated organizations.

In a colloquy on the Senate floor during the Senate vote on PL. 99-514, Senator Gorton of Washington stated that the proposed amendment to section 501 would clarify the tax status of this organization and will encourage and stimulate the transfer of technology so that the economy and the public will have the benefits to be derived from new products.

The legislation was narrowly drafted apparently to cover only the Washington Research Foundation. When asked by Senator Bradley of New Jersey whether any other university uses a 501(c)(3) to market patents, Senator Gorton said he did not believe so.

Mr. BRADLEY. So, to your knowledge, no other university is able to market their patents as a tax-exempt entity?

Mr. GORTON. That is not quite correct. When this organization or foundation was put together, it had only very slight differences, as I understand it, from a number of similar foundations which are engaged in this kind of efforts which are tax-exempt.

Mr. BRADLEY. So, to your knowledge, no other university uses a 501(c)(3) to market patents?

Mr. GORTON. I believe so.

The time is right to see whether the code could be amended to include a general provision recognizing that technology transfers are tax-exempt scientific activities that promote the broad practices of research and economic development for state universities independent research institutes that were created for those purposes to have the same relief afforded to the Washington Research Foundation in the 1986 legislation.

## VI. Unrelated Business Income Tax Issues

A. University and related research organizations can structure transfer of intellectual property to avoid imposition of the unrelated business income tax.

1. Ownership of the intellectual property.
2. Gross or net income royalties. LTR 9527031 extended royalty treatment to both net and gross income percentages.
3. Services provided by licensor to licensee. Rev. Rul. 81-178, 1981-2 C.B. 135. Can result in taxable transaction rather than a tax-exempt royalty.

B. "Capital gains" from the sale of intellectual property. Section 512(b)(5). Is generally excluded from tax.

### C. Income From Research

1. Payments from a commercial or governmental sponsor for the conduct of research activities by a college, university, or hospital are protected by section 512(b)(8), and payments for research by any EO done for a governmental sponsor are protected by section

512(b)(7). Independent research institutes with non-governmental sponsors must claim protection under section 512(5)(9).

a. The "fundamental research" and "freely available" conditions of section 512(b)(9) do not apply to the section 512(b)(7) or (b)(8) exclusions.

b. Research vs. testing distinction: Testing produces UBI. Reg. § 1.512(b)-1(f)(4).

2. Payments for consulting.
3. Payments for access to facilities.
4. Joint ventures.

a. In Rev. Rul. 2004-51, the Service has provided additional guidance for when a university conducts an insubstantial part of its activities through a limited liability company formed with a for-profit corporation. The importance of this ruling is that it provides a road map for universities to carry on related activities with a for-profit corporation through an LLC equally controlled by both without adversely affecting the university or subjecting it to UBIT.

## VII. Exempt Financing Issues

A. A "federally guaranteed" bond is not an exempt bond. Section 149(b)(1). A bond is "federally guaranteed" if payment of principal or interest is directly or indirectly guaranteed by the federal government or an agency or instrumentality. Section 149(b)(2).

1. LTR 199623032. The receipt by an EO of federal appropriations does not constitute a federal guarantee in circumstances in which federal law prohibits the use of the federal funds to pay any expenses of constructing the facility in question, including the payment of debt service on the bonds.

2. LTR 199914045. Payments by the federal government for research services under research contracts do not constitute a federal guarantee prohibited under section 149(b)(1).

### B. Sponsored Research

1. No more than 5 percent of the net proceeds of an issue for the benefit of an EO may be directly or indirectly "used for any private business use." Sections 141(b)(1), 145(a)(2)(B).

2. Under relevant regulations, if a nonexempt, non-governmental sponsor of research conducted by an EO is treated as an owner, lessee, manager, or other beneficial user of the research facility, private business use results. Reg. § 1.141-3(b)(6).

a. Rev. Proc. 97-14, 1997-1 C.B. 634, establishes operating guidelines for certain basic research agreements. Basic research for this purpose is defined as "original investigation . . . not having a specific commercial objective."

b. Rev. Proc. 97-14 concludes that a nonprivate business use can include corporate-sponsored basic research where the sponsor must pay a competitive price for any license, and cooperative basic research performed for multiple sponsors who are entitled to no more than nonexclusive, royalty-free licenses.

**c. LTR 199914045.** Research under several governmental research contracts was found to comply with the terms of Rev. Proc. 97-14, i.e., (1) the research contracts are for basic research with no specific commercial objective, (2) the price to be paid by any of the contracting federal agencies for the use of the research would be not less than the price payable by any non-federal government party, and (3) the license to use the research would be nonexclusive and royalty-free. Therefore, the use of the bond-financed facility to provide research services would not constitute private business use under sections 141(b) or 145(a).

**3.** Cost of research facility allocated between exempt use and private business use by commercial sponsors on basis of proportion of discounted revenues. LTR 9125050.

### C. Tax-Exempt Bonds

The IRS has published guidance on those conditions where an agreement for corporate-sponsored research will not constitute a private business use under code section 141(b) to disqualify section 501(c)(3) tax-exempt bonds.

**1.** A research agreement relating to property used for basic research that is supported or sponsored by a sponsor (defined below) does not result in 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 — i.e., the sponsor must pay a competitive price for its use. The price paid for the use must be determined at the time the license or other resulting technology is available for use. The recipient does not have to let persons other than the sponsor use any license or other resulting technology, but 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, Sec. 5.02, 1997-1 C.B. 634. A sponsor is any person, other than a qualified user, that supports or sponsors research under a contract. Rev. Proc. 97-14, Sec. 3.03, 1997-1 C.B. 634.

**2.** A corporation won't be treated as a sponsor for this purpose if it doesn't control the type of research or how it's performed, and doesn't provide financial or other support to the researcher as described in Sec. 3.03 of Rev. Proc. 97-14. Thus, the rules of reg. section 1.141-3(b)(7) (relating to arrangements that are treated as a private business use), are also used to determine whether a license agreement for the corporation's commercial marketing of intellectual property affects the tax-exempt bonds issued to finance the corporation's construction of the research laboratory.

**3.** The IRS has held adversely in the following situations.

**a.** A 501(c)(3) organization financed the contributions of the state-of-the-art laboratory for biomedical research with tax-exempt bonds. The activities of the laboratory were held to be substantially related to the 501(c)(3)'s tax-exempt purpose. The organization created a wholly owned for-profit corporation to commercialize the research. It planned to enter into licensing

agreements with an unrelated taxable corporation giving the corporation exclusive perpetual, nonterminable license to any research and to all patents relative to the applied research that was created before and during the term of the license. Under the agreement, the 501(c)(3) assigned exclusive rights to the laboratory's net income derived from the research. The corporation bears 100 percent of the cost and the 501(c)(3) and the corporation split the resulting net income after cost on a 50 percent-each basis. The scientists discovering the research will share in the 501(c)(3) income portion.

**b.** The IRS held that corporation is not a sponsor of the research within section 3.03 Rev. Proc. 97-14 and the agreement constitutes a private business use for the following reasons:

**i.** The corporation does not control the type or manner of performing the research.

**ii.** The corporation had special beneficial legal rights under the contract agreement that are comparable to an ownership interest.

**iii.** Because the corporation is neither a governmental unit nor a natural person its resulting interest in the laboratory constitute a trade or business under section 141(b)(6)(B).

**4.** Alternative solutions to the IRS action.

**a.** Structure the transaction so that the 501(c)(3) is granted exclusive license to the future research results. The 501(c)(3) then could transfer a 50 percent interest in the research to a separate 501(c)(3) affiliated supporting organization described under section 509(a)(3) of the code and enter into a licensing agreement with a commercial organization to market the results of the research. Problem is that IRS would probably hold that the 501(c)(3) using the research results in this manner was an unrelated trade or business and would be a private user.

**b.** Create a scientific research exception for technology transfers along the following lines to amend section 141(b) of the code:

#### Certain Scientific Research

(i) Exception — For purposes of this subsection, the term — 'private business use' shall not include any private business use that would exist without regard to this subparagraph (c) as a result of the receipt by a corporation that is not a governmental unit or 501(c)(3) organization of a right (exclusive or nonexclusive) to intellectual property created by scientific (within the meaning of section 501(c)(3)) research conducted by a governmental unit or 501(c)(3) organization, where one or more governmental units, or one or more 501(c)(3) organizations, or any combination thereof together control the corporation receiving that right, regardless of the degree to which persons other than governmental units and 501(c)(3) organizations have an economic interest in the corporation receiving that right.

(ii) Effect on Ownership Requirement — The receipt of a right described in subparagraph (c)(i) by a corporation described in subparagraph (c)(i)

shall not cause a bond to fail to satisfy section 145(a)(1).

(iii) Definition of Control — For purposes of this subparagraph, the term ‘control’ means ownership of stock possessing more than 50 percent of the total combined voting power of all classes of stock entitled to vote.

In order to be a charitable contribution of property such as patents and patent rights, patents must have a fair-market value at the time of the contribution. Simply stated, it is the price at which the property would change hands between a willing seller and a willing buyer with a reasonable knowledge of the facts without any compulsion to buy or sell. The taxpayer has the burden to establish reasonable, fair-market value.

### VIII. IRS Issues Warning on Valuation of Patents; White House Budget and Senate Finance Committee Issue Similar Warnings

#### A. IRS Concerns

1. In Rev. Rul. 2003-28, 2003-11 IRB 594, IRS identifies four specific issues that arise with respect to charitable contributions under section 170 of the code with respect to gifts of intellectual property including patents. The IRS made it clear that it would not only disallow the deduction but could impose penalties under sections 6700 and 6701 regarding promoters and section 6694 with respect to taxpayers and appraisers involving improper deductions.

(a) the transfer of a nondeductible partial interest in intellectual property;

(b) the taxpayer’s expectation or receipt of a benefit in exchange for the transfer;

(c) inadequate substantiation of the contribution; and

(d) overvaluation of the intellectual property transferred.

#### B. IRS identifies specific situations to watch

(1) If a donation agreement states that a transfer to the donee of the taxpayer’s interests in a patent is subject to a right retained by the taxpayer to manufacture or use any product covered by the patent, the taxpayer has transferred a nondeductible partial interest in the patent.

(2) A transfer to a charitable organization is not made with charitable intent if the transferor expects a return commensurate with the amount of the transfer.

For example, if a donation agreement states that the donee assumes a taxpayer’s liability for a lease of a research facility, this assumption of liability is consideration from the donee. Likewise, a donee’s promise to make available to the taxpayer the results of the donee’s research, such as laboratory notebooks, data,

and research files, is consideration from the donee. Similarly, a charitable organization’s promise to hold a patent and maintain it for a period of time is consideration to a taxpayer if the taxpayer is benefited when others are prevented from purchasing or licensing the patent. In each of these examples, the taxpayer has the burden of showing that it knew, at the time of the transfer, that the value of the donated property exceeded the value of the consideration it received from the donee. The taxpayer may deduct no more than this excess amount.

(3) A taxpayer’s failure to substantiate its contributions of \$250 or more by obtaining from the donee a statement that includes a description of any return benefit provided by the donee and a good faith estimate of the benefit’s fair-market value.

(4) A determination of the fair-market value of a patent must take into account the following factors: whether the patented technology has been made obsolete by other technology; any restrictions on the donee’s use of, or ability to transfer, the patented technology; and the length of time remaining before the patent’s expiration.

#### C. Methods of Valuations of Patents

1. **Income method.** Values a patent based on the present value of the “future stream of economic benefits one can enjoy by owning it.” This method derives a value for an item of property by determining the discounted present value of the income stream likely to be generated by the item. In the case of a patent, that would be the presumed royalties or other income to be derived from exploitation of the patent, with relevant economic, business, and competitive factors taken into account. The income method is particularly useful for valuing property where no comparable property exists. Since patents are, by their very nature, unique, the income method is well suited for valuing them, when underpinned by real-world market data. This method is preferred by valuation experts.

2. **Market approach.** Relies on an analysis of the pricing at which assets comparable to the property being valued were sold at or around the valuation date. This method is common and has been respected by the courts because it can so clearly reflect what a buyer in the market would be willing to pay for comparable property in an arm’s-length transaction. As one court stated, the market method reflects “the ebb and flow of competing judgments between buyers and sellers.” Even though the market method is highly regarded, the “data needed to implement the market approach are rarely available for patents and technology.”

#### 3. Cost method

Analyzes value by “aggregating all of the costs necessary to recreate” the property rights being valued. This method has been seen as useful in valuing charitable contributions of unusual property. When applied to patents and patent rights, however, the cost approach may fail to consider important factors such as

profits from commercializing investment risk, and earnings growth potential.

### C. Best approach

The most persuasive patent valuation methodology for charitable contribution purposes is likely to be an income approach, especially if the approach takes account of the economic and market forces that could affect the income stream to be generated by the patent, reflects reasonable expectations about patent validity along with other relevant factors as of the date of valuation, and is based on actual market data. See *Valuation Remains the Toughest Issue When Donating Patents*, WG&L July 1-Aug. 2003 for a detailed discussion of valuation of patent issues.

### Conclusion

There is every reason to believe that university technology transfer will continue to grow in years to come. All of the parties involved in university technology transfer in the United States, including the federal government, state and local governments, corporations, and the universities, have many incentives to support such activities, and to continue to increase support.

The federal government must continue to support technology transfer, through law and financial aid to remain competitive in the global marketplace. Local governments must support technology transfer because it leads to business job creation and tax revenues. Private industry will likewise continue to increase its support for university technology to remain competitive in the global market. The universities have great incentives to increase support for technology transfer to attract the best students and professors.

Universities and independent nonprofit institutes with their resources of talent and innovation must be coupled with the business community to produce the synergy for income, jobs, and new technologies that will not only improve the lives of our citizens but will create a future in this global economy. I have taken one vehicle, the supporting organization that can assist the university, and the research organization to create the opportunity for this innovation. However, the specific recommendations suggested in this article require a fresh approach to our tax laws regarding the commercialization of technology transfer that will not jeopardize the nonprofit organization's tax status or the tax-exempt bonds that permitted the resources for the initial basic research. Both of these issues require Congress' immediate attention.