

ECONOMIC CRISIS? TECHNOLOGY TRANSFER TO THE RESCUE



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Nonprofits, with their resources of talent and innovation, must be coupled with the business community to produce the synergy for income, jobs, and new technologies.

As Congress continues to work on stimulus measures, the U.S. economy is threatened by the possibility of a jobless economic recovery. The trend of outsourcing jobs, from manufacturing and auto jobs to programming and engineering jobs, creates fear that the U.S. economy will continue to suffer in the long term as countries such as China and India become fully employed. But the American people can continue to prosper in an information-based economy because of the creativity, innovation, and knowledge that inspires the development of new technologies that keep us competitive with other rising nations.

One of our greatest resources lies in our research companies and universities. They are continually discovering new technologies like better medical diagnostic tools and vaccines, environmentally-conscious methods of manufacturing, and clean and renewable energy sources. These technologies are not being developed quickly enough, however. Their benefits have not yet reached the public at large. At least as importantly, the employment opportunities they can produce have not yet materialized. One way to improve this situation is to

unleash the innovative talents of the many research-focused nonprofit entities. Doing so in creative joint ventures with other nonprofits and even commercial organizations to build businesses could hasten the pace of development.

These nonprofits must have the freedom to develop and commercialize their technologies to the point of being widely distributed at reasonable cost. The resulting expansion of domestic research and development would require and would support a larger workforce infrastructure, thus directly and indirectly stimulating new economic activity. The rapidity of new discoveries, however, has presented challenges in managing the coordination of basic research with the needs of the public and reduced funding constraints. Creating an independent supporting organization is one way to support scientific research and meet these challenges. Nonprofits could also benefit from an update of the applicable tax laws to encourage this outcome.

Foundations that support scientific research

Many research nonprofits today are aided in their efforts to further scientific discovery through supporting foundations. A supporting organization,

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as defined in Section 509(a)(3), 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.

The 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, depending on the type of relationship between the supporting organization and the beneficiary organizations.

Organizational test. To meet the organizational test, a supporting organization must be organized exclusively to benefit the supported organizations. The organization's governing document must limit the organization to such purposes, specifically identify the public charity or charities on whose behalf the organization is operated, and not expressly empower the organization to engage in activities that are not in furtherance of such purposes or support any other organizations.

Depending on the relationship with the supported organization(s), the supported organizations may be designated by class or purpose and need not be identified by name. To meet this test, however, such a supporting organization must not be in the loosest subcategory of relationship with its supported organizations.² In addition, for supporting organizations established before 1970, the organization may meet the organizational requirement if there has been an historic and continuing relationship and a substantial identity of interests between the supporting organization and the supported organization(s).³

Operational test. A supporting organization must also be operated exclusively to benefit the beneficiary organizations. An organization will meet the operational test only if it engages solely in activities that support the beneficiary organizations, such as by paying over its income to the public charities or by using its income to carry on an independent activity or program that supports or benefits the public charities.⁴ There is no requirement, however, that all beneficiary organizations receive grants every year or that they share the supporting organization's income in any fixed proportion.

Relationship test. Beyond the basic and fairly mechanical organizational and operational re-

quirements, a supporting organization must stand in one of three prescribed relationships with its beneficiary organization.⁵ Those three relationships are:

- Operated, supervised, or controlled by its beneficiary organization.
- Supervised or controlled in connection with its beneficiary organization.
- Operated in connection with its beneficiary organization.

Operated, supervised, or controlled by. For the supporting organization to be controlled by a public charity, there must be a substantial degree of direction over the policies, programs, and activities of a supporting organization.⁶ The required relationship, referred to as a Type I supporting organization, is comparable to that of a parent and subsidiary, where the subsidiary is under the direction of, and accountable or responsible to, the parent organization. This relationship may be established by a majority of the officers, directors, or trustees of the supporting organization being appointed or elected by the governing body, by members of the governing body, by officers acting in their official capacity, or by the membership of one or more public charities.

Supervised or controlled in connection with. This relationship, referred to as a Type II supporting organization, requires common supervision or control by the persons supervising both the supporting organization and the public charity that it supports.⁷ It is comparable to two subsidiaries of the same parent organization. To meet this test, control or management of the supporting organization must be vested in the same persons that control or manage the supported organization.

Operated in connection with. The third relationship involves the loosest permitted connection to the supported organizations and is referred to as a Type III supporting organization. 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 sup-

¹ Reg. 1.509(a)-4(c)(1). Supporting organizations can also support publicly supported entities that are tax-exempt under other paragraphs of Section 501(c), but such supporting organizations generally are not relevant in the scientific research context. See Section 509(a) (flush language).

² Reg. 1.509(a)-4(d).

³ Reg. 1.509(a)-4(d)(2)(iv).

⁴ Reg. 1.509(a)-4(e)(2).

⁵ Reg. 1.509(a)-4(f)(2).

⁶ Reg. 1.509(a)-4(g)(1)(i).

⁷ Reg. 1.509(a)-4(h)(1).

ported organization....”⁸ [Emphasis added.] More specifically, a Type III supporting organization must satisfy a “responsiveness test” and an “integral part test.”

The responsiveness test requires an organization to be responsive to the needs or demands of the charity that it supports. It is not necessary for the supporting organization to be controlled by the supported charity, but there must be sufficient ties between the supporting organization and the public charity.⁹ The test may be satisfied in several ways. One possibility is that one or more members of the governing body of the organization can be elected or appointed by the public charity. Another is that one or more members of the governing body of the organization can also be officers, directors, or trustees of, or hold an important office in, the public charity. A third is for the officers and directors of the supporting organization to maintain a close and continuous working relationship with the officers or directors of the supported organization. The responsiveness test also requires that by reason of the relationship between the supporting organization and the charity, the public charity has a significant voice in the organization’s investment policies, the timing of grants, the manner of making grants, the selection of recipients of grants, or the general use of the income or assets of the supporting organization.

The Pension Protection Act of 2006 made several changes in the rules applicable to Type III supporting organizations, including the elimination of an alternative method for charitable trusts to meet the responsiveness test. On 9/23/09, the Service and the Treasury released a Notice of Proposed Rulemaking, including proposed regulations addressing these provisions of the Act.¹⁰ Under the proposed regulations, all Type III supporting organizations (including those that are charitable trusts) must meet the responsiveness test under existing Reg. 1.509(a)-4(i)(2)(ii). The proposed regulations continue, however, to allow supporting organizations that were in

existence before 11/20/70 to use additional facts and circumstances, such as a historic and continuing relationship between the supporting and supported organizations, to satisfy the responsiveness test.¹¹

The integral part test requires an organization to maintain a significant involvement in the operations of the public charity, and in turn requires the public charity to be dependent on the supporting organization for the type of support it provides.¹² The purpose of the test is to ensure that at least one of the supported organizations has an incentive to monitor the supporting organization’s affairs. The integral part test can be satisfied in one of two ways, leading to the supporting organization being classified as either “functionally integrated” or “non-functionally integrated.”

Functionally integrated Type III supporting organizations. An organization will satisfy the integral part test as a functionally integrated Type III supporting organization if it meets the test that was previously referred to as the “but for” alternative. The “but for” alternative contemplates that an organization will carry on activities for or on behalf of the public charities to perform the functions of, or to carry out the purposes of, those charities. It further contemplates that, but for the involvement of the supporting organization, those charities normally would be engaged in performing those functions or carrying out those purposes.¹³

The proposed regulations provide new guidance on what type of activities are considered to “directly further” the exempt purposes of a supported organization. Holding title to and managing exempt-use property will be treated as furthering the supported organization’s exempt purposes directly. Fundraising, investing, and managing non-exempt-use property and making grants (to the supported organization or to third parties) will not be treated as furthering the supported organization’s exempt purposes directly.

An exception is made for a supporting organization that supports only one government entity whose assets are subject to a governmen-

⁸ Reg. 1.509(a)-4(f)(4).

⁹ Reg. 1.509(a)-4(i)(2).

¹⁰ See 74 Fed. Reg. 48,672 (9/24/09). The proposed regulations will become effective on the first day of the organization’s tax year that begins after the date on which the rules are published in the Federal Register as final or temporary regulations.

¹¹ See Reg. 1.509(a)-4(i)(1)(ii).

¹² Reg. 1.509(a)-4(i)(3)(i).

¹³ Reg. 1.509(a)-4(i)(3)(ii).

¹⁴ The proposed regulations include two slight differences from the Section 4942 rules. A non-functionally integrated Type III supporting organization is not allowed to use set-asides to satisfy the minimum distribution requirement. Also, in determining the use of carried-over excess distributions, any amount carried over from a previous year would be used first to reduce the distributable amount, and then actual amounts paid in the current year would be used (rather than in the reverse order, as applicable to private foundations).

¹⁵ Reg. 1.509(a)-4(i)(3)(iii).

tal appropriation process for purposes unrelated to the supported organization's exempt purposes. In that case, the investment and management of non-exempt-use property and making grants directly to the supported organization will be treated as furthering exempt purposes directly, as long as a substantial part of the supporting organization's total activities that further the supported organization's exempt purposes are activities other than fundraising, grant-making, and investing and managing non-exempt-use property.

Finally, the proposed regulations also add to the "but for" test a requirement that a functionally integrated Type III supporting organization's activities must directly further the exempt purposes of the supported organizations to which it is responsive under the responsiveness test.

An organization may also meet the integral part test, and be considered functionally integrated, if it is the parent of each of its supported organizations—that is, if it (1) exercises a substantial amount of direction over the policies, programs, and activities of the supported organization and (2) its governing body, or members of the governing body, or officers, appoint or elect a majority of the supported organization's directors, officers, or trustees. For example, if an organization oversees or facilitates the operation of an integrated system, such as a nonprofit hospital system, the organization may qualify as a functionally integrated Type III supporting organization.

Non-functionally integrated Type III supporting organizations. Organizations that previously satisfied the integral part test under what was known as the "substantially all income" alternative will now be considered to be non-functionally integrated Type III supporting organizations. Whereas this type of organization previously made payments of substantially all of its income to public charities that were attentive to the supporting organization's activities because of the amount of support, the Pension Protection Act now requires these organizations to meet a minimum distribution requirement and a new attentiveness test.

The proposed regulations require that, for each tax year, a non-functionally integrated Type III supporting organization must distribute, on or before the last day of such tax year, to or for the use of its supported organization(s), amounts equaling or exceeding 5% of the aggregate fair market value of its non-exempt-use

assets as measured by the asset values over the preceding tax year. The proposed regulations generally adopt the same rules for valuation, timing, and carryovers that are used for private foundations under Section 4942.¹⁴

The proposed regulations also require that a non-functionally integrated Type III supporting organization distribute one-third or more of its distributable amount to organizations that are attentive to the supporting organization's activities and to which the supporting organization is responsive. This test ensures that a supported organization has an interest in the amount of support it receives from the supporting organization and thus will be "attentive" to the supporting organization's activities. A supported organization is considered to be attentive to the supporting organization in the same circumstances as previously allowed under the integral part test, which treats as "attentive" any of the following:¹⁵

- The supporting organization provides 10% or more of the supported organization's total support.
- The supporting organization provides support that is necessary to avoid the interruption of a particular function or activity (i.e., the support is earmarked for a specific function or activity).
- The supporting organization provides an amount of support that, based on the facts and circumstances, is a sufficient part of the supported organization's total support (thus, taking into account actual attentiveness).

The proposed regulations specifically state that distributions to a donor-advised fund in and of itself will not cause the sponsoring organization of the donor-advised fund to be attentive to the supporting organization.

The proposed regulations continue to allow certain trusts created before 11/20/70 to meet the integral part test by meeting certain requirements as set forth in existing Reg. 1.509(a)-(4)(i)(4). This test allows such trusts to bypass the distribution and attentiveness requirements, but classifies them as non-functionally integrated Type III supporting organizations for all other purposes.

Non-functionally integrated organizations must also now comply with the private foundation excess business holdings rules. A transitional rule allows non-functionally integrated supporting organizations, as well as organizations that were previously classified as Type III supporting organizations but are now reclassified as private foundations, additional time to

comply with the excess business holdings rules. The proposed regulations also provide that charitable trusts that meet the exception from the integral part test for trusts established before 11/20/70 are exempt from the application of the excess business holdings rules.

Finally, the Pension Protection Act added a requirement that all Type III supporting organizations provide certain information to their supported organization(s) to ensure that the supporting organization is responsive to its supported organization's needs. The proposed regulations require that a Type III supporting

year beginning after the date when the final or temporary regulations are published.

Organizations previously classified as Type III supporting organizations under the "substantially all income" test in existing Reg. 1.509(a)-4(i)(3)(iii) will be treated as non-functionally integrated supporting organizations until these proposed regulations become effective. Such organizations must meet the new requirements by the first day of their second tax year beginning after the date when the final or temporary regulations are published; provided that (1) the first year after the final or temporary regulations are published must be used to value the organization's assets and (2) the mandatory distributions must commence in the second year, based on those values. The distributable amount for the first tax year after publication of final or temporary regulations will be zero.

After the proposed regulations are published as final or temporary regulations, an organization that was previously classified as a Type III supporting organization but fails to meet the requirements of the proposed regulations will be classified as a private foundation for the tax year in which it fails such requirements and all subsequent tax years.

Limitation on control. The last requirement under Section 509(a)(3) imposes certain limits on who may control a supporting organization. An organization cannot qualify as a supporting organization if it is controlled directly or indirectly by "disqualified persons," as that term is defined in Section 4946, other than organization managers and publicly supported organizations. Thus, in the typical scenario, in which a majority of the supporting organization's board overlaps with the board of one or more public charities, the organization will usually meet this requirement.

Conducting scientific research

A supporting organization may be used to support beneficiary organizations that conduct scientific research. 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

A supporting organization must stand in one of three prescribed relationships with its beneficiary organization.

organization *annually* provide the following information to *each* of its supported organizations:

- Written notice addressed to the principal officer of the supported organization identifying the supporting organization and describing the amount and type of support it provided in the past year.
- A copy of the supporting organization's most recently filed Form 990 (or other return required to be filed under federal tax law).
- A copy of the supporting organization's governing documents, including any amendments, if not previously provided.

The supporting organization must provide this information by the end of the fifth month after the close of its tax year (ordinarily, the month in which its tax return is due) and must retain proof of delivery of the required information, but the organization is permitted to send such information by electronic media.

As previously noted, a Type III supporting organization will need to be ready to comply with the proposed regulations once they become effective. Until then, organizations previously classified as Type III supporting organizations under the "but for" test in existing Reg. 1.509(a)-4(i)(3)(ii) will be treated as functionally integrated Type III supporting organizations. Such organizations must meet the new requirements by the first day of their first tax

¹⁶ Reg. 1.501(c)(3)-1(d)(5).

¹⁷ Senate floor amendment, 132 Cong. Rec. S8072 (6/20/86).

¹⁸ Specifically, section 1605 provided that an organization incorporated on 7/20/81 that transfers technology from universities and scientific research organizations to the private

sector is treated as organized and operated exclusively for charitable purposes.

¹⁹ "General Explanation Of The Tax Reform Act of 1986, (H.R. 3838, 99th Congress, Public Law 99-514)," JCS-10-87 1331 (1987).

entity. In order to be considered as meeting the requirements of Section 501(c)(3), however, the organization must be "scientific," must conduct "research," and must be organized and operated in the public interest.

The 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.¹⁶ Although the regulations do not define "scientific" or "research," 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 includes both "fundamental" or "basic" research, as well as "applied" or "practical" research.

An organization may meet the public interest requirement in several ways, such as by making the results of such research available to the public on a nondiscriminatory basis. Also, any research performed for the United States, any of its agencies or instrumentalities, or a state or a political subdivision will be regarded as carried on in the public interest.

The regulations also give specific examples of scientific research that is considered as directed toward benefiting the public and that therefore meets the public interest test. These examples include aiding in the scientific education of college or university students; obtaining scientific information published in a treatise, thesis, trade publication, or in any other form available to the interested public; discovering a cure for a disease; and aiding a community or geographical area by attracting new industry to or by encouraging 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 it is performed pursuant to a contract or agreement under which the sponsor or sponsors of the research have the right to obtain ownership or control of any patents, copyrights, processes, or formulas resulting from it. Thus, commercially sponsored scientific research, in which the spon-

sor retains all rights to the research, can also meet the public interest requirements if the results are published or they fall within one of the four examples.

Tax exemption for technology transfer

It is not as clear that technology transfer will be considered as furthering a "scientific" or otherwise charitable purpose. In 1982, the Service ruled that a nonprofit organization formed to transfer technology from universities and nonprofit research institutions to private industry by obtaining patents, copyrights, 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 adverse ruling issued to the Washington Research Foundation was upheld by the Tax Court in *Washington Research Foundation*, TCM 1985-570.



Creating an independent supporting organization is one way to support scientific research.

The Foundation sought legislative relief in the Tax Reform Act of 1986. Act section 1605 provided that relief solely to the Foundation, and qualified it for tax exemption under Section 501(c)(3). It appears that the author of the provision, Senator Thomas Slade Gorton, III (R-Wash.), meant for the proposed amendment to encourage and stimulate the transfer of technology so that the economy and the public would have the benefits to be derived from new products.¹⁷ The actual provision, however, was narrowly drafted to cover only the Foundation.¹⁸ In the General Explanation of the provision after enactment, the staff of the Joint Committee on Taxation stated "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 Code section 501(c)(3) or section 170(c)."¹⁹ Accordingly, it remained an open question whether the Service would challenge the tax-exempt status of other technology transfer organizations.

Since then, the Service has not provided much guidance on whether technology transfer and commercialization activities will jeopardize an organization's tax-exempt status. A few organizations, though, have obtained rulings confirming that their technology transfer activ-

ities qualify as exempt activities under Section 501(c)(3).

In Ltr. Rul. 8512084, an organization was formed for the purposes of advancing scientific research through the transfer of technology from laboratory to public use and supporting scientific investigation through grants. The organization wanted to start a new program in which universities would assign the copyrights to specialized research software to the organization for licensing to end-users in exchange for a percentage of the gross income produced. The Service ruled that the program appeared to be in furtherance of the organization's exempt purpose of transferring technology, but also emphasized that the activity would be an insubstantial part of the organization's total activities.

Ltr. Rul. 9243008 involved an organization created for the purpose of creating and operating a communication network to enhance the exchange of information between the public and private sectors. It did so in accordance with state legislation that authorized and appropriated funds to contract with a nonprofit corporation to operate the network. The organization also obtained a federal grant to assist in technology transfer among various governmental and private organizations. The Service ruled that the organization's commercial activities were exempt activities because they lessened the burden of government within the meaning of the regulations accompanying Section 501(c)(3).

In Ltr. Rul. 9316052, an organization that conducted research and development decided to shift its emphasis from basic research to applied research and economic and industrial development. Its goal was to create marketable technologies to help diversify the economy and develop and encourage industry in the surrounding states. The Service ruled that the change did not affect the organization's exempt status because substantially all the research would be scientific research carried on in the public interest. The Service also found that the public interest test was

met because the research was performed for a governmental instrumentality, was published and made available to the interested public, and aided the surrounding states by attracting industry and encouraging industrial and economic development.

Where it is not certain that technology transfer activities will qualify as furthering an exempt purpose under Section 501(c)(3), an organization may opt to transfer such activities to a for-profit subsidiary that is structured to ensure that the subsidiary's activities are not attributed to the exempt parent. In Ltr. Rul. 9604019, a supporting organization wanted to commercialize its software technology. It formed a for-profit subsidiary to take over its activities of participating and assisting in technology transfers and the development of small business enterprises including research parks. The organization intended to exchange all its intellectual property rights for stock in the subsidiary, but the subsidiary would be managed at arm's length and not as an integral part of the exempt organization's operations. The Service found that the subsidiary would have a bona fide business purpose and ruled that this structure would not affect the tax-exempt status of the parent organization. The Service blessed similar structures in Ltr. Ruls. 9705028, 9720031, and, more recently, 200602039, 200602040, and 200602041.

Using a for-profit subsidiary, however, may lead to concerns of private benefit and private inurement. In Ltr. Rul. 200326035, the Service examined an exempt organization that conducted biological and medical research regarding diseases caused by genetic abnormalities. The organization wanted its supporting organization to create a wholly owned for-profit subsidiary that would commercialize the medical discoveries. The organization would transfer an exclusive license in its intellectual property to the for-profit, along with a royalty interest of costs plus 50% of income generated by the intellectual property. The exempt organization would retain the other 50% royalty interest. The Service ruled that, while the exclusive license provided a private benefit to the for-profit, the benefit was incidental because the for-profit would not have any control over the direction of the exempt organization's research and because the for-profit was wholly owned by an exempt organization. Therefore, the license would not jeopardize the organization's tax-exempt status.

²⁰ See Lach and Schankerman, "Royalty Sharing and Technology Licensing in Universities," 2 *Journal of European Economic Association* 2/3 (Apr/May 2004) at 252.

²¹ See Darling and Friedlander, "Intellectual Property," *Exempt Organizations Continuing Professional Education Technical Instruction Program for FY 1999* (1998), available at www.irs.gov/pub/irs-tege/eotopicb99.pdf.

²² The "Bayh-Dole Act," P.L. 96-517, 12/12/80.

²³ See Lach and Schankerman, *supra* note 20 at Table 1.

Because of these outstanding issues of possibly jeopardizing tax-exempt status or providing private benefit, a generic legislative standard for similar technology transfer organizations is needed to provide more certainty. An amendment to the Code, recognizing that technology transfers are exempt activities that promote the broad practices of research and development, would allow similar organizations the same relief afforded to the Washington Research Foundation in 1986. Such a change could have a significant impact on the ownership and handling of intellectual property by research organizations and their supporting organizations.

Intellectual property considerations

Research organizations, because of their nature, generally encounter multiple issues concerning intellectual property, including the sharing of royalty income with inventors and the licensing and donation of patents.

Royalties. Research organizations frequently attempt to attract and retain inventors and researchers by offering to share a percentage of the royalties derived from the exploitation of inventions with the inventor.²⁰ Rev. Rul. 81-178, 1981-2 CB 135, defines a "royalty" as a payment related to the use of a valuable right. Payments for the use of trademarks, trade names, service marks, or copyrights, whether or not payment is based on the use made of such property, are ordinarily classified as royalties for federal income tax purposes. On the other hand, royalties do not include payment for personal services, notwithstanding that the payment may be labeled as a royalty.

The Service has gradually accepted that it is permissible for an exempt organization to share royalties with the inventor. Nevertheless, the Service will examine arrangements for commercial exploitation of an exempt organization's intellectual property rights to ensure that they are not contrary to industry norms, that they satisfy arm's length standards, and that they do not result in excessive compensation or other forms of private benefit or private inurement.²¹ Thus, the Service will give considerable weight to comparable royalty-sharing arrangements of similar organizations when determining if a particular arrangement is reasonable.

Intellectual property policies of research organizations and universities typically grant the organization exclusive control rights over inventions and other intellectual property, so the organization can disseminate the results

of the research to the interested public in a timely manner. The Patent and Trademark Law Amendments Act of 1980,²² which governs the ownership of intellectual property created in the course of research sponsored by the federal government, encourages exempt organizations to support research and development by allowing the organization to elect ownership of the inventions and protection of the intellectual property. In return, employees receive a share of any royalties received. The percentage of the inventor's personal share can range anywhere from 15% to 65% of net revenues, or can involve a step-wise schedule of percentages (e.g., 40% of revenues up to \$500,000 and 25% of revenues over that). Typical percentages paid to inventors appear to range from 33-1/3% to 50%.²³

The Service has examined several situations of royalty-sharing and has approved various structures. In Ltr. Rul. 9316052, an organization not only shared its royalties with employees, but also had a compensation bonus policy based on a percentage of compensation and the organization's gross receipts. The Service found these to be reasonable compensation plans that did not result in prohibited inurement. In Ltr. Rul. 8204016, an exempt organization gave its employees the option of choosing to receive either 15% of gross income derived from the intellectual property created by the employee or 50% of the net income after the exempt organization paid the costs of obtaining protection for the intellectual property. The Service ruled that this compensation arrangement did not jeopardize the organization's exempt status.

The Service also permits royalties to be shared with for-profit corporations that sponsor scientific research. Rev. Rul. 76-296, 1976-2 CB 141, states that commercially sponsored research may qualify as scientific research carried on in the public interest. In Ltr. Rul. 9627023, the Service ruled that sharing royalties with a corporate sponsor would not jeopardize the organization's tax-exempt status.

Compensation in the form of an equity interest in a for-profit subsidiary is also frequently used by research organizations and universities. A tax-exempt organization can use this form of compensation without violating the private inurement and private benefit prohibitions, as long as the total amount of compensation is reasonable. In Ltr. Rul. 200602039, an exempt organization formed a for-profit subsidiary to sell

and license its intellectual property to third parties. The Service ruled that the organization could transfer stock in the subsidiary, or grant options to purchase shares of stock in the subsidiary, as compensation to its employees and contractors without adversely affecting its tax-exempt status, as long as the total compensation paid was reasonable in amount. Compensation consisting of an equity interest would be included in gross income for the tax year in which it is actually or constructively received by the taxpayer.²⁴

Patents. Intellectual property issues, compensation issues, and private benefit and private inurement issues can also arise for an exempt organization if a for-profit entity holds a patent and wants a university or other exempt research organization to conduct further research on the subject, or use, of the patent. In such a situation, the for-profit entity may choose to license the patent to the exempt organization.

In Ltr. Rul. 200905033, an exempt organization was formed to investigate the science of magnetic resonance imaging (MRI) and its use in the medical field. The organization entered into a research agreement with a sponsor that held a non-exclusive license on three patents involving a method of using MRIs. The parties agreed that any knowledge, inventions, or copyrights resulting from the research would be the property of the party that created the results (i.e., jointly owned if jointly created). The exempt organization designed the studies to be conducted under the agreement, engaged in the research, and published the results, but did not test any commercial product or evaluate the commercial value of the method. The Service ruled that the exempt organization's activities under the agreement were scientific research carried on in the public interest. The Service also examined the possible benefits conferred on both the sponsor and the corporation that owned the patents. While the research had the potential to increase the value of the patents held by the corporation and the licenses held by the sponsor, the Service held that

such benefit was incidental to the benefit to the public from the results of the research, and there was no private inurement.

As another option, the for-profit entity may choose to donate the patent to the exempt organization. In general, a donor taxpayer may deduct the lesser of the value of its basis in the patent or the patent's fair market value.²⁵ A taxpayer donor also may be permitted to take additional charitable deductions based on varying percentages of any income received by the charitable donee that is attributable to the donated patent, to the extent that the total amount of the additional deductions exceeds the taxpayer's initial deduction.²⁶ To claim such deductions, the taxpayer must inform the charity that the taxpayer intends to treat the patent as a "qualified intellectual property contribution" for the purposes of Sections 170(m) and 6050L. The taxpayer also must obtain written substantiation from the charity of the amount of any net income received by or accrued to the charity that is properly allocable to the qualified intellectual property.

In Rev. Rul. 2003-28, 2003-1 CB 594, the Service identified three specific issues that arise with respect to charitable contributions of intellectual property including patents. The Service also made clear that, in certain situations involving improper deductions, 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.²⁷

The first issue identified by the Service involved the transfer of a nondeductible partial interest in intellectual property. If a donation agreement states that a transfer to a donee of the taxpayer's interest in a patent is subject to a right retained by the taxpayer, such as the right to license the patent or to manufacture or use any product covered by the patent, this transfer would be nondeductible because it is a partial interest in the patent. In the second situation, the transfer of a patent subject to a conditional reversion to the taxpayer is not deductible unless the condition is so remote as to be negligible. The third situation allows a deduction for a patent transferred subject to a license or restriction, but the deduction is reduced by the fair market value of the license or restriction.

The Service thus emphasized that a donor taxpayer's deduction must account for the value of any benefit received by the taxpayer, and that the transfer must be made with char-

²⁴ Section 83; Reg. 1.451-1.

²⁵ Section 170(e)(1).

²⁶ Section 170(m).

²⁷ Notice 2004-7, 2004-3 IRB 310.

²⁸ See Reg. 53.4958-4(a)(1).

itable intent. For example, if the donee assumes a liability of the taxpayer for the lease of a research facility or promises to make available the results of the donee's research to the taxpayer, the taxpayer has received consideration for the transfer. Likewise, an organization's promise to hold and maintain a patent for a period of time is consideration to the taxpayer if the taxpayer benefits from others being prevented from purchasing or licensing the patent. A failure to substantiate the contribution can result in penalties.

Other tax considerations

In addition to intellectual property matters, research organizations may also encounter other tax issues that are common to exempt organizations, including excess benefit transactions, unrelated business income tax, and exempt financing.

Excess benefit transactions. Section 4958 imposes an excise tax on disqualified persons who engage in an excess benefit transaction with an organization described in Section 501(c)(3), as well as managers of the organization who participate in the transaction. In general, an excess benefit transaction means any transaction in which an economic benefit is provided by a Section 501(c)(3) organization (other than a private foundation), directly or indirectly, to or for the use of any disqualified person, and the value of the economic benefit provided exceeds the value of consideration (including the performance of services) received for providing the benefit.²⁸

A disqualified person is defined by Section 4958(f)(1) as anyone who, during the five-year period ending on the date of the transaction in question, was in a position to exercise substantial influence over the affairs of the organization, as well as certain family members of such individuals and entities in which disqualified persons have a 35% interest. Thus, the question arises of whether an inventor could be a disqualified person. The typical researcher or faculty member of a university may not have any control over the exempt organization, or even its contracting activities, but this person may be able to influence the terms of a particular license. As a best practice, an exempt organization may want to follow the procedure for raising a rebuttable presumption that any compensation paid to a researcher or inventor will be considered reasonable.

The rebuttable presumption applies if (1) the compensation arrangements are approved in

advance by members of the governing body, or a committee, where none of the members have a conflict of interest with respect to the compensation arrangements; (2) before making its determination, the governing body or committee obtains and relies upon appropriate data as to comparability that is sufficient to determine to whether the compensation arrangements are reasonable; and (3) the governing body or committee adequately documents the basis for its determination concurrently with making that determination. An exempt organization may avoid the excess benefit rules if the employment agreement is an initial contract that does not provide for any non-fixed payments. In royalty-sharing agreements, however, this exception will not apply.

Unrelated business income tax. A research organization, even one engaged in scientific research in the public interest, may be subject to unrelated business income tax (UBIT) if it does not properly structure the transfer of intellectual property and technology and the income received from these activities.

Section 511 imposes a tax on certain unrelated trade or business activities. Certain categories of unrelated income are not included in the definition of unrelated business taxable income under exceptions found in Section 512, including dividend and interest income, royalty income, and gain from the sale of property (other than inventory or property held for sale in the ordinary course of business).

Income derived from intellectual property generally will be considered royalty income and not included in unrelated business taxable income. The importance of the ownership of intellectual property, however, is made clear by two revenue rulings. In Rev. Rul. 73-193, 1973-1 CB 262, an exempt organization owned only the bare legal title to intellectual property of other scientific and educational institutions, and promoted, developed, and licensed such inventions to third parties. The Service ruled that the income from licensees was received in exchange for patent development and management services and therefore did not qualify as royalties and would not be treated as unrelated business taxable income. Rev. Rul. 76-297, 1976-2 CB 178, on the other hand, described an exempt organization formed to evaluate and pursue patent protection for inventions associated with a university, where the organization owned both the legal and beneficial rights to the inventions. On this basis, the Service ruled

that amounts paid by licensees to the organization were royalties and therefore excluded from unrelated business taxable income. Ltr. Rul. 8827017 followed this line in ruling that an organization that was the legal and beneficial owner of patents to be licensed to third parties would receive royalties that would be excludable in computing unrelated business income.

Rev. Rul. 81-178, 1981-2 CB 135, clarified that payments received for the use of intellectual property will be considered royalties and not included in unrelated business taxable income, but that if any services are provided by a licensor to a licensee, the payments will not be considered a royalty to the extent they are for such services and so will be subject to UBIT. In addition, various private letter rulings indicate that the structure of the payments is not determinative as to whether payments are considered royalties. For example, in Ltr. Rul. 9527031, the Service allowed royalty treatment for payments based on net proceeds as well as gross profits.²⁹

Non-royalty income that is received in the course of scientific research may also be excludable from unrelated business taxable income in certain cases. Section 512(b)(7) protects income when the research is performed for the United States, any agency or instrumentality, or any state or political subdivision. Section 512(b)(8) protects income from research performed for any person if conducted by a college, university, or hospital. For all other research organizations, however, if research is performed for a non-governmental sponsor, income is protected from UBIT only if the research is "fundamental" and the results are made freely available to the general public.

Alternatively, a research organization might choose to sell its intellectual property. In that case, the gain from the sale will generally be excluded from unrelated business taxable income.³⁰ If sales are too frequent, however, an

organization runs the risk of being considered to be in the business of developing intellectual property for sale, and this exception to unrelated business taxable income would not apply.

A research organization might also be liable for UBIT if its research projects involve more than incidental private benefit. In Ltr. Rul. 9414003, an exempt organization was established to research and promote improved use and design of urban public open spaces, primarily by providing study and development services on a consulting basis with respect to public spaces owned by public and private entities in urban centers. The majority of the organization's projects were performed for governmental and quasi-governmental bodies, but some projects provided more than incidental private benefit, such as by improving pedestrian flow or public access in and around a private sponsor's facilities. The Service found that, while the organization's projects primarily served the public interest and only incidentally furthered commercial purposes, some of the fees paid for consulting services would be considered unrelated business taxable income, depending on the facts and circumstances of the particular project.

Unrelated business taxable income also is a concern when research organizations engage in a joint venture with a for-profit entity. An exempt organization generally may form and participate in a partnership, or limited liability company (LLC) treated as a partnership for federal income tax purposes, if participation in the partnership furthers a charitable purpose and the partnership agreement permits the exempt organization to act exclusively in furtherance of its exempt purposes and only incidentally for the benefit of any for-profit partners.³¹ If the partnership's activities are unrelated to the exempt organization's purposes, but do not constitute a substantial part of the organization's activities, the income from the partnership might be unrelated business taxable income.

In Rev. Rul. 2004-51, the Service provided additional guidance particular to a university conducting an insubstantial part of its activities through an LLC formed with a for-profit corporation. This ruling provides a road map for exempt organizations that want to carry on related activities with a for-profit entity through an LLC that is equally controlled by both parties without adversely affecting the exempt status of the

²⁹ Royalties also will no longer be exempt from UBIT if they arise from debt-financed property. See Sections 512(b)(4), 514.

³⁰ See Section 512(b)(5).

³¹ See Rev. Rul. 98-15, 1998-1 CB 718; Rev. Rul. 2004-51, 2004-22 IRB 974.

³² Section 141(b).

³³ Section 145(a)(2)(B).

³⁴ Reg. 1.141-3(b).

³⁵ Rev. Proc. 2007-47 provides that the federal government rights under the Bayh-Dole Act do not cause private business use if the other requirements are met.

³⁶ Compare, e.g., Ltr. Rul. 200326035.

³⁷ Rev. Proc. 97-14 was later superseded by Rev. Proc. 2007-47.

organization or subjecting its share of the LLC's income to UBIT.

Exempt financing. Research organizations need to be aware of the requirements for bonds to be qualified 501(c)(3) tax-exempt bonds. All of the proceeds of the debt must produce property that is owned by Section 501(c)(3) organizations, and 95% of the net proceeds of the debt must produce property that is used by such organizations.³² Ownership of the bond-financed property is seldom a problem, but use of the property can create an issue for research organizations. If a use by a sponsor is determined to be a private business use, it must stay below the 5% limitation.³³

Private business use can result if a non-exempt, non-governmental sponsor of research is treated as an owner, lessee, manager, or other actual or beneficial user of the bond-financed property.³⁴ Rev. Proc. 2007-47, 2007-29 IRB 208, provides guidance regarding when research sponsorship agreements will not result in private business use. In order to avoid jeopardizing the bond's tax exemption, a license or other use of the technology by the sponsor must be permitted only on the same terms as would be allowed for an unrelated, non-sponsoring party (i.e., the sponsor must pay a competitive price for the license), and the price paid must be determined at the time the license becomes available for use. The exempt organization 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 would have been paid by a non-sponsoring party for those same rights. In addition, in the case of federally and industry-sponsored research, where a single sponsor or multiple sponsors may agree to fund governmentally performed basic research, the research agreement will not result in private business use if (1) the exempt organization determines the research to be performed and the manner in which it is performed, (2) title to any intellectual property incidentally resulting from the research remains exclusively with the exempt organization, and (3) the sponsor is entitled to no more than a nonexclusive, royalty-free license to use the product of any research.³⁵

In certain circumstances, a facility may be constructed as a mixed-use facility, where part of the facility is financed by tax-exempt bonds. In Ltr. Rul. 9125050, a research organization that was supported mostly by charitable and government grants, but also by privately sponsored research agreements, sought to construct

a research building, treat the building as a mixed-use facility, and finance a portion of it with tax-exempt bonds. The organization stated that the grants and sponsored contracts were not allocable to any particular research project and therefore used a revenue-allocation test to determine the percentage of the building that would be bond-financed. The Service ruled that the test was a reasonable method of allocating costs because it reflected the proportionate benefit derived by the users and no other method was feasible. Thus, the organization was permitted to finance a portion of the facility with tax-exempt bonds. This type of revenue allocation method was also approved in Ltr. Rul. 200132017.

In contrast, the Service ruled in Ltr. Rul. 200347009 that a license agreement between an exempt organization and a for-profit corporation would be considered private business use because the rights were comparable to an ownership interest. The exempt organization had financed a laboratory for biomedical research with tax-exempt bonds. The organization proposed to enter into a license agreement with a wholly owned for-profit subsidiary that would commercialize and market the research created at the laboratory for the organization. The license agreement would give the subsidiary an exclusive, perpetual, non-terminable, worldwide license to all of the organization's intellectual property created at the laboratory and an exclusive right to sublicense the intellectual property. The organization would also assign to the subsidiary a royalty interest of costs plus 50% of net income derived from the intellectual property.³⁶ The Service ruled that the subsidiary was not considered a sponsor under the guidelines of Rev. Proc. 97-14, 1997-1 CB 634,³⁷ and the agreement was considered a private business use of the laboratory because the license granted to the subsidiary was a beneficial use of the laboratory that was comparable to an ownership interest in the laboratory. The net income interest further demonstrated that the interest was comparable to ownership.

As discussed earlier, this structure might otherwise be used by a research organization to create a for-profit subsidiary to commercialize its technology and intellectual property. An exception to the private business use rules to allow the use of this structure in the context of tax-exempt bond-financed property would be particularly useful to research organizations. An amendment to Section 141(b) might read as follows:



(10) Certain scientific research.

(A) 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 paragraph (10) as a result of the receipt by a business enterprise treated as a corporation for federal income tax purposes 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 business enterprise 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 business enterprise receiving that right.

(B) Effect on ownership requirement. The receipt of a right described in subparagraph (A) by a business enterprise described in subparagraph (A) shall not cause a bond to fail to satisfy section 145(a)(1).

(C) Definition of control. For purposes of this paragraph (10), the term "control" means ownership of more than 50 percent of the total combined voting power of all classes of stock (or profits or beneficial interest in the case of any unincorporated enterprise) entitled to vote.

Another requirement of tax-exempt financing is that a federally-guaranteed bond, for which payment of principal or interest is directly or indirectly guaranteed by the federal government or any agency or instrumentality, is not a tax-exempt bond.³⁸ Ltr. Rul. 9623032 clarifies that, if an exempt organization receives federal appropriations, but is prohibited by federal law from using the appropriated funds to pay for the costs of a project, including principal and interest payments on bonds, the bonds are not federally guaranteed. Ltr. Rul. 199914045 states that a research organization may finance the building of a research facility with tax-exempt bonds, even if the organization receives payments on research contracts from federal agencies. Because the payments under the research contracts could be reduced at any time and are dependent on the contin-

ued activity and viability of the organization, the payments do not cause the bonds to be federally guaranteed.

Conclusion

There is every reason to believe that technology transfer will continue to grow in years to come. All of the parties involved in technology transfer in the United States, including the federal government, state and local governments, corporations, and 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 technology to remain competitive in the global market. Universities have great incentives to increase support for technology transfer to attract the best students and professors.

Nonprofits, 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 not only will improve the lives of our citizens, but also will create a future in this global information-based economy. The supporting organization is one vehicle that can assist research organizations to create the opportunity for this innovation. The specific recommendations suggested above, however, require a fresh approach to the tax laws regarding the commercialization of technology transfer; one that will jeopardize neither the nonprofit organization's tax status nor the exempt interest status of bonds that finance the initial basic research. Given the current political emphasis on economic stimulus legislation, these issues deserve the immediate attention of Congress. ■

³⁸ Section 149(b)(1).