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IRS Clarifies Sponsored Research Limitations

On June 26, 2007, the Internal Revenue Service provided clarification as to the circumstances in which the sponsorship of research activities conducted in a tax-exempt bond-financed facility will or will not be treated as creating "private use" of the facility by the research sponsor. Revenue Procedure 2007-47 modifies and supersedes Revenue Procedure 97-14, a prior safe harbor. The new Revenue Procedure provides much-requested clarification that the so-called "Bayh-Dole" rights provided to the federal government in connection with federal research grants do not create troublesome private use by the federal government. It also modifies rules as to certain industry-sponsored research arrangements by clarifying that the rules apply to single sponsorships and not just certain multiple sponsor arrangements, which may facilitate use of such contracts in connection with research conducted in bond-financed facilities. These changes affect determinations of private use with respect to both governmental and qualified 501(c)(3) bonds. The new provisions may be applied to existing research contracts on an elective basis.

The Prior Safe Harbor

Revenue Procedure 97-14 had provided two safe harbors against treatment of research sponsors as users of bond-financed facilities. First, private use would not be found if the sponsor was required to pay a competitive price for use of any intellectual property resulting from the research, even if the sponsor was given exclusive rights to use of such property. This provision was titled "corporate-sponsored research." It is included in new Revenue Procedure 2007-47 without change.

Second, a so-called "joint industry-governmental cooperative research arrangement" allowed "multiple unrelated sponsors" to have royalty-free licenses, but only if the right was a non-exclusive one. In addition, the governmental (or charitable) recipient of the payment from the sponsor had to have the right to determine the research to be

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performed and the manner in which it was performed and had to retain title to any resulting intellectual property. Could this provision protect below-market licenses to individual corporate sponsors? Based upon the legislative history of the Tax Reform Act of 1986, which instructed Treasury to provide these two safe harbors, there was reason to believe that the second one was intended only for a particular then existing model for multi-sponsor funding of research, such as that provided under programs of the National Science Foundation, and ought not to be extended by analogy.

Federally Sponsored Research and Bayh-Dole Rights

The Patent and Trademark Law Amendments Act of 1980, commonly known as the Bayh-Dole Act, provides that research grants made by federal government agencies must retain for the federal government various rights, including a non-exclusive, non-transferable, irrevocable, paid-up license to use the products of federally sponsored research and so-called “march-in rights. “ March-in rights constitute the right to take certain actions, including granting licenses to third parties, to ensure public benefits from the dissemination and use of the results of federally sponsored research if the grant recipient or its assignee fails to take steps to achieve the practical application of the research. The federal government has rarely if ever exercised its march-in rights.

The federal government is treated as a private person under the private activity bond provisions of the Internal Revenue Code. Because the federal government is one of the most significant outside sponsors of research conducted by state governmental entities, colleges and universities, and hospitals, it is crucial to determine that any rights retained by it under a research grant do not constitute a “use” of bond-financed property for private activity bond purposes.

Because Bayh-Dole rights did not appear to be protected under Revenue Procedure 97-14, there has been considerable discussion in the bond community in recent years as to the need to clarify that such rights do not constitute use of bond-financed property. The tax exemption of billions of dollars of bonds might have been affected by a contrary conclusion. Revenue Procedure 2007-47 is intended to confirm that Bayh-Dole rights will not by themselves cause a federal research grant to constitute private use.

One warning: The federal government remains a “private person” under the private activity bond provisions, and the new Revenue Procedure is intended to provide comfort only as to Bayh-Dole rights. Some federal grants, including ones involving defense and homeland security, may involve additional retained rights beyond those required under the Bayh-Dole Act. Any such additional rights retained by the

federal government in connection with research grants require separate scrutiny.

Industry Sponsored Research

Revenue Procedure 2007-47 modifies the second safe harbor in a manner which appears intended to make it more useful as a shield against private use treatment. The prior Revenue Procedure provided rules for "joint industry-governmental cooperative research arrangements" which allowed multiple sponsors to obtain non-exclusive royalty-free licenses of technology resulting from their sponsorship payments. Bond counsel had debated whether this provided comfort as to non-exclusive royalty-free licenses when provided on a preferential basis to a single corporate research sponsor.

New Revenue Procedure 2007-47 modifies the language of its predecessor to eliminate the language referring to "cooperative" arrangements and to specifically apply the modified provision to single sponsors. It now applies to "industry or federally-sponsored research agreements." This second safe harbor, as so modified, allows corporate sponsorship in a broader array of circumstances, so that a non-exclusive royalty-free license may be granted to a sponsor on a preferential basis in lieu of the exclusive market-rate license, which previously had been the only preference that could be provided to a sponsor.

What is the relationship between the two safe harbors under the new Revenue Procedure? The heading provided for the first refers to "corporate" sponsorship while the heading for the second refers to "industry" and "federally" sponsored research. However, these differences in terminology probably reflect only the historical development of the Revenue Procedure rather than an intended substantive distinction as to applicability. It would appear that either safe harbor should be available to a private for-profit sponsor (or to the federal government). Again, the principal difference between the two is that the first safe harbor allows the sponsor to have exclusivity but at the cost of a market-rate royalty while the second safe harbor allows the sponsor to pay a below-market royalty but at the cost of a lack of exclusivity.

Questions Remain

While Revenue Procedure 2007-47 provides helpful clarification as to allowable sponsored research, several questions remain. They include:

- *The scope of protection of Bayh-Dole rights*:

  - The operative language protecting Bayh-Dole rights can be read to suggest that this protection is not available when the technology resulting from federally sponsored research is licensed to any party other than the federal government, unless such license is on a non-exclusive royalty-free basis. It is understood that this was not the intended result. The IRS appears to have been concerned with sub-licensing to third parties by the federal government under its march-in rights, not with arm's-length licensing by the qualified user, *i.e.*, the state or local government or charitable entity that received the federal grant. The language in the Revenue Procedure explaining the changes supports this reading, although the operative language is not clear. Language clarifying this point may be needed.

  - The protection of Bayh-Dole rights by its terms applies only to the (now-revised) second safe harbor. Is it not applicable as to federal contracts otherwise covered by the first safe harbor?

- *What is "basic research"?* The new Revenue Procedure, like its predecessor, applies only to grants for "basic research," which is defined as any original investigation for the advancement of scientific knowledge not having a specific commercial objective. "Product testing" is offered as an "example" of non-basic research. Is it only an example, or does it describe the dividing line? Stating the question another way, can corporate sponsored research have a specific commercial objective prior to the existence of a "product"?

- *Who picks the project?* The modified second safe harbor which allows non-exclusive royalty-free licenses to single sponsors requires the grant recipient, *e.g.*, the college or hospital, to determine the research to be performed. Does that mean that the sponsor cannot specify the research project? If it cannot, the second safe harbor may be of little value.

- *Are there other factors of concern?* The new Revenue Procedure, like its predecessor, focuses only on rights in the patents and other technology which may result from sponsored research. What about physical presence, for example? Can the corporate sponsor send its employees to the bond-financed facility to observe the research? To participate? Under applicable Treasury Regulations, whether sponsored research results in private business use remains a "facts and

circumstances" inquiry.

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If you wish to discuss the contents of this advisory, or for assistance with issues raised by the legal developments that are the subject of this advisory, please contact the Mintz Levin lawyers listed below or any other member of Mintz Levin's Public Finance section.

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