

March 11, 2020

To: Contact & Grant Officers
Intellectual Property Directors
Industry Directors

Subject: Supplemental Guidance to the Tax Reform Act of 1986

Background

The University finances certain facilities in whole or in part with proceeds of tax-exempt or other tax-advantaged bonds. Federal tax law, including the Tax Reform Act of 1986, places limits on the private business use¹ of such bond-financed facilities and the University may not permit such bond-financed facilities to be used in any manner that would violate the IRS private business use rules or otherwise cause the interest to become taxable under federal tax law income tax provisions.² Sponsored research agreements that give sponsors certain intellectual property rights may be considered private business use under the federal tax law. Fortunately, IRS Revenue Procedure 97-14 provides safe harbor provisions under which broad categories of research activities do not result in a private business use. On May 24, 2000, UCOP's then-Office of Technology Transfer issued [OTT Operating Guidance Memo 00-01 \("OTT-00-01"\)](#) discussing the '86 Tax Act, IRS Revenue Procedure 97-14, and the safe harbor provisions.

In 2007, IRS issued [Revenue Procedure 2007-47](#), modifying and superseding Revenue Procedure 97-14. This RPAC Guidance Memo was developed by Research Policy Analysis and Coordination ("RPAC") in collaboration with Office of General Counsel ("OGC") and University bond counsel to supplement OTT-00-01, extending guidance based upon Revenue Procedure 2007-47. To minimize repetition, this RPAC Guidance Memo is supplemental to, and not a replacement of, OTT-00-01.

Purpose

This RPAC Guidance Memo (RPAC-20-02) is intended for University administrators, such as

¹ Private business use of a financed facility is any use other than use by a state or local government entity or use as a member of the general public. Private business use is further discussed in OTT-00-01, a foundational document which should be read and understood in conjunction with this Memo.

² It should be noted that "private business use" for purposes of tax-exempt and tax-advantaged bond financing is distinct from "private benefit," which applies to all organizations qualified under Section 501(c)(3) of the Internal Revenue Code. Contact OGC for further guidance.

contract and grant personnel and licensing personnel, involved in the review, negotiation of, or approval of intellectual property language in sponsored research agreements, material transfer agreements, visitor agreements, equipment loan agreements, or other agreements. With regard to the federal tax law, the responsibilities of such personnel are to:

1. negotiate intellectual property terms of such agreements to minimize and/or avoid private business use issues in research agreements;
2. recognize when intellectual property rights in such agreements (and/or the activities proposed within such agreements) result in private business use;
3. coordinate with campus Capital Planning / Budget departments to avoid exceeding allowable private business use limits; and
4. provide input to campus Capital Planning / Budget departments for the annual private activity questionnaire (PAQ) conducted by the Office of the President Capital Markets Finance to ensure compliance with the Tax Reform Act.

Monitoring compliance with the allowable private business use limitation presents a significant administrative burden given the total number of facilities involved and the ever-changing mix of financing sources supporting individual campus facilities. The private business use limitation is in effect for the entire duration of the bonds (typically 30 years), and covers all types of private activity taking place in the facility including conducting research, leasing of space, management contracts, energy efficiency agreements, and other special entitlements like naming rights and special concessions to vendors. More than de minimus private business use of bond financed facilities could jeopardize the bonds' tax-exempt status retroactively.

As discussed in OTT-00-01, research agreements relating to facilities used for basic research sponsored by a single corporate sponsor will not result in private business use so long as:

1. The University determines the research and the manner in which it is to be performed;
2. Title to any patent or other product incidentally resulting from the basic research lies exclusively with the University;
3. Except for NERF licenses, sponsor must pay a fair, competitive price for use of the resulting technology; and
4. The price paid for sponsor's use of resulting technology is determined at the time the license or other resulting technology is available for use.

Safe harbor criteria for cooperative research agreements are different and also discussed in OTT-00-01, a foundational document which should be read and understood.

IRS Revenue Procedure 2007-47 Addresses Federally Sponsored Research

New sections 6.03 and 6.04 under Revenue Procedure 2007-47 specifically address federally sponsored research, but the corporate-sponsored safe harbor rules remain unchanged. Changes implemented by IRS Revenue Procedure 2007-47 (compared to Revenue Procedure 97-14) can be found in Enclosure A.

Section 6.03 clarifies that the safe harbor test for federally sponsored cooperative (multi-party) research agreements is identical to the safe harbor test for corporate sponsored cooperative research agreements; all of the following conditions must be met:

1. Multiple unrelated sponsors agree, to fund University-performed basic research.
2. The University determines the research and the manner in which it is to be performed.
3. Title to any patent or other product incidentally resulting from the basic research lies exclusively with the University.
4. The sponsor or sponsors are entitled to no more than a non-exclusive, royalty-free license to use the product of any of that research.

Section 6.04 clarifies that the rights of the federal government and its agencies mandated by the Bayh-Dole Act will not cause a research activity to result in private use, even though some federal government's rights under the Bayh-Dole Act do not meet conditions 1-4 above. Federal government march-in rights are specifically cited as an example of a Bayh-Dole mandated right that will not cause a research activity to result in private use. The federal government's right to receive title if the University chooses not to elect title would be another such Bayh-Dole mandated right.

Tax Act Principles

In consultation with the University, University bond counsel developed Principles for Avoiding Private Business Use in Research Contracts that establish parameters for ensuring that research agreements remain within safe harbor provisions. Frequently Asked Questions (FAQs) supplement these Principles.

Principle 1: The University can always agree to a non-exclusive royalty-free license (a "NERF") with an individual sponsor or group of sponsors, including the federal government. Contracts with Federal entities that contain standard, Bayh-Dole invention rights do not cause private business use.

1. Does it matter if the NERF license is commercial or an internal research use license?

No. The fact that a sponsor is granted a commercial NERF license does not constitute private business use of the bond financed facility where the research is being conducted.

Principle 2: Only in single sponsor circumstances are exclusive licenses to the sponsor (or an entity specified by it) allowed and then only if fair market value is charged. Fair market value is determined at the time of the license in question. We believe that exclusive licenses are much more likely than non-exclusive licenses to cause private business use and, therefore, extra care should be taken to make sure that exclusive licenses satisfy these principles. In determining whether a particular research project has only a single sponsor, contributions by the University to the research project can be ignored.

2. Does agreeing to an upfront royalty range, technology fee, one-time license fee, or royalty cap for an exclusive license in the research agreement cause the activity to result in private use?

If the campus, through consultation with its respective Authorized Licensing Office ("ALO"), agrees that the royalty range (or other consideration) in the research agreement represents the "fair market value" of the anticipated and pre-identified

invention at the time the technology becomes available, then the royalty range (or other consideration) in the research agreement likely does not cause the activity to result in private use. The “fair market value” should be justified and documented by the campus accordingly.

3. Will a research consortium agreement fail to meet the requirements the safe harbors if one of the consortium members receives an exclusive license, subject to all consortium members providing their consent?

Yes. Only in single sponsor circumstances are exclusive licenses allowed without causing the research activity to result in private use. Granting an exclusive (or co-exclusive) license to one (or several) sponsor(s) in a multi-sponsor consortium agreement falls outside the safe harbors, even if all other members in the consortium consent to the arrangement. The determining factor is not whether consortium members provide consent, but whether the agreement explicitly enables any member to receive a license that is more exclusive than a NERF license.

4. Is a present grant of a NERF license in a research agreement (e.g. “University hereby grants sponsor”) considered pre-pricing of the invention?

According to Principle 1, a NERF license is always allowed. The pre-pricing guidelines apply to licenses that are more exclusive than NERF licenses.

5. Does agreeing to a time-limited, fixed-fee option agreement or letter of intent in the research agreement cause the activity to result in private use?

Option agreements and letters of intent are short-lived arrangements intended to allow a potential licensee to evaluate its interest in a license agreement. Option agreements and letters of intent in research agreements that do not pre-price the full value of an exclusive license would not cause the activity to result in private use.

6. Is a material provider considered a single or multi-party sponsor, where the underlying research is funded by another party?

In most cases, the material provider and funding sponsor are two different parties. Each would be considered a multi-party sponsor and the rules for cooperative research sponsors apply to both parties (i.e., neither party can receive a license more exclusive than a NERF license without creating a private business use). However, University bond counsel has advised that there may be less risk of creating a private business use when there is a very close nexus between the material provider’s material and the invention to which the material provider will receive exclusive rights (e.g., inventions that “necessarily use or necessarily incorporate” the provided material).

In some cases, if the funding sponsor does not require use of a specific third-party’s material and UC determines which third party material will enhance or improve the outcome of the activity, then the material provider may be considered a single sponsor with respect to the material transfer agreement, and the funding sponsor may be considered a single sponsor with respect to the funding agreement. Thus, the option to negotiate an exclusive license to the material provider (or to the funding sponsor)

under this scenario may not cause the MTA (or the funding agreement) and related research activities to fall outside the safe harbors.

If the sponsor of the research agreement and the material provider are the same entity, such entity would also be treated as a single sponsor.

Principle 3: Where the only licenses provided are non-exclusive, it is fine to charge different sponsors differently. The key language point in the IRS guidance is that the safe harbor applies so long as no one is allowed anything BETTER than a NERF. It is not better than a NERF to have a non-exclusive license that costs something. There is no requirement that multiple sponsors or any non-sponsors be treated consistently in terms of cost, but any different or inconsistent treatment of non-sponsors has to be entirely at the discretion of the University. (See the fifth Principle below.)

7. What if the University grants a funding sponsor a NERF license and also grants a non-sponsor a royalty-bearing, non-exclusive license? Would this cause the activity to result in private use?

If the terms of the non-sponsor's license are controlled entirely by the University and not the sponsor, the answer is no. Under this Principle, there is no requirement that non-sponsors be treated consistently in terms of the financial provisions of a license if the non-sponsor's terms are controlled by the University. (See also Principle 4).

Principle 4: Consistent treatment among all licensees, whether sponsors or non-sponsors, is not required. There are no limitations on the terms of individual licenses granted to non-sponsors. The IRS has ruled, however, that in some circumstances an agreement that grants broad rights to a research institution's present and future intellectual property may cause that private business to be a private business user of the facilities in which the research developing the intellectual property was performed. This does not impact agreements with invention management organizations (such as F, www.warf.org) relating to existing inventions.

8. Does a provision in a single sponsor research agreement granting the sponsor a time-limited option to negotiate an exclusive license to all fields of use for inventions conceived and reduced to practice in the performance of the research agreement constitute "granting broad rights" as described in Principle #4?

No. A broad grant of rights refers to the grant of rights to inventions made outside the performance of the research agreement. Pipelining of future inventions or the grant of licenses to background intellectual property are examples of broad grants of invention rights.

Principle 5: The University must be careful to guard against contractual provisions with sponsors which limit the University's discretion over what to charge non-sponsors. Sponsors are allowed to know at the beginning what they will be charged, but sponsors cannot dictate to the University what the University will charge others.

9. Does a "most favored nations clause" or "right of first refusal" (e.g., requiring the University not to license an invention to a non-sponsor on financial terms more favorable to the non-sponsor than the terms last offered to the sponsor without first providing the sponsor the right to elect such more financially favorable terms) run

afoul of this Principle 5?

So long as the financial terms last offered to the sponsor are determined by the cognizant ALO to be “fair market” value, the most favored nations clause should not cause the research activity to result in private use. The “fair market” value of the invention must be justified as being reasonable under the specific facts and circumstances of each case as of the date the technology is available and documented by the campus.

Principle 6: It is important for the University ultimately to be in control of the manner in which the research is performed. For this purpose, the University will be treated as in control, even in the context of a committee or board with industry members, so long as the University has the final say by way of a veto right, a “tie-breaker” vote or other effective majority control.

10. Does the establishment of an Advisory Board that is tasked with setting up the overall technical agenda for the work to be performed and overseeing the research progress cause the activity to result in private use?

The answer depends on the composition and voting structure of the Advisory Board. If University members of the Advisory Board have the collective ability to determine the research to be performed and the manner in which it is to be performed, the establishment of the Advisory Board will likely not cause the activity to result in private use. If non-University members of the Advisory Board have the collective ability to make the final decision as to which projects receive funding or how the project will be performed, the establishment of the Advisory Board will likely cause the activity to result in private use.

11. Sponsor-initiated clinical trials involve protocols that are written by the sponsor. Would lack of control over a clinical trial protocol cause the activity to result in private use?

UC Bond Counsel has developed different guidelines for clinical trials. Patient care activities conducted by UC at its facilities are not considered private business activities.

Additional FAQs

12. Does a visitor’s research activities on campus constitute private business use even if the research agreement provides the University with title to any inventions made by the visitor while using bond financed facilities

Yes. A visitor’s research activities using bond-financed facilities constitutes a private business use regardless of how inventions are handled because use of bond financed property by any third party (i.e., by any non-University personnel) is treated as a private business use. The campus will need to identify all visitor research activities for reporting in the annual private activity questionnaire (PAQ).

13. Is use of bond financed facilities for bona fide “recharge activities” covered under the safe harbors?

Under §141 of the Internal Revenue Code of 1986, Basic research is defined as any original investigation for the advancement of scientific knowledge not having a specific commercial objective. For example, product testing supporting the trade or business of a specific nongovernmental person is not treated as basic research. For purposes of the '86 Tax Act, University Bond Counsel opined that any research, including applied research, performed by the University is considered "Basic research."

If a recharge activity involves non-University personnel using bond financed facilities to conduct their own activities, such activity is not considered basic research and the safe harbor provisions do not apply. Use of bond financed facilities by non-University personnel is considered private business use and should be reported in the PAQ. Capital Planning/Budget may determine that "general public" or "incidental" use exception(s) apply.

Incidental use by private parties is permitted if (1) the space used is not financed for the principal purpose of providing that space for use by the private parties' users (use of the space must be incidental to use by the University); and (2) user rates are either (a) negotiated at arm's length and are fair market rates, and a term limited to 50 days per user for the term of the contract, including all contract extension and renewal options, or (b) negotiated at arm's length and a standard, uniform pricing model for all users is used, and a term limited to 100 days per user for the term of the contract, including all contract extension and renewal options.

14. Can the University agree to assign joint title to a material provider for an invention made solely by the University and still be within the safe harbors?

No. A specific requirement under the safe harbor provisions is that title to any patent or other product incidentally resulting from the basic research lies exclusively with the qualified user (e.g., University). (See Rev. Proc. 2007-47, §6.03(3)). Agreeing to joint title in a MTA for a sole University invention made in a bond-financed facility puts the research activity outside the safe harbors. If a material is jointly owned because it is jointly created, such joint ownership under property law does not constitute private business use.

15. Does giving up title to inventions under a penalty clause, for example, in an MTA constitute private business use?

No. A penalty clause granting the material provider either title or an exclusive license option to a resulting University invention is considered a separate arrangement triggered by a breach of contract on the part of the University. The granting of such rights are not considered part of the research activity and thus not subject to the Tax Act requirements.

Additional Information

The RPAC website [includes a dedicated resource that includes these Principles and FAQs](#). Additionally, to aid in identifying potential private business use associated with research activities, the RPAC website also provides additional materials, including a [reference guide organized by research activity](#).

If there is uncertainty regarding whether a research activity constitutes private business use, the safest approach is to report the activity as private business use in the annual PAQ for further review. Capital Markets Finance will coordinate with RPAC to determine which contracts, if any, could potentially apply to the safe harbor provisions.

Contact

For questions about this guidance or assistance in applying the Tax Act Principles to your proposed research activity, please contact Felice Lu at Felice.Lu@ucop.edu or 510-987-0348.

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A handwritten signature in blue ink that reads "Janna C. Tom". The signature is fluid and cursive, with the first letters of each name being capitalized and prominent.

Janna C. Tom
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