

**MONETIZING INTELLECTUAL PROPERTY:**  
**Colleges, Universities and the Tax Treatment of Research and IP Revenue**

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Tax-exempt colleges and universities own billions of dollars' worth of intellectual property ("IP") in every form imaginable.

First, most colleges and universities recognize today that they have "brand" equity. Thus, for example, the Harvard Business School does not confine itself to conducting classes and programs on the Harvard Business School Campus in Cambridge, Massachusetts. The Harvard Business School conducts "branded" executive education programs using full-time faculty in California and seven countries, including China and India. Similarly, The Pennsylvania State University ("Penn State"), as with many other universities, has used its brand and faculty to promote its distance learning program—"Penn State World Campus." Penn State's courses are fully online, and academically equivalent to campus courses.

Online students participate in many student activities that are specially designed for adult learners, such as a national honor society and student membership in the alumni association and are invited to attend the same commencement ceremony as on campus students. Second, colleges and universities have firm specific intangible resources. These resources include their own faculties and researchers, their systems and methods for conducting educational programs and research, and their own data.

Third, colleges and universities have a wealth of "traditional" intellectual properties, such as patents, trademarks, trade secrets and the like. These are developed with their own resources, government grants<sup>2</sup> and funding provided by private industry. Funding of re-

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<sup>2</sup> According to [grants.gov](http://grants.gov), there are over 1,000 grants programs and 26 federal grant-making agencies.

search at public and private colleges and universities has grown dramatically in recent years as government sources of funding have declined.

Fourth, colleges and universities have two unique assets that they have been exploiting aggressively in recent years through their affinity programs—their student bodies and their alumni graduates.

Some of their IP is of little or no known value to anyone other than the university that developed and utilizes it. In fact, little of a university's IP will show up on a balance sheet as an asset because most of the costs to develop the IP have been expensed rather than capitalized.

However, much of a typical university's IP, both deliberately and inadvertently developed by their faculty, staff and students, is of considerable value to other exempt organizations (and not just other colleges and universities), domestic and foreign commercial businesses, and domestic and foreign governments.

Finally, colleges and universities that receive research funding from the federal government are incentivized to commercially exploit their intellectual property rights under the Bayh-Dole Act.<sup>3</sup>

Since the Great Recession, in what appear to be leaner times for years to come, and in the face of a potential loss or reduction in the charitable contribution deduction and declines in federal grants moneys, universities must consider new ways to employ their existing resources to support their missions.<sup>4</sup> The conduct of research and the monetization of IP should be accomplished in the most tax-efficient manner possible and structured to avoid

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<sup>3</sup> Under the Bayh-Dole Act, 35 USC § 201 et seq., universities (and other tax-exempt organizations such as hospitals) are permitted to retain title to inventions that are conceived or first reduced to practice in the performance of a federal grant, contract, or cooperative agreement in exchange for certain obligations on the grantor. In Revenue Procedure 2007-47, 2007-2 C.B. 108, the Service updated its guidance on the issue of when sponsored research agreements will not result in private business use under Section 141(b) of the Code.

<sup>4</sup> See, e.g., Cerny and Hellmuth, *Economic Crisis? Technology Transfer to the Rescue*, 21:06 Taxation of Exempts 6 (May/June 2010).

conflicts of interest,<sup>5</sup> inurement and private benefit and the diversion of resources and focus from the core educational and research missions. The Massachusetts Institute of Technology's ("M.I.T.") *Guide to the Ownership, Distribution and Commercial Development of M.I.T. Technology* describe striking the proper balance between mission and monetization well, as follows:

The prompt and open dissemination of the results of M.I.T. research and the free exchange of information among scholars are essential to the fulfillment of M.I.T.'s obligations as an institution committed to excellence in education and research. Matters of ownership, distribution, and commercial development, nonetheless, arise in the context of technology transfer, which is an important aspect of M.I.T.'s commitment to public service. Technology transfer is, however, subordinate to education and research; the dissemination of information must, therefore, not be delayed beyond the minimal period necessary to define and protect the rights of the parties.<sup>6</sup>

Consider these research and IP monetization variations:

- *Traditional IP Exploitation:* The Wisconsin Alumni Research Foundation ("WARF") owns and licenses a diverse portfolio of more than 1,500 patents in the medical and biotech fields, a standard means generating revenue from traditional IP. In its 2012 fiscal year, WARF had derived excess of \$40 million in revenue from royalties and licensing.<sup>7</sup> WARF's website also indicates it is currently working with over 60 active startup companies and that it owns equity stakes in many of them.
- *Brand Identity Exploitation:* Penn State came up with another tactic for exploiting its brand name IP along with traditional property rights: in 1992 it signed a \$14 million contract with Pepsi-Cola for the exclusive right to sell its products on cam-

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<sup>5</sup> See, e.g., *Faculty of Arts and Sciences: Policies Relating to Research and Other Professional Activities Within and Outside the University*, Harvard University Gazette (Oct. 30, 1997) ("With the acceptance of a fulltime appointment to the Faculty of Arts and Sciences, an individual makes a commitment to the University that is understood to be fulltime in the most inclusive sense. Every member is expected to accord the University his or her primary professional loyalty, and to arrange outside obligations, financial interests, and activities so as not to conflict or interfere with this overriding commitment to the University.").

<sup>6</sup> *Guide to the Ownership, Distribution and Development of M.I.T. Technology*, Section 2.0 (Revised June 2010).

<sup>7</sup> This information was obtained from WARF's website and its Form 990 for FYE June 30, 2012.

pus, advertise in programs and add its name to scoreboards - so-called “naming” and “pouring” rights.<sup>8</sup>

- *Joint Ventures:* Other exempt organizations contribute their core know-how and other IP to taxable joint ventures in exchange for majority or minority shares of partnership or limited liability company (“LLC”) interests, with their allocable income taxable as unrelated business income (“UBI”).
- *Sponsored Research:* In Private Letter Ruling 201145027, a private foundation dedicated to supporting diabetes research provided several million dollars to a university hospital over a three year period. The amounts were for the advancement of clinical trials for the treatment of Type 1 diabetes, including preliminary research necessary for conducting the trials. The program-related investment agreement provided the foundation with a one-sixth royalty interest in any payments received by the hospital for the use of any invention resulting from the funded research. The IRS ruled that the agreement was a program-related investment.<sup>9</sup>
- *Firm Specific Resource Exploitation:* M.I.T. and Harvard University have effectively made nearly their entire curriculum available online through edX.org, an open source platform. Of course, providing the benefits of IP worth hundreds of millions at no cost may not be the obvious way to monetize IP, but Facebook does operate under similar conditions. No “paywall” does not necessarily mean no revenue in the long-term.
- *Affinity Programs:* Alumni credit card and life insurance programs are completely ubiquitous. For example, The Ohio State University Alumni Association promotes “The Alumni Insurance Program” on its website as “a convenient source for health, life, travel, and auto insurance for alumni and their family members.” It is also a source for travel tours, affinity credit cards and regular season and bowl game foot-

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<sup>8</sup> See McKay, Gretchen, *Soft drink makers vie for ‘pouring rights’ in schools*, *Pittsburgh Post-Gazette*, June 24, 1998: E-1, 3.

<sup>9</sup> For further information about program-related investments, see Lion and Mancino, *PRIs—New Proposed Regulations and the New Venture Capital*, 24:2 *Taxation of Exempts* 3 (Sept./Oct 2012).

ball and regular season and “March Madness” basketball tickets, other examples of the exploitation of firm specific resources.

As these examples illustrate, the nature of research capabilities and IP developed and owned by tax-exempt universities and the transactional structures available to monetize those research capabilities and IP are as diverse as the exempt organization sector itself.

Various types of IP owned by tax-exempt universities are discussed in Part I of this paper, including traditional IP (patents, copyrights, etc.) and non-traditional IP (access to captive audiences, endorsements, sponsorships, naming opportunities, etc.).

Part II discusses the legal definition of “scientific” as it relates to research conducted by colleges, universities and other types of tax-exempt organizations. It also discusses the tax treatment of research income derived by such organizations from governmental and private sources, including sponsored research.

Part III discusses the tax treatment of a variety of structures for monetizing IP by a transfer of rights to related or unrelated persons, including:

- fees and royalties from licensing;
- royalties versus service fees;
- cross-licensing agreements;
- royalties from sponsored research; and
- sales of IP or derivative products.

The tax treatment of IP transfers depends in part on the form and structure of the transfer as well as the relationship of the transferee to the exempt organization. Restrictions on the ability to offset UBI with losses from exempt activities and the use of net operating losses are also discussed.

Part IV presents various structures for generating revenue through the direct utilization of IP. Many exempt organizations have the capacity to exploit IP themselves by manufacturing and/or marketing and selling derivative products or services. While these activities can

be done by the exempt organization directly, they are often undertaken by related parties.

Part IV also discusses:

- cost-sharing agreements;
- taxable corporate subsidiaries;
- technology transfer organizations;
- the use of single member LLCs; and
- Section 512(b)(13)'s effective bar on deductions for payments to related tax-exempt organizations treated by the exempt organization as tax-exempt rents, royalties or other expenses paid.

Part V addresses corporate sponsorships and the UBI exclusion for “qualified sponsorship payments.” The difference between acceptable “acknowledgements” versus advertising is discussed, along with the difference between exclusive sponsorship arrangements and exclusive provider arrangements.

Part VI provides further detail regarding exclusivity arrangements, akin to the Penn State “pouring rights” sold to Pepsi, and whether exclusivity fees are taxable as UBI.

Part VII addresses revenue from credit card affinity programs and the all too common sale or rental of mailing lists.<sup>10</sup>

Part VIII briefly discusses inurement issues that arise in connection with IP exploitation.

Part IX briefly concludes with a warning: contemplated technology transfer transactions should be reviewed to ensure that they do not violate tax-exempt bond or other contractual covenants.

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<sup>10</sup> Luckily for the trees, the author recycles his junkmail.

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## **I. TYPES OF IP CREATED AND OWNED BY TAX-EXEMPT ORGANIZATIONS**

### **A. “Traditional” IP**

The “traditional” types of IP typically created and owned by tax-exempt university mirrors that of the for-profit and governmental sectors, including patents, copyrights, trademarks and trade secrets or other “know-how.”

#### **1. Patents**

Patent rights are created under federal law, the Patent Act of 1952, as amended.<sup>11</sup> A patent is a federal grant of a monopoly to an inventor to use, manufacture, license and sell an invention for a limited period of time.

#### **2. Copyrights**

Copyright protection is granted under the federal Copyright Act of 1976, as amended (the “Copyright Act”).<sup>12</sup> The copyright owner of an artistic, literary, musical or similar creative work, including computer software and coding, enjoys the exclusive right to reproduce, distribute, publicly perform and publicly display the work, and to prepare derivative works. Under the Copyright Act, the owner is permitted to register the copyright with the U.S. Copyright Office, but is not required to do so in order to enjoy the basic protections under federal law.<sup>13</sup> However, a copyright must be registered with the Copyright Office in order for the owner to enforce a copyright infringement claim against a third party.<sup>14</sup>

#### **3. Trademarks and Service Marks**

Trademarks and service marks are acquired through usage in commerce. Trademarks are words, names, logos, symbols and other devices used by an organization to identify itself and its products and to distinguish them from other organizations and their products. A service mark is essentially the same as a trademark, except that it applies to services.

Trademarks and service marks are common-law rights that may be federally registered un-

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<sup>11</sup> 35 U.S.C. § 1 et seq.

<sup>12</sup> 17 U.S.C. § 101 et seq.

<sup>13</sup> 17 U.S.C. § 208(a).

<sup>14</sup> 17 U.S.C. §§ 410, 411.

der the Trademark Act of 1946, as amended (the “Lanham Act”), if used in interstate commerce.<sup>15</sup> The registered owner of a trademark enjoys the exclusive right to use the mark, and federal registration provides prima facie evidence of the validity and ownership of the mark. Marks may also be registered under state laws.

#### **4. Trade Secrets**

Trade secrets constitute information not generally known in an industry or trade that creates an economic advantage. Generally, trade secrets include information such as secret formulas or processes that may or may not be patentable. “[A] trade secret, as a tool for commercial competition, derives much of its value from the fact of its secrecy.”<sup>16</sup>

#### **B. “Non-Traditional” IP**

Many tax-exempt universities have recognized that they have created or simply own, by reason of the nature of their exempt functions or activities, other valuable IP assets or more traditional property rights that are susceptible to exploitation for financial benefit. These include:

##### **1. Provision of Access to Captive Audiences**

Universities (along with hospitals, cultural and arts organizations, and other types of exempt organizations) have natural constituent groups who attend, receive services from, or otherwise participate in the educational, health care, cultural or other activities of the organization. The provision of exclusive access to these students, patients, and concert and museum goers through exclusive provider or supplier arrangements, such as “pouring” rights, has proven to be extremely valuable.

##### **2. Provision of Access to Friends and Supporters**

Tax-exempt colleges and universities have natural constituent groups in the form of graduates and their families. Most colleges and universities have membership-based alumni associations that are comprised of persons who have evidenced an even greater degree of loyalty to or interest in supporting the college or university through the payment of dues,

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<sup>15</sup> 15 U.S.C. § 1051 et seq.

<sup>16</sup> *E.I. DuPont de Nemours and Co. v. United States*, 288 F.2d 904, 911 (Ct. Cl. 1961).

participation in social or other events, etc. Other types of nonprofit organizations are membership organizations. It is increasingly common for tax-exempt organizations such as colleges, universities, fraternities and sororities to exploit these valuable IP rights by providing access to these constituent groups for a fee. That access may take the form of selling a mailing list, selling advertising space in the organization's publications, including its website, or combining the use of a mailing lists with some other form of activity, such as an affinity credit card or insurance program.

### **3. Corporate Sponsorship Opportunities**

The tax treatment of corporate sponsorship has origins with college football bowl games, in which a commercial concern such as a car company would obtain the right to associate its name with the bowl game. The sponsor would display its logo and merchandise during and in connection with events associated with the bowl game and in programs and other forms of media presentation. Since the amendment of the Internal Revenue Code (the "Code") to add Section 513(i) and publication of Treasury regulations that clarify the circumstances in which corporate sponsorship payments are excluded from unrelated business income ("UBI"), a broad range of tax-exempt organizations have gotten onto the corporate sponsorship bandwagon and are actively pursuing prospective corporate sponsors, large and small.

### **4. Traditional Naming Opportunities**

Colleges and universities, and other types of tax-exempt organizations, have provided diverse types of donor acknowledgments, including the naming of wings, buildings and entire colleges (e.g., the Anderson School of Business at University of California, Los Angeles, the Keck School of Medicine at University of Southern California) after donors in exchange for substantial contributions. Such "mere acknowledgements" typically do not reduce the deductible amount of the associated charitable contributions or cause the amounts received to be treated as taxable (advertising) income.<sup>17</sup>

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<sup>17</sup> See, e.g., Drennan, *Where Generosity and Pride Abide: Charitable Naming Rights*, 80:1 U. Cinn. L. Rev. 53, 66 (2012).

## 5. Endorsements

In appropriate cases, the name and reputation of a tax-exempt organization is extremely valuable if lent to a commercial organization in the form of an endorsement. For example, the American Medical Association entered into an endorsement deal whereby it gave its “seal of approval” to various Sunbeam Corporation products.<sup>18</sup> Health care organizations such as hospitals and research institutes from time to time endorse medical devices or products. The American Heart Association endorses certain meals it considers healthy, recently adding a number of items at Subway.<sup>19</sup> Certification can cost companies as much as \$700,000 annually.<sup>20</sup>

Whether the proceeds from such sales of endorsements are taxable as UBI depends on whether the making of the endorsements themselves constitutes an exempt function. The Treasury regulations provide the following example:

U, an exempt scientific organization, enjoys an excellent reputation in the field of biological research. It exploits this reputation regularly by selling endorsements of various items of laboratory equipment to manufacturers. The endorsing of laboratory equipment does not contribute importantly to the accomplishment of any purpose for which exemption is granted U. Accordingly, the income derived from the sale of endorsements is gross income from unrelated trade or business.<sup>21</sup>

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<sup>18</sup> The deal became something of a debacle, as lawsuits and resignations ensued. “[T]he association announced a five-year agreement in which it would give a ‘seal of approval’ to Sunbeam humidifiers, blood-pressure monitors and other products. The association was to receive millions in royalties, although it had no plans to test the products. The association came under heavy criticism for allowing commercial use of its name and announced a week later that it was backing out of the deal.” *Challenge in A.M.A. After Sunbeam Deal*, New York Times, June 12, 1998, available online at <http://www.nytimes.com/1998/06/12/us/challenge-in-ama-after-sunbeam-deal.html>.

<sup>19</sup> Huston, Larry, *Subway Meals Get American Heart Association Endorsement*, Forbes, June 4, 2012, available at <http://www.forbes.com/sites/larryhusten/2012/06/04/subway-meals-get-american-heart-association-endorsement/> (“The AHA certification logo will be displayed on Subway meals that meet the AHA’s nutritional criteria for levels of sodium, calories, cholesterol, saturated fat and trans-fats. But the new program does not mean that all meals certified by the program will necessarily be heart healthy...”).

<sup>20</sup> *Id.*

<sup>21</sup> Reg. § 1.513-1(d)(iv), Example 1.

## II. SCIENTIFIC PURPOSES AND TAXATION OF RESEARCH INCOME

### A. Scientific Purposes Defined

#### 1. Introduction

The treatment of scientific activities illustrates the general principle that exempt status is not based on the intrinsic nature of the activities but on the performance of activities in a manner resulting in a public benefit to a charitable class.<sup>22</sup> A scientific organization serving private interests or engaging primarily in commercial business activities does not qualify for exemption even though its activities may fall within the general meaning of “scientific.”<sup>23</sup>

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.”<sup>24</sup> Although the regulations do not define “scientific,”<sup>25</sup> 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.

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<sup>22</sup> Reg. §§ 1.501(c)(3)-1(d)(5)(i), 1.501(c)(3)-1(d)(5)(ii)

<sup>23</sup> Reg. §§ 1.501(c)(3)-1(d)(5)(i), 1.501(c)(3)-1(d)(5)(ii).

<sup>24</sup> Reg. § 1.501(c)(3)-1(d)(5)(i). See generally Gray, *What Is ‘Research’ for the Purpose of Exemption?* 5th Biennial NYU Conf. on Char. Found. 233 (1961); Sugarman & Mancino, *Tax Aspects of University Patent Policy*, 3 J.C. & U.L. 41 (1975). See also Darling & Friedlander, *Intellectual Property*, Internal Revenue Service Exempt Organizations Continuing Professional Education Technical Instruction Program for FY 1999, at 21-54.

<sup>25</sup> Before regulations addressing scientific organizations were issued, several courts had determined that certain organizations did not meet the statutory “scientific” requirements. For example, in *American Kennel Club, Inc. v. Hoey*, 148 F.2d 920 (2d Cir. 1945), the court held that an organization formed to adopt and enforce uniform rules regulating and governing dog shows and to advance the study, breeding, and maintenance of thoroughbred dogs was not a scientific organization, even though genealogical data resulting from the organization’s activities could be used scientifically by geneticists. Also, in *Underwriters’ Labs., Inc. v. Comm’r*, 135 F.2d 371 (7th Cir.), cert. denied, 320 US 756 (1943), an organization created by fire insurance companies that used scientific methods to test manufacturers’ products for hazard resistance was found “not to operate on the basis of science for the sake of science.” *Id.* at 373. However, Section 501(c)(3) was revised in 1954 to include organizations organized and operated exclusively for purposes of testing for public safety. See also *American Soc’y of Cinematographers, Inc. v. Comm’r*, 42 BTA 675 (1940) (nonprofit corporation formed to advance cinematography organized and operated exclusively for scientific purposes under prior destination-of-income test, despite certain other nonexempt activities).

<sup>26</sup> The regulations further state that scientific research can be either “fundamental” or “basic” as contrasted with “applied” or “practical.”<sup>27</sup>

In addition, the Service has ruled that scientific research includes research concerning both the physical and social sciences.<sup>28</sup> The exempt status of organizations engaged in scientific research or the advancement of science<sup>29</sup> is also frequently based on the organization’s educational or charitable purposes and activities.<sup>30</sup> As the Tax Court has observed, “research is not the only activity that can be ‘scientific.’”<sup>31</sup>

A review of the Service’s rulings indicates that rather than providing additional guidance on what constitutes scientific activities or research, the Service usually bases its determina-

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<sup>26</sup> Reg. § 1.501(c)(3)-1(d)(5)(ii).

<sup>27</sup> However, only income derived from scientific research activities conducted by organizations operated primarily for the purpose of carrying on “fundamental” research (the results of which are freely available to the public) qualifies for the Section 512(b)(9) unrelated business taxable income exclusion.

<sup>28</sup> See, e.g., Rev. Rul. 76-455, 1976-2 CB 150; Rev. Rul. 65-60, 1965-1 CB 231; see also Gen. Couns. Mem. 35536 (Oct. 30, 1973) (organization and operation of prepaid legal services plan on experimental basis furthers organization’s “scientific” purpose despite the fact that research activities undertaken under plan incidentally further business interests of legal profession).

<sup>29</sup> The advancement of science is among the numerous charitable purposes described in Regulation Section 1.501(c)(3)-1(d)(2).

<sup>30</sup> See, e.g., *Science & Research Found., Inc. v. United States*, 181 F. Supp. 526 (SD Ill. 1960) (organization formed to obtain and compile articles, pamphlets, and books explaining and summarizing knowledge about universe qualifies as Section 501(c)(3) educational organization); Rev. Rul. 65-298, 1965-2 CB 163 (organization engaged in research concerning human diseases, developing scientific methods for treatment, and disseminating research results through physicians’ seminars is Section 501(c)(3) educational organization); Rev. Rul. 66-147, 1966-1 CB 137 (organization formed to survey scientific and medical literature published throughout world and to prepare and distribute abstracts of literature free of charge ruled to be charitable because its programs advance education and science); Rev. Rul. 71-506, 1971-2 CB 233 (society engaged in scientific research concerning heating, ventilating, and air conditioning ruled educational and scientific); Rev. Rul. 76-455, 1976-2 CB 150 (organization that encouraged and assisted establishment of nonprofit regional health data systems, conducted studies regarding the quality, use, and effectiveness of health care, and educated health care professionals in order to increase the efficiency and reduce the cost of health care ruled exempt as educational and scientific organization); Gen. Couns. Mem. 38577 (Dec. 5, 1980) (publication of technical journals is educational as well as scientific). In addition to the statutory category of “scientific” purposes, the regulations also provide that the advancement of science is a charitable purpose. Reg. § 1.501(c)(3)-1(d)(2). The regulations further provide that

[t]he fact that any organization (including a college, university or hospital) carries on research which is not in furtherance of an exempt purpose described in section 501(c)(3) will not preclude such organization from meeting the requirements of section 501(c)(3) so long as the organization meets the organizational test and is not operated for the primary purpose of carrying on such research....

Reg. § 1.501(c)(3)-1(d)(5)(v).

<sup>31</sup> *Washington Research Found. v. Comm’r*, 50 TCM 1457, 1461 (1985).

tions that an organization's activities are not "scientific" or do not constitute scientific research on the fact that the public benefit requirement is not met, or that the organization's activities are normally incident to commercial or industrial operations and thus result in private rather than public benefit. Generally, then, it has been left to the Service and to the courts to define "scientific" and to determine what constitutes scientific research on a case-by-case basis.<sup>32</sup>

In *IIT Research Institute v. United States*<sup>33</sup> for example, the Court of Claims defined "science" as "the process by which knowledge is systematized or classified through the use of observation, experimentation, or reasoning," and further delineated five types of activities constituting scientific research, including research that

(1) involved the use of observation or experimentation to formulate or verify facts or natural laws; (2) could only have been performed by an individual with advanced scientific or technical expertise; (3) added to knowledge within a particular scientific field; (4) involved the application of mathematical reasoning; and/or, (5) was an attempt to systematize or classify a body of scientific knowledge by collecting information and presenting it in a useful form.<sup>34</sup>

In another case, *Midwest Research Institute v. United States*<sup>35</sup> a federal district court described "scientific research" as follows:

[W]hile projects may vary in terms of degree of sophistication, if professional skill is involved in the design and supervision of a project intended to

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<sup>32</sup> In the case of organizations that conduct numerous research projects, determinations of whether the research is scientific are made on a project-by-project basis. See Gen. Couns. Mem. 35804 (May 6, 1974).

<sup>33</sup> *IIT Research Inst. v. United States*, 85-2 USTC ¶ 9734 (Cl. Ct. 1985).

<sup>34</sup> *IIT Research Inst. v. United States*, 85-2 USTC ¶ 9734, at 90,003 (Cl. Ct. 1985).

<sup>35</sup> *Midwest Research Inst. v. United States*, 554 F. Supp. 1379, 1386 (WD Mo. 1983), *aff'd*, 744 F.2d 635 (8th Cir. 1984).

solve a problem through a search for a demonstrable truth, the project would appear to be scientific research.<sup>36</sup>

## 2. Scientific Research Directed Toward Benefiting the Public

The regulations' underlying policy is to ensure that scientific research is carried on in the public interest. Under the regulations, scientific research will be regarded as carried on in the public interest if

1. The results of such research (including any patents, copyrights, processes, or formulas resulting from such research) are made available to the general public on a nondiscriminatory basis;
2. Such research is performed for the United States or any of its agencies or instrumentalities, or for state or political subdivision of a state;<sup>37</sup> or
3. Such research is directed toward benefiting the public.<sup>38</sup>

The Tax Court has held that a trust operating an experimental model farm to test and demonstrate conservation techniques, the restoration of overcultivated land to ecological balance, and the commercial viability of ecologically sound farming techniques qualifies as a scientific and educational organization described in Section 501(c)(3).<sup>39</sup> The court rejected the government's argument that the trust was engaged in commercial farming activities, where the farm benefited the community industry of farming; the research results would be shared with county farmers, the general public, and student groups by opening

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<sup>36</sup> *Midwest Research Inst. v. United States*, 554 F. Supp. 1379, 1386 (W.D. Mo. 1983), *aff'd*, 744 F.2d 635 (8th Cir. 1984). See generally Wolfman, *Federal Tax Policy and the Support of Science*, 114 U. Pa. L. Rev. 171 (1965).

<sup>37</sup> See Rev. Rul. 65-60, 1965-1 CB 231 (contract research on behalf of governmental agencies is conducted in the public interest); Tech. Adv. Mem. 8146012 (1981) (criteria applicable to scientific research carried on for U.S. government are the same for that carried on for foreign governments); Gen. Couns. Mem. 35804 (May 6, 1974) (research performed for various governmental bodies is regarded as carried on in public interest where projects relate to land use plans in connection with urban renewal, governmental operations, traffic flow, or development of recreational areas).

<sup>38</sup> Reg. §§ 1.501(c)(3)-1(d)(5)(iii)(a)-1.501(c)(3)-1(d)(5)(iii)(c).

<sup>39</sup> *Dumaine Farms v. Comm'r*, 73 T.C. 650 (1980).

the farm on specified visiting days; and the farm property would be used by student groups from the local schools and community college.

Similarly, the Tax Court also held that an organization certifying crop seed in accordance with state and federal regulations for the state of Indiana (a service generally performed directly by a state agency) and conducting scientific research in seed technology in conjunction with Purdue University is a Section 501(c)(3) organization. Rather than merely promoting the economic interests of commercial seed producers and commercial farmers, the organization, as the state's official seed-certifying agency, protected the public from perceived abuses in the sale of agricultural and vegetable seed; moreover, the organization's scientific research was carried on in the public interest as demonstrated by the research results' availability through educational meetings, seminars, and newsletters.<sup>40</sup>

The regulations further provide four examples of scientific research that are considered as directed toward benefiting the public, and examples of two factual situations in which an organization will not be regarded as meeting the public interest test. The four examples of scientific research regarded as carried on in the public interest include scientific research carried on for the purpose of

1. Aiding in the scientific education of college or university students;
2. Obtaining scientific information published in a treatise, thesis, trade publication, or in any other form available to the interested public;<sup>41</sup>
3. Discovering a cure for a disease;<sup>42</sup> or

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<sup>40</sup> *Indiana Crop Improvement Ass'n v. Comm'r*, 76 T.C. 394 (1981).

<sup>41</sup> Numerous rulings address whether an organization conducting commercially sponsored research published sufficient information in a timely manner so as to come within this example. See Rev. Rul. 76-296, 1976-2 CB 141; Tech. Adv. Mem. 8028004 (Mar. 26, 1980); Priv. Ltr. Rul. 7937061 (June 14, 1979). Revenue Ruling 76-296 was narrowly read by the Claims Court in *IIT Research Inst. v. United States*, 85-2 USTC ¶ 9734 (Cl. Ct. 1985).

<sup>42</sup> Compare Rev. Rul. 69-526, 1969-2 CB 115 (group of physicians specializing in heart defects that conducts research into cause and treatment of cardiac and cardiovascular conditions and diseases that is made public through lectures and journals qualifies as Section 501(c)(3) organization) with Rev. Rul. 73-567, 1973-2 CB 178 and Rev. Rul. 74-533, 1974-2 CB 293 (organizations that certify physicians or operate as

4. 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.<sup>43</sup>

The regulations indicate that research described in these four examples will be regarded as carried on in the public interest even though the results are not made available to the public; the regulations state that the research described in these examples will be regarded as carried on in the public interest even though such research is performed pursuant to a contract or agreement under which the research's sponsor or sponsors have the right to obtain ownership or control of any patents, copyrights, processes, or formulas resulting from such research.<sup>44</sup>

In cases of commercially sponsored scientific research where the sponsor retains all rights to the research results (including all ownership rights or control of patents resulting from the research), the public interest requirement is most frequently met by publication of the research results, through what the Service calls the publication test. In Revenue Ruling 76-296,<sup>45</sup> the Service addressed the publication test in two factual situations concerning commercially sponsored scientific research where the sponsor retained all rights to the research results, including ownership of any patents resulting from the research. In the first situation, the results of projects (including all relevant information) were generally published so as to be available to the public either (1) currently; (2) within a reasonably short time after the project's completion; or (3) if patent rights were involved, publication was delayed pending a reasonable opportunity to establish patent rights, such as through filing a patent application. In the second situation, the organization would, at the sponsor's request, agree to forgo publication of a particular project's results in order to protect against disclosure of processes or technical data that the sponsor desired to keep secret for various

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peer review boards qualify as Section 501(c)(6) (rather than Section 501(c)(3)) organizations that further interests of medical profession despite fact that some public benefit may be derived from maintaining standards of excellence in certain medical specialties).

<sup>43</sup> Reg. § 1.501(c)(3)-1(d)(5)(iii)(c).

<sup>44</sup> Reg. § 1.501(c)(3)-1(d)(5)(iii)(c).

<sup>45</sup> Rev. Rul. 76-296, 1976-2 C.B. 141.

business reasons. In other instances, the organization may agree to extend delay in publication of results in cases where the sponsor wanted to protect its patent rights for business reasons, but wanted to defer initiation of patent procedures so as to delay or control the timing of public disclosure of the project results.

The Service ruled that publication must be adequate and timely, and must disclose “substantially all” information concerning the research results that would be useful and beneficial to the interested public. The Service also ruled that adequate publication of the research results should be made as promptly after the research is completed as is reasonably possible without jeopardizing the sponsor’s right to secure patents or copyrights necessary to protect its ownership or control of the results.<sup>46</sup> Accordingly, the Service ruled that the publication test was clearly met in the first situation, but not in the second; thus, the research connected with projects described in the second situation would not be treated as scientific research carried on in the public interest.

The Service has interpreted Revenue Ruling 76-296 very broadly, indicating that the regulations require publication of all information resulting from research of any type described in Regulation Section 1.501(c)(3)-1 (d)(5)(iii)(c) in order for the research activity to constitute research directed toward benefiting the public. However, in *Midwest Research Institute v. United States*,<sup>47</sup> the court held that published research is only an alternative example of scientific research carried on in the public interest, and that privately sponsored research for the purpose of aiding industrial development in a particular geographic area is in the public interest, even if it does not meet the additional criteria of the publication test.

Similarly, in *IIT Research Institute v. United States*,<sup>48</sup> the Claims Court held that the regulations do “not require publication in every instance,” and observed that it is apparent that publication of the results is not the only means by which scientific research can be in

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<sup>46</sup> See Gen. Couns. Mem. 35358 (June 1, 1973).

<sup>47</sup> *Midwest Research Inst. v. United States*, 554 F. Supp. 1379, 1383, 1391 (W.D. Mo. 1983), *aff’d*, 744 F.2d 635 (8th Cir. 1984).

<sup>48</sup> *Midwest Research Inst. v. United States*, 554 F. Supp. 1379, 1383, 1391 (W.D. Mo. 1983), *aff’d*, 744 F.2d 635 (8th Cir. 1984).

the public interest.” The government also argued in *IIT Institute* that Revenue Ruling 76-296 required publication of all information resulting from research of any kind within Regulation Section 1.501(c)(3)-1(d)(5)(iii)(c), but the Claims Court determined that an organization need not publish the results of tests relating to the scientific principles developed from the research.<sup>49</sup>

Although these cases support interpretation of the regulations that the publication of research results is not specifically required under the three alternative examples of research carried on in the public interest in Regulation Section 1.501(c)(3)-1(d)(5)(iii)(c)(1), Regulation Section 1.501(c)(3)-1(d)(5)(iii)(c)(3), or Regulation Section 1.501(c)(3)-1(d)(5)(iii)(c)(4), Revenue Ruling 76-296 may nonetheless retain some validity. Because IIT had published substantially all information resulting from the research projects conducted, or had published papers or conducted symposia addressing the general subject matter of the research projects at issue, IIT had essentially met the ruling’s publication requirements.

### 3. Prohibition Against Serving Private Interests

The two factual situations in the regulations in which an organization will not be regarded as organized and operated for the purpose of carrying on scientific research in the public interest are

1. If the organization performs research *only* for persons that are (directly or indirectly) its creators and that are not described in Section 501(c)(3)<sup>50</sup> or
2. If the organization retains (directly or indirectly) the ownership or control of more than an insubstantial portion of the patents, copyrights, or formulas

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<sup>49</sup> *IIT Research Inst. v. United States*, 85-2 USTC ¶ 9734, at 90,007 (Cl. Ct. 1985).

<sup>50</sup> Reg. § 1.501(c)(3)-1(d)(5)(iv). *See, e.g.*, Rev. Rul. 69-632, 1969-2 CB 120 (primary purpose of nonprofit association composed of members of particular industry that develops new and improved uses for existing industry products is to serve private interest of association’s creators; any public benefit is secondary to that of association’s members).

resulting from its research *and* does not make them available to the public on a nondiscriminatory basis.<sup>51</sup>

Thus, although there is no exception to the prohibition against conducting research exclusively for an organization's creators (which are not described in Section 501(c)(3)), a Section 501(c)(3) scientific organization may retain ownership of the research results provided that it also makes the results available to the public, e.g., through publication. The Service has ruled that a Section 501(c)(3) organization does not retain ownership of intellectual property that it transfers to its wholly owned subsidiary.<sup>52</sup>

The regulations further state that the public availability requirement would be met in instances where the scientific organization retains ownership or control of the research results even if one person is granted the exclusive right to a patent, copyright, process, or formula if the granting of such exclusive right is the only practicable manner in which it can be used to benefit the public.<sup>53</sup> However, where such exclusive rights are granted, only research carried on for the United States (or any of its agencies or instrumentalities) or a state or political subdivision thereof will be regarded as carried on in the public interest, or if such research is directed toward benefiting the public as in the four examples described in Regulation Section 1.501(c)(3)-1(d)(5)(iii)(c).<sup>54</sup>

These two examples supplement the general prohibition<sup>55</sup> against serving private interests. For example, in *Universal Oil Products Co. v. Campbell*,<sup>56</sup> the Seventh Circuit upheld the

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<sup>51</sup> Reg. § 1.501(c)(3)-1(d)(5)(iv). See, e.g., Priv. Ltr. Rul. 9627023 (Apr. 9, 1996).

<sup>52</sup> Priv. Ltr. Rul. 9604019 (Oct. 30, 1995). The Service based this ruling on the separate-identity principle analyzed at ¶¶ 27.03,27.02.

<sup>53</sup> Reg. § 1.501(c)(3)-1(d)(5)(iv)(b). See, e.g., Priv. Ltr. Rul. 8531073 (May 13, 1985) (exclusive license conducting biomedical research and for-profit corporation, where organization retains full ownership of patents, copyrights, processes, or formulas, is only practical way that certain scientific equipment can be developed to benefit public).

<sup>54</sup> Reg. § 1.501(c)(3)-1(d)(5)(iv)(b). This regulatory provision concerning granting exclusive rights does not appear to impose additional limitations on the kinds of research that will be regarded as carried on in the public interest or as directed towards benefiting the public, but rather restates the conditions of Regulation Section 1.501(c)(3)-1(d)(5)(iii). See Monroe, *Collaboration Between Tax-Exempt Research Organizations and Commercial Enterprises—Federal Income Tax Limitations*, 62 Taxes 297, 305 n.64 (1984).

<sup>55</sup> Reg. § 1.501(c)(3)-1(d)(5)(i).

<sup>56</sup> *Universal Oil Prods. Co. v. Campbell*, 181 F.2d 451 (7th Cir. 1950), *cert. denied*, 340 US 850 (1950).

Service's determination denying exempt status to an organization conducting research, development, and patent work in the petroleum field, where major oil companies received the research results without charge and where such results would substantially benefit their commercial business advantage. Similarly, in an earlier case, *Underwriters' Laboratories, Inc. v. Commissioner*,<sup>57</sup> the Seventh Circuit determined that the primary purpose of the organization's tests, experiments, and investigations of manufacturers' products served the private interests of manufacturers and the organization's insurance company members.<sup>58</sup> In contrast, the Sixth Circuit held in *Orton v. Commissioner*<sup>59</sup> that a foundation manufacturing and selling pyrometric cones used for firing ceramics and conducting research to overcome technical and manufacturing difficulties, thus advancing the ceramic art industry in the United States, is organized and operated for scientific purposes.

In *Washington Research Foundation v. Commissioner*<sup>60</sup> the Tax Court specifically addressed the commercial development of scientific research. The organization's purpose in that case was to facilitate the transfer of technology from the research departments of Section 501(c)(3) educational and scientific research institutions to public use, by obtaining patent, copyright, trade secrets, and other rights from researchers for the purpose of licensing them to third parties. The organization also planned to sponsor seminars to inform interested persons of technological opportunities and to discover what new technology was needed, as well as to publish a science newsletter and information for the general public regarding discoveries on which it had obtained patents. Although the organization argued that it was organized and operated exclusively to promote scientific research, the Tax Court held that it had a substantial nonexempt purpose, consisting primarily of patent

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<sup>57</sup> *Underwriters' Labs., Inc. v. Comm'r*, 135 F.2d 371, 373 (7th Cir.), *cert. denied*, 320 U.S. 756 (1943).

<sup>58</sup> See also *Medical Diagnostic Ass'n v. Comm'r*, 42 B.T.A. 610 (1940) (nonprofit corporation that furnishes cooperative diagnostic laboratory facilities at cost to member physicians is not exempt from income tax); Tech. Adv. Mem. 8016010 (Jan. 16, 1980); Gen. Couns. Mem. 37378 (Jan. 13, 1978). Cf. *St. Luke's Hosp. v. United States*, 494 F. Supp. 85, 90 (WD Mo. 1980) (hospital pathology department tests performed for staff physicians' patients contributed to hospital's teaching function, and does not result in UBIT); Tech. Adv. Mem. 8230002 (Mar. 1982).

<sup>59</sup> *Orton v. Comm'r*, 173 F.2d 483 (6th Cir. 1949). See also *Orton v. Comm'r*, 56 TC 147 (1971).

<sup>60</sup> *Washington Research Found. v. Comm'r*, 50 TCM 1457 (1985).

licensing services and facilitating commercial development of scientific research for private industry so as to maximize license fees for the research sponsors.<sup>61</sup>

In response to the court's decision, Congress added a specific exemption for qualified technology transfers by the Washington Research Foundation in the Tax Reform Act of 1986.<sup>62</sup> However, the provision's legislative history indicates that no inference was intended as to whether technology transfers or related purposes or functions of any other organization constitute purposes described in either Section 501(c)(3) or Section 170(c).<sup>63</sup>

#### 4. Activities Incident to Commercial or Industrial Operations

Activities incident to commercial or industrial operations are not exempt activities within the meaning of Section 501(c)(3). The regulations provide that “[s]cientific research does not include activities of a type ordinarily carried on as an incident to commercial or industrial operations, as, for example, the ordinary testing or inspection of materials or products or the designing or construction of equipment, buildings, etc.”<sup>64</sup>

Although rulings by the Service provide some general guidance concerning what constitutes activities incident to commercial operations, distinguishing between commercial and noncommercial research can be difficult,<sup>65</sup> and the Service's determinations often seem inconsistent.

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<sup>61</sup> See generally Sugarman & Mancino, *Tax Aspects of University Patent Policy*, 3 J.C. & U.L. 41 (1976).

<sup>62</sup> Pub. L. No. 99-514, 100 Stat. 2085 (1986). This provision is not included in the Code.

<sup>63</sup> Staff of Joint Comm. on Tax'n, 100th Cong., 1st Sess., General Explanation of the Tax Reform Act of 1986, 1331 (Joint Comm. Print 1987).

<sup>64</sup> Reg. § 1.501(c)(3)-1(d)(5)(ii). See *Midwest Research Inst. v. United States*, 554 F. Supp. 1379, 1386 (W.D. Mo. 1983), aff'd, 744 F.2d 635 (8th Cir. 1984), for a restricted interpretation of this regulation. The Service has generally adopted a broader interpretation. See Rev. Rul. 65-1, 1965-1 CB 226.

<sup>65</sup> See Gen. Couns. Mem. 34444 (Mar. 4, 1971). In this memorandum, the Service acknowledged that [p]robably, one of the most difficult problems involved in determining whether certain activities constitute scientific research is the formulation of the proper distinction between “applied” or “practical” scientific activities, on the one hand, and activities of a type ordinarily carried on as an incident to commercial or industrial operations...on the other hand....). Therefore, it would appear that the differentiation can be applied only by the exercise of common sense and the evaluation of the facts with respect to the particular activity or contract in the light of industrial and commercial practices in similar situations.

Generally, the type of activity that the Service has found to be related to commercial activities is the testing of products before marketing, such as the testing of drugs for commercial pharmaceutical companies;<sup>66</sup> the testing of building materials for flammability under a contract with a building materials manufacturer;<sup>67</sup> or the inspection, testing, and certification of cargo shipping containers under contracts with manufacturers of shipping containers.<sup>68</sup> Similarly, the Service has ruled that an organization making grants to public agencies or firms to develop agricultural machinery is engaged in activities incident to commercial operations rather than scientific research where the organization licenses patents on an exclusive or nonexclusive basis to selected manufacturers, thus benefiting manufacturers;<sup>69</sup> and that income derived by an organization from its contract with a corporation to design and develop a patentable medical device and an accessory to a previously patented medical device is engaged in research “incidental to [the corporation’s] ordinary commercial activity of expanding its existing product line” where the organization was required to license the patents exclusively to the corporation in exchange for a preset royalty.<sup>70</sup>

On the other hand, the Service has determined that research into methods of reducing air pollution is considered scientific research directed toward benefiting the public and therefore conducted in the public interest.<sup>71</sup> However, the Service has also ruled that testing for compliance with environmental laws is essentially incident to commercial testing activity and thus constitutes an unrelated trade or business,<sup>72</sup> and that an organization testing hydraulic and mechanical devices designed for the protection of the public water supply from contamination and pollution is engaged in activities incident to commercial or industrial

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<sup>66</sup> See Rev. Rul. 68-373, 1968-2 CB 206; Priv. Ltr. Rul. 8020009 (Feb. 1980).

<sup>67</sup> Tech. Adv. Mem. 7930005 (Sept. 29, 1978).

<sup>68</sup> Rev. Rul. 78-426, 1978-2 CB 175; Gen. Couns. Mem. 37425 (Feb. 23, 1978).

<sup>69</sup> Rev. Rul. 65-1, 1965-1 CB 226.

<sup>70</sup> Tech. Adv. Mem. 8028004 (Mar. 26, 1980).

<sup>71</sup> Gen. Couns. Mem. 34325 (July 31, 1970).

<sup>72</sup> Gen. Couns. Mem. 39196 (Aug. 3, 1983).

operations, where the devices tested were submitted by private commercial companies.<sup>73</sup> The distinction between these activities and testing for public safety is blurred at best.

The Service continues the pattern of ambiguity and inconsistency in this area in a technical advice memorandum involving overlapping boards of the exempt entity and a taxable corporation that contracted with the sponsor of the research, another taxable entity.<sup>74</sup> The Section 501(c)(3) organization conducted research for a number of funders and consistently published the results of these studies in scientific journals. In this case, the results of the research would not on their own constitute marketable products and the organization was not conducting market research or evaluating the feasibility or practicability of commercial applications. There were no restrictions on publication of the research results, and the results here were published in two scientific journals. Based on these facts, the Service ruled that the research was scientific research in the public interest. Although this conclusion does not appear controversial based on the facts presented in the ruling, the determination that there was no inurement to private parties appears to raise difficult questions that the ruling does not address thoroughly. The Section 501(c)(3) organization's three-person board of directors consisted exclusively of the same three persons who were the board members of the taxable corporation's board of directors. The corporation entered into a nonexclusive license with another taxable corporation, its sponsor, to use three of the corporation's patents. The research agreement between the Section 501(c)(3) organization and the sponsor included the "collection of data gathered using the method covered by the patents licensed to Sponsor by Corporation." The Service ruled that any benefits to the corporation and the sponsor were "incidental" and were not inconsistent with the conclusion that the research was conducted in the public interest. This may well be the case, but the ruling would have been far more helpful if the Service had explained its reasoning process beyond noting that the research results were published in a timely manner in two scientific journals. Is a private benefit discounted if it is not an exclusive benefit to a particular party? Was either the corporation or the sponsor uniquely situated to benefit from the

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<sup>73</sup>Tech. Adv. Mem. 7852007 (Sept. 13, 1978).

<sup>74</sup>Tech. Adv. Mem. 200905033 (Nov. 3, 2008).

research and, if so, would this have mattered to a determination of whether the research was in the public interest?

## **B. Taxation of Research Income**

### **1. Research Defined**

As discussed in the following sections, Sections 512(b)(7), 512(b)(8), and 512(b)(9) provide for various exclusions from UBI for income derived from research. However, none of these exclusions defines the term “research,” and the regulations only define what the term “research” does not include, specifically, “activities of a type ordinarily carried on as an incident to commercial or industrial operations, for example, the ordinary testing or inspection of materials or products or the designing or construction of equipment, buildings, etc.”<sup>75</sup>

In *Midwest Research Institute v. United States*,<sup>76</sup> the court was faced with the question of whether a nonprofit scientific research organization was subject to UBIT with respect to a number of research projects it conducted for independent sponsors on a contract basis. The court distinguished scientific research from ordinary and routine testing by examining the level of professional skill involved in the design and supervision of a project. In the court’s view, “While projects may vary in terms of degree of sophistication, if professional skill is involved in the design and supervision of a project intended to solve a problem through a search for a demonstrable truth, the project would appear to be scientific research.” In contrast, the court characterized ordinary or routine testing as follows: “This work was described as generally repetitive work done by scientifically unsophisticated employees for the purpose of determining whether the item tested met certain specifications, as distinguished from testing done to validate a scientific hypothesis.”

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<sup>75</sup> Reg. § 1.512(b)-1(f)(4).

In FSA 200012051 (Dec. 14, 1999), the Office of Chief Counsel opined that the use of data from a weight management program to prepare research studies constituted research within the meaning of Sections 512(b)(7), 512(b)(8), and 512(b)(9).

<sup>76</sup> *Midwest Research Inst. v. United States*, 744 F.2d 635 (8th Cir. 1984).

In *IIT Research Institute v. United States*,<sup>77</sup> the U.S. Claims Court similarly discussed the question of what constituted research. Citing *Midwest Research Institute*, the court analyzed several contracts under which IIT Research Institute had agreed to perform various types of services for various governmental and corporate sponsors. The criteria used by the court to determine what constituted scientific research were as follows:

Any of these contracts can be deemed to be scientific research because it either: 1) involved the use of observation or experimentation to formulate or verify facts or natural law; 2) could only have been performed by an individual with an advanced scientific or technical expertise; 3) added to knowledge within a particular scientific field; 4) involved the application of mathematical reasoning; and/or, 5) was an attempt to systematize or classify a body of scientific knowledge by collecting information and presenting it in a useful form.

These court decisions adopt a view of what constitutes research that is more expansive than the view typically taken by the Service. The Service, in contrast, takes a more expansive view of what constitutes ordinary or routine testing. In any case, however, even activities that might constitute ordinary or routine testing may nonetheless be exempt from UBIT if they are carried on in connection with a related activity, such as the participation in drug studies for pharmaceutical companies by health care organizations in which patient care is directly involved.

## **2. Government-Sponsored Research**

Section 512(b)(7) excludes from the UBIT income derived from research performed (1) for the United States, its agencies, and its instrumentalities and (2) for any state and its political subdivisions. The regulations do little more than restate the statute and add that research does not include activities carried on as incidental to commercial or industrial oper-

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<sup>77</sup> *IIT Research Inst. v. United States*, 85-2 USTC ¶ 9734 (Ct. Cl. 1985).

ations, such as ordinary testing or inspection of materials or products or designing or constructing equipment or buildings.<sup>78</sup>

For most tax-exempt organizations, the Section 512(b)(7) modification will have its greatest application to revenues derived from government-sponsored research for which the organization is not required by contract or otherwise chooses not to either publicize the results of the research or satisfy the licensing requirements that would allow the research to be treated as scientific research.

### 3. Special Rules for Colleges, Universities, and Hospitals

The research activities of colleges, universities, and hospitals are accorded special treatment under Section 512(4)(8). If the research activities are not otherwise treated as related activities because they further neither charitable (i.e., promotion of health), educational, nor scientific purposes (e.g., because the college, university, or hospital fails to satisfy the publication requirement), then the resulting revenues are still exempt from the UBIT. All research-generated revenues, including but not limited to commercially sponsored research revenues, are nontaxable under Section 512(b)(8).

Importantly, Section 512(b)(8) applies only to colleges, universities, and hospitals. This modification is, therefore, applicable only to colleges and universities described in Section 170(b)(1)(A)(ii), or hospitals described in Section 170(b)(1)(A)(iii). In this context, the Service has taken the position that a separately incorporated research institute established by a university will not be treated as a university unless it has a faculty, curriculum, and student body,<sup>79</sup> and that a medical research organization will not be treated as a hospital for Section 512(4)(8) purposes unless it also provides patient care services.<sup>80</sup> However, if the research is conducted by a single-member limited liability company owned by the college, university, or hospital that elects to be treated as a disregarded entity, the research

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<sup>78</sup> Reg. §§ 1.512(b)-1(f)(1), 1.512(b)-1(f)(4).

<sup>79</sup> See Gen. Couns. Mem. 39196 (Mar. 20, 1984).

<sup>80</sup> Gen. Couns. Mem. 39196 (Mar. 20, 1984); see also Gen. Couns. Mem. 32196 (Jan. 24, 1962); Priv. Ltr. Rul. 8637004 (May 30, 1986).

should be treated as being directly conducted by the college, university, or hospital for purposes of Section 512(b)(7).<sup>81</sup>

#### 4. Special Rules for Basic Research Organizations

Section 512(b)(9) excludes from taxation income derived from any person by organizations that are operated primarily to carry on fundamental research the results of which are freely available to the general public. To qualify for this exclusion, two tests must be met. First, the organization itself must be one that is operated primarily to conduct basic research. As the regulations under Section 501(c)(3) emphasize, it is necessary to determine whether the organization is operated primarily for purposes of carrying on fundamental as compared with applied research.<sup>82</sup> The regulations under Section 512(b)(9) add that the term “fundamental research” does not include research carried on for the primary purpose of commercial or industrial application.<sup>83</sup> Second, only those research organizations whose results are freely available qualify for this modification.

If the two tests are satisfied, the importance of this modification is that it allows basic research organizations to undertake commercially sponsored research projects that have delays in publications dictated by the business interests of the sponsor without causing the research income to be taxable, as long as the research projects do not become the primary purpose of the research institution.<sup>84</sup>

### III. MONETIZING IP

The traditional and nontraditional IP of exempt organizations can be monetized by various transfers of rights to related or unrelated persons. The tax treatment of IP transfers will depend in part on the form and structure of the transfer (via license, sale, etc.) as well as on the relationship of the transferee to the exempt organization (related or unrelated).

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<sup>81</sup> See Priv. Ltr. Rul. 200223067 (June 7, 2002).

<sup>82</sup> Reg. § 1.501(c)(3)-1(d)(5)(i).

<sup>83</sup> Reg. § 1.512(b)-1(f)(4).

<sup>84</sup> See, e.g., Priv. Ltr. Rul. 8637004 (May 4, 1986).

## A. Royalty Payments from Licensing

Patents, copyrights, rights to use trade names and similar items of IP are typically transferred by license. In general, a license will grant rights to use the protected IP to the licensee in exchange for the payment of fees known as royalties. A license of IP can be exclusive or non-exclusive, extend for a limited or indefinite period of time, and include worldwide rights or be limited to a particular geographic area. Typically, licenses call for the licensee to pay a royalty to the licensor either payable in scheduled amounts or based on the sales, profit or an amount per unit produced.

Section 512(b)(2) excludes from unrelated business taxable income (“UBTI”) “all royalties... whether measured by production or by gross taxable income from the property...” The applicable Treasury regulations state that whether revenue is royalty income depends upon the facts and circumstances of the case.<sup>85</sup>

In general, a royalty is a payment for the right to use an intangible asset. It is the fact that royalties are paid for the use of the asset rather than for services rendered that distinguishes excludable royalties from taxable income from services or taxable income derived from the commercial exploitation of an exempt function.

Payments are considered royalties whether they are made in a lump sum or are measured by the use of the underlying property rights, as long as the payments relate to the use of the rights and are not made for services.<sup>86</sup> However, lump sum or deferred payments received in connection with the sale of the underlying property itself are governed by Section 512(b)(5) (the UBI exclusion for capital gain) rather than by Section 512(b)(2).

### 1. Royalties vs. Service Fees

Revenue Ruling 69-430, 1969-1 C.B.129, points out important factors that distinguish royalties excluded under Section 512(b)(2) from income derived from the provision of services or the sale of goods. In the ruling, the exempt organization owned publication

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<sup>85</sup> Reg. § 1.512(b)-1(b).

<sup>86</sup> Gen. Couns. Mem. 38083 (Sept. 11, 1979).

rights to a book that did not contribute in any manner to the accomplishment of its exempt purposes. The organization itself undertook to exploit the book in a commercial manner by arranging for the printing, distribution, and retail sales of the book. It also arranged for publicity and advertising in connection with the distribution and sale of the book. While the ruling held that the activities of the organization constituted the conduct of an unrelated trade or business, it concluded with the observation that “had the organization transferred the publication rights to a commercial publisher in return for royalties, the royalty income derived would have been excluded from the computation of unrelated business taxable income under section 512(b)(2) of the Code.”

An exempt organization is permitted to perform certain types of services with respect to its licensed property rights without jeopardizing the availability of the royalty modification.<sup>87</sup> The limitations are akin to the rules under Section 512(b)(3) governing the exclusion from UBI of rents from real property. Those rules seek to ensure that rents excluded from UBI are derived from a passive investment rather than from the active operation of a business (a hotel, a parking lot, etc.). While hourly or daily “rents” received from those parking in a lot actively operated by a tax-exempt organization will likely be considered taxable income as a fee for services, rents received from the more passive long-term lease of the entire parking lot to a commercial operator could be excluded from UBI.

Similarly, an agreement to develop IP and to disclose or assign the IP to another party will likely be treated as an agreement to perform services and not as a passive sale or license of the IP.<sup>88</sup> However, activities involving the oversight of leased real property or licensed intellectual property to ensure that it is not being damaged or abused are not considered services for UBI purposes.

The royalty modification has been used successfully by many types of tax-exempt organizations to allow them to receive income from various types of affinity programs, such as

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<sup>87</sup> Rev. Rul. 81-178, 1981-2 C.B. 135; *Cf.* Rev. Rul. 64-56, 1964-1 C.B. (Part 1) 133.

<sup>88</sup> *Ruge v. Comm’r*, 26 T.C. 138 (1956), *acq.* 1958-2 C.B. 7; *Kimble Glass Co. v. Comm’r*, 9 T.C. 183 (1947), *acq.* 1947-2 C.B. 3.

the affinity credit card programs discussed in further detail in Part IV, below.<sup>89</sup> However, in distinguishing the licensing of IP rights from the provision of services, the courts generally hold that the sale of advertising constitutes a taxable unrelated trade or business, rather than a passive licensing activity.

## **2. Cross-Licensing Agreements**

Occasionally, exempt organizations will enter into cross-licensing agreements or reciprocal licenses. These are agreements pursuant to which each party to the agreement allows the other to use the technology it owns, and these agreements may be royalty-free or may involve the payment of a net royalty to the party that cross-licenses a more valuable technology to the other. Properly structured, revenue from these arrangements may also qualify under the royalty modification under Section 512(b)(2).

## **3. Royalties from the Results of Sponsored Research**

As discussed in the introduction, the IRS has approved, as a program-related investment, an agreement giving a private foundation a one-sixth interest in any royalties derived from diabetes research it paid a hospital to conduct.<sup>90</sup> The agreement obligated the foundation to provide several million dollars to the university hospital over three years for diabetes research, specifically, “to advance the conduct of human clinical trials for the treatment of Type 1 diabetes in humans, including preliminary research necessary for conducting such clinical trials.”<sup>91</sup>

The foundation, in turn, retained a one-sixth royalty interest in the event the hospital or its IP licensing entity received payments of any kind in return for the use of any invention resulting from the sponsored research.

The Service determined that the purpose of the agreement was to develop a cure for Type I diabetes, and not to receive royalties from the license or sale of this research. Further, the ruling states that “it is uncertain any royalties will be generated” and that the founda-

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<sup>89</sup> See, e.g., *Planned Parenthood Federal of America, Inc. v. Comm’r*, 77 T.C.M. 2227 (1999).

<sup>90</sup> Priv. Ltr. Rul. 201145027 (Nov. 10, 2011).

<sup>91</sup> *Id.*

tion represented that “most investors would demand royalties well above [Redacted Text] percent of future sales revenue in return for funds provided at this stage of research because of the uncertainty of any useful results being generated.”<sup>92</sup>

Nonetheless, exempt organizations providing research funding may wish to consider procuring a similar royalty interest. After all, “[t]he fact that the Agreement has the potential to create research which may be later sold to a third-party and may create royalties which will be received by you does not prevent the research from qualifying as ‘scientific research in the public interest’ because this potential benefit is incidental to your activities.”<sup>93</sup>

## **B. Proceeds from the Sale of IP or Derivative Products**

The IP of a tax-exempt organization may also be transferred by a sale of the IP itself or through the sale of products derived from the IP.

### **1. Disposition of Products Produced Through Exempt Activities**

When a tax-exempt organization sells products that result from the performance of its exempt functions, the sale ordinarily does not constitute the conduct of unrelated trade or business if the product is sold in substantially the same state it was in on completion of the exempt function.<sup>94</sup> The regulations use as an example of this principle a Section 501(c)(3) organization engaged in a rehabilitation program for disabled individuals, concluding that income from the sale of articles made by those individuals as part of their rehabilitation training would not be gross income from the conduct of unrelated trade or business.<sup>95</sup>

The operative clause of this clarification of the substantially related exemption requires that the product (which the Treasury regulations assume to be some form of tangible personal property) be “sold in substantially the same state it is in on completion of the exemption functions.”<sup>96</sup> Thus, when a product resulting from an exempt function is used or exploited in a business endeavor beyond that reasonably appropriate or necessary for dispo-

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<sup>92</sup> *Id.*

<sup>93</sup> *Id.*

<sup>94</sup> Reg. § 1.513-1(d)(4)(ii).

<sup>95</sup> *Id.* See also Rev. Rul. 68-581, 1968-2 C.B. 50.

<sup>96</sup> *Id.*

sition in its state upon the accomplishment of the exempt functions, the regulations indicate that income derived would be from the conduct of an unrelated trade or business.

From a planning standpoint, the key consideration is whether the product is sold in “substantially” the same state that it was in when the exempt function was completed. The Treasury regulations suggest that the packaging and sales advertisement of original products are not problematic; rather, the principal issue is whether the exempt organization has undertaken additional steps to process the product itself.

## 2. Outright Sales of IP

It is critical to distinguish a sale of IP from a license for a number of reasons. First, a sale of an IP right will be treated differently for tax purposes, and whether a transfer is a sale will not depend on whether the payment is in a lump sum or is payable over time based on use, similar to a royalty. Generally, in order for a transfer of IP to be treated as a sale for tax purposes, there must be a complete transfer of all substantial rights of economic value in the IP.<sup>97</sup>

If the transfer of IP rights is treated as a sale, Section 512(b)(5) must be considered. Section 512(b)(5) excludes from the computation of UBTI gains and losses from the sale, exchange, or other disposition of property.<sup>98</sup> Section 512(b)(5) applies to gains realized in connection with capital gains-type property<sup>99</sup> and not ordinary income property. Specifically, Section 512(b)(5) does not apply to sales of stock in trade or other inventory, nor does it apply to sales of property held for sale to customers in the ordinary course of a trade or business.

## C. Offsetting UBIT and Net Operating Losses

UBI is the income from a regularly carried on trade or business which is not substantially related to the tax-exempt organization’s exempt purpose. Unrelated business taxable in-

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<sup>97</sup> *Bell Intercontinental Corp. v. United States*, 381 F.2d 1004, 1010 (Ct. Cl. 1967).

<sup>98</sup> *See, e.g.* Priv. Ltr. Rul. 9635001 (April 6, 1984) (mailing list exchanges amount only to exchanges of use and not exchanges of property, and thus Sections 512(b)(5) and 1031(a)(1) are not applicable).

<sup>99</sup> Note that Section 512(b)(5) applies sales, etc. of “property” and not “capital assets” as defined in Section 1221(a). Thus, gains from the sale of copyrights and other items excepted from the definition of “capital asset” in Section 1221(a)(3) are still eligible for exclusion under Section 512(b)(5).

come (“UBTI”) is the UBI that is taxable after deducting expenses directly connected to the unrelated trade or business. In most cases, losses from one unrelated business activity can offset UBI from another. Once UBI is reduced to zero for a fiscal year, any unused net operating losses (“NOLs”) can be carried forward to offset UBI in future years, subject to certain limitations.

The Final Report of the Colleges and Universities Compliance Project, released by the IRS on April 25, 2013, focuses in part on the reporting of UBI by tax-exempt colleges and universities, but its assessments are directed at all tax-exempt organizations. In the report, the IRS announced plans to review the UBI of tax-exempt organizations more broadly, focusing on the characterization of activities as exempt or unrelated, methodologies for allocating expenses between the two, and the use of current-year losses and net operating loss carry-forwards used to reduce UBI

The report describes a wide variety of activities examined, some of which are common across the tax-exempt sector, including advertising and exclusive provider arrangements.

The report concludes that (i) substantially all of the 34 colleges and universities examined led to increases in UBTI, totaling about \$90 million; (ii) there were more than 180 changes to the amounts of UBTI reported on Form 990-T; and (iii) more than \$170 million in NOLs were disallowed.

Primarily, and as further detailed below, the increases to UBTI resulted from:

- the disallowance of expense deductions,
- computation or substantiation errors, and
- the reclassification of activities from exempt to unrelated,

all of which must be considered when structuring the monetization of IP.

## 1. Disallowed deductions

The report finds that losses were being inappropriately used to offset UBI where a profit motive was lacking and through improper expense allocations.

*Lack of profit motive.* The report indicates that almost 70 percent of those examined reported losses from activities with a pattern of recurring losses, which the IRS believes indicates the lack of a profit motive. Without a profit motive, the activity is not considered a “trade or business” for UBI purposes. The IRS therefore disallowed the use of expenses and losses from those activities to reduce UBI from other activities.

As a result, exempt organizations may wish to reconsider their utilization of losses from lines of business with a pattern of recurring losses to offset UBI from profitable unrelated trades or businesses or be prepared to establish the requisite profit motive even if the activity is a loss activity.

On the other hand, the Treasury regulations appear to offer a potential rebuttal:

“[W]here an activity carried on for the production of income constitutes an unrelated trade or business, no part of such trade or business shall be excluded from such classification merely because it does not result in profit.”<sup>100</sup>

*Improper expense allocations.* The report found that on nearly 60 percent of the Form 990-T unrelated business income tax returns examined, losses from exempt activities were used to reduce UBTI, which is inappropriate. Expenses, including for personnel, applicable to both exempt and unrelated activities must be allocated on a reasonable basis. All expenses used to reduce UBTI must be *directly connected* to unrelated trade or business activities. For example, if an officer earning \$200,000 in salary and benefits annually devotes approximately 10 percent of his or her time to an unrelated trade or business and 90 percent to exempt functions, \$20,000 could be deducted from UBI — the allocable portion of the salary and benefits.

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<sup>100</sup> Reg. § 1.513-1(b).

Tax-exempt organizations may wish to confirm that expenses used to reduce UBTI are directly connected and reasonably allocable to the unrelated trade or business. For any salary expense being apportioned in part to reduce UBTI, the IRS could request documentation, in the form of timesheets or other contemporaneously maintained records, evidencing the reasonableness of the percentage of the employee's time being allocated to the unrelated trade or business.

## **2. Errors in computation or substantiation**

Of all the returns examined that claimed NOLs, the IRS found that more than a third of the returns had NOLs that were either improperly calculated or unsubstantiated. Nearly \$19 million in NOLs were disallowed.

In an examination, exempt organizations could be asked to provide evidence of the business purpose for a claimed deductible expense. As a result, tax-exempt organizations may find it advisable to review their practices for tracking and documenting the business purposes of expenses used to offset UBI from the taxable exploitation of IP or other unrelated business activities. In addition, care should be used to comply with special rules, such as the "accountable plan" rules and those that apply to meals, entertainment and business travel expenses.

## **3. Improperly classifying unrelated activities as exempt**

The IRS determined that nearly 40 percent of those examined had misclassified certain activities as exempt or otherwise not giving rise to UBI. Nearly \$4 million in income was reclassified as arising from an unrelated trade or business.

For a trade or business to be an exempt activity, the production or distribution of the goods or the performance of the services from which the gross income is derived must contribute importantly to the accomplishment of the organization's exempt purposes. Otherwise, the activity is an unrelated trade or business.

A careful review of the various methods utilized to exploit the IP of an exempt organization may be desirable in order to ensure their proper classification as exempt or unrelated for UBTI purposes.

#### **IV. STRUCTURES FOR EXPLOITING IP INTERNALLY**

The exploitation of IP owned by tax-exempt colleges and universities does not necessarily call for its license or sale to a third party. Much of the decision-making concerning how to exploit IP depends on business issues, such as the amount of capital needed to exploit the IP, the ability of the exempt organization to market the developed technology or the products derived therefrom, the manufacturing requirements for the exploitation of the IP and similar factors.

##### **A. Direct Ownership Exploitation**

Certain ways of exploiting IP rights must almost by definition always be conducted by the organization itself, such as corporate sponsorship arrangements, exclusive provider/supplier arrangements, sales or exchanges of mailing lists, etc.

It is quite common for tax-exempt organizations to exploit their IP rights by licensing or selling the IP rights directly.

Increasingly, however, a growing number of tax-exempt organizations are using the single-member LLC option discussed in the next section in order to obtain limited liability protection and in some cases to facilitate the raising of investment capital in the future.

##### **B. Transfers of IP to Related Parties**

For tax, liability, asset protection, business segregation and other reasons, tax-exempt organizations often transfer IP to be utilized for commercial purposes to related parties, whether tax-exempt, taxable, or wholly-owned or partially owned in a joint venture.

## 1. Cost-Sharing Agreements

An initial consideration when dealing with related entities is the implementation of a cost-sharing agreement that accurately allocates expenses between organizations, including for the use of employees, office space, computer systems, etc..

The sharing of employees, facilities and other items with a for-profit corporate subsidiary will not constitute inurement of net income or otherwise jeopardize a parent's status as a tax-exempt organization so long as the applicable costs are allocated between the tax-exempt parent and its corporate subsidiary on the basis of actual usage.<sup>101</sup>

In Private Letter Ruling 9604019, for example, the IRS approved of a cost sharing agreement whereby a for-profit corporate subsidiary would use its tax-exempt parent's employees, reimbursing it for their time. All expenses incurred by the nonprofit in organizing the subsidiary, "including the value of the use of [the nonprofit's] office space, equipment and supplies, as well as the time worked by [the nonprofit's] employees in [the subsidiary's] operations, shall be computed and itemized, and shall become an obligation of [the subsidiary], payable to [the nonprofit], and bearing interest at a rate necessary to avoid the imputation of interest under the applicable provisions of the Internal Revenue Code."<sup>102</sup>

## 2. Taxable Corporate Subsidiaries

UBI producing IP may be "dropped down" into a taxable corporate subsidiary nontaxable as a contribution to capital. The taxable subsidiary, in turn, can monetize the IP and provide upstream dividend distributions that are exempt from UBI pursuant to Section 512(b)(1). Two limitations should be considered.

First, unless they are maintained in the same entity, or part of a controlled group of corporations that files a consolidated return, the ability to offset taxable income from one UBI producing business by the net operating losses of another unrelated business may be hampered.

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<sup>101</sup> See, e.g., Priv. Ltr. Rul. 9604019 (Jan. 26, 1995).

<sup>102</sup> Id.

Second, as discussed below, Section 512(b)(13) effectively prevents the nonprofit parent (the “controlling organization”) from attaining a tax advantage from deductible payments by the corporate subsidiary (and other “controlled entities”) to it for interest, annuities, royalties or rents (with the exception for fair market value payments described in section 512(b)(13)(E), which does not apply to payments received or accrued after December 31, 2013). As a result, the use of license agreements in otherwise effective tax minimization structures may not be useful.

### 3. Section 512(b)(13)

Generally, if the controlling organization receives or accrues (directly or indirectly) any interest, annuity, royalty or rent from a controlled entity, then the controlling organization must include the payment in UBI (notwithstanding the modifications in Sections 512(b)(1), (2) and (3)) to the extent the payment reduces the taxable income or increases net losses of the controlled entity.

Importantly for tax planning purposes, the term “control” means —

(I) in the case of a corporation, ownership (by vote or value) of more than 50 percent of the stock in such corporation,

(II) in the case of a partnership, ownership of more than 50 percent of the profits interests or capital interests in such partnership, or

(III) in any other case, ownership of more than 50 percent of the beneficial interests in the entity.<sup>103</sup>

As a result, a corporation, partnership or LLC owned 50/50, for example, would be able to pay a tax-exempt license fee to a 50% tax-exempt owner for the use of its IP which was also deductible from the “controlled entity’s” taxable income.

Keep in mind that dividends are not impacted by this rule, as the payment of a dividend typically is not deductible from a for-profit corporation’s taxable income.<sup>104</sup>

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<sup>103</sup> I.R.C. § 512(b)(13)(D)(i).

#### 4. Technology Transfer Organizations

Many large exempt organizations, research universities in particular, maintain controlled technology transfer organizations tasked to hold, protect and monetize IP created by its faculty, researchers, physicians, scientists, etc. Taxable technology transfer corporations can be established as wholly-owned subsidiaries or as multi-party organizations, often through a wholly-owned subsidiary of a supporting organization with multiple supported organizations.

Technology transfer organizations are intended to:

- avoid the diversion of a tax-exempt organization's time to patenting, developing and commercializing IP on a discovery by discovery basis;
- combine synergistic IP from multiple partners; and
- facilitate the recruiting of top scientists, technology transfer experts, and other personnel.

For example, in Private Letter Ruling 200326035, a supporting organization, T, had multiple "Research Partner" supported organizations that entered into technology transfer agreements with Z, T's wholly-owned subsidiary, pursuant to which the Research Partner granted an exclusive license to Z to IP developed by the Research Partner.<sup>105</sup> Z engaged in technology commercialization activities, including patent prosecution and maintenance.

The IP license provided to Z gave it the right to a royalty interest equal to its technology transfer costs plus 50% of the net income generated by the IP. Each Research Partner retained ultimate ownership of the IP and a 50% royalty interest in any net income generated by the IP (after Z's reduction for commercialization costs). For Section 512(b)(13) purposes, it is critical that the 50% retained royalty interest gave the Research Partner the

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<sup>104</sup> See, for example, Priv. Ltr. Rul. 960409 (Jan. 26, 1995) ("The stock dividends to be declared and paid by [wholly-owned technology transfer corporation] to [its parent tax-exempt organization, N] will not either jeopardize the tax-exempt status of N under section 501(c)(3) of the Code or result in unrelated business income to N pursuant to sections 512(b)(1) and 512(b)(13) of the Code.").

<sup>105</sup> Priv. Ltr. Rul. 200326035 (June 27, 2003).

right to receive, directly from the sub-licensees, 50% (following Z's recovery of its technology transfer costs) of any royalty paid by any sub-licensee of the IP.

As such, the Service found that “[t]he royalties you receive are excluded from unrelated business income tax under section 512(b)(2). There is no unrelated business income under section 512(b)(13) relating to payments received from controlled entities because the payments are not from Z, but from the payor of the income derived from the commercialization of your intellectual property. Neither T nor Z have any right to your 50% retained royalty interest.”<sup>106</sup> In other words, the retention of a direct royalty interest allowed the tax-exempt Research Partner to receive non-taxable royalties resulting from Z’s commercialization of the IP.

Clearly, technology transfer organizations require careful structuring to ensure that the intended tax results are achieved, the governance structure is effective, exempt purposes are furthered, and multiple exit strategies are available.

## **5. Use of Single Member LLCs**

Tax-exempt organizations form single-member LLCs for tax, liability, asset protection, business segregation and other purposes.

Forming a tax-exempt corporate subsidiary generally requires an application for tax-exempt status and a review by the IRS that can often take nearly a year or longer. A single-member LLC can be formed in a day, allowing a tax-exempt organization to quickly and efficiently restructure to separate and protect its assets and operations.

The “check-the-box” regulations that create the default treatment of single-member LLCs as entities disregarded as separate from their owners allows for numerous planning opportunities for tax-exempt organizations seeking to exploit their IP rights. A disregarded single-member LLC’s activities, revenues and expenses, whether for exempt or for unrelated purposes, (i) are imputed to its sole member for purposes of determining the tax-exempt

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<sup>106</sup> Id. Interestingly, the tax-exempt organization paid its 50% retained royalty amounts over to the researcher/inventor as a bonus. Typically, the researcher/inventor is granted only a one-third interest in the revenue stream from any IP created.

owner's eligibility for tax exemption, liability for excise taxes and UBIT liability and (ii) are to be reported on the tax-exempt owner's Form 990 information return. In addition, the IRS has recently confirmed that if a contribution to a domestic 501(c)(3) organization is tax-deductible, then so is a contribution to its domestic, wholly-owned LLC.<sup>107</sup>

Of course, tax-exempt organizations should keep in mind that state laws are distinct from federal tax rules. A single-member LLC disregarded for federal tax purposes may be "re-garded" for state law purposes, including for tax-exempt status and reporting requirements. It is critical to consider potentially applicable state law issues such as whether gifts made directly to a single-member LLC will generate state income tax deductions, whether assets a tax-exempt organization transfers to its single-member LLC will remain eligible for property tax or sales and use tax exemption, and what state and local reporting obligations are applicable to a single-member LLC.

In its most basic form, a properly structured single-member LLC affords some liability protection to the tax-exempt organization for claims arising from assets or operations after their transfer to the LLC. For example, the transfer of a copyright for computer software to the LLC may shield the tax-exempt organization for breach of warranty and other types of claims that are not contractually limited under the licensing agreement itself. It is important to note, however, that the liability protection does not extend to infringement or similar types of claims brought by parties other than the licensees.

Increasingly, single member LLCs are being used as a first step in structuring a potential new company that may someday seek to attract public and private equity investors. Formation of a single-member LLC allows the tax-exempt organization to treat income derived from the activity as income from a related trade or business and to retain the eligibil-

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<sup>107</sup> IRS Notice 2012-52, 2012-35 I.R.B. 317. Even though a gift goes to a single member LLC, Notice 2012-52 makes its member 501(c)(3) responsible for meeting substantiation and disclosure requirements applicable to the gift. To avoid unnecessary inquiries by the IRS, the Notice encourages the charity to disclose, in a gift acknowledgment or another statement, that the single-member LLC is wholly owned by the 501(c)(3) and is disregarded for federal income tax purposes. Annual percentage limitations on charitable contribution deductions apply to a donor's gifts to a single-member LLC as if the contributions were made to the sole member 501(c)(3).

ity for modifications to UBI, such as the exclusion of royalties pursuant to Section 512(b)(2).

Importantly, however, from a business point of view, use of a single-member LLC allows the organization to develop in the LLC a separate employment compliment, establish a separate legal owner without adverse tax consequences to the exempt organization, create an opportunity for separate audited financial statements and creates a useful opportunity to establish a business using the IP as a going concern prior to a capital event, such as an infusion of venture capital, an initial public offering of stock or a sale of the business.

## **6. Use of S Corporations**

The Small Business Job Production Act of 1996 made several modifications to the tax rules applicable to S corporations, including by permitting tax-exempt organizations described in Section 501(c)(3) to be shareholders.<sup>108</sup>

However, items of income or loss of an S corporation will flow through to the qualified tax-exempt shareholders as UBI, regardless of the source or nature of the income. Thus, for example, royalty income of an S corporation will flow through to the qualified tax-exempt shareholders as UBI notwithstanding the Section 512(b)(2) modification. In addition, gain or loss on the sale or other disposition of stock of an S corporation by a qualified tax-exempt shareholder will be treated as UBI notwithstanding the Section 512(b)(5) modification for capital gain.<sup>109</sup>

However, the ownership of S corporation stock by a tax-exempt organization creates a de facto consolidated return for UBIT purposes. Thus, an S corporation may prove useful for taxable research or IP exploitation that is not otherwise eligible for one of the modifications or exceptions such as the royalty modification of Section 512(b)(2) or the research modifications in Sections 512(b)(7)-(9).

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<sup>108</sup> I.R.C. § 1361(b)(7); *see, e.g.*, Priv. Ltr. Rul. 199914052 (Jan. 13, 1999)(a Section 501(c)(15) organization is not qualified to be a shareholder of an S corporation).

<sup>109</sup> I.R.C. § 512(e).

## V. CORPORATE SPONSORSHIP AND LICENSING

One classic and legislatively approved way to monetize IP is to collect “qualified sponsorship payments” for allowing businesses or individuals to associate their names or logos with a tax-exempt organization. Examples are myriad, including when college football’s Fiesta Bowl became the Sunkist Fiesta Bowl in 1986 and the IRS battle surrounding the Mobil Cotton Bowl that sparked the initial 1993 proposed regulations on corporate sponsorships.

The activity of soliciting and receiving “qualified sponsorship payments,” as opposed to the provision of advertising, is not an unrelated trade or business and does not give rise to UBI.<sup>110</sup> A “qualified sponsorship payment” includes:

any payment made by any person engaged in a trade or business with respect to which there is *no arrangement or expectation that such person will receive any substantial return benefit* other than the use or acknowledgement of the name or logo (or product lines) of such person's trade or business in connection with the activities of the organization that receives such payment. Such a use or acknowledgement does not include advertising such person's products or services (including messages containing qualitative or comparative language, price information, or other indications of savings or value, an endorsement, or an inducement to purchase, sell, or use such products or services).<sup>111</sup>

“Qualified sponsorship payments” may not be contingent upon the level of attendance at one or more events, broadcast ratings, or other factors indicating the degree of public ex-

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<sup>110</sup> I.R.C. § 513(i)(1). Qualified sponsorship payments in the form of money or property (but not services) are treated as contributions for purposes of the public support tests under Section 170(b)(1)(A)(vi) and Section 509(a)(2). See Reg. §§1.513-4(e)(3), 1.509(a)-3(f)(1) and 1.170A-9(e)(6)(i).

<sup>111</sup> I.R.C. § 513(i)(2)(A) (emphasis added).

posure to one or more events.<sup>112</sup> Also, note that the exception does not apply to qualified convention and trade show activities or periodicals (regularly scheduled and printed material published, including electronically, by or on behalf of the payee organization that is not related to and primarily distributed in connection with a specific event conducted by the payee organization).<sup>113</sup>

If only a portion of a payment constitutes a qualified sponsorship payment, such portion and the non-qualifying portion are treated as separate payments.<sup>114</sup> The tax-exempt organization must be able to establish that the payment exceeds the fair market value of any substantial return benefit. Otherwise, no portion of the payment constitutes a qualified sponsorship payment.<sup>115</sup>

In determining whether a payment, or an allocable portion of a payment, is a qualified sponsorship payment, “it is irrelevant whether the sponsored activity is related or unrelated to the recipient organization's exempt purpose. It is also irrelevant whether the sponsored activity is temporary or permanent.”<sup>116</sup>

The applicable regulations include an example in which tax-exempt organization licenses the use of its logo to a pharmaceutical company for marketing purposes.<sup>117</sup> In the example:

U, a national charity dedicated to promoting health... grants the pharmaceutical company a license to use U's logo in marketing its products to health care providers around the country. .... [T]he license granted to the pharmaceutical company to use U's logo is a substantial return benefit. Only that portion of the payment, if any, that U can demonstrate exceeds

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<sup>112</sup> I.R.C. § 513(i)(2)(B)(i).

<sup>113</sup> I.R.C. § 513(i)(2)(B)(ii). For rules governing qualified convention and trade show activity, see Reg. § 1.513-3. For rules governing the sale of advertising in exempt organization periodicals, see Reg. § 1.512(a)-1(f).

<sup>114</sup> I.R.C. § 513(i)(3).

<sup>115</sup> Reg. § 1.513-4(d)(1).

<sup>116</sup> Reg. § 1.513-4(c)(1).

<sup>117</sup> Reg. § 1.513-4(f), Ex. 9.

the fair market value of the license granted to the pharmaceutical company is a qualified sponsorship payment.

As a result, payments allocable to the license do not constitute qualified sponsorship payments excluded from UBI. However, for payments or portions of payments that are not qualified sponsorship payments, the treatment of any such amount is determined by general UBIT principles, including the application of Sections 512, 513 and 514. As such, the portion of the payment received by U in the foregoing example for the use by the pharmaceutical company of an intangible asset of the tax-exempt organization, its logo, is evaluated separately in determining whether the payment is treated as UBTI,<sup>118</sup> and may well come under the general exception for royalties under Section 512(b)(2).

#### **A. Substantial Return Benefit**

Benefits provided to the sponsor may include (i) advertising, (ii) exclusive provider arrangements, (iii) goods, facilities, services or other privileges, and (iv) exclusive or nonexclusive rights to use an intangible asset (e.g., trademark, patent, logo, or designation) of the exempt organization, all as further detailed below.

A “substantial return benefit” means any benefit other than de minimis “disregarded benefits” and a “use or acknowledgment.”

##### **1. Disregarded Benefits**

Benefits are disregarded if the aggregate fair market value of all the benefits provided to the sponsor in connection with the payment during the organization's taxable year is not more than 2% of the amount of the payment. If the aggregate fair market value of the benefits exceeds 2% of the amount of the payment, then the entire fair market value of such benefits is a substantial return benefit.

##### **2. Use or Acknowledgement**

The use or acknowledgement exception from what is considered a benefit is the heart of the UBI exception for sponsorship payments. A “substantial return benefit” does not in-

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<sup>118</sup> Reg. § 1.513-4(d)(1)(i).

clude the use or acknowledgment of the name, logo or product lines of the sponsor's trade or business in connection with the activities of the tax-exempt organization. Use or acknowledgment does not include advertising, but may include:

- exclusive sponsorship arrangements;
- logos and slogans that do not contain qualitative or comparative descriptions of the sponsor's products, services, facilities or company (logos or slogans that are an established part of a sponsor's identity are not considered to contain qualitative or comparative descriptions);
- a list of the sponsor's locations, telephone numbers, or Internet address;
- value-neutral descriptions, including displays or visual depictions, of the sponsor's product-line or services; and
- the sponsor's brand or trade names and product or service listings.<sup>119</sup>

## **B. Advertising**

For "qualified sponsorship payment" purposes, advertising means:

any message or other programming material which is broadcast or otherwise transmitted, published, displayed or distributed, and which promotes or markets any trade or business, or any service, facility or product. Advertising includes messages containing qualitative or comparative language, price information or other indications of savings or value, an endorsement, or an inducement to purchase, sell, or use any company, service, facility or product. A single message that contains both advertising and an acknowledgment is advertising. This section does not apply to activities conducted by a payor on its own. For example, if a payor purchases broadcast time from a television station to advertise its product during commercial breaks in a sponsored program, the exempt organization's activities are not thereby converted to advertising.<sup>120</sup>

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<sup>119</sup> Reg. §§ 1.513-4(c)(2)(iii) and (iv).

<sup>120</sup> Reg. § 1.513-4(c)(2)(v).

For example, assume that a university's noncommercial radio station airs a program funded by a local music store. In exchange for the funding, the station broadcasts the following message: "This program has been brought to you by the Music Shop, located at 123 Main Street. For your music needs, give them a call today at 212-555-1234. This station is proud to have the Music Shop as a sponsor." The message contains both advertising (an inducement to use the company or make a purchase) and an acknowledgment, so the entire message is considered to be advertising, a substantial return benefit.

The mere display or distribution, whether for free or remuneration, of a sponsor's product to the general public at the sponsored activity is not considered an inducement to purchase, sell or use the sponsor's product and, thus, will not be considered advertising or negatively impact the determination of whether a payment is a qualified sponsorship payment.<sup>121</sup> This rule should explain the oddly located luxury car you sometimes find parked inside the concert hall.

### **C. Exclusivity Arrangements**

Generally, an exclusive sponsor agreement does not by itself result in a substantial return benefit, while an exclusive provider arrangement does result in a substantial return benefit. For example, Visa will be the exclusive payment services sponsor accepted at the Olympic Games through 2020, an exclusive sponsor agreement. Visa will also be the only card accepted at the Olympic Games through 2020, an exclusive provider arrangement.

Exclusive provider arrangements limit the sale, distribution, availability, or use of competing products, services, or facilities in connection with a tax-exempt organization's activity.

The regulations provide the following example:

R is a liberal arts college. A soft drink manufacturer enters into a binding, written contract with R that provides for a large payment to be made to the college's English department in exchange for R agreeing to name a writing competition after the soft drink manufacturer. The contract also provides that R will allow the soft drink manufacturer to be the exclusive provider of all soft drink sales on campus. The fair market value of the exclusive provider component of the contract exceeds 2% of

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<sup>121</sup> Reg. § 1.513-4(c)(2)(iv).

the total payment. R's use of the manufacturer's name in the writing competition constitutes acknowledgment of the sponsorship. However, the exclusive provider arrangement is a substantial return benefit. Only that portion of the payment, if any, that R can demonstrate exceeds the fair market value of the exclusive provider arrangement is a qualified sponsorship payment.<sup>122</sup>

While payments made pursuant to an exclusivity arrangement may not qualify as a qualified sponsorship payment, the payments are not inescapably included in UBI. As noted above, non-qualifying payments simply do not meet the safe harbor for sponsorships, and their treatment as tax-exempt or as UBI is determined by general UBIT principles, including the application of Sections 512, 513 and 514. In that regard, exclusivity arrangements are addressed in further detail in Part V, below.

#### **D. Internet Hyperlinks**

The Treasury Decision announcing the final corporate sponsorship regulations in 2002 indicates that “the issue of whether a hyperlink constitutes an acknowledgment or advertising is addressed in the final regulations with two new examples.”<sup>123</sup>

In the first example, a symphony orchestra posts a list of its sponsors on its website, including the name and Internet address of a concert series sponsor, which appears as a hyperlink to the sponsor's website. The hyperlink is deemed to be no more than an acknowledgement of the sponsor, and the entire payment a qualified sponsorship payment, which is not UBI.<sup>124</sup>

In the second example, a health-based charity, X, sponsors an public education initiative with respect to about a particular medical condition. A pharmaceutical company manufactures a drug used to treat the condition, and provides funding for the initiative. The charity's website contains a hyperlink to the pharmaceutical company's website, where the following statement appears, “X endorses the use of our drug, and suggests that you ask your doctor for a prescription if you have this medical condition.” X reviewed and permitted

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<sup>122</sup> Reg. § 1.513-4(f), Ex. 6.

<sup>123</sup> TD 8991, Unrelated trade or business—treatment of certain sponsorship payments (4/24/2002).

<sup>124</sup> Reg. § 1.513-4(f), Ex. 11.

the endorsement prior to its being posted on the pharmaceutical company's website, which is considered advertising, a substantial return benefit. As a result, the portion of the payment allocable to the advertising is not a qualified sponsorship payment.<sup>125</sup>

However, the payment allocable to advertising could qualify as a royalty for the use of X's intellectual property, which would be excluded from UBI under Section 512(b)(2).

The two examples demonstrate that a hyperlink to a sponsor will be characterized for corporate sponsorship purposes – as an acknowledgement or as advertising – in part based on whether clicking on the link reveals an endorsement. Clearly, however, the websites of tax-exempt organizations and any hyperlinked websites or sponsors or other sites linked to from the tax-exempt's website will be subject to review upon an audit for UBI and other purposes. Sponsorship agreements must carefully be structured accordingly.

## **VI. EXCLUSIVITY ARRANGEMENTS**

While often more in the nature of personal or real property rights than IP, with increased frequency, tax-exempt universities are making their facilities accessible to a wide range of vendors of goods and services on an exclusive basis.

Traditionally, a university might have entered into a lease or license agreement with a fast food company or bank, pursuant to which the fast food company would have the right to establish and operate a restaurant in the facility, such as a student union, or the bank would have the right to install an ATM in the facility. The restaurant or bank would then sell its products or provide its services through the restaurant or ATM to the students, faculty, patients or visitors in the facility, and the exempt university would agree not to permit a competitor to establish a similar facility or provide a similar service in that facility or on the campus of the organization. Consideration for this exclusivity right would be reflected in the rents paid by the tenant to the exempt organization and, generally, such rents would be non-taxable if they met the requirements for being classified as rents from real property.

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<sup>125</sup> Reg. § 1.513-4(f), Ex. 12.

In recent years, however, universities have been paid separate fees in exchange for granting vendors of goods or services the exclusive right to be the supplier to the exempt organization's students, faculty, or visitors.

Since the payment received by the exempt organization is in exchange for the exclusive right to supply goods or services, the question is raised whether the exclusivity payment should be taxable as UBI.

The corporate sponsorship regulations distinguish between exclusive sponsor and exclusive provider arrangements, and conclude that an exclusive provider arrangement, “[a]n arrangement that limits the sale, distribution, availability, or use of competing products, services, or facilities in connection with an exempt organization's activity, generally results in a substantial return benefit.”<sup>126</sup> Thus, payments received in exchange for exclusive provider status will not be excluded from the definition of unrelated trade or business under Section 513(i). As discussed above, however, the failure to qualify for the sponsorship payment safe harbor does not mean that the payment constitutes UBI. All other UBIT principals must still be applied before making a determination.

Several potential issues may give rise to a reasonable position that payments received in exchange for exclusive provider status are not taxable, as follows:

1. The agreement to grant exclusive provider status to a for-profit supplier of goods or services to an exempt organization arguably does not rise to the level of a trade or business. While the exempt organization may have a profit motive when it enters into an exclusive provider arrangement, the presence of a profit motive, alone, is not determinative of whether the activity is, in fact, a trade or business. The level of the organization's activity is also an important factor in the unrelated business income context.<sup>127</sup> In *Ohio Farm Bureau Federation, Inc. v. Commissioner*, 106 T.C. 222 (1996), the Tax Court concluded that a one-

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<sup>126</sup> Reg. § 1.513-4(c)(2)(vi)(B).

<sup>127</sup> See, e.g., Priv. Ltr. Rul. 9717002 (Nov. 27, 1996) (provision of food services to unrelated organization did not rise to the level of being a trade or business, since it was not undertaken for the predominant purpose of producing income; the services were provided as an accommodation to the purchaser, and there was no evidence that a business plan or other methodology was undertaken to begin a food service).

time agreement not to engage in certain activities did not constitute the kind of continuous and regular activity characteristic of a trade or business. While covenants not to compete have been held to be the equivalent of affirmative personal services in other contexts, the Tax Court declined to treat the absence of activity resulting from a covenant not to compete as equivalent to the affirmative conduct of a trade or business in the UBIT context.<sup>128</sup>

2. The exclusive provider arrangement may also fall under the statutory exclusion from the term “unrelated trade or business” for trades or businesses carried on primarily for the convenience of the exempt organization’s members, students, patients, officers or employees. Even though the corporate sponsorship regulations state that an exclusive provider arrangement generally results in a substantial return benefit, an argument can be made that the overriding reason for entering into an exclusive provider arrangement is to obtain a level and/or quality of service and other related benefits that override any profit motivation.
3. The exclusive provider arrangement may not constitute an activity that is regularly carried on.
4. The exclusive provider arrangement may be substantially related to the exempt purpose or function of the organization.
5. Assuming all of the other arguments fail, what is the nature of the exclusive provider arrangement? Is it in the nature of a rent from real property - a negative easement, or the right to deny competitors with the right to access the real property of the exempt organization? Is it in the nature of the provision of services (e.g., advertising or endorsements), or is it in the nature of the provision of the use of an intangible asset, i.e., the exclusive right to access to the organization’s students, faculty, patients or visitors, that is involved?

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<sup>128</sup> See, also, GCM 39865 (Dec. 12, 1991), revoked by GCM 39891 (Jan. 2, 1997); Priv. Ltr. Rul. 9719002 (Nov. 27, 1996) (Service follows *Ohio Farm Bureau Federation, Inc.* and holds that income for a covenant not to compete is not subject to tax).

In any case, even if UBI can successfully be avoided with respect to payments derived from exclusive provider arrangements, the Service may assert that long-term exclusive provider arrangements result in excessive private benefit to the vendor of the services or goods, as it has in the past.<sup>129</sup>

## VII. AFFINITY CREDIT CARDS AND MAILING LISTS

For many years, the Service sought to tax income derived by tax-exempt organizations from affinity credit card arrangements and sales, rentals and exchanges of mailing lists. In the affinity credit card area, the principal argument advanced by the Service has been that the work performed by the exempt organization with respect to the affinity card arrangement constituted services. The Service therefore asserted that the resulting payments were fees for unrelated services, rather than excludable royalty payments for the use by the credit card company of the exempt organization's IP.

Likewise with respect to mailing lists, the Service's principal argument was that the mailing list activity was a service, and that resulting revenue could be excluded from UBTI if, and only if, the requirements of Section 513(h)(1)(B) were satisfied.

Section 513(h)(1)(B) provides that the term "unrelated trade or business" does not include any trade or business which consists of the exchange *with another exempt organization* the names and addresses of donors to (or members of) such organization, or the renting of such names and addresses to another such organization.

After early IRS victories in *Disabled American Veterans v. United States*, 650 F. Supp.2d 1178 (1981), *affd after remand*, 704 F.2d 1570 (Fed. Cir. 1983) and *Disabled American Veterans v. Commissioner*, 94 T.C. 60 (1990), *rev'd on other grounds*, 942 F.2d 309 (6th Cir. 1991), the courts more recently generally have concluded that such transactions involve intangible property rights, and that the incidental services provided by the exempt

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<sup>129</sup> See *United Cancer Council, Inc. v. Commissioner*, 165 F.3d 1173 (7th Cir. 1999) and Revenue Ruling 98-15, 1998-1 C.B. 718.

organization did not prevent the treatment of such revenues as royalties exempt under Section 512(b)(2).<sup>130</sup>

In a memorandum dated December 16, 1999 directed to Acting EO Area Managers, the Director, Exempt Organization Division, acknowledged defeat and concluded that “further litigation in cases with facts similar to those decided in favor of the taxpayer should not be pursued.” However, the memorandum also notes as follows:

Language in at least one of the court cases suggests that it may have been possible to allocate the payment between services and the intangible, but since the Service did not make the argument, the court did not consider it. The issue of allocation in these situations is currently under consideration in the National Office.

The memorandum then suggests that if a case in which the organization provides extensive services or the facts indicate a good case for allocating payment between the services and the intangibles is identified, the case should be discussed and the examining agent should consider requesting technical advice.

As a preventative measure, universities or their alumni associations may find it advisable to track the level of services involved with credit card and other affinity programs, and with respect to sales or rentals of mailing lists that do not qualify for the Section 513(h)(1)(B) exception discussed above.

Colleges, universities, research organizations, and other tax-exempt organizations that develop, acquire, and exploit intellectual property rights frequently put in place plans to compensate persons who helped create those rights or help exploit them.<sup>131</sup>

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<sup>130</sup> See *Oregon State University Alumni Association, Inc. v. Commissioner*, 193 F.3d 1098 (9th Cir. 1999); *Sierra Club v. Commissioner*, 86 F.3d 1526 (9th Cir. 1996); *Common Cause v. Commissioner*, 112 T.C. 332, (1999); *Planned Parenthood Federation of America, Inc. v. Commissioner*, 77 T.C.M. 2227 (1999); *Mississippi State Alumni Association v. Commissioner*, 74 T.C.M. 458 (1997).

<sup>131</sup> See, e.g., Harvard University Statement of Policy in Regard to Inventions, Patents and Copyrights, Appendix A, available at <http://www.techtransfer.harvard.edu/royaltysharing.html>.

## VIII. INUREMENT AND IP EXPLOITATION

Generally, a sharing of royalties with an employed inventor will be regarded as reasonable compensation if the sharing arrangement is in place prior to the creation of the invention, even if the invention ultimately is proven to be highly successful and profitable.<sup>132</sup>

A more difficult issue arises with respect to incentivizing key managers who are responsible for exploiting an invention or class of intellectual property right even though they were not involved in the creation of such intellectual property rights. This issue was dealt with by the Service in Private Letter Ruling 200601030.<sup>133</sup> In that private letter ruling, the organizations desired to adopt a long-term incentive bonus program to provide financial incentives for its senior managers that would, in part, be measured by the performance of a subsidiary that was established to develop commercial uses for the organization's science and technology discoveries. The organization established a compensation committee and designed the long-term incentive bonus plan with a number of checks and balances to insure that the organizations received its capital contribution as well as a return on capital from the subsidiary. The Service analogized that organization's situation with the situation in Revenue Ruling 97-21, which addressed several situations where hospitals described in Section 501(c)(3) provided various types of financial recruitment incentives to physicians to encourage them to work for the hospital. By analogy, according to the Service, the bonus payments under the long-term incentive program were designed to reward the senior managers of the organization for their accomplishment of objectives consistent with the organizations' charitable purposes.

## IX. CONCLUSION

Tax-exempt universities own all manner of IP that they have developed or acquired, and there are countless transactional structures that may be available to monetize that IP.

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<sup>132</sup> Under Section 1235 of the Code, such amounts may be eligible for capital gains treatment. Jennings, "The Taxation and Reporting of Distributions Derived from Licensing Intellectual Property," 15:15 Tax' of Exempts 207 (Mar./Apr. 2004)

<sup>133</sup> Priv Ltr. Rul. 200601030 (Oct. 12, 2005).

The structuring of sales, licensing or other means to monetize IP should be carefully considered to both avoid inurement and private benefit, excess benefit transaction exposure, and to minimize or eliminate tax on revenue. Transactions with related parties should be carefully tracked and documented to avoid re-characterization of transactions or the denial of deductions from taxable income. Internally, attention should be paid to whether losses from certain activities can be used to offset taxable income from other unrelated activities.

And finally, a warning: contemplated technology transfer transactions should be reviewed to ensure that they do not violate tax-exempt bond or other contractual covenants. For example, there may be restrictions on the sale or commercial use of IP developed in facilities funded with tax-exempt bond financing. In addition, there may be restrictions on the conduct of commercial activities in such facilities.