Internal Revenue Service

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Department of the Treasury

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Person to Contact:

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LEGEND

Issuer -

Institute -

Series A Bonds -

Series B Bonds -

Date 1 -

Date 2 -

Corporation -

Organization -

State -

$<u>a</u> -

<u>b</u> percent -

Dear

This responds to your request for the following three rulings: (1) the License Agreement described below will not cause the Series A and Series B Bonds (collectively, “the Bonds”) to satisfy the private business use test under §§ 145(a)(2)(B)

and 141(b)(1) of the Internal Revenue Code; (2) the Scientist Agreement described below will not cause the Bonds to satisfy the private business use test under §§ 145(a)(2)(B) and 141(b)(1); (3) the right of the Large Contributors described below to require the Organization to transfer shares of the Corporation's Class A Stock to one or more § 501(c)(3) organizations chosen by the Large Contributors will not cause the Bonds to satisfy the private business use test under §§ 145(a)(2)(B) and 141(b)(1). For the reasons described below, we decline to rule on the second and third issues presented.

FACTS AND REPRESENTATIONS

The Internal Revenue Service has determined that the Institute is exempt from federal income tax under § 501(a) as an organization described in § 501(c)(3). On Dates 1 and 2**,** the Issuer issued the Bonds and loaned the proceeds to the Institute. The Institute financed the construction of a state-of-the-art laboratory complex (the "Facility"), with the proceeds of the Bonds. The Institute conducts basic biomedical research (the "Research") at the Facility. The Internal Revenue Service has determined that the research activities the Institute conducts at the Facility are and will be substantially related to the furtherance of the Institute's exempt purposes and will not constitute an unrelated trade or business.

The Corporation is a for-profit State corporation that will commercialize and market the Research for the Institute. In order to achieve this result, the Institute plans to enter into a license agreement with the Corporation (the "License Agreement").

Pursuant to the License Agreement, the Institute will grant the Corporation an exclusive, perpetual, non-terminable, worldwide license to any and all Research and to all patents the Institute has obtained or for which an application is pending (hereinafter, "the Research" includes patents and pending applications). The exclusive license will apply to Research that is created both before and during the term of the License Agreement and will arise automatically at the time that the Research is created. The Corporation's exclusive license includes the right to grant all sublicenses regarding the Research to any individual or entity, provided that the sublicenses further the Corporation's purpose of commercializing and marketing the Research.

The License Agreement will also require the Institute to assign to the Corporation the exclusive right to a portion of the Institute's net income that will be derived from the Research (the "Corporation Royalty Interest"). The Corporation Royalty Interest is equal to 100 percent of the costs that the Corporation incurs to commercialize any particular Research, plus 50 percent of any net income that the particular Research produces. The Institute will retain the right to receive the 50 percent of the net income after the Corporation recovers its costs (the "Institute Royalty Interest").

The License Agreement does not permit the Corporation to direct or control the types of research activities that the Institute undertakes or the manner in which any

research activities are performed. The Corporation will not provide financial or other support to the Institute in the same or a similar manner to the support that would be provided by a sponsor as that term is defined in § 3.03 of Rev. Proc. 97-14, 1997-1 C.B. 634.

The Corporation will issue two classes of common stock (the “Class A Stock” and the “Class B Stock”, collectively, “the Stock”). Although the Class A Stock will have certain voting rights, the Class B Stock will have superior voting rights compared to the Class A Stock.

Initially, the Organization will own 100 percent of the Class A Stock and 100 percent of the Class B Stock. The Organization is a supporting organization for the Institute, which the Internal Revenue Service has determined is exempt from federal income tax under § 501(a) as an organization described in § 501(c)(3).

The Organization may sell shares of Class A Stock to third parties in order to generate additional funding for the Research. However, the Organization will sell Class A Stock only to § 501(c)(3) organizations for the foreseeable future. In addition, when an individual or entity makes a contribution to the Organization in the amount of $a or more (the “Large Contributor”), the Large Contributor will be entitled to require the Organization to transfer a portion of the Class A Stock to any § 501(c)(3) organization that the Large Contributor chooses.[1] The Organization does not plan to sell any shares of the Class B Stock. The Class B Stock is not subject to the Large Contributors’ designation.

The Institute will enter into an incentive compensation agreement with scientists who perform research activities at the Facility (the “Scientist Agreement”). The Scientist Agreement will provide that the scientist who discovers particular Research that the Corporation commercializes will receive all or a portion of the Institute Royalty Interest (the “Scientist Royalty Share”). The Issuer represents that, for federal income tax purposes, each of the scientists with whom it will enter into a Scientist Agreement is an employee of the Institute and the scientists’ compensation, including the Scientist Royalty Share, is reasonable compensation.

LAW AND ANALYSIS

Section 103(a) of the Internal Revenue Code provides that gross income shall not include interest on any state or local bond. Section 103(b)(1) provides that § 103(a) shall not apply to any private activity bond which is not a qualified bond (within the meaning of § 141).

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[1] The portion of the Class A Stock to be transferred will have an aggregate fair market value equal to b percent of the amount of the contribution. The fair market value of the Class A Stock will be determined by an independent, qualified appraiser at the time the contribution is made to the Organization.

Section 145(a)(2) provides that a bond is a qualified 501(c)(3) bond if the bond would not be a private activity bond if 501(c)(3) organizations were treated as governmental units with respect to their activities which do not constitute unrelated trades or business, determined by applying § 513(a), and paragraphs (1) and (2) of § 141(b) were applied by substituting "5 percent" for "10 percent" each place it appears and by substituting "net proceeds" for "proceeds" each place it appears.

Section 141(a) provides, in part, that the term "private activity bond" means any bond issued as part of an issue which meets the private business use test of § 141(b)(1). Under § 141(b)(1), an issue meets the private business use test if more than 10 percent of the proceeds of the issue are to be used for any private business use. Section 141(b)(6)(A) defines the term "private business use", in part, as use (directly or indirectly) in a trade or business carried on by any person other than a governmental unit, but use as a member of the general public is not taken into account. Under § 141(b)(6)(B), any activity carried on by a person other than a natural person shall be treated as a trade or business.

Section 1.141-3(a)(2) of the Income Tax Regulations provides that in determining whether an issue meets the private business use test, it is necessary to look to both the indirect and direct use of proceeds.

Section 1.141-3(b)(1) provides that, in general, both actual and beneficial use by a nongovernmental person may be treated as private business use. Section 1.141-3(b)(1) further provides as follows. In most cases, the private business use test is met only if a nongovernmental person has special legal entitlements to use the financed property under an arrangement with the issuer. In general, a nongovernmental person is treated as a private business user of proceeds and financed property as a result of ownership; actual or beneficial use of property pursuant to a lease, or a management or incentive payment contract; or certain other arrangements, such as a take or pay or other output-type contract.

Section 1.141-3(b)(2) provides that, subject to certain exceptions that are not material to this ruling request, ownership by a nongovernmental person of financed property is private business use of that property. Section 1.141-3(b)(2) further provides that ownership refers to ownership for federal income tax purposes.

Under § 1.141-3(b)(6)(i), except as provided in § 1.141-3(d), an agreement by a nongovernmental person to sponsor research performed by a governmental person may result in private business use of the property used for the research, based on all of the facts and circumstances.

Section 1.141-3(b)(7)(i) provides, in part, that any other arrangement that conveys special legal entitlements for beneficial use of bond proceeds or of financed property that are comparable to special legal entitlements described in § 1.141-(3)(b)(2) results in private business use. Section 1.141-3(b)(7)(i) further provides that, for

example, an arrangement that conveys priority rights to the use or capacity of a facility generally results in private business use.

Section 1.145-2(a) provides that, with certain exceptions that are not material to this ruling request, § 1.141-0 through 1.141-15 apply to § 145(a).

Rev. Proc. 97-14 sets forth conditions under which a research agreement does not result in private business use under § 141(b) and applies to determinations of whether a research agreement causes the test in § 145(a)(2)(B) to be met for qualified 501(c)(3) bonds. *See* Rev. Proc. 97-14, § 1. Section 5.02 of Rev. Proc. 97-14 generally provides that a research agreement relating to property used for basic research supported by a sponsor does not cause the research agreement to result in private business use of the bond-financed facility if any license or other use of resulting technology by the sponsor is permitted only on the same terms as the recipient would permit that use by any unrelated, non-sponsoring party (that is, the sponsor must pay a competitive price for its use), with the price paid for that use determined at the time the license or other resulting technology is available for use. Section 3.03 of Rev. Proc. 97-14 defines a sponsor as any person, other than a qualified user, that supports or sponsors research under a contract.

<u>Whether the License Agreement will cause the Bonds to satisfy the private business use test under §§ 145(a)(2)(B) and 141(b)(1)?</u>

Because the Issuer represents that the Corporation will not control the type of or manner of performing the Research and will not provide financial or other support to the Institute in a manner described in § 3.03 of Rev. Proc. 97-14, the Corporation is not a sponsor of the Research. Consequently, we analyze the License Agreement under the regulations set forth at § 1.141-3(b)(7).

The Corporation's rights under the License Agreement include an exclusive, perpetual, non-terminable, worldwide license to all of the Research created at the Facility and the exclusive right to sublicense the Research to any person of the Corporation's choice. These rights conveyed to Corporation under the License Agreement are among the various rights that are inherent in the Institute's ownership of the Facility and the Research. Consequently, under § 1.141-3(b)(7)(i), these rights are special legal entitlements for beneficial use of the Facility that are comparable to an ownership interest in the Facility. The fact that the Corporation is also entitled to receive 50 percent of the total net income that the Research created at the Facility produces further demonstrates that the Corporation's interest in the Facility is comparable to an ownership interest.

The Corporation is neither a governmental unit nor a natural person. Consequently, its license to the Research and its resulting interest in the Facility are activities that constitute a trade or business under § 141(b)(6)(B).

CONCLUSION

We conclude that the License Agreement will cause the Bonds to satisfy the private business use test under §§ 145(a)(2)(B) and 141(b)(1) because, under § 1.141-3(b)(7)(i), the rights conveyed to the Corporation pursuant to the License Agreement are special legal entitlements for the Corporation's beneficial use of the Facility that are comparable to an ownership interest. Because the remaining two issues regarding the Scientist Agreement and the Large Contributors depend on a favorable ruling with respect to the License Agreement, we decline to rule on these remaining two requests for rulings.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,
Assistant Chief Counsel (Exempt Organizations/Employment Tax/Government Entities)

By: ______________________________
Timothy L. Jones
Senior Counsel
Tax Exempt Bond Branch

cc: