Panelists’ Note: We recommend the following article as background reading for this panel. It was originally prepared by Julie Noel Gilbert when she was a partner at Morgan, Lewis & Bockius and she delivered a presentation on this topic at Georgetown’s Eleventh Annual Program on Representing and Managing Tax-Exempt Organizations held on April 28-29, 1994. Although the article is now over 20 years old, the legal precedents discussed below remain highly relevant to the field, and Julie’s expert analysis provides a superb introduction to issues that confront independent research institutions.

Research, Technology Transfers and the Unrelated Business Income Tax

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I. Introduction

Tax-exempt organizations that engage in the conduct of scientific or medical research, the results of which may be of significant commercial value, have a number of concerns. Some of these concerns are institutional, some ethical, and some bear upon the relationship of the organization to the larger scientific community.

Particular questions may arise as a result of government funding of research activities, or government support of such activities in the form of tax exemption, in cases where private parties have significant interests in the research. The tax principles applicable in such cases, and the relationship between these principles and the policies that govern direct federal funding, are far from clear.

II. Exempt Status of Independent Research Institutions

Section 501(c)(3) of the Internal Revenue Code of 1986 provides an exemption from federal income tax for entities that are organized and operated “exclusively” (a term actually interpreted by Treasury regulations as meaning “substantially”) for qualified religion, scientific, charitable or educational purposes. In theory, an organization exempt under any one of these broad categories could carry on a program of scientific research. Typically, however, research activities are part of the exempt function either of “educational” organizations (whether they be primarily teaching institutions such as colleges and universities or more specialized educational organizations with research components) or of “scientific” organizations.

As discussed below, colleges and universities are exempt from federal income tax by reason of their educational function as broadly construed, and research activities have traditionally been treated as an element of that educational function without further requirement or specification. This special treatment of college or university research is evidenced by the provisions of the Internal Revenue Code that exempt from the unrelated business income tax any income arising from the conduct of research activities by a college or university, without reference to the nature of such research or (at least explicitly) the extent of public benefit arising therefrom.

For other exempt organizations, research activities must qualify independently as exempt activities under section 501(c)(3), either because the research is subsidiary to or an integral part of an educational function, or because it qualifies as a “scientific” activity. For most research activities, the specific basis for exemption will be found in Treas. reg. section 1.501(c)(3)-1(d)(5), which provides that the term “scientific” as used in section 501(c)(3) includes the conduct of “scientific research in the public interest.”

A. Exempt Research Must Be “Scientific Research”

Treas. reg. section 1.501(c)(3)-1(d)(5) provides that in determining whether an activity constitutes “scientific research in the public interest,” there must be an initial determination that
the activity fits within the definition of “scientific research.” The regulations in this respect, unfortunately, fail to define several key terms other than in the negative.

Thus, for example, the regulations provide that the determination of whether research is “scientific research” does not depend on whether such research is classified as fundamental or basic, as contrasted to applied or practical. The regulations do provide, however, that “scientific 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.”

In Midwest Research Institute v. U.S., 554 F.Supp. 1379 (W.D. Mo. 1983), the District Court suggested that Treas. reg. section 1.501(c)(3)-1(d)(5) might be best understood as an effort to respond to the concerns of commercial testing laboratories, which were fearful of the consequences of exempt status for scientific research institutes. Thus, as a practical matter the regulations may be interpreted as excluding from the definition of scientific research the kind of generally repetitive or relatively unsophisticated work done by commercial laboratories to determine whether items tested meet certain specifications, as distinguished from more sophisticated testing done to validate a scientific hypothesis.

In GCM 39883 (October 16, 1992), the IRS referred to the court’s definition of scientific research in Midwest Research Institute as having three components.

First, there must be project supervision and design by professionals. Second, researchers must design the project to solve a problem through a search for demonstrable truth. This component suggests the use of the scientific method to solve a problem. The scientific method requires the researcher to form a hypothesis, design and conduct tests to gather data, and analyze data for its effect on the verity or falsity of the hypothesis. Third, the research goal must be discovering a demonstrable truth. Information on the novelty and importance of the knowledge to be discovered is also important to determine whether a particular activity furthers a scientific purpose.

In its rulings policy, the IRS has most frequently applied Treas. reg. section 1.501(c)(3)-1(d)(5) to two types of activity found not to qualify as “scientific research.” One is the development of products for commercial exploitation. For example, in TAM 8028004 (March 26, 1980), the IRS reviewed a contract entered into by an exempt organization with a corporation engaged in developing and marketing medical equipment, under which the organization agreed to design and develop a patentable medical device capable of serving a specific function. Under the contract, the organization obligated itself to license any patents for such device exclusively to the corporation in exchange for a royalty. The IRS determined that the organization’s activities did not constitute “scientific research,” because the research was incidental to the corporation’s ordinary commercial activity of expanding its existing product line.

The other area of activity commonly found to bar treatment as “scientific research” involves testing of products prior to marketing. For example, Rev. Rul. 68-373, 1968-2 C.B. 206, involved a nonprofit organization engaged in the clinical testing of drugs for pharmaceutical companies, as required in order for the companies to obtain FDA approval to take products to market. The ruling concluded that the activities involved clinical testing incident to the company’s ordinary commercial operations, rather than scientific research within the meaning of section 501(c)(3).
The IRS has acknowledged that although the degree of linkage between research and commercial operations is an important factor in identifying scientific research activities, an analysis that focuses too narrowly on the relationship between research activities and a commercial company’s operations may be misleading.

In its 1986 Exempt Organizations Continuing Professional Education Technical Instruction Program textbook, the IRS noted that the approach of rulings such as Rev. Rul. 68-373 is useful in a traditional manufacturing context, but may have more limited utility when applied to commercially-sponsored research projects funded by high-technology enterprises such as firms engaged in producing advanced biomedical equipment. As the 1986 training publication indicated:

- the ‘ordinary commercial activity’ of such a firm may include scientific research projects and the design and testing of experimental prototypes of new equipment.
- Instead of conducting the research or experimental testing itself, the biomedical firm may contract for these tasks to be performed by an exempt scientific research organization. When the nonprofit research organization performs the research, is it engaged in activities of a type ordinarily carried on as an incident to the commercial operations of the sponsor?

In GCM 39196 (August 31, 1983), the IRS suggested that in differentiating between research and testing it may be useful to look to the law that has evolved in an analogous area, involving treatment of research and experimental expenditures under section 174. As the GCM pointed out, the term “research and experimental expenditures” includes generally all costs incident to the development of an experimental or pilot model, a product, a formula, an invention, or similar property, and the improvement of already existing property of these categories. The term does not include expenditures such as those for the ordinary testing or inspection of materials or products for quality control purposes or for efficiency surveys, management studies, consumer surveys, advertising, or promotion.

Thus, for example, testing blood samples or other samples for trace elements lacks the uniqueness or originality which is inherent in the concept of research. Projects of this type have all the indicia of ordinary testing: a standard procedure is used, no intellectual questions are posed, the work is routine and repetitive and the procedure is merely a matter of quality control. As such, these studies cannot be considered scientific research.

In the 1986 training publication analysis, the IRS concludes that it is the nature of the activities rather than the nature of the organization that determines whether its research activities are scientific research or ordinary testing.

Scientific research can be performed by a commercial enterprise or by an exempt organization. It is scientific In Memoriam: Julie Noel Gilbert and José E. Trias research in either case. Therefore, the question posed earlier can be answered this way: a commercial enterprise engaged in scientific research can either do its own research or contract it out to an exempt scientific research organization. If the commercial firm contracts out scientific research to an exempt organization, such research will not become, by virtue of that fact alone, ordinary testing incident to commercial operations for the exempt organization performing the research.
B. Exempt Research Must be Carried on “In the Public Interest”

In order to qualify for exemption under section 501(c)(3), an activity must not only constitute “scientific research” but must also be carried on “in the public interest.” Treas. reg. section 1.501(c)(3)-1(d)(5)(iii) provides that scientific research will be regarded as carried on in the public interest

a) if the results of such research (including any patents, copyrights, processes, or formulae resulting from such research) are made available to the public on a non-discriminatory basis;

b) if such research is performed for the United States, or any of its agencies or instrumentalities, or for a state or political subdivision thereof; or

c) if such research is directed toward benefiting the public.

Most of the questions that have arisen with respect to this provision have involved the meaning of the term “directed toward benefiting the public,” which the regulations define only by example. Treas. reg. section 1.501(c)(3)-1(d)(5)(iii)(c) provides that scientific research considered as “directed toward benefiting the public,” and therefore as carried on “in the public interest,” will include

1) scientific research carried on for the purpose of aiding in the scientific education of college or university students;

2) scientific research carried on for the purpose of obtaining scientific information, which is published in a treatise, thesis, trade publication, or in any other form that is available to the interested public;

3) scientific research carried on for the purpose of discovering a cure for a disease; or

4) scientific research carried on for the purpose of aiding a community or geographical area by attracting new industry to the community or area or by encouraging the development of, or retention of, an industry in the community or area.

Treas. reg. section 1.501(c)(3)-1(d)(5)(iii)(c)(4) further provides that research that is otherwise “directed toward benefiting the public” will not be disqualified as exempt research solely because the sponsor of the research has the right pursuant to a contract or other agreement to obtain ownership or control of any patents, copyrights, processes or formulae resulting from the research.

Treas. reg. section 1.501(c)(3)-1(d)(5)(iii)(c) does not expressly preclude an organization from showing that its activities are in the public interest even though the activities are not specifically described in any of the categories or examples set out above. However, as a practical matter, if an organization’s scientific research activities are not described in the regulations, it will generally be found that the public benefits arising from such activities are too ill-defined, too remote, or too conjectural in nature to support the conclusion that they are in the public interest.

In several recent private rulings, the IRS has taken a particularly expansive view of research efforts designed to benefit local geographic areas by developing new biotechnology products and processes that can broaden the local industrial base and promote jobs creation. In LTR 9316052 (January 29, 1993), for example, the IRS reaffirmed the exempt status of an organization that intended to “concentrate on applied research and economic and industrial
development to create technologies that help diversify the economy and develop and encourage industry” in the area. In that connection, the organization would “maintain a greater degree of confidentiality for much of its research in order to maximize the potential of creating marketable technologies with practical utility. . .”

Most of the other IRS rulings in this area have involved the question of whether an organization conducting commercially-sponsored research has published or otherwise made available to the public sufficient information on a sufficiently timely basis to fall within the second of the examples of Treas. reg. section 1.501(c)(3)-1(d)(5)(iii)(c).

Rev. Rul. 76-296, 1976-2 C.B. 142, described the application of the public availability requirement of Treas. Reg. section 1.501(c)(3)-1(d)(5)(iii)(c) in two situations. In the first situation, an exempt scientific research organization engaged in commercially-sponsored scientific research projects and informed the interested public of the results of the research by timely publication of its findings. The publication was deemed to be timely even though the organization allowed the lapse of a reasonable time in order to afford the sponsor an opportunity to establish patent or other ownership interests in the results of the study. In the second situation described in the ruling, a scientific research organization engaged in commercially-sponsored scientific research projects and kept secret or unreasonably delayed publishing results of the projects in order to serve some private interest of the project’s commercial sponsor.

Rev. Rul. 76-296 emphasized that scientific research may be regarded as carried on in the public interest even though such research is performed pursuant to a contract or agreement under which the sponsors of the research have the right to obtain ownership or control of any patents, processes or formulae resulting from such research. Because the organization described in the first of the two situations published the results of its commercially-sponsored scientific research projects as soon as it was feasible to do so without denying the sponsor a reasonable opportunity to protect its interests in the intellectual information, the requirements of the regulations were satisfied. However, because the organization described in the second of the situations did not publish the results of its commercially-sponsored scientific research project in a timely fashion, but rather delayed publication in order to serve primarily commercial interests, the project was not treated as carried on in the public interest.

In GCM 39883, the IRS referred to Treas. reg. section 1.501(c)(3)-1(d)(5)(iii) as setting out a “specific public interest test,” to be applied along with the general public interest test applicable to all organizations exempt under section 501(c)(3). “Both public interest tests require a balancing of public benefits and private benefits to determine if the private benefits are incidental to the public benefits. Private interests may only be served if they are incidental to the public interests served.”

C. Control Over Research Results Can Affect Claim to Exemption

In addition to the affirmative requirement that exempt research qualify as “scientific research in the public interest,” the Treasury regulations dealing with the treatment of research under section 501(c)(3) contain a parallel set of rules under which exemption will be denied to organizations conducting research activities under certain circumstances. Treas. Reg. section 1.501(c)(3)-1(d)(5)(iv) provides that an organization will not qualify as a scientific research organization under section 501(c)(3) if
a) such organization will perform research only for persons which are (directly or indirectly) its creators and which are not described in section 501(c)(3), or

b) such organization retains (directly or indirectly) the ownership or control of more than an insubstantial portion of the patents, copyrights, processes, or formulae resulting from its research and does not make such patents, copyrights, processes, or formulae available to the public.

Treas. reg. section 1.501(c)(3)-1(d)(5)(iv) also provides that the results of research will be considered as made available to the public even though the right to the use of a patent, copyright, process, or formula is granted exclusively to one or more persons, where the granting of the exclusive right is the only practical manner in which the patent, copyright, process or formula can be utilized to benefit the public.

It is difficult to understand the intended effect of Treas. reg. section 1.501(c)(3)-1(d)(5)(iv)(b), when seen in the context of the more generally applicable requirements of Treas. reg. section 1.501(c)(3)-1(d)(5). As a general matter, Treas. reg. section 1.501(c)(3)-1(d)(5)(iii)(c)(4) provides that research that is otherwise “directed toward benefiting the public” will not be denied treatment as exempt research solely because the sponsor of the research retains the right pursuant to contract to obtain ownership or control of any patents or similar rights resulting from the research. In such a case, the patent rights are not made “available to the public.”

Treas. reg. section 1.501(c)(3)-1(d)(5)(iv)(b), if read literally, would impose an obligation to make patent or similar rights “available to the public” in only two situations: where the research organization itself directly retains the ownership of more than an “insubstantial” portion of the intellectual property rights resulting from its research, or where it indirectly retains such rights through a license or transfer of the rights to a commercial organization that it controls. Even in these situations, this obligation would seem to be subject to the provision in the regulations that research results will be considered as made available to the public even though rights are licensed on an exclusive basis, where the grant of exclusive rights is the only practical means by which the research results can be utilized to benefit the public.

If the regulations were read literally, therefore, they would draw a rather curious distinction. In a case in which the research organization licenses patent rights to a commercial organization in which it has no ownership interest or only a minority ownership interest, the arrangement would have to satisfy the requirement of Treas. reg. section 1.501(c)(3)-1(d)(5)(iii)(c) that it “benefit the public,” but it would be subject to Treas. reg. section 1.501(c)(3)-1(d)(5)(iii)(c)(4) under which the sponsor could be given a right by contract to obtain ownership or control of patents or other property rights resulting from the research. Only if the research organization decided to retain the patent rights itself or to transfer such rights to a controlled entity would it be required to make the rights available to the public.

D. General Principles as to the Exemption Qualification of Independent Research Institutions

There is simply not enough authority interpreting the various provisions of the regulations on scientific research to allow the apparent confusions and contradictions to be resolved with confidence. It is certainly possible, however, to emerge with a few governing principles.
First, any scientific research effort by an independent research institution must have a definable public benefit purpose, to which private or commercial interests are subservient.

Second, as a general matter, intellectual property rights are to be transferred to commercial entities on an exclusive basis only when there is a public interest reason to do so — when, for example, the granting of exclusive rights is the only practicable manner of ensuring that research results will be developed into usable products.

Finally, the research organization should avoid not only unnecessary enrichment of commercial firms but also unnecessary or undue retention of research rights or profits (perhaps the principle behind the provision of Treas. reg. 1.501(c)(3)-1(d)(5)(iv)(b)).

III. UBIT Concerns of Independent Research Institutions

Treas. reg. section 1.501(c)(3)-1(d)(5)(v) provides that

The 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.

However, an organization that is primarily engaged in the conduct of exempt activities (including the conduct of scientific research in the public interest), and is thus secure in the continuation of its exempt status under section 501(c)(3), may still face the possibility of incurring unrelated business income tax (UBIT) under the provisions of sections 511 et seq. if it engages to not more than an insubstantial extent in research activities that give rise to unrelated business taxable income.

Section 511 imposes a tax on the income from certain unrelated business activities carried on by an organization otherwise exempt from federal income tax under section 501(c)(3). Section 513 defines the term “unrelated business taxable income” (the base upon which the tax is actually imposed) as the gross income derived from the conduct of a trade or business regularly carried on by an exempt organization when such trade or business is not substantially related to the organization’s exempt function, reduced by allowable deductions and subject to certain statutory exclusions.

Except in the situation where an exempt organization undertakes a single isolated research project, the conduct of scientific research will typically constitute a “trade or business” as that term is defined for purposes of the UBIT, and it will typically be considered as regularly carried on.

Application of the UBIT will thus depend in the first instance upon a determination as to whether the research is related to the accomplishment of the organization’s exempt purpose. In the case of an organization other than a college or university, this determination is in most cases made by reference to the same principles set out in Treas. reg. section 1.501(c)(3)-1(d)(5) that determine whether an organization substantially engaged in such activities qualifies for exemption under section 501(c)(3). Thus, for example, income from the conduct of a research project, the results of which are withheld from the public beyond the period necessary for patent protection, will in general be treated as unrelated business income potentially subject to the
UBIT. If such a project becomes substantial within the context of the organization’s operations, exempt status may be jeopardized.

Section 512 provides statutory exceptions to the definition of the term “unrelated business taxable income” for certain categories of unrelated income, including dividend and interest income (section 512(b)(1)); royalty income (section 512(b)(2)); gains from the sale of property other than inventory-type property or property held for sale in the ordinary course of business (section 512(b)(5)); income derived from research for the United States or its agencies or instrumentalities or for any state or political subdivision (section 512(b)(7)); and in the case of an organization operated primarily for purposes of carrying on fundamental research, the results of which are freely available to the general public, any income derived from research performed for any person (section 512(b)(9)). For each of the specific research exclusions, the term “research” is defined so as to exclude “activities of a type ordinarily carried on as an incident to commercial or industrial operations” — the same exception applied in determining whether research is “scientific research” for purposes of section 501(c)(3).

Exempt organizations other than colleges or universities that conduct research programs can in some circumstances rely for UBIT protection on a determination that such research is scientific research in the public interest or is in some other respect related to exempt function under rules governing the qualification for exempt status under section 501(c)(3). In the alternative, it can be argued that the income from such research can be excluded from the calculation of unrelated business taxable income because the research was conducted for a governmental unit; or because the research qualified as fundamental research the results of which are freely available to the public; or because the income was earned in the form of a royalty; or because the income represented gain from the sale of qualified property.

A. Research Exceptions

The UBIT exception of section 512(b)(9), which applies to any research performed by “an organization operated primarily for purposes of carrying on fundamental research, the results of which are fully available to the general public,” is self-explanatory, both as to application and as to policy.

The exception of section 512(b)(7), for research performed for the government or government instrumentalities, presumably reflects a view that when any kind of research is performed on behalf of a governmental unit, the public interest is necessarily served. In this respect, the policy basis for the provision is similar to the policy basis (which must also be inferred) for the UBIT exclusion applicable to any research conducted by a college, university, or hospital, as discussed below.

B. Royalty Exception

The term “royalty” is not defined in section 512(b)(2) itself, and it is therefore necessary to refer to other areas of the tax law for the elements of a definition. In the context of a research project, the important elements of such a definition are:

1) that the income be received in exchange for the privilege of using “property” rather than as compensation for services or as a share in the profits arising from the active conduct of a business activity;
2) that the exempt organization not own a controlling interest in the corporation paying the royalty (in which case the rules of section 512(b)(13) might override the normal royalty exception); and

3) that the exempt organization not be engaged in the regular business of developing patentable products for licensing.

For other purposes of the law, intellectual property is considered “property” if it is patented or patentable, and if the taxpayer has substantial legal protection against the unauthorized disclosure or use of the process, formula or other information involved. For a discussion of the circumstances under which “know-how” is treated as property when a business incorporates, see Rev. Proc. 69-19, 1969-2 C.B. 301.

If intellectual property is developed using the proceeds of debt, the rules of section 514 may apply to limit the application of the royalty exception.

C. Capital Gains Exception

As an alternative to a licensing arrangement qualifying for exemption from the UBIT under the royalty exception, a research organization can transfer all substantial rights in research results in a transaction qualifying as a sale of intellectual property, in which case the gain realized will qualify for exemption from the UBIT under section 512(b)(5) as gain from the sale of property other than inventory-type property or property held for sale to customers (a category of gain frequently referred to as “capital gain”). Such arrangements, which are less common than licensing or royalty arrangements, cannot be entered into with any frequency, or the organization will become vulnerable to a charge that it is engaged in the business of developing intellectual property for sale, in which case the exception would cease to be applicable.

IV. Issues in Use of Tax-Exempt Bond Financed Facilities

When facilities of a tax-exempt organization are financed through the issuance of tax-exempt bonds, the continued treatment of the bonds as “qualified 501(c)(3) bonds” depends upon, among other things, a showing that not more than five percent of the facility is used for a non-exempt purpose, including use by a private person in its (rather than the exempt organization’s) trade or business.

A. Facilities Used for Sponsored Research

In this connection, the “General Explanation of the Tax Reform Act of 1986,” prepared by the Joint Committee on Taxation (May 4, 1987), indicated that the Congress was aware that “the conduct of basic research is an integral function of universities,” and that universities may enter into cooperative agreements with private parties for the conduct of such research. “The findings in connection with research conducted at these facilities are disseminated to the general public through various scientific and technical journals,” and “title to any patents incidentally resulting from the research lies exclusively with the educational institution.”

Such arrangements, the Joint Committee indicated, would not be treated as a non-exempt use of bond-financed facilities, potentially disqualifying the exemption of interest on the bonds, in either one of two circumstances.
First, a university facility may be used for corporate-sponsored research as long as any license or other use of resulting technology by the sponsoring party is permitted only on the same terms as the university would permit such use by any non-sponsoring party; that is, the sponsor must pay a competitive price for its use of the technology.

The university is not actually required to grant use of the technology to any other party. However, the sponsoring party must pay a price for the use of any resulting technology that is the same as a non-sponsoring party would pay. “Further, that price must be determined at the time the technology is available for use rather than an earlier time (e.g., when the research agreement is entered into.”

The second circumstance in which sponsored research will not be treated as a non-exempt or private use is if the facilities are used pursuant to joint industry-university cooperative research arrangements in which

1) multiple unrelated sponsors agree to fund university basic research;
2) the research and the manner in which it is to be performed are determined by the university;
3) title to any resulting products lies with the university; and
4) sponsors are entitled to no more than a non-exclusive royalty-free license to use of the research products.

LTR 9125050 (March 29, 1991) confirmed that although the Joint Committee discussion refers specifically to universities, the IRS sees the limits on use of bond-financed facilities for sponsored research as applying to any exempt organization that has bond-financed facilities.

B. Measurement of Use

In LTR 9125050, the IRS approved a procedure for determining the extent of non-exempt use of a bond-financed facility, where it was assumed that a sponsored research arrangement would not satisfy the standard set out above. The procedure (which IRS personnel have since referred to as “liberal”) determined the extent of non-exempt use on the basis of an allocation of revenue.

V. Research Activities of Universities

As indicated above, the basic exemption of colleges and universities follows from their educational function as broadly construed. Accordingly, various kinds of activities that if carried out by an independent research organization would have to qualify as “scientific” under the rules discussed above may in the case of a college or university be exempt on the ground that they are “educational.” In any event, such activities are unlikely to be of a magnitude relative to university activities overall that they could jeopardize exemption.

For colleges and universities, therefore, the issues arising from the conduct of research activities are likely to involve not exemption issues but rather UBIT issues, tax-exempt bond issues, and issues of possible inurement and private benefit. An analysis of these issues may raise definitional questions similar to those discussed above.
A. UBIT Issues in University Research

Under the general UBIT scheme, the tax is imposed only if it is determined that income was generated through the regular conduct of a trade or business that was unrelated to the exempt purposes of an organization, and further that the income was not covered by one of the statutory exceptions of sections 512 or 513.

1. Relatedness Determination for Research

In making the initial determination as to relatedness in the case of a college or university, it can in most cases be assumed that activities undertaken for the primary purpose of providing instruction to students would be classified as “educational” and thus related. Accordingly, if it can be shown that research activities are primarily instructional in nature, that should resolve the relatedness inquiry.

If college or university research is not educational, it should still qualify as related if it satisfies the tests set out above for treatment as scientific research in the public interest, since research of this kind is assumed to be another element of a college or university’s exempt purpose.

Accordingly, it will only be necessary to look to the statutory UBIT exceptions if a college or university carries out research activities that are not primarily instructional in nature and that cannot be classified as scientific research in the public interest.

2. UBIT Research Exception

As indicated above, there are statutory UBIT exceptions for research carried on for the government or its agencies (section 512(b)(7)), and (in the case of an organization operated primarily for purposes of carrying on fundamental research, the results of which are freely available to the general public) all qualifying research (section 512(b)(9)). A college, university, or hospital, however, can rely on the much broader UBIT exception of section 512(b)(8), which excludes from the UBIT “all income derived from research performed for any person.”

The research exception of section 512(b)(8) would appear to apply to virtually all research conducted by colleges, universities or hospitals, provided only that such research may not include “activities of a type ordinarily carried on as an incident to commercial or industrial operations.” Treas. reg. section 1.512(b)-1(f)(4). This provision of the regulations is identical to Treas. reg. section 1.501(c)(3)-1(d)(5)(i), discussed above, which excludes certain kinds of activities from the definition of “scientific” research, and the two provisions have been interpreted in a similar manner.

B. Is There an Implicit Public Interest Requirement for University Research?

There has been very little analysis of the differences between the detailed and fairly complex rules under which research carried on by an independent research organization can qualify as “scientific research in the public interest,” and the apparently rather simple provision under which colleges and universities can enjoy the benefits of tax exemption for any kind of “research” performed for “any person.”

The differences between the standards, and the relative open-handedness of the regulations as applicable to college and university research, would make sense if one were to assume that the statutory drafters were content to leave to colleges and universities themselves the responsibility for ensuring that research efforts were undertaken only when such efforts
would either promote the institution’s own educational objectives (which are recognized as serving a public interest) or independently serve a broad public interest. A similar assumption would presumably account for the equally unrestricted exemption applicable to research performed for the government.

An assumption of this kind finds support in the policies applicable to direct federal funding of university research, and the principles governing federal support for technology transfer from universities to industry.

The Bayh-Dole Act (P.L. 96-517), which was enacted in 1980 and amended in 1984, encourages universities to collaborate with commercial companies to promote the utilization of inventions arising from federal funding. Specifically, the Act provides that universities can elect to retain title to inventions developed through government funding, and can license such rights subject only to certain general licensing guidelines. The Act reflected a congressional recognition that the policy ‘prior to 1980, which involved a retention by the government of patent rights to technology developed with federal funding, had not in fact served the public interest because it left no incentive for commercial investment in the development of new products based on research results.

The Bayh-Dole Act itself leaves considerable flexibility to universities as to how the licensing of technology is to be handled. In this respect, it is similar to the tax law treatment of university research. However, recent debate within the National Institutes of Health (NIH), the Congress, and the university community itself suggests that the freedom of universities to exploit federally-funded research is not unqualified. Some believe that universities take title to technology under the Bayh-Dole Act subject to a kind of fiduciary responsibility to see that the technology is developed in such a way as to most effectively promote the public good.

The debate over the effects of the Bayh-Dole Act and other federal policies on the funding of research has been heightened by concern over the sponsorship arrangement entered into last year between the Scripps Research Institute and Sandoz, a Swiss pharmaceutical.

The Scripps arrangement prompted hearings in the House Committee on Small Business in March of 1993, and was one of the factors that prompted the NIH to create a “Task Force on the Commercialization of Intellectual Property Rights from NIH-Supported Extramural Research.”

The federal income tax effects of research activities of colleges and universities will be subject to renewed scrutiny over the next few years in connection with the IRS Coordinated Examination Program for universities. If that IRS review is coordinated with the NIH review currently under way, the commonality of policy concerns in tax administration and in direct funding can be more fully explored.