

CareGroup, Inc.

## Issues Encountered in Contracting with Pharmaceutical Companies

### 1. UBI:

- a. The conduct of *scientific* research is an exempt activity and might not generate UBI because scientific "research" carried on by a hospital is sometimes excluded from UBI as scientific research or a research conducted pursuant to 512(b)(8).
  - i. The IRS interprets the term "research" very narrowly.
    1. Exclusion does not include activities of a type normally carried on as incidental to commercial or industrial operations.
    - ii. Certain research may also be excluded if it is substantially related to the entity's exempt purpose.
- b. To be excludable scientific research certain publication rights are generally necessary. See 1.501(c)(3)-1(d)(5)(iv)(b). The results of the research must be made available to the general public. The exempt organization must not forego publication to protect against disclosing the information sponsors wish to remain secret, or, agree to delay publication to enable the sponsors to defer patent procedures.
- c. The exempt organization can permit an exclusive right to use a patent or other similar process if granting this right is the only manner in which the process can be used for public benefit.
- d. Royalties are excluded from UBI unless the entity is actively involved in the enterprise that generates the revenue, such as providing services.
- e. The college and university audit guidelines issued by the IRS include a section on research activities. The auditing agent is directed to determine whether "purported research is actually the conduct of an activity incident to a commercial enterprise; determine whether the research is conducted by the institution or by a separate entity; review the institution's safeguards for managing and reporting conflicts of interest and any requirements imposed by any federal agency sponsoring research; review the institution's policy regarding ownership of intellectual property; review research arrangements with government sponsors and joint venture or royalty-sharing arrangements with industry sponsors; determine who holds the patent or right to license technology derived from the research; etc.
- f. Research for the government is not UBI

### 2. Non-Exempt Use of Bond Financed Space:

- a. Use or ownership of tax-exempt qualified section 501(c)(3) bond property by anyone other than section 501(c)(3) organizations is "private business use."
- b. If more than 5% of bond proceeds is private business use, the bond may lose its exempt status unless certain remedial actions are taken. Up to 2% of costs of issuance, which are treated as private business use, may be paid out of bond proceeds, so as a practical matter the limitation on private business use is 3%.

- c. Unrelated trades or businesses are treated as private business use.
  - d. The requirements of Rev. Proc. 97-14 must be met for corporate sponsored research contracts to prevent classification as private use. Rev. Proc. 97-14 are contained in the attached checklist.
3. Intermediate Sanctions:
- a. In order for intermediate sanctions to apply to a situation the following must be present:
    - i. An "applicable tax-exempt organization"
    - ii. A "disqualified person" and
    - iii. An "excess benefit transaction"
  - b. Does pharmaceutical company qualify as a disqualified person (i.e., does it exercise substantial influence or under a facts and circumstances test is it a disqualified person)?
4. Joint Venture:
- a. If the JV is treated as a separate legal taxable entity, then transactions entered could jeopardize the parent's exempt status on private inurement or private benefit grounds, or result in intermediate sanctions. There could also be UBI issues and tax-exempt bond issues.
  - b. If the JV is a contractual arrangement, still may have Intermediate Sanction, UBI, and Tax-Exempt Bond issues to be aware of.
5. Technology Transfer Issues
- a. Licensing agreements should be structured as royalties to the exempt organization
  - b. If services are to be provided, the services should be separated into a separate agreement.
  - c. To avoid exempt status issues, if large, consider taxable subsidiary – remember space rental will be UBI under 512(b)(13) to the exempt organization that is the parent of the taxable subsidiary.
  - d. Creative transfer – exempt offered investment interest in a C Corporation
    - i. Subsequent services provided by the exempt to the C Corporation may be UBI
    - ii. Need third party to certify valuation (if exempt receives less than value of technology transferred, intermediate sanctions, private benefit and inurement concerns arise).
  - e. Creative transfer with a twist – exempt offered interest in LLC
    - i. UBI from flowthrough may not be offset by cash distribution
    - ii. Conflict with business operations and charitable requirements
    - iii. Same valuation issues as C corp

**Rev. Proc. 97-14 Corporate Sponsored Research in Tax Exempt Debt Financed  
Space Checklist**

<b>Requirements</b>	<b>Test</b>	<b>Satisfy the Test?</b>
1.	<b>Basic Research:</b> Does the contract involve original investigation for the advancement of scientific knowledge not having a specific commercial objective.	
and		
2a.	<b>Corporate Sponsored Research:</b> Is any license or other use of resulting technology by the sponsor permitted only on the same terms as the recipient would permit that use by any unrelated, non-sponsoring party. The price paid by the sponsor must be no less than the price that would be paid by any non-sponsoring party for those same rights.	
or,		
2b.	<b>Cooperative research agreements:</b> A research agreement relating a joint industry-governmental <sup>1</sup> cooperative research arrangement does not result in private business use if: <ol style="list-style-type: none"> <li>1. Multiple, unrelated sponsors agree to fund governmentally performed basic research;</li> <li>2. The research to be performed and the manner in which it is to be performed (for example, selection of the personnel to perform the research) is determined by the qualified user;</li> <li>3. Title to any patent or other product incidentally resulting from the basic research lie exclusively with the qualified user; and</li> <li>4. The sponsors are entitled to no more than a nonexclusive, royalty-free license to use the product of any of the research?</li> </ol>	

To be excluded, must answer "Yes" to #1 and "Yes" to either #2a or #2b.

<sup>1</sup> For this purpose, references to governmental persons include section 501(c)(3) organizations with respect to their activities that do not constitute unrelated trades or businesses.