

INTELLECTUAL PROPERTY ISSUES FOR NONPROFITS

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I. Intellectual Property

A. Intellectual Property defined —

1. Refers to creations or works of the mind or intellect. Under law, holders of this property may have rights to control its use.

2. Four main categories of intellectual property:

a. Patent, 35 U.S.C. sections 1 *et seq.*;

b. Copyright, 17 U.S.C. section 1 *et seq.*;

c. Trademark, 15 U.S.C. sections 1114 *et seq.*;

d. Trade secret, 18 U.S.C. section 1839.

3. There are other types of intellectual property as well.

B. Copyright

1. Protects original works of authorship fixed in a tangible medium of expression, including books, publications, software, website design, photos, art (pictorial, graphic and sculptural works), music, sound recordings, dramatic works, motion pictures, architectural work, choreography, and in some cases, data.

2. Gives the author certain exclusive rights over the work for a set period of time, including the exclusive right to:

a. Reproduce the copyrighted work;

b. Modify the work or create derivative works;

c. Distribute copies of the work; and

d. Perform and/or display the work publicly.

3. Copyright protects published and unpublished works.

4. Unlike patent rights, copyright arises upon creation and it is not necessary to register a copyright for it to be protected.

5. Typically, author of a work will be owner except

a. Employee within scope of employment;

b. Work-made-for-hire agreement; or

c. Assignment.

6. In addition, notice (©) is useful (in the case of a dispute), but no longer necessary for protection in the U.S. (though it is required for pre-1978 works).

7. The length of copyright protection varies depending on when the work was created.

8. Term of copyright in U.S.:

a. For works created from 1978 on, life plus 70 years for individuals;

b. For corporate works (including works for hire), the shorter of 95 years after publication or 120 years after creation;

c. Works published from 1923 to 1963 had a term of 28 years, which could be renewed for 47 years (now extended by 20 years), bringing the total term to 95 years if the first term was renewed;

d. Works published from 1964 to 1977 have a term of 95 years; and

e. Pre-1923 works are in the public domain.

C. Trademarks

1. A trademark is a name, word, phrase, symbol, logo, design, sound, or color:

a. Used in connection with a good or service; and

b. Used to indicate the source of the goods/services and to distinguish them from the goods/services of others.

2. In the U.S., trademark rights arise upon use. In other countries, trademark rights arise upon registration (*e.g.*, first to file).

3. Registration in the U.S. affords certain protections and legal presumptions.

D. Patents

1. Patent rights allow the owner the right to exclude others from making, using, selling, offering for sale, or importing an invention;

a. In the territory of the patent for a limited time;

b. In exchange for public dedication of the invention after the term of the patent.

2. In general, patents may be obtained for “inventions” that are:

- a. Novel;
 - b. Useful (has some function or value); and
 - c. Non-obvious (to a person reasonably skilled in the relevant field).
3. Typically the term of a patent (once granted) is 20 years from the filing date of the patent application.
4. What can be patented?
- a. Any new and useful process, machine, manufacture, or composition of matter, or any new and useful improvement thereof;
 - b. But not abstract ideas, laws of nature, literary works, compositions of music, compilations of data, legal documents, forms of energy, signals, products of nature, or mathematical formulae.
5. Patent status — In order to exercise patent rights, a patent must be granted or issued.
- a. The issued or granted patent describes the invention or process and its boundaries.
 - b. The patent owner has the right to exclude others from making, using, selling, offering-to-sell and importing the patented invention.

E. Trade Secrets

- 1. A trade secret is a confidential practice, method, process, design, know-how, or other information that is treated as secret and has economic value.
- 2. A trade secret is information that:
 - a. Is not generally known or reasonably ascertainable;
 - b. Confers economic benefit on its holder; and
 - c. Is the subject of efforts to maintain its secrecy.

F. Ownership and Licenses

- 1. Subject to certain exceptions, owners of intellectual property may exercise all rights in intellectual property themselves or grant rights to third parties through assignment (which transfers ownership) or license.
- 2. A license is a grant of permission to use an owner's intellectual property.
 - a. Can be exclusive or non-exclusive in all or some fields/uses;

- b. Defines the territory and term of permitted use;
- c. Defines whether others can use under same conditions (sublicense);
- d. Defines whether a fee (such as royalty on sales or annual maintenance) will be charged for use;
- e. Does not transfer ownership; and
- f. Can be terminated in certain cases.

3. Exceptions/Alternatives — There are exceptions and unique alternatives to owners' rights to intellectual property.

- a. Copyright
 - (i) Public Domain
 - (ii) Fair use under copyright law permits certain uses without copyright owner's permission; need to consider four factors in determining whether a use is a fair use:
 - (1) Purpose and character of the use;
 - (2) Nature of the copyrighted work;
 - (3) Amount and substantiality of the portion taken; and
 - (4) Effect of the use on the potential market.
 - (iii) Library exceptions under Section 108 of the Copyright Act.
 - (iv) Alternative models
 - (1) Creative Commons: all rights granted or combinations of:
 - attribution;
 - (no) share;
 - (non)-commercial;
 - (no) derivative works
 - (2) Open Access: "author pays" model (vs. "subscription" model)

(3) Open Source

- For computer software.
 - Allows public to access the source code of the software for its own needs.
 - Is often free and allows users to make modifications and redistribute the software without having to pay the author.
 - Important to know what, if any, obligations are associated with the particular Open Source license.
 - Many different varieties of open source licenses, not all of them compatible.
 - Important to keep track of what Open Source software is in use and applicable licenses.
- b. Fair use under trademark law
- (i) Generic marks are not protected — available for all;
 - (ii) Descriptive uses only protected when they have acquired secondary meaning.
- c. Compulsory licensing of patents.
- d. Public domain.

II. General Issues**A. Inurement (also overlap with private benefit)**

1. Promoting Works of Insiders (Overlap with Self-Dealing)

a. Private Letter Ruling (“PLR”) 9408006: Private operating foundation formed for the purpose of promoting textile arts by establishing a collection and participating in exhibitions. Founders, directors and substantial contributors included well-known textile artist and her husband. Foundation did purchase textile arts, but assets of foundation also used to promote founder’s art and defray costs of exhibiting textiles in founder’s private collection. Foundation also incurred the costs of printing a book of founder’s biography and list of her personal collection, though founder owned the copyright to the catalogue. Foundation sold copies of catalogue and received the proceeds. Internal Revenue Service (“IRS”) found inurement, private benefit and self-dealing. Discussion of the book did not figure in the analysis, which mainly focused on the exhibitions and promotion of founder’s art.

b. Technical Advice Memorandum (“TAM”) 8045019: President wrote book related to exempt organization (“EO”)’s educational mission of instructing the public on methods of achieving greater efficiency and economy in municipal government. The contract between EO and President provided that EO would retain copyrights in materials produced under the auspices of EO, but not this book. The EO was to offer this book along with its other published materials. President maintained that he wrote the book on his own time, using his own office space at home, etc. IRS held not enough evidence to conclude that the book resulted in inurement.

c. General Counsel Memorandum (“GCM”) 38982 (May 3, 1983): GCM mainly about an EO seeking classification as a church. However, background to how the EO got its exemption indicated that the IRS was concerned on inurement grounds about the fact the President held the copyright on the books and recordings sold by the EO. The President stated at conference that he intended to transfer the copyrights once the EO was recognized as exempt. IRS satisfied and exemption granted.

d. GCM 34796 (March 2, 1972): Foundation arranged to sponsor publication of paperback edition of book authored by President. Not clear who owns copyright, but President received percentage of net royalties and Foundation covered costs of commissions and printing. IRS said that this is distinguishable from situation in which organization formed for primary purpose of promoting book of founder, as in Rev. Rul. 55-231. No indication that President overcompensated, and IRS persuaded that President gave up something of value—the right to publish paperback edition which also undercut value of hardcover edition to the President since hardcover copies are now less likely to sell (and it seems that the President received greater royalties per hardcover copy sold, but this information was redacted). IRS concluded that there was no inurement. (Also see GCM 34340 (Aug. 28, 1970), which according to GCM 34796 had very similar facts and conclusions but difficult to get a sense of those conclusions because GCM was heavily redacted.)

2. Scientific Research

a. PLR 9316052: EO (public charity) undertakes biological research for purpose of promoting economic development in its state. EO achieves this aim by developing patents, copyrights, processes and formulae and transferring them to the private sector, generally licensing them to private sector for commercialization. EO additionally undertakes sponsored research; EO generally retained title to patents and other intellectual property (“IP”) and granted research sponsors a right of first refusal to obtain an exclusive license in return for appropriate consideration. Any such exclusive license agreements required sponsors to make the IP reasonably available for public benefit, and EO retained nonexclusive royalty-free right and license to use the IP for its internal, noncommercial research and development activities. The subject of letter ruling involved the following:

(i) Applied Research: Rather than continuing with basic and discovery research, EO wants to shift to applied research and economic and industrial development to create technologies that will diversify economy and encourage industry in EO’s and surrounding states. Research sponsors may obtain ownership of any IP resulting from sponsored research. IRS found that research agreements with industrial sponsors that retain

ownership or control of the resulting IP are necessary to commercialize EO's technology for economic benefit of state and surrounding states, and consequently do not result in unrelated business income tax ("UBIT"). Otherwise, following the same analysis discussed in the for-profit subsidiary section below, IRS found that subsidiary's activities will not be attributable to EO or jeopardize EO's exempt status.

(ii) Patent Policy: Inventors of patent, copyright, process, or formula share in 1/3 of revenue. For IP that is donated to EO, employees who make "unique, significant and non-routine contributions to evaluating and assessing the donation" share in 15% of the revenue from the particular IP. No inurement because EO demonstrated that patent policy is reasonable compensation. The policy was established by the Board in an arm's length relationship with its employees, payments under the policy serve a real and discernible business purpose in line with the normal practices of similar businesses, and the amount is dependent upon the employee's contributions to the purposes and objectives of the EO.

(iii) For-Profit Subsidiary: EO created a for-profit subsidiary (of which a state created entity owned all the preferred stock) to which it transferred an option to acquire all right, title, and interest in any IP owned by EO or to which EO has exclusive rights, but only after the IP becomes commercially viable. The for-profit is to achieve commercial application through a joint venture ("JV") or subsidiary venture. If the for-profit determines licensing is the best way to achieve commercial application or if the for-profit does not make progress after 3 years, the IP rights revert to the EO. Possible that EO will sell shares of its stock, but will always retain more than 50%. Found that the granting of exclusive rights to for-profit subsidiary was the only practicable manner in which EO's technology could be utilized to public benefit.

b. PLR 98933030: University granting graduate degrees in sciences and engineering has membership consisting of North American companies and suppliers in particular industry. Membership open to any such company upon payment of dues. University creates research consortium, through which it will conduct research in furtherance of its educational purposes. University will hold title to all rights arising out of research, but consortium members will have a non-exclusive royalty-free license, without right to sublicense, to use any of the rights generated by the research. Consortium members will collectively have the exclusive license to the IP. All decision about applications of the IP will be made by committee of the consortium. The research will be published by researchers within reasonable period. IRS found that the consortium arrangement will not result in inurement nor serve the members private interests to an impermissible degree. No further analysis.

3. *International E22 Class Association*, 78 T.C. 93 (1982): Issue of case has nothing to do with IP, but there is an interesting background. EO formed for the purpose of promoting athletic competition, specifically International E22 Class yacht competition. Apparently an individual holds the patent to the E22 Class, and initially the EO was collecting the royalties due to him. The IRS found inurement, so the EO and patent holder revised agreement so that EO would no longer act as conduit for the royalties. This apparently satisfied the IRS.

4. For-Profit Subsidiaries: Rulings involve transfers of EO's IP to newly created for-profit subsidiaries that more or less continue EO's activities but with a potentially commercial bent.

a. PLR 9542045: Educational organization (public charity) that, among other things, produces films for television and video. Programs historically broadcast on PBS and supported by corporate sponsors. In 1995, EO unable to obtain corporate sponsorship for its new program, and therefore agreed to produce a program for a commercial network which agreed to underwrite the production costs. EO concerned that broadcast on commercial network would be viewed as UBIT by IRS, so instead created a for-profit subsidiary. EO transferred, among other things, its film library and copyrights, and an exclusive license to use EO's trade name in connection with the existing film library and future development, production and distribution of film, television and other audio visual programs. Subsidiary will pay annual royalty "in an amount commensurate with the income attributable to use of the Trade Name." Held that since the subsidiary had *bona fide* business purpose, EO's exempt status not affected by subsidiary's activities or the transfer of assets to the subsidiary. The EO also requested as a separate ruling that the amount of royalties paid by the subsidiary to the EO would not result in inurement or private benefit. The IRS said that "approval of such cash/asset transfers" requires the EO to receive fair market value for the assets and arm's length compensation for any services provided, which here were to be determined in accordance with Section 482.

b. PLR 9705028: Ruling involving transfer of EO's IP to for-profit subsidiary for conduct of research, the results of which will be owned by government and commercial sponsors. Scientific research organization (public charity) does research in area of electrical power for members, which consist of government and private businesses. EO historically retained ownership of research results it funded and published research results on a non-competitive basis. Due to industry changes, however, EO wishes to change this policy with respect to research substantially funded by member and give members greater ownership rights, and EO would not necessarily publish the results of this research. EO to form taxable subsidiaries for purposes of conducting such sponsored research and to transfer cash, ownership or exclusive royalty-free license to incomplete research related to these projects, option to acquire nonexclusive royalty-bearing license for background IP owned by EO, limited term royalty-free exclusive licenses to certain completed and commercially viable IP, non-exclusive royalty-free license to use EO's names and marks in connection with research activities, and other assets. Held (based on similar separate identity analysis) that transfer of assets to and new research activities of for-profit subsidiary will not affect EO's exempt status. Also held that royalties under the non-exclusive licenses would not result in inurement or private benefit assuming such amounts are determined in accordance with Section 482.

B. Private Benefit

1. Are private individuals unjustly enriched by the EO? Depends on industry norms and whether activity conducted in a manner typical of parties that are dealing at arm's length. (IRS Continuing Professional Education ("CPE") 1999)

a. Frick/PLR 200114040: Great niece of founder and substantial contributor to charitable trust requested access to archives relevant to a book she is writing. The

archives were in poor condition and the trustees adopted a resolution to fund a conservation project involving the archives and prohibiting public access to the archives until further action by the Trust. The book by the great niece is not a project of the Trust, but is a commercial venture of the great niece, who will hold the copyright and other proprietary rights. Although the great niece is not a disqualified person (“DP”) for Section 4941 purposes, the IRS said that granting her preferential exclusive access would result in impermissible private benefit because the Trust had passed a resolution denying access to the archives, and access for the great niece would serve her private interests by allowing her to profit commercially since access to the archives would contribute to her book.

b. PLR 201129043: Organization was formed to create children’s educational television programs designed to nurture children’s capacity for values such as kindness, helpfulness, and respect for others. Organization intended to produce a children’s television show. The show was to feature characters owned by a for-profit LLC, which also owned all intellectual property associated with the characters. The LLC published and sold books based on the characters. Among other arrangements, the organization and the LLC entered into a license agreement whereby the organization would need the LLC’s permission to create any new characters and would pay a license fee of 50% of the commercial rate to use existing intellectual property associated with the characters. The IRS found that the organization existed to market the intellectual property of another entity, per Rev. Rul. 55-231. Because the organization did not own the intellectual property, all of its efforts to produce television shows and other products would enhance the value of the characters owned by the LLC.

c. University Licensing of Scientific Research/IRS Announcement 92-2, Exempt Organizations: Proposed Examination Guidelines Regarding Colleges and Universities, Section 342.8 Research and Contracts: The IRS notes that the relationship between universities and the commercial licensees of technology and research is becoming more complex. One example cited by the IRS is a situation in which a university scientist has a relationship to the licensee, such as that of a stockholder, officer or consultant, which may raise questions of impermissible private benefit. Guidelines for IRS agents conducting examinations of colleges and universities consequently include the following:

(i) Agent should determine whether private sponsors of research are entitled to the patent on any technology deriving from the research.

(ii) Agent should examine rights of the scientists under sponsored research contracts, such as whether the scientists are entitled to retain or license the results of the research.

(iii) Agent should consider whether a sponsored research contract gives private parties the right to exploit university facilities or equipment.

(iv) Agent should review the university’s safeguards on managing and reporting conflicts of interest, disclosures filed by university scientists and technology licensing employees concerning their relationships to research sponsors or licensees, as well as disclosures made by the sponsor.

(v) Agent should consider whether the university competes with taxable entities for research contracts, and the circumstances and conditions under which it competes.

2. Licensing Work of For-Profit/*est of Hawaii*, 71 T.C. 1067 (1979): EO licenses educational materials of for-profit for use in educational seminars. Under the license agreement, the for-profit controls how many seminars will be conducted, tuition charged, requires EO to hire staff from related for-profit, etc. For-profit gets 50% of seminar proceeds, though EO gets to keep all of proceeds from other types of classes on EST and special events (which EO was required to hold under license agreement). Court did not buy EO's argument that payments to the for-profit were essentially ordinary and necessary business expenses and that it is irrelevant whether the for-profit makes a profit. Tax court held that the organization is not exempt but a commercial franchise operating for the benefit of the for-profit. Tax Court based its conclusion in part on the control exerted by the for-profit. Although this was not discussed in the facts, in Tax Court notes in the analysis that upon termination of the license agreement, the EO must return all copyrighted material, including new material, to the for-profit. EO would be reimbursed for the cost of the new developments but EO would have no right to continued use of such developments.

3. For-Profit Subsidiary of Scientific Research Organization/PLR 20032635: Ruling involves a public charity scientific research organization which is a supported organization of a 509(a)(3) supporting organization. The supporting organization is to form a for-profit subsidiary that will be owned by it and other 501(c)(3) organizations for the purpose of licensing patents of the EO and other research institutions (that also are supported organizations, and thus 501(c)(3)s) for commercial development. The EO (and any other participating research institution) will enter into an agreement with the for-profit automatically granting the for-profit an exclusive license to any IP deriving from the EO's medical research. The EO will retain ownership of the IP and 50% of the net royalties. Of the EO's 50% royalty interest, the scientist responsible for the discovery will receive half pursuant to the EO's incentive compensation arrangements, which are consistent with arrangements at other medical research institutions. The EO will continue to publish its research within a reasonable time period. Held that the exclusive license arrangement with the for-profit will not affect the EO's exempt purposes since the EO will continue to conduct research in the public interest as a result of its publications. In addition, the exclusive license arrangement will not result in impermissible private benefit because neither the for-profit nor a potential sublicensee will have control over the direction of the EO's research; and the for-profit has only the right to receive progress reports and access to the research results to know when the IP is ready to be marketed.

C. Taxable Expenditures (Section 4945)

1. Distribution of Materials Authored by Disqualified Person (also see self-dealing below): Private foundation ("PF") considering reprinting materials previously printed by substantial contributor. PF would remove all references to substantial contributor in the text and headings, but the substantial contributor would be listed as the copyright holder. The ruling is silent with respect to the use (but might be for use in the PF's Health and Safety Education Program) and distribution of the materials, whether they would be sold, and whether the substantial contributor would receive a royalty stream or other payment to use the materials. IRS

said that any benefit received by substantial contributor from appearing as copyright owner is incidental and tenuous, and therefore the printing of materials would not result in self-dealing or a taxable expenditure.

a. PLR 8014057: A PF's substantial contributor, who was therefore a DP with respect to the PF, sponsored a health and safety education program that mainly consisted of printing, production, and distribution of educational materials and films relating to health and safety topics. The PF planned to adopt a health and safety education program similar to that of the DP, and although its program would replace a substantial portion of the DP's activities, the PF did not intend to assume any obligations or commitments of the DP, nor would the PF mention the DP in any of its materials. Preparatory work and some distribution for the materials would be done by DP employees. All materials will be distributed at schools, hospitals, community groups, etc. The DP also authorized the PF to use the DP's logo without charge. The IRS found that the amounts the PF would spend on the program would be direct expenditures that benefited the general public, and therefore not taxable expenditures under Section 4945(d). The IRS also concluded that services performed by the DP for the PF, and the use of the DP's logo, did not constitute self-dealing, because they would be done without charge.

b. PLR 8119015: The same PF from PLR 8014057 requested a ruling from the IRS that its program would not result in taxable expenditures or self-dealing. The PF requested the second ruling because it was considering using sales representatives of the DP to distribute program materials to the general public. The representatives would distribute materials to the people they came into contact with. No representative would be required to distribute the materials, although those who chose to do so could obtain some "good will benefit," which could also benefit the DP, but the PF claimed those benefits would be incidental and tenuous. The expenses incurred in connection with distribution would be paid for by the DP, and would not be reimbursed by the PF. The IRS found that this would not result in taxable expenditures, because the expenditures would benefit the general public. It also found that the program would not result in self-dealing, because the distribution by DP employees would be done without charge and the benefits to the employees would be tenuous and incidental.

2. Commissions/PLR 9210026: PF commissioned musical works with aim of preserving the heritage of an ethnic group. Such music is not commercially viable and in danger of being lost. The copyright of the musical work remained with the artist and the organization received a license for the purpose of fulfilling its educational project. The CDs would be distributed through advertising in relevant houses of worship, community newspapers, mailing lists of individuals likely to be interested in the preservation of such music, and to universities and other libraries. Held that amounts expended for this project would not constitute taxable expenditures.

3. Taxable Entity Assumes Control of PF's Operations/PLR 8415103: A private operating foundation scientific research organization entered into a sponsored research and laboratory agreement with a non-501(c)(3) nonprofit organization under which the PF's lab would essentially be controlled by the non-501(c)(3). Prior to closing, the non-501(c)(3) would assume direction of the PF's lab and assume the costs of acquiring new equipment; however the PF will continue to pay the costs of operating the lab and will pay the salaries of the non-501(c)(3)'s employees who operate the lab, but no other compensation. After closing, the non-

501(c)(3) will complete pre-existing research projects, which the PF will assign to the non-501(c)(3); will fundraise for further research; and undertake further research. All IP will belong to the PF, but the non-501(c)(3) will have the right to obtain an exclusive license (including with respect to the IP developed by the PF prior to closing). The non-501(c)(3) will market and sublicense the IP and publish all research results. The PF and non-501(c)(3) will share the royalties—for IP developed prior to closing, PF will receive 75%, and for IP developed after closing, PF will receive 40%. In addition, the non-501(c)(3) will be compensated an undisclosed specified amount for its services. No analysis, but the IRS held that the transaction would not affect the PF's exempt status or result in a taxable expenditure.

D. Self-Dealing (and Intermediate Sanctions)

1. Code Section 4941

a. Section 4941(d)(1)(C): Self-dealing includes any direct or indirect furnishing of goods, services, or facilities between a PF and a DP.

b. Section 4941(d)(1)(E): Self-dealing includes any direct or indirect transfer to, or use by or for the benefit of, a DP of the income or assets of a PF.

2. IP Contributed by DP (Example in 1999 CPE (p. 37)): Founder of foundation donates IP (here, a recipe). Foundation then enters into exclusive license with company owned by founder to exploit the IP in exchange for royalties from product. Cites 4941(d)(1)(E)—using foundation's assets for benefit of DP.

3. PLR 9408006 (textile artist—see above under inurement): Private operating foundation formed for the purpose of promoting textile arts by establishing a collection and participating in exhibitions. Founders, directors and substantial contributors included well-known textile artist and her husband. Foundation did purchase textile arts, but assets of foundation also used to promote founder's art and defray costs of exhibiting textiles in founder's private collection. Foundation also incurred the costs of printing a book of founder's biography and list of her personal collection, though founder owned the copyright to the catalogue. Foundation sold copies of catalogue and received the proceeds. IRS found inurement, private benefit and self-dealing. Discussion of the book did not figure in the analysis which really focused on the exhibitions and promotion of founder's art.

4. Quasi Co-Investment Arrangement/PLR 8251120: A PF makes expenditure responsibility grants to a for-profit to conduct research. The PLR does not say who owns the patent, but based on the IRS's conclusion it seems to be the for-profit (see below). A substantial contributor of the PF wishes to enter into "investment ventures" with the president and sole shareholder of the for-profit for the purpose of exploiting potentially patentable research similar to the research the for-profit performs for the PF. The investment venture will be a DP with respect to the PF. The IRS determined that the proposed investments of the substantial contributor would not result in self-dealing "provided that in no case will the research to be exploited by the venture be that research [funded by the PF] or patents arising therefrom."

5. Distribution of Materials Authored by DP: See Section C(1) above. PF considering reprinting materials previously printed by substantial contributor. PF would remove

all references to substantial contributor in the text and headings, but the substantial contributor would be listed as the copyright holder. The ruling is silent with respect to the use (but might be for use in the PF's Health and Safety Education Program) and distribution of the materials, whether they would be sold, and whether the substantial contributor would receive a royalty stream or other payment to use the materials. IRS said that any benefit received by substantial contributor from appearing as copyright owner is incidental and tenuous, and therefore the printing of materials would not result in self-dealing or a taxable expenditure.

E. Ownership

1. Form 1023: Asks whether EO will publish, own or have rights in music, literature, tapes, artworks, choreography, scientific discoveries or other IP. If yes, EO must discuss who owns the copyrights, patents or trademarks.

2. Scientific Research Organizations: Reg. 1.501(c)(3)-1(d)(5)(i) provides that an organization will qualify as a scientific organization only if it serves public rather than private interests. While research can be fundamental or basic, as well as applied or practical, the regulations make clear that for UBIT purposes, it will be necessary to determine whether the organization is operated primarily for fundamental research purposes as contrasted with applied research. The regulations further specify what qualifies as research undertaken in public interest and what does not qualify as research undertaken in the public interest.

a. Research undertaken in the public interest (Reg. 1.501(c)(3)-1(d)(5)(iii)) includes the following:

(i) Scientific research the results of which (including any patents, copyrights, processes or formulae) are made available to the general public on a nondiscriminatory basis.

(ii) Research directed toward benefiting the public, which includes, but is not limited to, scientific research carried on for the purpose of obtaining scientific information which is published and research aimed at promoting economic development in a particular geographic area. Such research can be performed pursuant to a contract with a sponsor, under which the sponsor has the right to obtain ownership or control of any patents, copyrights, processes or formulae resulting from the research.

b. Research not undertaken in the public interest (Reg. 1.501(c)(3)-1(d)(5)(iv)) includes the following:

(i) The organization performs research only for persons which are (directly or indirectly) its creators and which are not described in Section 501(c)(3).

(ii) The organization retains (directly or indirectly) ownership or control of more than an insubstantial portion of the patents, copyrights, processes or formulae resulting from its research and does not make them available to the available to the public. IP is considered made available to the public if it is made available to the public on a nondiscriminatory basis. IP will be considered made available to the public even if the organization grants an exclusive license if the granting of the exclusive right is the only

practicable manner in which the IP can be utilized to benefit the public. In such a case, however, the research will be regarded as carried on in the public interest only if it is conducted for the U.S. (including its agencies or instrumentalities) or a state or any political subdivision of a state, or if the research aids scientific education at the university level, is published, is conducted for the purposes of discovering a cure for disease, or encourages economic development for a particular community.

c. Rev. Rul. 76-296: Scientific research organization may satisfy the publication test even though it may delay publication for a reasonable period while it is establishing patent rights. Nevertheless, the publication must be adequate and timely to meet the test. Some public disclosure beyond that revealed by the patent itself is required, and publication must disclose “substantially all of the information concerning the results of the research which would be useful or beneficial to the interested public.” Delays or inadequate disclosures convert the research into UBIT activity. (Also see IRM 7.25.3.15.2.3 and 4.)

d. PLR 8501082: This is a self-dealing ruling, but the relevant players were found not to be DPs. A scientific research PF and two other EOs (one of which is a PF, the other a public charity) form a for-profit owned by the scientific research PF, the other EOs, consultants to the scientific research PF, and eventually independent contractors who will perform research for the scientific research PF. The for-profit is not a DP with respect to the scientific research PF. The for-profit will be a consultant to the scientific research PF in that it will identify research projects related to its scientific purposes and locate qualified researchers to perform the research. As a means of attracting scientists to perform the research for the scientific research PF in the capacity of independent contractor, the researchers may in some cases receive equity interests in the for-profit. The for-profit will fund 25% of the research costs. The scientific research PF will retain ownership in the IP resulting from its research, but will grant the for-profit an exclusive license to any patentable inventions in exchange for royalties that will reflect the going arm’s length rate for such a license. In addition, the scientific research PF would receive all initial net revenues until it recovers all costs of the research project. Costs of developing the patents into marketable products would be covered by the for-profit. The scientific research PF would have to publish the research results. The IRS said that “although [the for-profit] may ultimately benefit from its contractual relationship with [the scientific research PF] by holding exclusive patent licenses, its benefit is entirely incidental to the major purpose and effect of the proposed transaction, which is to develop and disseminate knowledge. Consequently, the proposed transaction will have no effect on the” exempt status of the scientific research PF.

e. PLR 200603031: A private foundation had a primary objective of reducing global health inequities by accelerating the discovery, development, and adoption of health interventions that could save lives and reduce disease in developing countries. The health interventions included vaccines, drugs, diagnostics, etc. The foundation supported discovery and invention of technologies essential for global health problems, development, including testing, of medical tools and technologies, and testing of access strategies for reaching needy populations. The foundation wanted to stimulate private industry to create answers for health problems disproportionately affecting the developing world in order to further its charitable goals of preventing and eliminating disease and increasing resources in needy areas. The foundation wanted to directly engage commercial pharmaceutical and biotech companies in these efforts

through investment in those companies. The foundation stated that it would only enter into transactions (either grants or program-related investments) with these companies if the proposed transaction would (i) support the discovery or development of health solutions essential to solving global health problems or inequities, (ii) facilitate adoption of such solutions, or (iii) enable availability of such solutions to low-resource populations. With respect to intellectual property, the foundation said it would evaluate each transaction proposal in the context of its Global Access Policy, the purpose of which was to make the solutions readily available at affordable prices to those without other access to them in the developing world. The IRS blessed the foundation's proposed transactions process, finding that the research funded by the transactions would be carried on in the public interest because it would be directed toward benefiting the public, and the research funded would not be carried on pursuant to commercial or industrial operations. The ruling did not specifically address the ownership or use of intellectual property after the transactions were finished, but it did state that the researchers involved would be "required to adequately and timely publish [their] research results, disclosing substantially all information concerning [those results] that would be useful and beneficial to the interested public."

3. Grants and Awards

a. Rev. Rul. 66-103: EO formed for purpose of encouraging the creative arts by, among other things, making grants to needy writers, composers, painters, sculptors and scholars for projects in their respective fields. The grantees retain all IP rights, with the result that the EO derives no monetary benefit from the grantmaking activity. Grantees promise to make their work available for the benefit of the public in ways customary and appropriate to the particular work. Held that the organization qualified for exemption under Section 501(c)(3). The IRS alludes to potential private benefit issues where it states, "[t]he fact that the recipient may receive money or other benefits from other sources in addition to the grant or award, as a result of his work does not preclude the grantor organization from qualifying as a charitable organization" under Section 501(c)(3). Although in this situation the grants were to needy artists, the IRS has elsewhere stated that it did not rely on that fact in reaching its conclusion since the grants furthered the EO's exempt purpose by promoting creativity in the arts (see PLR 9802045 (discussed below)). In distinguishing the EO's grantmaking activities from the textbook publishing activities in Rev. Rul. 66-104, the IRS pointed out that the EO here does not receive any monetary benefit from its activities (see discussion of Rev. Rul. 66-104 under UBIT section). This is a somewhat strange rationale, but it does fit in with the theory that there is some kind of relationship between private benefit and UBIT where IP is concerned.

b. PLR 9802045: Public charity sponsors contest soliciting solutions to a stated environmental problem. Charity gives monetary award to the individual who submits the most innovative, creative, feasible solution with the best impact on the world and environment. The ruling does not state whether the charity or the winner will own the rights to the solution, but the charity "reserves the right to make public, by any appropriate means, the scientific and research content of the winning application." The charity will publish the winning solution in trade and scientific journals and display the solution at a permanent exhibit at a local museum. IRS held that the award does not result in inurement. The ruling recognizes that such award results in some element of private benefit, but explains that, as in Rev. Rul. 66-103, the private benefit is incidental to the public benefit.

c. PLR 9651036: IRS approves individual grantmaking procedures for research grants in the area of housing, community development, and community welfare. The PF's grant agreement provides for assignment of copyright (it does not specify in which direction, but presumably from the author/grantee to the foundation).

d. PLR 7941021: IRS approval of individual grantmaking procedures to support scientific research undertaken by graduate students at two universities. All patents arising from the research will be the joint property of an institute with which the PF is somehow affiliated and the university attended by the students. The PF is an operating foundation and distributes substantially all of its adjusted net income to the institute. The institute and PF are called "one and the same" for practical purposes elsewhere in the PLR; the institute is the PF's "operating arm."

4. Commissions: PLR 9210026: See Section C(2) above. EO commissioned musical works with aim of preserving the heritage of an ethnic group. Such music is not commercially viable and in danger of being lost. The copyright of the musical work remained with the artist and the organization received a license for the purpose of fulfilling its educational project. The CDs would be distributed through advertising in relevant houses of worship, community newspapers, mailing lists of individuals likely to be interested in the preservation of such music, and to universities and other libraries. IRS held that amounts expended for this project would not constitute taxable expenditures.

a. With respect to commissions, there does not seem to be a bright-line rule respecting EO ownership or lack thereof of commissioned works. However, the Berkman Center for Internet and Society at Harvard University issued a 2009 report, "An Evaluation of Private Foundation Copyright Licensing Policies, Practices, and Opportunities," which stated that in a survey of private foundation licensing practices, the author found that "the most common foundation copyright practice was for foundations to allow their grantees to hold the copyright for the work they created but also to include language in the contract or grant agreement that permitted the foundation to reproduce and disseminate the work if necessary." The survey also noted that some foundations reported that "if there is a reason to believe a grantee (or some other entity) will profit commercially from foundation-supported work, the foundation may craft language into the contract that will entitle it to some share of the proceeds or will ensure that the work will be made available to the public at low or reasonable cost."

b. For consultants, foundations seem to take a different view: the survey stated that "most of the foundations represented in the survey interviews consider the copyright for work done by consultants on behalf of the foundation, and work created by foundation staff, to belong to, or require it to be assigned to, the foundation, where it is then licensed under a traditional copyright approach. This practice appeared to be fairly uniform."

F. UBIT/Non-Exempt Activity

1. Is the foundation receiving royalties or payment for services? If payment for services, are the services substantially related?

2. Joint Ventures: sharing in percentage of net sales proceeds while providing services relating to exploitation of IP is characteristic of JV (1999 CPE). UBIT unless activity in furtherance of exempt purposes and EO has sufficient control.

a. Also see GCM 37259 (Sept. 19, 1977), involving an educational organization that entered into agreement with commercial distributor to show EO's educational film on commercial theater. EO retained ownership of film and television distribution rights. Focus on net income versus gross income, but in a very unclear way.

3. Scientific Research (CPE 1999): Must be carried on in the public interest as described in 1.501(c)(3)-1(d)(5)(iii)(c), royalty, research for government unit (Section 512(b)(7)), performed by a university or hospital (Section 512(b)(8)), or fundamental research, with results freely available to the public (Section 512(b)(9)).

4. Publishing:

a. Rev. Rul. 66-104: Educational organization made funds available to authors and editors to prepare teaching materials and textbooks that would be used primarily by colleges and universities. The primarily commercial publishers of the materials received the copyrights and publishing and selling rights, and in return they paid all publication costs and a royalty to the organization. According to the terms of the agreements between the organization and the authors and editors, the royalty income first would be paid to cover the costs of preparing the materials from publication, including the amounts paid to the authors and editors. The remaining royalty would be shared by the organization, authors and editors. The organization was denied exemption on the ground that the publishing activities were "conducted in an essentially commercial manner, in which all the participants expect to receive a monetary return." This situation was distinguished from the grants to artists and writers described in Rev. Rul. 66-103 in that the grantmaking EO "does not receive any monetary benefit from the activity." A quasi-university press also was distinguishable from Rev. Rul. 66-104 on the ground that the publishing activity was not "conducted in an essentially commercial manner, in which all participants expect to receive a monetary return" (see GCM 38691 (April 14, 1981), addressing whether a scholarly journal published by a university constituted UBIT where the contents of the journal are authored by another 501(c)(3) organization and the university receives royalties from the sale of journal; it seems as though the university does not retain the copyright, but the GCM does not say one way or the other).

b. Rev. Rul. 79-369: EO promotes appreciation of contemporary symphonic and chamber music by recording works of unrecognized composers and neglected works of more established composers, which have a limited commercial market and are not produced by commercial labels. Composers receive royalties from the sale of recordings as required by federal law, but such royalties are expected to be insignificant due to limited commercial market (seems as though EO holds the rights to the actual recordings, but the ruling does not address who owns what rights). In addition, individuals and for-profits who provide subsidies for the recordings receive 9% of the gross sales up to the amount of their subsidy. According to underlying GCM 37607, the amount paid back to each subsidizer is not expected to exceed \$50. The GCM also indicates that the recordings would be sold below cost. Organization was exempt in part because it conducts its musical recording activities in a non-

commercial manner (facts indicate that that records will not be made for sale through commercial dealers other than a few specialty shops, organization sells recordings primarily to libraries and educational institutions, no advertising, etc.) The underlying GCM indicates that the revenue ruling should not base its exemption on compliance with the 4-part publishing test set forth in Rev. Rul. 67-4. Rather, the situation is closer to that of an organization that promotes jazz through public jazz festivals or concerts (Rev. Rul. 65-271) and the income from sale of records is like ticket revenue.

c. IRM 4.76.6.6 Examinations Guidelines for Religious Activities (April 1, 2003): In determining whether publishing religious literature is in competition with commercial enterprises, one factor the IRS looks to is whether the literature is copyrighted, and if so, in whose name the copyright is held.

d. IRM 4.76.11.2 Educational Organizations other than Schools: When determining whether an activity is educational or propaganda, the IRS looks to whether the organization otherwise satisfies the requirements of Section 501(c)(3). “If the organization has royalty income, [the agent should] review the cash disbursement and receipt journals to determine if cash has been advanced to authors and income has been received from publishers in the type of arrangement described in Rev. Rul. 66-104.”

III. IRS Solutions

1. CPE 1999 (p. 38): Resolution of issues depends on industry practices in both the EO and commercial worlds. Conduct activities in manner that is “usual and customary in the industry.” (1999 CPE, p. 31)
2. Satisfy arm’s length standards. (1999 CPE, pp. 31, 38)
3. Make sure that arrangements do not result in forms of excessive compensation or other forms of private benefit or inurement. (1999 CPE, p. 38)

IV. Situations

A. Exploiting IP Owned by Foundation (License IP to For-Profit, Self-exploitation)

1. IRS recognizes that “appropriate exploitation” of IP is “no less a fiduciary duty than managing [the EO’s] financial endowment.” (1999 CPE, p. 38)
2. Scientific Research: exclusive license to for-profit would result in private benefit unless the exclusive license is the only practical way to exploit the patent. (1999 CPE, 1.501(c)(3)-1(d)(5)(iv)(b))
3. Need to be careful that commercial projects involving EO’s IP are not consuming a substantial portion of EO’s money, time, and efforts. (1999 CPE)

B. Royalty Sharing

1. Permissible to allow employees to share in royalties or even projects from exploitation of IP, such as licensing of patent, provided compensation is reasonable and compensation not based on net profits of the foundation itself. (1999 CPE, p. 37) “All compensation arrangements must be based on services performed for the exempt organization activities that further its exempt purposes.” (1999 CPE, p. 37)

2. Such royalty sharing arrangements should be decided in advance and at arm’s length. Easiest to satisfy these requirements if organization has adopted a written policy after considering the industry norms. (CPE 1999, p. 37)

C. Publishing Activities of EO

1. Royalties to authors: According to 1999 CPE, 5% to author is the norm for university presses, compared with 15% to 20% paid by commercial publishers.

2. Sizeable advances generally not paid, though commercial publishers typically pay several thousand dollars (1999 CPE).

3. Exempt Organization Example

a. Agreement with Publisher

b. 1023 and Private Benefit: IRS initially took position that the agreement did not contain acceptable terms that were favorable to the EO such that the agreement was providing “substantial benefits that are in the best interest of the book company.” It was successfully argued that:

(i) Because the agreement was the result of arm’s length negotiations between two unrelated parties, there was no incentive to enter into an agreement that would provide impermissible private benefit to publisher and the agreement was entitled to the presumption that it was reasonable and did not result in impermissible private benefit (citing Rev. Rul. 76-91; 1993 CPE (Wright and Rotz) at 191, 201);

(ii) Profit margins generally are narrow in the publishing industry and publisher was taking on the financial risk by investing its assets in the book series and by paying from the “bulk” of the publishing costs;

(iii) Any benefit to publisher was offset by the facts that organization’s name and mission would appear on each book; EO did not have to expend large sums of money, publisher would lend credibility to the series and attract qualified authors;

(iv) Any private benefit to publisher or the author is incidental to the public benefit that results from the encouragement of greater readership of high quality books on Jewish subjects:

(1) Qualitatively incidental private benefit (*i.e.*, insubstantial when compared to the public benefit) because financial risk shifted to publisher, and EO’s supplemental payments will be used to promote the books and thereby stimulate public

awareness of and interest in high quality publications, which will result in the public benefit of increased knowledge and understanding of Jewish culture and ideas. Due to EO's oversight and its right to control the quality of the books, the emphasis in producing the services will be on quality and not commercial aspects of what will sell best.

(2) Private benefit is qualitatively incidental if it is "a necessary concomitant of the activity which benefits the public at large" and is indirect or unintentional (GCM 37789). Given arm's length negotiation, any private benefit is unintentional and a necessary result of the EO's efforts to accomplish its exempt purposes.

(v) Argued that publication not commercial, drawing on Rev. Rul. 67-4 4-part test:

(1) Educational content of books;

(2) Generally accepted methodology;

(3) Distribution of books necessary and valuable in achieving organization's educational purposes; and

(4) Distribution distinguishable from ordinary commercial practices.

c. Copyright Ownership: The IRS initially took the position that "all titles, copyrights, royalties or similar interests in books or other material prepared" for organization's activities will be held by organization. It was argued:

(i) Not always appropriate or possible for the EO to hold copyright, such as in the case of a grant to an author, or in situations in which it is sufficient for the EO to hold an exclusive or non-exclusive license to publish the work.

(ii) The important thing is to make the work widely available to the general public or those with a particular interest in the materials, and not necessarily to own the copyright.

(iii) Author needs to receive a share of the royalties for financial survival, and the author is entitled to reasonable compensation.

(iv) EOs need the ability to make appropriate decisions as to when they should have ownership of the copyright versus when they should obtain an exclusive or non-exclusive license.

(v) Would not be able to attract authors otherwise.

4. Music Foundation: educational music DVDs on jazz, jazz artists, and educational and instructional DVDs on playing instruments.

a. **Copyright Ownership:** In the Form 1023, the foundation disclosed that in some instances the copyright would be owned by the artists and not the foundation, but that in those instances the foundation would obtain a non-exclusive license to reproduce and use the material in furtherance of its educational mission to ensure that the materials are widely available to the public.

b. **Royalties:** Foundation disclosed in the Form 1023 that it expects to pay royalties to featured artists, but that such royalties would apply only to DVDs sold, and not those distributed to educational institutions at no charge. The IRS raised questions about the royalties paid to artists in a telephone conversation. The foundation, however, assured the IRS in a supplemental submission that the royalties would be reasonable and would be paid only when necessary to achieve the foundation's charitable objectives, and that any private benefit that may result would be incidental to the large public benefit of making these materials available. The foundation estimated that its royalty expense would not exceed 5% of the foundation's total expenses.

D. Hiring For-Profit Entity to Create IP

1. Compensation must be reasonable.

2. See Rev. Rul. 97-21 for financial incentive standards. In this Revenue Ruling, the IRS provided five scenarios to illustrate how hospitals could avoid violating qualifications for Section 501(c)(3) exemption when offering physician recruitment incentives. Generally, reasonable incentives are permissible as long as the hospital has objectively determined that the incentives will allow it to reasonably promote and protect the health needs of its surrounding community service area. 1999 CPE says this ruling is applicable to both employee and non-employee situations. Non-employee standard has four requirements:

- a. Does the activity bear a reasonable relationship to the accomplishment of the EO's exempt purposes?
- b. Does the activity result in inurement?
- c. Does the activity serve private interests to such an extent as to justify a conclusion that the organization has more than an insubstantial nonexempt purpose?
- d. Does the activity accomplish substantial unlawful purposes?

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