

KANSAS STATE UNIVERSITY

PUBLIC POLICY MANDATES: A DISCUSSION OF INTELLECTUAL PROPERTY AND
WORKS-FOR-HIRE CONTRACT LANGUAGE

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and Works-For-Hire Contract Language**

Introduction

Kansas State University (K-State), as a non-profit institution of higher education and an agency of the State of Kansas, is subject to specific statutes and regulations, including those issued by the United States Internal Revenue Service (IRS), that govern K-State's activities conducted in pursuit of its public, tax-exempt purpose. K-State has established numerous policies and guidelines that address the need for it to perform all activities in a manner that is consistent with its public mission and exempt structure, in compliance with IRS regulations. K-State, as is the case of any public institution, is discouraged from performing "Works-For-Hire" by regulations and guidelines established by the IRS. These mandates have established that Works-For-Hire activities are "questionable", in regard to the appropriate activity of public not-for-profit institutions and allowing this form of activity to occur could subject K-State to Unrelated Business Income Tax (UBIT) and raise concerns as to whether the organization is conducting its business pursuant to its exempt purpose. Notwithstanding, K-State faculty perform a myriad of research, testing and evaluation services projects for our sponsors that are appropriately structured to ensure K-State's compliance with public policy and regulatory mandates, while ensuring the protection of our sponsor's investment in its proprietary materials and its potential competitive position in the commercial marketplace.

Educational Mission and Rights in Intellectual Property

The IRS has deemed that research and sponsored projects performed by an educational or non-profit institution that are not consistent with its educational mission (as defined by the IRS) could endanger the non-profit status of the institution and lead to UBIT. The educational/research mission is defined by the IRS as "being in the public interest". Research and sponsored projects that result in intellectual property creation by a public entity are regarded as in the public interest if all patents or other resulting rights created by the public entity are made "available to the public" and the dissemination of results are not unduly restricted or prohibited. The IRS has indicated that giving up ownership of Intellectual Property (IP) created by an educational or non-profit entity and limiting a faculty member's right to publish creates the appearance that the non-profit or educational institution is no longer adhering to its educational mission since the products of its activities may not be made available to the public. Agreeing to Works-For-Hire principles means that K-State would automatically give up its rights to its IP, and thus, K-State would not be able to assure compliance with the public mandate to make the products of its research and sponsored projects available to the public. Therefore, in order to avoid the potential negative ramifications associated with Works-For-Hire principles, and in compliance with the underlying regulations, K-State's IP policy ensures the following:

- 1) Retention of copyright and ownership of IP created by K-State employees;
- 2) Preservation of publication rights for K-State faculty; and
- 3) Assurance that sponsored project activities, including but not limited to those that involve testing and evaluation, are appropriately structured to guarantee K-State's pursuit of its public purpose.

Works-For-Hire Clarification

Since K-State is a taxpayer-supported institution of higher education it does not enter into Works-For-Hire agreements. Its infrastructure and resources are considered taxpayer supported resources and thus, all activities carried out by K-State employees are considered part of an employer/employee relationship with K-State and the State of Kansas in fulfillment of the university's tax-exempt purpose. When K-State enters into agreements with outside entities, K-State is agreeing to accept a contract to redirect certain components of its public supported infrastructure to perform certain sponsored activities for those parties and because K-State is a public entity, it and its employees are prohibited from being "hired" under such contracts, or accepting contract terms that establish an "employer/employee relationship" with the outside entities. Thus, the standard "employer/employee relationship" between K-State and its employees is necessarily preserved, to ensure the protection of the academic freedom of its faculty and provide the accountability K-State owes to the citizenry in fulfillment of its tax-exempt purpose. Notwithstanding the aforementioned, K-State is fully able and prepared to protect and help develop and preserve the proprietary and intellectual rights owned by our many collaborators. One of K-State's paramount missions is to contribute to the innovation ecosystem and it takes the value proposition that it offers to its sponsors in this regard very seriously. The awareness and proactive compliance with public policy mandates informs and enables K-State to assist its many collaborators in enhancing their investments in research and sponsored activities to support subsequent commercialization objectives by developing or preserving their respective positions in the commercial marketplace.

Federal Tax Laws and Related Statutes

The IRS has published many rulings, publications and notices regarding the exempt operations of educational organizations that are classified as tax-exempt organizations, especially those units of government operating as public institutions such as K-State. These rulings provide definitions clarifying the requirement of public institutions that carry on scientific research in the public interest. For example, IRS Revenue Procedure 2007-47 provides clarification for §141(b) and §145(a)(2)(B) of the Internal Revenue Code (IRC) of 1986 in regard to qualified 501(c)(3) bonds and expands on the requirements contained in Rev. Proc. 97-14, 1997-1 C.B. 634. In addition, the Bayh-Dole Act was enacted to permit small businesses and non-profit organizations, such as universities, to retain title to inventions resulting from federally funded research, while reserving a royalty-free, non-exclusive, nontransferable license for the federal government to use the invention. The United States Code §501 states that organizations are exempt from taxation as long as their objective is not to provide profit to private shareholders or to promote a political agenda.

"Scientific purposes" are among the tax-exempt purposes listed in IRC 501(c)(3). IRS Revenue Ruling 76-296 was enacted to provide advice about situations when sponsored research is "scientific research carried on in the public interest" within the meaning of section 501(c)(3) of the IRC of 1954. The official interpretation of the IRC by the Department of Treasury in Reg. 1.501(c)(3)-1(d)(5)(iii), ratified by IRS Revenue Ruling 76-296, addresses the issue by stating that in order to comply with the purpose of tax exemption in 501(c)(3), the "scientific" term includes the "carrying on of scientific research in the public interest". Furthermore, the guidance specifies that in order to be scientific, the research must be carried on "in furtherance of a scientific purpose", regardless of whether such research can be classified as "fundamental" versus "basic" or "applied" versus "practical". The myriad of guidance documents mandate that all activities carried out by a not-for-profit, public institution be directly related to that institution's tax-exempt purpose. Granting rights that are inconsistent with its public mandate can jeopardize its not-for-profit status and subject the institution to UBIT. Excessive amounts of UBIT may indicate that an institution is engaged in a preponderate amount of activity counter to its public mission. In fact, no more than 10% of an exempt organization's total activity performed in facilities constructed with tax-free municipal bonds can be for "commercial or private business purposes". Because these bond-financed

buildings can be a part of a larger bond issue for other State of Kansas purposes, calculating the *de minimis* use of bond-financed facilities is quite complex and prudence requires K-State to exercise care to ensure that use of such facilities by the university for sponsored projects does not qualify as “private use”.

Other public policy mandates that require compliance monitoring and are related to governing statutes and taxing authority regulations prohibit K-State from “commercially competing” with the private sector and engaging in excessive amounts of unrelated business activity, that is, business not consistent with K-State’s public research, education and outreach missions.

Private Business Use and Non-Exempt Activities at Public Institutions

Under the IRC, “private business use” involves use in a trade or business carried on by any person other than a governmental unit (IRC 141(b)(6)). Private business use may be found even in situations where the private entity does not physically occupy the tax-exempt space, but enjoys special legal entitlements of use, or special economic benefits. The IRS has published determinations that indicate that granting rights to for-profit, or commercial entities that exceed the test of those normally accepted or which exceed the test of reasonableness are not exempt activities, by definition.

Some examples of non-exempt activities that exempt public institutions must take great care in avoiding, as dictated by IRS regulations and guidance, are directly related to the relationship that may be proposed between an external corporate sponsor and K-State and could include but are not limited to the following:

- 1) The transfer of ownership rights of IP developed by employees of the exempt organization to a for-profit entity;
- 2) The pre-negotiation and/or acceptance of royalties at rates that have been discounted below normal industry standards without supporting justification that the public has been properly reimbursed and that the commercial entity is not being granted special consideration inconsistent with the exempt mission of the institution (i.e. activity may be deemed an activity that supports a commercial profit mission versus an activity in support of the institution’s exempt mission);
- 3) Activities that prohibit the exempt educational organization from freely disseminating the results of its scholarly activities (a paramount mission of public universities) giving due consideration to reasonable measures to protect a contributing entity’s proprietary information; and
- 4) Any other activity that serves to provide a benefit to a non-exempt entity, such as but not limited to the discounting of project costs below the public entity’s actual cost of performance, which exceeds the test of reasonableness and capitalizes on the underlying support provided to the exempt educational institution by tax-payer generated appropriations provided for the purpose of underwriting the exempt institution’s public mission.

Safe Harbors for Industry-University Collaborations

Under IRS Rev. Proc. 2007-47 and its predecessor 97-14, industry or federally sponsored research will not be considered “private business” use if:

- 1) The university determines the research to be performed and the manner in which it is to be performed;
- 2) Title to any patent or other product incidentally resulting from the basic research lies exclusively with the university;
- 3) The sponsor or sponsors are entitled to no more than a NERF license to use the product of any of that research, unless sponsor pays a fair, competitive price for the exclusive use of the resulting technology; and

- 4) The price paid for sponsor's use of resulting technology is determined at the time of license or other resulting technology is available for use.

K-State has developed "safe harbor" contractual language that allows mutually beneficial industry-university collaborative work to proceed within these regulations. The relevant "safe harbors" relate to the overall ownership of project IP, allowances for publication, and the process for accessing the IP resulting from corporate or privately funded research and sponsored projects for commercial purposes. IRS Rev. Proc. 2007-47 allows K-State's industrial partners to be granted a non-exclusive royalty free (NERF) license¹ to inventions resulting from research that they fund, while also providing them the option to gain exclusive right to the technology at commercially reasonable terms. These terms do not trigger the "private use" disqualification for tax-exempt treatment, and they only require the sponsor to assume the costs of protecting the associated invention. Contractual terms relating to commercial licensing are flexible and allow an industrial partner to self-determine their tolerance for risk, by either (1) delaying upfront costs by accepting an option to negotiate commercialization terms once the IP has been developed, its level of maturity in regard to commercial readiness has been identified, and a valuation of all respective intellectual contributions have been determined (inventorship), or (2) allowing for the upfront assumption of reasonable costs of commercialization, based on customary industry rates and practices, in situations where the anticipated research outcomes fall within categories of products that have known rates and practices which are well-established and verifiable. In the event an industrial partner prefers to determine the range of the costs of commercialization upfront to pre-determine anticipated costs, and it is deemed possible to do so within the "safe harbors", K-State's Office of Research and the university's technology transfer office, Kansas State University Research Foundation DBA K-State Innovation Partners, will assist in developing reasonable terms based on customary industry practices. These terms may include upfront technology access fees, longer-term commercial option periods, bonanza clauses, and in some unique situations, pre-determined royalty rates.

Intellectual Property Options within the Public Policy Framework

At the outset of any research and development project, it is impossible to identify individual(s) who may be responsible for an inventive contribution to a specific invention that may lead to a patent filing. Failure to identify the correct inventorship may risk patent validation. Thus, K-State's policy helps to ensure a defensible patent by insisting that invention ownership needs to be in accordance with U.S. patent law and cannot be properly assigned or titled until the invention has been developed and the inventor(s) is/are known. Likewise, as a public institution of higher education, K-State policy prohibits the institution from forcing K-State employees to relinquish their title to inventions to any outside party, however, such rights may be licensed by the university for commercial purposes. As noted above, K-State, as a standard practice, offers first option commercialization rights to project created IP to those entities that sponsored the research and development activity that led to the discovery/development of patentable subject matter. Subsequent license agreements are negotiated by K-State Innovation Partners under good faith efforts and with mutual agreement on terms, which are consistent with the customary industry standards for the applicable technology sector. K-State's commercial partners may decide, at their sole discretion, whether to pursue commercialization of K-State IP developed from projects they fund on a non-exclusive or exclusive basis and within specific geographies and fields of use that best apply to the company's

¹ K-State through its technology transfer office, offers a fully paid-up, non-transferable, NERF license (without the right to sublicense except to Sponsor's affiliates worldwide) to use, make or have made any products or processes containing K-State owned Research Intellectual Property and jointly owned Research Intellectual Property, exclusively for Sponsor's own internal, research and development purposes. K-State will expand the NERF to commercial uses if Sponsor elects to pay a pro-rata share of all patent/patent application and prosecution costs; and executes a confirmatory commercial NERF license.

operations. K-State assumes the position of nurturing long-term relationships and thus, negotiated terms are established in accordance with the “safe harbors” noted above, while also considering the needs and strategies of our industrial partners to successfully compete in the commercial marketplace.

Summary

K-State has attempted to capture a sampling of the applicable regulatory and taxing authority regulations and guidelines that are pertinent to this discussion within this paper. It is recommended that sponsors rely upon their own personnel and judgment in their consideration of these standard public policy mandates which are presented by K-State for the purposes of introducing the background regulations that govern this issue and which establish the rationale behind the stance that K-State must assume in negotiating contract terms with our for-profit collaborators. It is the goal of K-State, and it is assumed that the same holds true for our industry collaborators, that a legally binding and mutually beneficial agreement reflective of industrial business practices and the myriad of governing regulations and statutes, may be prepared and executed between our organizations in a timely manner. K-State officials hope that this document will be helpful in this endeavor by identifying and clarifying some of the constraints that K-State must work within when collaborating with our industrial partners.