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Using Tax-Exempt Bonds to Finance Stem Cell Research

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General Federal Tax Rules

- Bonds issued by a State bear tax-exempt interest
- Exceptions
  - Private activity bonds
  - Arbitrage Bonds
  - Miscellaneous technical rules
- Private activity bonds
  - More than 5% (or $5 million) is loaned to one or more private users OR
  - Both
    - More than 10% (or $15 million) is used in one or more private trade or businesses AND EITHER
    - More than 10% of the bond issue is secured by private payments or property to be used in a trade or business OR
    - Issuer or related party will receive payments from private users greater than 10% or $15 million

Private Use—Research Facilities

- For bond-financed facilities, there are rules relating to private use
- Consider bond-financed research facility
  - Facility of private corporation would be taxable
  - Tax-exempt owned or state-owned facility where private entity has control would be problem
- Certain research contracts not treated as private use
  - Multi-sponsor research with non-exclusive royalty-free license
  - Single sponsor research with exclusive at-market license

Private Use—Bond-financed Research Grants

- Private grantee is "using" grant in its trade or business
  - Special rule for 501(c)(3) organizations
- Even for 501(c)(3) organizations or state institutions, private use will arise upon licensing of technology to private corporations
  - Bond proceeds used to finance a building that is leased
  - If technology is tied back to bond financing, bond proceeds will be allocated to technology
- Note major question here: how is technology attributed to funding?

Private Security/Payments

- Assume there will be private use of bond-financed research. Still must show private security or private payments
- State GOs will not have private security
- However, what happens if State/Grantor share in royalties?
  - No reason to think it would be treated differently from rentals at a bond-financed building
- Note the same result if the grantee/researcher is the state ("State University") and State University licenses technology even if State General Fund gets no payments

Role of "Reasonable Expectations"

- Bonds are private activity bonds if it is reasonably expected at the time the bonds are issued that there will be both more than 10% private use and 10% private payments during the time the bonds are outstanding (the "measurement period")
- What expectations do we have concerning the receipt of any significant revenues from licensing of technology during any measurement period applying to the Stem Cell Bonds?
  - Note that bonds will be issued in various tranches over a number of years
  - Shorter maturities? Multipurpose issue election positives and negatives

What Constitutes a "Payment"?

- Context: tentative policy decision to require some payments in the future
- Suppose State were not to receive direct payments, but mandated some use of future royalties?
  - Requiring that royalties be turned back into more research? (Problem with State University)
  - Requiring that royalties be paid into trust and used to provide future healthcare/research?
  - Requiring that any licensee provide "lowest cost" for access to technology?

Other Payments

- Payments of royalties to the extent they reimburse direct costs?
- Payments of royalties to researchers?

Suffice to Say: There are a lot of unknowns

- Context: Hostile regulator
- Context: Unqualified opinion
- Ability to seek private letter ruling

Taxable Bonds?

- Estimates of additional costs vary
- In large state, like California, may be possible to structure to minimize costs

Policy Decision

- Ultimately, there are a number of policy decisions that go into determining how to run a bond-funded research grant program
  - How to best accomplish the objectives of the voters
  - Whether and how to minimize costs
  - How to further the research efforts
- The additional cost of taxable debt may be taken into account as a factor, but: The Tax Tail Should Not Wag the Policy Dog

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