



ORRICK

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Another State entity which might be covered by SCA 13 is the University of California. Moreover, the definition of "biomedical research" to which Section 9 applies would seem to cover much more than stem cell research. If "other resources" includes laboratory buildings, this new Section 9 could indirectly impact State bonds issued for UC construction of research facilities. The same could apply to the California State Universities. Some of the difficulties we note above with respect to the specific provisions of Section 9 as applied to the Proposition 71 bonds might thus apply to other State bonds.

PART II - TAX LAW ISSUES

As you are aware from our briefings for your office from time to time, one of the principal rules for tax-exempt bonds is that the bonds may not be "private activity bonds." Among other limitations, bonds are private activity bonds if more than 10% of the assets financed by the bonds are used in private business and if the issuer of the bonds receives payments with respect to the privately used assets of more than 10% of the debt service on the bonds, on a present value basis. In many circumstances, these 10% amounts are limited to 5%, and for large bond issues (larger than \$150 million), these 10% amounts are capped at an aggregate amount (of assets or payments) of \$15 million for the entire bond issue.

* [In an earlier memorandum outlining our initial analysis of Proposition 71, we advised you that it was likely that intellectual property rights (e.g. patents) derived from research which was financed from proceeds of State bonds would be treated as assets financed by the bonds. Therefore, if private industry licenses the patents to produce drugs or therapies and the State receives royalties, we have a situation where bond financed assets are arguably used in a private trade or business, and the State will receive a payment in respect of that asset from private industry. In our earlier memorandum, we identified this issue but indicated the exact impact on future bonds would depend on the details of the intellectual property arrangement which CIRM would include in its grants. Among other things, Proposition 71 as originally enacted did not appear to mandate that the State receive royalties in all cases, nor did it indicate any "target" for how much money the State would seek to recover from intellectual property rights.

SCA 13 would make it clear that royalty provisions in favor of the State would be standard in all grants, and that substantial private payments could result from a successful discovery. This would definitely make it more difficult to structure bonds under Proposition 71 which would bear tax-exempt interest. We note that the particulars of each bond issue, both in terms of the expected uses of bond proceeds (not all of the Proposition 71 moneys will fund research grants leading to patents) and structuring details (such as the \$15 million allowable private activity use for any single bond sale), will have to be examined, so that some bonds possibly could be issued on a tax exempt basis. We might, furthermore, seek Internal Revenue Service guidance on certain aspects of the bond program. However, at this time we can give you no assurance that the bulk of Proposition 71 bonds can be issued on a tax-exempt basis if SCA 13 is adopted.