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Re: Consultation on Creating a Patent Box Regime – Deloitte LLP’s Comments

We are writing to provide our comments on the consultation paper entitled “Creating a Patent Box Regime” released by the Department of Finance (“Finance”) on January 31, 2024. We appreciate the fact that Finance has released a consultation paper to gather feedback on the introduction of a patent box regime (the “regime”) and believe that this affords stakeholders with the opportunity to provide input based on their experience and practical insights. We believe this approach will foster a greater understanding of the benefits and issues associated with a patent box regime.

Deloitte and its affiliated entities constitute one of the largest professional service firms in Canada. We work with many taxpayers, ranging from individuals and private businesses to Canadian and global multinationals, to advise and support them in their compliance obligations under the *Income Tax Act*.¹

We are encouraged that the government is exploring the potential introduction of a patent box, as not having such a regime could put Canada at a competitive disadvantage as other countries continue to implement and support these incentive regimes. Currently, the patent box regime is a tax policy instrument used by 13 European Union member states, the United Kingdom, Switzerland, China, South Korea, and others. The United States, while lacking a formal patent box regime, has preferential tax rates for certain foreign derived intangible income (FDII), which can include similar scope activities. Furthermore, within Canada, provincial governments have begun implementing patent box regimes. For example, Quebec has already implemented its own patent box regime called the *Déduction incitative*

¹ Unless otherwise indicated, all section references are to the *Income Tax Act* (Canada), RSC 1985, c. 1 (5th Supp.) as amended (the “Act”) or the regulations thereto (the “Regulations”).

pour la commercialisation des innovations du Québec (DICI or Quebec's incentive deduction for the commercialization of innovations) for innovative companies in Quebec.² Currently, the effective tax rate on eligible intellectual property (IP) related income can be as low as 2% compared to the Quebec province's general corporate tax rate of 11.5%. Saskatchewan also has an incentive similar to a patent box called the Saskatchewan Commercial Innovation Incentive.³

Patent box regime observations, recommendations, and considerations (summary)

The expected forthcoming introduction of the Pillar Two rules presents an opportunity for Canada to revisit its long-standing approach regarding patent boxes while potentially modernizing the Scientific Research and Experimental Development (SR&ED) regime. It is our view that the two regimes would be best served together, with the SR&ED applying to the innovation phase of IP, while the patent box applies to the commercialization phase of such IP. It is crucial that the government legislate patent boxes to ensure that tomorrow's Canada is competitive and is a place where the development and commercialization of eligible assets result in the retention of IP in the country, thereby generating economic benefits which all Canadians can enjoy.

The proposed patent box tax regime should find its basis in the following key principles: it should be simple and adapted to the different challenges faced by small and medium-sized enterprises (SMEs) and multinational enterprises (MNEs), fair and promote economic activity in Canada.

For purposes of simplicity and adaptability, we recommend that the patent box include several provisions to simplify the process for SMEs. Furthermore, the potential to use multiple calculation methods to determine the eligible IP profit will allow companies to choose the method most suitable for their own business model.

In addition, it is understandable that a larger enterprise that would benefit more from a patent box (in absolute dollar amounts) has additional requirements to ensure the overall integrity of the system with our proposed modular approach. Thus, the greater the patent box benefit, the greater the level of scrutiny will apply.

We also believe that the government should use the existing SR&ED program as leverage to determine the modified nexus approach⁴ and to perform R&D tracing, in the form of the definition of projects.

Naturally, the patent box must also be fair. A balance must be struck between entities that are subject to Pillar Two compared to those that are not, while considering the Canadian tax system as a whole. The proposed dual rate deduction ensures that MNEs are treated equally with SMEs.

MNEs, with their often large corporate structure, should also be allowed to benefit from a "consolidated" IP approach, where IP created by a related entity should allow for a patent box for the group as a whole,

² For more information on this measure, see [Dédution incitative pour la commercialisation des innovations au Québec](#).

³ See [Saskatchewan Commercial Innovation Incentive \(SCII\)](#).

⁴ As defined by the Organisation for Economic Co-operation and Development (OECD) in "[Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance, Action 5 - 2015 Final Report](#)," OECD/G20 Base Erosion and Profit Shifting Project (Paris: OECD Publishing, 2015) (hereinafter referred to as the "OECD guidance").

as long as the asset was developed in Canada. This represents a shift in focus from the current modified nexus approach, which does not consider R&D expenditures from related companies. We would also suggest a modification of the treatment of subcontractors in the modified nexus approach. The current model, proposed by the OECD, considers all subcontractor costs to an unrelated third party to be eligible in the determination of the nexus, regardless of their jurisdiction as the knowledge/IP created should all remain with the payer (in Canada). To promote the use of Canadian companies, we would exclude costs related to subcontractors from other countries and only allow costs from Canadian subcontractors in the calculation of the modified nexus.

As direct patent acquisitions from unrelated parties are not permitted for a patent box, anti-avoidance rules should also be implemented to prevent the acquisition of a company with a primary purpose to obtain access to their patent box. Such a mechanism could be similar to loss restriction rules and be triggered by way of an acquisition of control of the ultimate owner of the IP. With this proposed measure, any IP eligible for the patent box that is disposed of to a third party would become ineligible for the patent box regardless of the acquisition method.

Another perspective on fairness would be that stakeholders should have access to clear and timely advance eligibility rulings and guidance from revenue authorities responsible for the program.

We also believe an efficient patent box would incentivize the harnessing of IP in Canada, with an enhanced rate for businesses that have a significant economic impact on the economy. For example, a company that exceeds a certain threshold of employee expenses and tangible assets used in Canada would benefit the most from the patent box with an enhanced rate. Otherwise, the company would only benefit from a limited patent box equal to the global minimum tax of 15%.

Legal costs and corporate strategy are considerations that companies take into account when they choose not to formally register their research in a patent. In this sense, a company's economic footprint extends beyond its patents and should be rewarded as such. A broad definition of eligible assets should be considered to further enable and reward companies that advance research. This could include assets such as patents, software, certificates of supplementary protection, plant breeders' rights, and circuit topography protection.

Upon divestiture of the IP, the resulting capital gain (if any) should not create eligible IP income. It may be included in the patent box if the company has previously commercialized its IP in Canada and previously generated sufficient income (and taxes). This, in turn, should limit the exportation of IP to foreign jurisdictions and provide an incentive to maintain IP in Canada.

Finally, for simplicity and to reduce the cost of the measure, companies should be able to opt out of the patent box.

These recommendations are critical for the success and prosperity of Canadian businesses. Therefore, we urge the government to implement these improvements to create an environment that emphasizes the critical need for business investment in Canada to improve labour productivity. We have provided more

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detail on each of these aspects, as well as on specific questions from Finance as part of the formal consultation process, in Appendix 1.

We are committed to playing a key role in shaping Canada's future and we hope that our recommendations will provide helpful guidance as you consider how best to implement a patent box regime. We would be pleased to meet with you, or other officials from the Department of Finance, to discuss our submission further.

We consent to the disclosure of our comments under the *Access to Information Act* and have made a copy of our submission available on our website at www.deloitte.ca.

Sincerely,

A handwritten signature in blue ink that reads "Deloitte, LLP".

Rob Jeffery, CPA, CA

National Tax Policy Leader

Deloitte LLP

APPENDIX 1 - Consultations on Creating a Patent Box Regime

Detailed submissions related to the key questions for consideration

1. In contrast to its international peers, Canada has a net balance of payments deficit (receipts minus payments) on charges for the use of IP that has grown over the last two decades. In other words, businesses in Canada outlay more to entities in other countries for the use of IP than they receive from international sources for the same purpose. What sort of dynamics might be underlying this trend? What factors have contributed to Canada's negative balance?

We are choosing to focus our comments on taxation matters in our submission, and do not have specific comments for this question.

2. Would implementation of a patent box regime improve Canada's competitiveness as a location for developing, commercializing, and retaining ownership of IP? With respect to competitiveness as a location for developing IP, how would support through a patent box regime compare to support provided through the SR&ED program?

Question #2 will be answered along with Question #3 below.

3. How important are tax considerations in decisions regarding where to commercialize IP and where to locate IP? Which factors besides tax rates impact businesses' decisions around where to locate and commercialize IP derived from R&D conducted in Canada? How should the Department of Finance account for these factors in determining how businesses might alter their behaviour in response to implementation of a patent box regime?

To understand how a patent box would impact Canada's competitiveness as a location for developing, commercializing, and retaining ownership of IP, it is important to consider the interplay between tax considerations and the IP location and determination process.

Impact on competitiveness

In recent years, we have seen a shift in corporate behaviour. At one point, the location of IP was largely tax driven. However, with the introduction of the Base Erosion and Profit Shifting (BEPS) project,⁵ the tax considerations, while still important, are no longer the primary driving factor. For example, the patent box may have an impact on foreign direct investment (FDI), as it may help to attract foreign companies seeking to establish a first foothold in North America. As such, the tax consideration will not be the primary deciding factor for that foreign company in determining when and where to expand. The patent box will more likely have an impact on whether this foothold is first located in Canada or in the

⁵ OECD/G20, [Base Erosion and Profit Shifting Project](#).

United States. Other considerations will include tax incentives (R&D, patent box, statutory rate, capex acquisition incentives, etc.), quality of labour, free trade, etc.⁶

In other instances, where a business simply wants to establish a sales office in North America, the attractiveness of the patent box would be considerably reduced. This is because the parent company is likely to retain the IP, as the business need is focused only on commercialization and not on the relocation of various functions such as R&D, production, and sales.

The implementation of a patent box may also help with the retention of IP within Canada in the case of an outbound international expansion. For example, a Canadian company looking to expand its business in Europe or in the United States will have an advantage by keeping any existing IP in Canada as it will not be eligible for the other country's patent box because of the modified nexus approach. In addition, foreign companies that benefit from the current SR&ED program to develop IP at a low cost will be enticed to keep their newly developed IP within Canada. In other words, with the introduction of a patent box in Canada, the foreign company would have limited benefits from disposing of its IP to its parent company as that IP would only be eligible in the country in which it was developed. With this fact pattern, only the Canadian company could claim the patent box preferential tax rate on the global revenue attributable to its IP as long as the IP remains in the Canadian corporation. Canada would benefit from this as an additional tax revenue stream; without the patent box, this IP may very well have been expatriated to the parent's country of origin or in a country with a lower income tax rate.

Furthermore, the regime would complement the SR&ED investment incentives with tax benefits on income from the commercialization of IP, thereby promoting a full innovation lifecycle within Canada. A patent box would encourage the transition from R&D to commercial phases, thereby enhancing the economic output from innovations within Canada.

Also, amidst the global trend of tax rate reduction and increased tax competition,⁷ Canada's adoption of a patent box could be a strategic move. It would not only emphasize the importance of IP,⁸ but also enhance Canada's competitive position in the global marketplace.

Comparison with the SR&ED program

The SR&ED program and the patent box both share similar goals of fostering innovation and IP development within Canada. However, the nature of their government support differs in timing and focus. SR&ED mitigates the financial risks of R&D by providing tax credits for eligible expenses, potentially leading to IP development. The patent box, on the other hand, offers tax advantages post-innovation that encourage the profitable exploitation of R&D outcomes.

In terms of scope and impact, the SR&ED program has a broader reach by supporting a variety of R&D activities across industries to foster a culture of innovation and IP development. Conversely, the patent

⁶ Simon Munongo, Olusegun Ayo Akanbi, and Zurika Robinson, "Do tax incentives matter for investment? A literature review" (2017) 13:2 *Business and Economic Horizons* 152-168.

⁷ Tax Foundation, "[Corporate Tax Rates around the World, 2022](#)," December 13, 2022.

⁸ Intellectual property account for more than 90% of the S&P 500 total assets. See Martin Jarzebowski, "[As Intangible Assets Grow, So Does The Role Of ESG Standards](#)," *Forbes*, December 29, 2020.

box is more targeted, focusing on the economic gains from IP and encouraging its commercialization within Canada.

The addition of a patent box to the existing SR&ED program could prove to be highly beneficial. This addition would not only extend the scope of support to the post-innovation stages, but also further incentivize the commercialization of R&D outcomes. By rewarding successful market-driven innovation, a patent box can stimulate economic growth and strengthen Canada's competitive edge in the global innovation economy.

These two incentives complement each other very well. When implemented in parallel, they cover the entire innovation lifecycle, from support for R&D expenditures (SR&ED) to commercialization of IP (patent box). This dual approach incentivizes both the creation and monetization of IP, bolstering Canada's position in the global innovation economy.

Finally, the strategic focus of each program is distinct yet complementary. SR&ED supports a wide range of innovation activities, emphasizing R&D expenditures without requiring a direct link to commercial success. The patent box, on the other hand, specifically rewards the successful commercialization of R&D, shifting the focus towards market-driven innovation outcomes. Together, they create a comprehensive support system for innovation in Canada, fostering a stronger and more dynamic innovation ecosystem.

As noted above, tax incentives are often seen as one of many factors when considering the IP location. With the introduction of the patent box, the innovation tax incentive cycle would be fully covered, from the innovation cycle (i.e., SR&ED) to the commercialization cycle (i.e., the patent box). While the SR&ED program encourages the development of IP, the patent box would incentivize the commercialization of that IP. It is therefore critical to view both incentives as complementary rather than competing.

4. What would be a competitive combined federal-provincial/territorial tax rate under a Canadian patent box regime?

The effective tax rate of the patent box regime will be an important factor in determining the overall cost of the regime and to incentivize taxpayer behaviour. The optimal tax rate would need to strike a balance between incentivizing corporations to hold the IP within their Canadian subsidiary without over-subsidizing innovation through a lower than necessary tax rate.

In setting this optimal tax rate, the government should consider any provincial incentives. For simplicity, especially as it pertains to benchmarking in relation to the global minimum tax, we have focused our comments on a combined federal/provincial effective tax rate. Furthermore, the rate of tax should be compared to other reduced rates available for activities that the government has chosen to incentivize from a policy perspective (e.g., clean technology manufacturing, which is set at 50% of the ordinary federal corporate tax rate). We have two main concerns related to the determination of an "optimal" tax rate.

First, the government may find this tax rate to be lower than the global minimum tax rate of 15% (as required by Pillar Two, which would be expected to affect the largest global multinational corporations). As such, when comparing MNEs with SMEs, corporation groups subject to the global minimum tax rate

could be put at a disadvantage compared to corporate groups not subject to such rules. In other words, the optimal tax rate should be aligned with the Pillar Two rules so as to not ill-affect MNEs.

Second, the economic benefits associated with the patent box should be considered in determining the optimal tax rate. The system's emphasis on percentages rather than actual spend can distort outcomes. Patents developed at low cost can be fully eligible for the patent box, while a company with high economic impact using affiliates may receive less favourable rates. Furthermore, companies may focus only on developing high-value patents to meet the nexus approach without relocating much research, allowing companies with low economic impact in Canada to gain favourable patent box rates from high-efficiency patents. Therefore, in addition to the percentage of expenses incurred in Canada, the *quantum* of actual expenses spent in Canada, and not just the percentage, should be considered.

To address these concerns, we propose a patent box that could be variable based on different circumstances and inputs. This tax rate could be modulated taking into account international policies, such as Pillar Two, specifically the substance-based exclusion. Certain income of in-scope entities may be carved out of Pillar Two based on the substance-based test which is the sum of the value of 5% of the tangible asset and 5% of the payroll expenses for a given year. The amount obtained would be carved out of its income for Pillar Two purposes as the entity will be deemed to have genuine activities in the said jurisdiction (subject to various exceptions).

Considerations should be given by the government to determine the patent box tax rate that would best align with the actual economic impact that an entity has in Canada, e.g., its genuine economic impact, as measured by the substance-based test. Naturally, an entity with a higher economic impact could be entitled to a better patent box tax rate. This would ensure that the proposed regime is competitive while remaining aligned with Pillar Two rules.

For example, the tax incentive could be divided into two distinct portions:

1. An **enhanced patent box rate** of 10% combined federal/provincial rates (i.e., a 63% reduction from an assumed 26.5% combined federal/provincial rate) on the amount of carved-out income previously calculated (i.e., income that meets the substance-based test); and
2. A **regular patent box rate** of 15% combined federal/provincial rates (i.e., a 43.4% reduction) on any income in excess of the amount allowed at the enhanced tax rate.

In setting the enhanced patent box rate, consideration should be given to being competitive with other patent box regimes or similar export driven incentives, including preferential tax rates on FDI income in the United States. Furthermore, the in-scope activities will need to be considered to ensure that the expected total tax expenditure yields the expected behavioural responses from taxpayers.

When considering these two tax rate portions, the patent box regime may still create a Pillar Two top-up tax as the effective tax rate may fall below 15%, but the use of two rates, with one being the minimum global tax rate, will significantly reduce the spread between companies where Pillar Two is applicable, especially compared to other patent boxes that offer a rate in the single digits. While a lower rate could be considered, care should be taken to ensure overall affordability while maintaining competitiveness with relevant comparative economies. In this case, the Pillar Two top-up tax would create a major distortion between MNEs just below the Pillar Two threshold.

It is important to note that the patent box deduction should be limited by certain factors to ensure that a company is actually making IP profits. A simplified calculation will be provided as an example in our response to Question #7.

In addition, the narrow breadth of the enhanced tax rate would limit the cost of the tax measure as this rate would be restricted to businesses with genuine economic impacts in Canada. This rate would also ensure fairness of the tax policy as MNEs would not be at a disadvantage compared to SMEs. Similar to the SR&ED tax credit, the calculation of the limit for the enhanced rate should be done on a consolidated basis for Canadian corporations in a given group.

Another important carve-out of Pillar Two is the treatment of a refundable tax credit. Therefore, the government could even consider using a refundable tax credit and a deduction jointly to further alleviate the impact of the potential of the Pillar Two top-up tax, recognizing that this would provide a higher tax expenditure towards larger organizations. The overall cost of the support for R&D needs to be carefully considered in the context of any SR&ED proposals.

5. The Action 5 Final Report identifies the IP assets that are in-scope of a nexus compliant approach. Should all these assets be eligible for a potential patent box regime in Canada? Are there differences in business practices with respect to different types of IP assets that should lead the Department of Finance to expect that commercialization and IP location decisions for each asset would respond differently to a patent box regime?

With the Action 5 Final Report, the potential scope of assets was restricted to three distinct categories:⁹

1. Patents and functionally equivalent IP assets that are legally protected and subject to approval and registration processes;
2. Copyrighted software; and
3. Other IP assets that are non-obvious, useful, and novel (limited to SMEs).

Action 5 also strictly prohibits the use of trademarks and logos. We believe that a broad scope of IP including patents, functionally equivalent IP, and software would be appropriate for the Canadian ecosystem.

Furthermore, Finance should be aware that the nature of business practices may vary depending on the type of IP asset. However, the modified nexus approach and BEPS project standards should confine the influence on IP location decisions for each asset type, as eligibility requires that all assets be developed in Canada. Therefore, regardless of the IP asset type, the response to a patent box regime in terms of commercialization and IP location decisions should be similar, given the consistent requirement for in-country development.

- **Patents:** Patents should be eligible for a patent box regime in Canada. We have identified three key characteristics to help determine the scope for patents.

⁹ OECD, Action 5 - 2015 Final Report, supra note 4, at 26.

First, the government should decide whether to limit the patent box to Canadian patents as opposed to allowing international patents to be claimed. We recommend that the government include foreign patents as this could be a key element in reducing the IP imbalance specifically targeted by Finance.

Secondly, the government should decide whether the patent box will apply to pending patents or only to granted patents. Looking at other countries with a patent box regime, the United Kingdom has chosen to limit eligible patents to those that are *actually* granted.¹⁰ This approach reduces the administrative burden on the government, as there is no clawback to recover incentives on patents that were ultimately not granted. A downside of this position is that the company may have to wait several years before it can claim the patent box incentive, as it waits for the patent to be formally granted by the relevant authority. If the patent is confirmed, a company would have to refile previous tax returns to claim the incentive, which can bring an administrative burden, and may be outside of the normal period of reassessment. The United Kingdom resolved this issue by implementing a system which allows an entity to claim up to six years of the tax benefit it would have received if the entity had been granted access to the patent box tax rate when it first applied for the patent in the year when the patent was granted. This approach differs from the one taken by Belgium where the patent box tax rate can be claimed as soon as the company files a patent application for its IP.¹¹ As both methods have benefits and drawbacks, we believe the government should tailor the patent box based on the focus they want to have. If the key aspect is to rapidly provide support to companies and to simplify the process for the taxpayer, Belgium's approach would be more appropriate. On the other hand, if the focus is more on the reduction of cost to administer the measure, it may be more appropriate to use the UK model as it would remove the need for any clawback.

Lastly, the government should determine whether the patent box will apply retroactively or only to patents granted or applied for after a certain date, such as the date of Royal Assent of the enabling legislation. For example, Quebec has limited the application of the DICI to patent applications filed after March 17, 2016, and to protected software after March 10, 2020.¹² We believe that the government should not limit the eligibility to a specific date prior to the introduction of the patent box or to the date of its enactment. With the introduction of the modified nexus approach, any potential date limit to claim the patent box should be determined by each entity's internal ability to track its own development costs. Since the modified nexus approach requires the ability to track and calculate the development of the IP, even without any dates most companies will be limited by their own internal records. Thus, if a company wants to claim the patent box on a patent dated 2012, and if it can demonstrate that the development took place in Canada, it should be eligible for the patent box. This approach will ensure that an early innovator and an MNE that have shaped the Canadian economic ecosystem are not put at a disadvantage against start-ups. New patents and R&D should be supported through other incentives, such as SR&ED.

¹⁰ HM Revenue & Customs, "[Guidance – Use the Patent Box to reduce your Corporation Tax on profits](#)," January 1, 2007, last updated May 7, 2020.

¹¹ For more information, see Brantsandpatents, [Belgian Patent Box](#).

¹² Supra note 2.

- **Asset functionally equivalent to patent:** The OECD guidance provides a broad definition of a patent.¹³ Therefore, other assets like utility models, IP assets that grant protection to plants and genetic material, orphan drug designations, and extensions of patent protection may be included in the patent box. We believe that a broad scope of assets would better represent the different types of IP used by Canadian businesses. We believe that the patent box should also include, but not be limited to, the following assets: certificates of supplementary protection, plant breeders' rights, and integrated circuit topography protection.
- **Software:** The second category of assets, proposed by the OECD, which can be included in the patent box, is copyrighted software as it shares many similarities with patents. With the shift in the economy towards greater reliance on software and the rise of artificial intelligence (AI), we believe that the inclusion of software can stimulate innovation, reflecting technological advancements and economic priorities.

Exclusion from the Canadian patent box

- **Category 3 (other assets that are new, non-obvious, and useful):** Based on the OECD guidance,¹⁴ these assets can only be included for SMEs and there should be a transparent certification process performed by an entity other than the tax authorities. This would add another administrative layer and could create an unnecessary divide between MNEs and SMEs. Instead of allowing these assets, the focus should be on creating a calculation method to indirectly include these assets when they are related on an eligible IP of an MNE or SME. For example, if a product consists of five trade secrets and one patent, the concepts discussed in Questions #7 will include the trade secrets as long as they are new, non-obvious, useful, and result from an R&D project originating in Canada.
 - **Trademarks, logos, marketing assets, and third-party acquired assets:** As per the OECD guidance,¹⁵ these assets must be excluded from any IP regime. We strongly believe that the focus of the Canadian patent box should be on technological innovation, not branding or marketing efforts. Furthermore, the exclusion of these assets is critical to ensuring fair taxation between nations.
6. If Canada were to implement a patent box regime, compliance with the nexus approach would require businesses to report detailed information around expenditures incurred in the development of eligible IP, similar to requirements in place under regimes in other jurisdictions that are compliant with the nexus approach. Drawing on experience with nexus-compliant regimes in other jurisdictions, please share any comments on challenges and best practices in this regard.

Question #6 will be answered along with Question #7 below.

¹³ Supra note 4, at 26.

¹⁴ Ibid.

¹⁵ Ibid., at 26-27.

7. Are there design features of a patent box regime that the Department of Finance should consider specifically to limit new fiscal costs to the government?

We believe that the modified nexus approach, proposed by the OECD, should be slightly tailored in light of the specific issues and challenges identified by other countries that have already implemented this approach. It is important to note that the core concept of the modified nexus approach is to ensure fair international taxation. As such, even with the modifications proposed herein, the core concept of the modified nexus approach will remain. The main objectives of the modifications are to simplify the calculation for SMEs, to better reflect the realities of MNEs, and to incentivize Canadian stakeholders to create eligible IP in Canada.

- **Calculation of development costs on a Canadian consolidated basis:** MNEs often have a complex corporate structure which may lead to different subsidiaries developing different IP in silos. In addition, the IP is sometimes isolated in a separate entity for legal protection purposes. In other cases, the corporate structure will consist of a sales office (which will commercialize the IP) and an R&D cost centre specific to the development of IP. As currently presented, the modified nexus approach proposes to perform the calculation on a company-by-company basis, thus excluding any R&D costs from a related party. We believe that a consolidated approach calculated for each tax jurisdiction would better reflect the complex corporate tax structure of MNEs. The intended goal would be to isolate the development costs incurred in Canada from foreign development costs.
- **Anti-avoidance rules regarding acquisition of control (AOC) outside of the affiliate group:** In recent years, Europe has seen companies being acquired primarily to exploit their patent box eligibility. Rather than acquiring an asset, which would not qualify for the patent box, companies are choosing to acquire the entire company, which would qualify, as the asset will still be exploited by the same company. This practice, while legal, undermines the intent of the patent box regime.

We believe anti-avoidance rules regarding an AOC should be implemented to curb this practice without hindering legitimate asset transfers between related companies. To ensure fairness, we recommend that any AOC event affecting the ultimate IP owner should trigger a patent box reset, rendering the indirectly acquired IP ineligible.

For example, within an affiliated group, the IP should be allowed to move freely as the parent company remains the ultimate beneficiary. A definition similar to the concept of affiliation as described in section 251.1 of the Act, or “eligible group entities” as defined in subsection 18.2(1) of the Act, may be appropriate. Further, an additional limitation could be contemplated with restrictions imposed upon a loss restriction event as defined in subsection 251.2(2) of the Act.

However, if the parent company sells the subsidiary to a third party, the ultimate beneficiary changes, therefore rendering the IP inadmissible for the subsidiary. This scenario is treated as if the asset had been sold to an unrelated third party given the change in the ultimate beneficiary.

This nuanced approach can help preserve the integrity of the patent box regime while allowing for legitimate business transactions.

- **Change in the eligibility of foreign subcontractor costs:** In the proposed modified nexus approach, any subcontractor cost would be eligible, regardless of whether it originates in Canada or in other jurisdictions. The rationale is that the IP and know-how will likely flow to the Canadian entity. While this may be true, we believe that the nexus criteria should focus on actual costs incurred in Canada. This change will further incentivize Canadian businesses to use Canadian subcontractors rather than foreign subcontractors and could facilitate the creation of spillover in Canada.
- **Calculation of development costs adjusted to mirror the Canadian SR&ED program:** To reduce the complexity of the calculation, we recommend mirroring the modified nexus calculation with the SR&ED program calculation. For example, subcontractor costs would still be limited to 80% in the calculation to encourage in-house development.
- **Uplift:** The modified nexus approach allows for a potential 30% uplift on qualified expenditures to account for acquisition costs and IP development. Since every country with a patent box included a maximum uplift of 30%, the Canadian patent box should have the same uplift to not be at a disadvantage.

By making certain adjustments to the modified nexus approach, we are confident that Canada could achieve a more accurate reflection of economic realities while simplifying the nexus calculation process. Our suggestions are based on the best practices and obstacles that other countries have encountered with the modified nexus approach. It is crucial to recognize that the OECD's recommendations are intended to set a standard for mitigating harmful tax practices. Ultimately, the entire Canadian regime will be subject to a peer review process, including the changes we have proposed herein. We strongly believe that even with these adjustments, the Canadian regime will retain its status as non-harmful because it is directionally the same as the modified nexus approach and will prevent harmful tax practices.

- **Calculation of the modified nexus ratio by product or revenue stream:** The calculation of the modified nexus approach should be based on the cumulative R&D attributable to each revenue stream or by product type. This will ensure a more representative approach than looking only at the eligible IP, as there may be multiple layers of other imbedded IP that would apply to a single revenue stream or product. It would also provide a way of including trade secrets and other intangibles.

Moreover, businesses are not always, economically speaking, tempted to register their trade secrets through the formal legal patent system. There are two main reasons for this:

1. Legal costs and time constraints of going through the patent legal process, especially when numerous IP assets are involved, for both the taxpayer and the government agency assessing those patent claims.
2. Some businesses are reluctant to potentially opening the door to their trade secrets. Simply put, the patent that is accessible to third parties can be reversed engineered, relied upon, or otherwise heavily inspired upon by competitors. Businesses view certain patent claims, and risks associated thereto, as having the potential to limit their competitive edge.

Therefore, our recommendation is to expand the patent box beyond the patent-only patent box. The OECD recognizes this need, but only applies it for SMEs. As such, many patent boxes have started to indirectly include trade secrets in the calculation of eligible IP profit. This inclusion is mainly due to the use of the revenue stream or product when the IP cannot be isolated. For example, in a complex good like an aircraft engine, there may be hundreds of patents and thousands of trade secrets. By calculating the profit on the entire engine, this allows the company to indirectly include some of its trade secrets. We believe that this broad inclusion of eligible IP should also be allowed in Canada, but it would need to be closely monitored as some businesses may strategically patent certain inventions developed in Canada while purposely leaving other inventions underdeveloped. To alleviate this risk, we recommend that all R&D projects that are related to a particular revenue stream or product be considered as a whole, rather than just the eligible IP. This broader scope of inclusion would ensure that any trade secrets indirectly included in the patent box are also developed in Canada, as opposed to other foreign jurisdictions.

- **R&D and patent box calculation:** R&D is generally undertaken with a specific goal in mind, which may be the enhancement of an existing product or the development of a new product. As such, we believe that all qualifying R&D projects should be taken into account in the calculation of the modified nexus approach and the related eligible profit or to potential future IP.
- **R&D tracing:** Our proposed approach to R&D tracing is to leverage the existing SR&ED program for simplicity. The R&D tracing should be divided by using the R&D project as a base point. The company that wants to claim the patent box must categorize all its R&D projects by potential IP or group of IP or function as the case may be. The goal is to be as precise as possible, although the OECD recognizes that it may be impractical in some situations to perform an exact tracing by IP.¹⁶ Finance could provide guidance and examples of what would be considered acceptable and examples of where a full IP tracing must be performed. In addition, it is imperative that all R&D costs incurred outside of Canada be traced back to its related IP group to calculate the nexus ratio of each IP group. In many cases, tracing by IP will be possible from an R&D perspective but may be challenging in terms of matching the R&D project with the revenue stream or product. Therefore, we believe the tracing should be aligned with the business need rather than the R&D project.
- **Calculation of the eligible IP income:** Determining the profit associated with an intangible asset has always been complicated. If we want the new patent box regime to reach its objectives, this determination must be as simple as possible. One of the common approaches is to use transfer pricing methods to determine the fair market value of the asset. In our experience, this method of calculation can be useful, but it also has some important challenges. For example, this method is not suitable for SMEs, as the cost to determine the fair market value of the assets and their respective revenue share can be quite intensive and very costly. Furthermore, this approach is often disputed with tax authorities as it can be difficult to isolate the fair market value and the CRA may calculate a different value than the one calculated by the company.

¹⁶ Ibid., at 30-34.

Another commonly used method is called the cost-plus method. With this approach, the company starts with the gross income from its eligible IP and removes the costs for creating and commercializing that IP (ranging from development, material, labour, sales cost, etc.). Even if we remove all those costs, this method recognizes that the company should have a routine profit embedded in the IP profit. To remove this routine profit, this method increases certain costs by a factor. For example, in the United Kingdom, the following cost are increased by 10% to account for this routine profit: capital cost allowances, premises cost, personnel costs, plant and machinery costs, professional services and other miscellaneous services.¹⁷ The United Kingdom also has an intersecting approach to further remove any marketing or trademarks embedded in the IP profit.¹⁸

- Option 1: Transfer pricing methods are used to determine the fair market value of the marketing asset and this is removed from the eligible IP profit.
- Option 2: Simplified method for SMEs. As previously noted, the United Kingdom also recognizes that applying transfer pricing concepts may be difficult for SMEs so, below a certain revenue threshold, the company can remove 25% of its eligible IP profit to represent the amount related to trademarks and marketing asset.
- Option 3: A *de minimis* exclusion. If the company can demonstrate that the impact of trademarks and marketing asset embedded in its eligible IP is less than 10%, the company will not have to make an adjustment to its eligible IP profit.

A third method called the peel-off method, which is used in the Netherlands, could also be considered for a Canadian patent box. Unlike the cost-plus method, the peel-off method uses the earnings before interest and tax as a starting point. The company then identifies a percentage of profit related to other functions (such as entrepreneurship, sales, production), and removes this routine profit from its eligible profit to isolate the profit related to the R&D function. A functional analysis is required to determine this percentage.^{19 20}

Finally, the Netherlands also has a simplified method called the flat rate method. As the name suggests, this method considers 25% of the overall profit of the company to be eligible for the patent box. As this method should be reserved for startups and very small companies or in cases where it is impossible to calculate the eligible IP profit, this method is capped at EUR25,000 per year. The inclusion of this method in the Canadian patent box can be debatable. This calculation could provide

¹⁷ HM Revenue & Customs, "[CIRD220440 - Patent Box: relevant IP profits: routine return figure: routine deductions](#)," in *HMRC internal manual: Corporate Intangibles Research and Development Manual*, published on March 11, 2016 and last updated on April 3, 2024.

¹⁸ HM Revenue & Customs, "[CIRD220490 - Patent Box: relevant IP profits: marketing assets return figure](#)," in *HMRC internal manual: Corporate Intangibles Research and Development Manual*, published on March 11, 2016 and last updated on April 3, 2024; and HM Revenue & Customs, "[CIRD275200 - Patent Box: streaming calculation steps continued CTA10/s357BF as modified by s357BQ](#)," in *HMRC internal manual: Corporate Intangibles Research and Development Manual*, published on March 11, 2016 and last updated on April 3, 2024.

¹⁹ Daniel Klein Velderman and Matthew van Zijl, "[Dutch Tax Incentives for Innovation: Enhancing your Investment Case](#)," November 10, 2022.

²⁰ SEO Economic Research and Dialogic, "Evaluation of the Innovation Box 2010-2019 Target Group Reach, Effectiveness and Efficiency," report commissioned by the Ministry of Economic Affairs and Climate Policy and the Ministry of Finance of the Netherlands (Amsterdam: Seo, 2023).

small companies with an easy and simple method to calculate their patent box income. On the other hand, it would likely increase the overall fiscal cost to the government as it may encourage small companies that would normally have waited until they have more revenue to claim the patent box to use this method and to claim the patent box earlier. Furthermore, this estimation may be completely off the actual value of the IP profit. Depending on the level of support the government wants to provide to small companies, it should decide whether a similar approach may be beneficial in the Canadian patent box.

As the calculation of the eligible IP profit can vary from one company to another, we believe that a broad approach similar to the Netherlands, where four calculation methods are available to determine the eligible IP profit, would be beneficial. This would allow companies to choose the most appropriate method depending on their business model.

Another option that may be considered by the government is to use a calculation system based on the complexity and size of the claimant. For example, a small company may have the option to use a simplified method (or any more complex method), a medium-sized company may have the option to use the cost-plus or peel-off method (or any more complex method), and finally, MNEs may be required to use transfer pricing concepts to determine the eligible IP profit.

The method used to calculate the IP profit will have a significant impact on the fiscal cost of the patent box and on the use of the tax incentive. A strict calculation method may limit the application of the patent box and reduce some of its impacts, such as IP retention. While, the opposite, a patent box with a flexible approach similar to the Netherlands, would provide flexibility that can also be tailored for SMEs with simplified calculations.

- **Limitation to the adjusted taxable income:** It is important to note that the patent box deduction should be limited by certain factors to ensure that a company is actually making IP profits. For example, we suggest that the enhanced rate (as described in our response to Questions #4) should be limited to the lowest amount between:
 - i. The cumulative eligible IP profit, which is the sum of
 - The cumulative eligible IP profit from the previous year
 - Profit from revenue stream 1 (calculated using one of the methods described above) * modified nexus of revenue stream 1
 - Profit from revenue stream 2 (calculated using one of the methods described above) * modified nexus of revenue stream 2
 - Profit from revenue stream 3 (calculated using one of the methods described above) * modified nexus of revenue stream 3
 - And so on;
 - ii. The adjusted net income before the application of the patent box, which is adjusted to isolate the portion of the net income that is related to the IP profit. Adjustments may include removing dividends and taxable gains that are unrelated to the business, such as investments; and

- iii. The substance-based test in Pillar Two, which is the sum of the value of 5% of the tangible asset and 5% of the payroll expenses for a given year.

After this step, the company should calculate the amount eligible for the regular rate patent box, which should also be limited to the lowest amount between:

- i. The cumulative eligible IP profit – amount used in the calculation of the enhanced rate; and
- ii. The adjusted net income – amount used in the calculation of the enhanced rate.

It is important to note that this example is not a representation of the entire calculation, but rather a simplified example to illustrate part of the process we believe could be optimal for calculating the patent box deduction.

This approach has two main benefits:

1. The use of a deduction rather than a refundable tax credit should reduce the cost as the company must have a positive net income to claim the deduction. Furthermore, the use of a stricter definition of net income should ensure that the deduction is used against IP income. Finally, the use of a deduction allows for an overall determination of the combined federal/provincial benefit due to a common calculation of taxable income in the majority of Canadian provincial jurisdictions.
 2. By using a cumulative eligible IP profit and adding any amount not used from the previous years, we recognize long-term commercialization. For example, in many R&D-intensive industries, the company may have an eligible IP profit but can still be at an overall loss. With this approach, any eligible IP profit can be used in the future. This can work much like the SR&ED pool. Therefore, even if a company is at a loss, it may be beneficial to do the patent box calculation to determine its IP profit, as this future tax asset may reduce future taxable income.
- **Types of income allowed in the patent box:** We recommend a broad approach to be implemented which would include the product income, licence income, and patent infringement claims. We believe that the gain related to the sale of IP should be included only to the extent of the available IP generated revenue in the pool. The goal of the patent box is to incentivize the commercialization of IP rather than the actual sale of the IP. Under the proposed patent box model, any gain as a result of the disposition of the IP will not generate any eligible IP profit, and, as such, will not be eligible for the patent box tax rate. However, if the company has generated a large pool of eligible IP revenue, the available pool could cover the gain associated with the sale of IP. Since this capital gain will be related to the business, it will not be adjusted in the *adjusted taxable income*.
 - **Capitalization and depreciation of SR&ED costs pre-IP:** The government could introduce a notion of capitalization of pre-IP cost to recognize the extensive R&D that goes into creating some IP. With this process in place, a company could claim the patent box faster because it would not have to cover all these costs in the first years of exploitation.

- **Advance eligibility rulings:** Similar to the approach in Belgium and the Netherlands, the CRA could provide advance rulings on the calculation of the modified nexus approach and the entity's method of tracing R&D costs and revenues. It should be noted that an advance eligibility ruling is different from what is usually seen in Canada, whereas this process is a free certification to validate the eligibility of the asset and the tracing method.

In the Netherlands,²¹ for example, a company requesting an advanced ruling receives a standardized questionnaire. After reviewing the answers, the tax authorities may ask more specific questions and schedule a visit to the company's headquarters. The ruling will provide information about the company in general, the R&D undertaken by the taxpayer, and the most suitable calculation method. Similarly, in Belgium,²² this advance eligibility ruling is based more on the modified nexus approach and the calculation method, and is valid for a period of five years. A combination of both could be beneficial for the Canadian patent box.

We believe that a strong program for advance eligibility rulings can provide predictability and reduce risk, particularly for foreign companies seeking to invest in Canada. This risk reduction could help increase FDI in Canada and could also reduce compliance costs for the government and taxpayers, as such rulings could be valid for several years. Conceptually, this would be similar to the advanced pricing agreement mechanisms found in transfer pricing, which allow for taxpayer certainty.

- **Election in and out of the patent box:** The proposed patent box model requires each R&D project to be linked to specific IP or clusters of IP, along with individual revenue streams, which can be complex and challenging. To make this process more manageable, we recommend that companies be given the option to either join or leave the patent box. This would spare those companies that decided against participation from the task of tracking R&D and calculating eligible IP. In addition, the adoption of an opt-in model could help to reduce the overall fiscal impact of the patent box, especially if a framework akin to that used in the United Kingdom²³ is implemented.

Should a company decide to opt-in to the patent box, they would be required to calculate its IP profit and conduct R&D tracing. The use of a cumulative IP profit base means that companies with an IP loss will have to offset this pool before they can claim the patent box benefits. Similar to the UK model, a two-year window is provided should the company decide to withdraw from the patent box. This period allows companies to assess whether their losses are temporary and whether they should remain in the patent box or opt out.

If a company chooses to opt out, as in the UK model, it will be subject to a waiting period before it can opt-in once more. This waiting period implies that either some losses will be factored into the

²¹ Supra note 19.

²² Supra note 11.

²³ HM Revenue & Customs, "[CIRD260110 - Patent Box: supplementary: revocation of a Patent Box election](#)," in *HMRC internal manual: Corporate Intangibles Research and Development Manual*, published on March 11, 2016 and last updated on April 3, 2024.

patent box calculation, or some profits may be taxed at the standard rate in the interim. This measure should help limit the cost of the patent box.

By requiring companies to balance their losses and imposing a waiting period before re-entering, the government can foster a more resource-efficient and fair system for all participants.

- **Clear guidance and documentation:** The application of the modified nexus approach and the overall calculation for the patent box will be both complex and extensive. One of the best practices is for the competent authority, such as Finance and the CRA, to provide a lot of documentation and guidance on the subject. The United Kingdom is a good example of such best practices.

In conclusion, the implementation of a patent box regime in Canada with a modified nexus approach would require businesses to provide detailed information about their expenditures in the development of eligible IP. While this approach is necessary to ensure fair international taxation, it would need to be tailored to address specific challenges already observed in other countries that have implemented it.

The proposed changes are designed to reflect the complex corporate tax structure of MNEs, to prevent tax avoidance through IP acquisitions, to incentivize the use of Canadian subcontractors, and to simplify the calculation process. Furthermore, the proposed approach encourages continuous development and innovation in Canada by allowing a broader range of IP assets, including trade secrets and know-how, to be eligible for the regime.

This submission also emphasizes the need for clear guidance and documentation to help businesses navigate the complexities of the modified nexus approach and the overall calculations for the patent box. This would allow businesses to make informed decisions and potentially increase their engagement in R&D activities, thereby fostering innovation and economic growth in Canada.

The proposed design, if implemented, could make the patent box regime more effective and efficient, while limiting new fiscal costs to the government.