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R&D tax update

Canada's first patent box regime – an incentive for domestic R&D commercialization

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In the past few years, the patent box has attracted widespread global attention, particularly in Europe. It has also been considered by the Organisation for Economic Co-operation and Development (OECD) as part of its Base Erosion and Profit Shifting (BEPS) project. This increasingly popular tax policy instrument has been the subject of some interest and discussion in Canada, though it has not to date been implemented at the federal level. At the provincial level, British Columbia has had a reduced tax rate for certain international patent income since 2006 and Quebec has just recently announced proposals to introduce a type of patent box regime in its 2016 budget. Quebec proposes to tax qualifying patent income at an effective provincial corporate tax rate of 4% starting in January 2017.

Why a patent box?

Patent boxes allow corporate income related to the sale of patented products to be taxed at rates which are significantly lower than those applied to ordinary business income. This preferential treatment of patent income is meant to provide firms with a **strong incentive to innovate and commercialize the innovations in the local jurisdiction.**[1] Patent boxes have existed for many years. They were pioneered by France and Ireland in the early 1970s. However, they have only recently increased in popularity as countries strive to be globally competitive and to maximize revenue from intellectual property. Only two countries had patent box regimes until the early 2000s. Now, more than 12 countries have some form of patent box[2], and other countries, such as the United States, are exploring the possibility of introducing one.

Countries vary significantly in their design of the patent box, most notably in respect of the effective tax rate on qualifying income, the range of eligible types of intellectual property (IP) and IP income, and the treatment of expenses. The following table outlines the key features of patent box regimes for Belgium, France, Italy and the United Kingdom, in addition to British Columbia and the Quebec proposals.

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[1] R.D. Atkinson and S. M. Andes. "Patent Boxes: Innovation in Tax Policy and Tax Policy for Innovation", *The Information Technology & Innovation Foundation Report*, October 2011.
[2] Countries with patent boxes include Austria, Belgium, Brazil, China, France, Hungary, Ireland, Italy, Malta, the Netherlands, South Korea, Spain, Switzerland, Turkey and the United Kingdom.

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Key features of selected jurisdictions

Jurisdiction	Top corporate tax rate	Effective tax rate on qualifying income	R&D activities must be carried out in the jurisdiction	R&D costs must be incurred in the jurisdiction	IP must be retained in the jurisdiction
Belgium	33.99%	6.8%	No	No	Yes
France	34.43%	15%	No, but qualified activity must occur within EU	Yes	No
Italy	27.5% (IRES) + 3.9% (IRAP)	15.7%[3]	Yes	Yes	No
United Kingdom	20%	10%	Yes	Yes	No
Canada:					
British Columbia	11%	2.75%	No	No	No
Quebec (2016 budget)	11.8% (2017)	4%	Yes, in whole or in part	According to R&D tax credit rules	No

The patent box regime received close scrutiny during the OECD/G20 BEPS project. Based on this review, a model for patent box structures - referred to as the “modified nexus approach” – was recommended for countries that choose to have such a regime.[4] The recommended approach requires a direct link between income eligible for benefits such as reduced tax rates, and the activity contributing to that income. In other words, under the modified nexus approach, reduced tax rates under a patent box can only apply to income from IP where the actual research and development (R&D) activity is undertaken by the business itself. This recommendation has been accepted as a “minimum standard” under the BEPS action plan. As a result, existing regimes and any new ones will be required to comply with the recommended model. Some countries (such as the United Kingdom) have already announced transitional measures to align their regimes with the BEPS action plan recommendations. Other countries may repeal their existing regimes and introduce a new OECD-compliant programs.

[3] Italy allows allow companies to benefit from a 50% exemption from corporate income tax (IRES) and local tax (IRAP) on income derived from the direct or indirect exploitation of qualifying IP. The exemption is equal to 30% for fiscal year 2015, to 40% for fiscal year 2016 and to 50% for fiscal year 2017 and beyond.

[4] *OECD, Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance – Action 5: 2015 Final Report* (Paris: OECD, October 2015), (http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/countering-harmful-tax-practices-more-effectively-taking-into-account-transparency-and-substance-action-5-2015-final-report_9789264241190-en#page1).

Patent boxes in Canada

British Columbia

Until the introduction of Quebec's patent box proposals, British Columbia was the only province in Canada to provide special tax treatment for patent income. Since 2006, British Columbia's International Business Activity (IBA) program has provided a refund to eligible corporations of the B.C. income tax paid related to the corporation's international patent business carried on through a fixed place of business in British Columbia. Qualifying income must be derived from:

- Selling, assigning or licensing a patent to a non-resident person, or
- Selling to a non-resident person, a good or service in respect of which the sales revenue is principally derived from an invention for which a patent is owned by the corporation.

The eligible classes of patents include life sciences, clean power generation, waste water treatment and fuel cell technology. Eligible corporations can apply for a refund of up to 75% of the B.C. corporate income tax paid, up to a maximum of $8 million per year. This results in an effective provincial tax rate of 2.75% on qualifying patent income.

Quebec

To encourage qualifying corporations to commercialize IP in-province, Quebec has introduced a deduction in calculating taxable income for "innovative manufacturing corporations" (DIC). Starting in January 2017, qualifying innovative manufacturing corporations with establishments in Quebec will be eligible for a lower effective tax rate on up to 50% of the net income derived from the sale or rental of qualified products integrating patented inventions developed in the province. We understand that the underlying R&D of the patent must have been carried out in part in the province. In addition, the qualifying corporation must have paid at least $500,000 of eligible R&D expenditures (in the five years prior to the patent application) which gave rise to refundable Quebec R&D tax credits. The effective provincial tax rate for the qualifying portion of net income will be reduced from 11.8% to 4% for 2017.

Deloitte applauds this initiative by Quebec, as it responds to a need expressed by industry for support for commercializing IP development within Canada. We would encourage the federal government to study the potential introduction of a patent box regime, taking into account the fact that not having such a regime might leave Canada at a competitive disadvantage as our trading partners (such as the United Kingdom, China and France) continue to implement and support these incentive regimes.

Would your business benefit from a patent box?

Many factors must be taken into consideration in assessing eligibility for the Quebec patent box or the BC IBA program. The proposed Quebec rules will likely be subject to interpretation and it will be necessary for taxpayers to carefully plan to ensure that they comply with the eligibility requirements, including the time period to obtain a patent, the determination of the value of a "qualified patented feature", and the exploiting of the results of R&D work that led to the granting of a patent. Your Deloitte representative is available to assist in optimizing your access to these programs.

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