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## R&D Tax Update

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### Patent box regimes What's inside? (Opportunities for Canada)

The global competition to attract research and development (R&D) spending has increased significantly in recent years. Not only are countries adopting or expanding R&D tax incentives to promote research activities but they are also providing new tax incentives to encourage the commercialization of that R&D, as outlined in our recent ***Global Survey of R&D Tax Incentives***. These incentives, often referred to as “patent boxes”, allow certain intellectual property (IP) income to be taxed at rates which are significantly lower than the rates applied to regular business income. This preferential treatment of IP income is meant to provide firms with a stronger incentive to innovate and commercialize the innovations, domestically.<sup>1</sup>

Currently, countries typically considered viable locations for conducting R&D that have enacted patent box-type regimes include Belgium, China, France, Hungary, the Netherlands and Spain. The U.K. has also proposed a patent box scheme that is to be in place by 2013. In addition, there is domestic pressure for the U.S. to adopt a similar regime in order to improve its global competitiveness.<sup>2</sup>

The key features of these patent box systems are summarized in the table below.

<sup>1</sup> Atkinson, R.D. and S. M. Andes. “Patent Boxes: Innovation in Tax Policy and Tax Policy for Innovation.” The Information Technology & Innovation Foundation Report. October 2011.

<sup>2</sup> Ibid.

## Key features of patent box regimes

Country	General corporate tax rate	Effective tax rate on qualifying income	R&D activities must be incurred in country	Costs must be incurred in country	IP must be retained in country
Belgium	33.99%	6.8%	No	No	Yes
China	25%	0 – 12.5%	Yes	Yes	Yes
France	34.43%	15%	No, but qualified activity must occur within the European Union (EU)	Yes	No
Hungary	10 – 19%	Potential minimum of 5%	No	No	No
Netherlands	20 - 25%	5%	No, but qualified activity must occur within the EU	Yes	Yes
Spain	30%	15%	All qualified R&D must occur in Spain or a member state of the EU or European Economic Area (EEA)	All qualified R&D must occur in Spain or a member state of the EU or EEA	No
UK Proposal	24% (2013)	10% (2013)	No	No	No

Source: Global Survey of R&D Tax Incentives (Deloitte, 2012)

### Is a patent box regime a good policy for Canada?

As suggested by the C.D. Howe Institute, with the increase in global tax incentives for the commercialization of R&D, Canada may also need to consider improvements to the tax treatment of IP income to remain globally competitive.<sup>3</sup>

Although the patent box appears to be an attractive option, it does come with some challenges:

- As patent box regimes are relatively new, very little evidence on their effectiveness is available
- The patent box, by itself, is not an effective incentive to promote research<sup>4</sup>
- Designing the patent box is complex, specifically in the determination of what types of patents and related income should be eligible for special tax rates
- Eligibility requirements come with their own set of administrative and compliance issues
- With the increase in the number of countries trying to attract patent income using patent box regimes, governments may be engaging in a race to the bottom in which related government revenues decline without the expected increase in economic activity<sup>5</sup>

<sup>3</sup> Parsons, M. "Rewarding Innovation: Improving Federal Support for Innovation." C.D. Howe Institute Commentary: Fiscal and Tax Competitiveness. No. 334, September 2011.

<sup>4</sup> Griffith, R., H. Miller, and M. O'Connell. "The UK will introduce a Patent Box, but to whose benefit?" Observations for The Institute of Fiscal Studies. November 2010. <http://www.ifs.org.uk/publications/5362>.

<sup>5</sup> Ibid.

Along with these challenges, Canada's foreign affiliate rules may limit the effect of a patent box regime in Canada. These rules allow tax exempt income to be earned by holding the legal title in an appropriate offshore jurisdiction and ultimately paying tax exempt dividends from the patent income back to Canada. Through cost-sharing arrangements and other techniques, many R&D jobs can still be located in Canada and therefore be eligible for Scientific Research and Experimental Development credits. As a result, the introduction of a patent box in Canada may not have a significant effect on corporate behavior in terms of attracting significant new investment into Canada.

In conclusion, Deloitte recommends further study to determine whether Canada would indeed benefit from a patent box-type regime. Benchmarking with other countries with which Canada typically competes for the same investment dollars will help assess whether the patent box regime will improve the taxation of IP in Canada.

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