Department of Finance releases consultation papers on patent box regime and SR&ED

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The Department of Finance opened two consultations on a potential patent box regime and on Canada's existing Scientific Research and Experimental Development (SR&ED) program. Each consultation is accompanied by a short consultation paper and is open until April 15, 2024. These tax initiatives were first announced in Budget 2022 and briefly addressed in Budget 2023.

Patent box regime consultation

Patent box regimes are intended to fiscally incentivize domestic research and development, resulting in the creation of specified types of intellectual property (IP), by providing preferential tax treatment of income from eligible IP assets and the disposition of such assets. Although the consultation paper and many jurisdictions use the term "patent box" regime, eligible IP assets are not limited to patents.

Preferential tax treatment can come in many forms, such as taxing eligible IP income at a lower effective tax rate (similar to existing small business rules in Canada), or providing tax credits which a taxpayer uses to reduce tax otherwise payable or effectively entitles the taxpayer to a cash payment (similar to existing SR&ED rules).

Numerous countries have already introduced patent box regimes, including half of the EU member states, the U.K., Switzerland, China, and South Korea. Québec introduced its first patent box regime effective as of January 1, 2017, which focused on promoting the manufacturing and commercialization in Québec of innovations designed by Québec businesses. Currently, the effective tax rate of eligible IP income can be as low as 2%, compared to Québec's general corporate tax rate of 11.5% (resulting in combined federal/provincial general corporate tax rate of 17% compared to 26.5%).

The consultation paper raises concerns that Canada lags behind other countries in terms of the number of patents held, and that less income is earned in Canada for the use of IP internationally than in other countries. While the G7 average is a net surplus, Canada has historically been in a deficit position for net IP payments, meaning more payments exit Canada for the use of IP than are paid into Canada for such use. Moreover, the gap between Canada's deficit and the G7 average surplus has grown significantly over time.

The consultation paper briefly mentions some of the non-tax initiatives taken by the federal government since 2015 to improve this situation. It also makes it clear that any patent box regime implemented in Canada would have to be compliant with the 2015 Final Report on Action 5 of the Action Plan on Base Erosion and Profit Shifting (BEPS), including the requirements in respect of the "nexus approach" that aligns access to tax benefits with substantial R&D activities and expenditures in the jurisdiction that gave rise to that IP income. Among other things, the BEPS nexus approach limits the types of IP assets that can be included in a patent box regime (including patents and copyrighted software — the latter of which have been excluded from the patent box regimes of certain jurisdictions) and sets out the reporting obligations that businesses must comply with to benefit from the patent box regime.

The emphasis on the "nexus approach" is not surprising when compared to the evolution of the Québec patent box regime, which was significantly revamped in 2021 to make it more consistent with that approach. The Québec regime's eligible revenue includes income from the sale or rental of goods and from the provision of services "intrinsically linked" to the IP asset, royalties, and even revenue from litigation of the IP asset. To qualify for that incentive, the corporation must

1. be established, and carry on business, in Québec
2. commercialize the eligible IP from an establishment in Québec
3. have incurred R&D expenses in Québec, all of which is consistent with the OECD's "nexus approach"

Moreover, while there was a soft requirement for the eligible IP to result, in whole or in part, from Québec-based SR&ED up until December 31, 2023, there now needs to be a direct connection between the Québec SR&ED expenditures and the creation, development or improvement of the eligible IP. Québec's experience with its evolving patent box regime might serve as a guide for Finance during the consultation process.

Finance does not address many specifics in the consultation paper, including:

- whether incentives will take the form of a lower tax rate on all eligible IP income, a tax deduction (such as in Québec), a tax credit or a partial exemption of eligible IP income from income taxation such that the total income is effectively taxed at a lower rate
- the types of taxpayers that will be eligible for the patent box regime and whether benefits should be structured to offer incentives to both taxable and tax-exempt entities
- the interaction between a Canadian patent box regime and the proposed *Global Minimum Tax Act*, which implements the OECD's Pillar Two global minimum tax. For example, will the rules applicable to large multi-nationals be structured to result in an effective combined federal/provincial tax rate of at least 15%? Or if tax credits are offered, will they be refundable tax credits that receive preferential PillarTwo treatment?

These details will be crucial in determining the effectiveness of any patent box regime and in assessing the prospects of achieving the government's goals of improving Canada's competitiveness in attracting, developing and retaining IP.

Finance sets out seven questions in the consultation paper for stakeholders to respond to:

1. why Canada has a growing deficit for the use of IP compared to the growing surplus of other G7 countries
2. whether a patent box regime would improve Canada's competitiveness for "developing, commercializing, and retaining ownership of IP"
3. the importance of tax considerations to businesses in deciding where to commercialize and locate IP, including whether any factors are considered other than tax rates, and how those factors might impact businesses' reactions to the introduction of a patent box regime
4. what total tax rate (federal plus provincial or territorial) would make Canada's patent box regime competitive
5. whether all the IP assets identified in the BEPS 2015 Final Report on Action 5 as being compliant with the nexus approach should be included in any Canadian patent box regime
6. lessons learned from existing patent box regimes that are compliant with the BEPS nexus approach for approaching the significant reporting obligations imposed on businesses
7. potential methods for reducing the fiscal costs of a patent box regime on the government

SR&ED consultation

The SR&ED consultation paper briefly discusses the existing tax and non-tax measures that are in place to promote R&D in Canada, including the SR&ED program's deduction against income and investment tax credits (ITCs). The existing rules offer enhanced tax benefits to corporations that qualify as "Canadian-controlled private corporations" (CCPCs), including the ability to claim refundable ITCs, which can be an important source of funding for early-stage businesses.

The SR&ED consultation paper notes that, in 2021, the SR&ED ITC "provided approximately $3.9 billion to over 22,000 businesses in Canada" for the purpose of supporting research and development (R&D) activities. Despite the existing measures, SR&ED spending has declined in Canada since 2011 and is lower than in other comparable countries.

The purpose of the SR&ED consultation is to assist the federal government in assessing whether the existing SR&ED program is effective in encouraging R&D in Canada, and whether it can be modernized and simplified (in addition to certain improvements already made or underway by the CRA).

The SR&ED consultation paper invites submissions on the following seven questions:

1. how to maintain the effectiveness of encouraging R&D investments and promote the growth and success of business with intense R&D activities through the SR&ED program
2. how to improve the definition of SR&ED, eligibility criteria, and overall architecture of the program
3. how the SR&ED program complements other R&D support programs, and how to improve their interaction

4. how to more effectively target assistance through the SR&ED program without increasing the overall cost
5. how to increase the retention of IP in Canada through the SR&ED program
6. how entrepreneurs' access to SR&ED support can be improved and streamlined
7. how to make sure any suggested changes are cost neutral and focused on benefitting Canada and Canadians

The SR&ED consultation paper caveats that any proposed improvements to the SR&ED program should be cost-neutral and that submissions should address how that goal will be achieved.

The effectiveness of the SR&ED program may be improved if Finance were to reconsider CCPC status as a requirement for claiming refundable ITCs and other enhanced SR&ED benefits. A Canadian corporation may not qualify as a CCPC where the majority of the voting shares of the corporation are held by one or more public corporations or non-residents. Since many corporations in Canada rely on funding from non-residents (particularly U.S. venture capital and private equity funds) or increasingly from large, often publicly-listed corporations looking to make strategic investments, it can be challenging and often impractical for Canadian-based businesses to maintain CCPC status (and thus their SR&ED benefits) even where the core business, assets and employees are principally located in Canada.

For further information on the implications of the two consultation papers, or if you have any interest in making or contributing to a submission on either consultation paper, please contact any member of our National Tax Group.