Intelligence MEMOS

From: John Lester

To: Finance Canada Officials

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Re: **Consultations on a Patent Box Regime for Canada**

Finance Canada announced on January 31 the start of consultations on a cost-neutral modernization and improvement of the SR&ED tax incentives and on the suitability of creating a patent box regime. In my previous Intelligence Memo, I recommended rebalancing the SR&ED credit rates in favour of large firms. In this Memo I explain why taxing income from intellectual property (IP) at a preferential rate is good public policy. As I have discussed **elsewhere**, a carefully designed IP Box would encourage firms to undertake more R&D and commercialize more of it in Canada at a surprisingly low fiscal cost.

The key reason to implement an IP Box is to stem the outflow of IP profits to low-tax jurisdictions. This option is particularly attractive now given the general acceptance that preferential tax treatment of IP income must be linked to real activity in the implementing jurisdiction and because of the agreement on a global minimum corporate tax rate. With these two developments, an IP Box has become a cost-effective way to reduce and possibly eliminate shifting of IP income to tax havens. There appears to be enough buy-in on a global minimum tax that setting the combined federal-provincial IP Box rate at or just above the 15 percent minimum rate could eliminate IP profit shifting over time. If so, and if more than 60 percent of IP profits generated in Canada are being taxed in other countries, the overall net fiscal cost of an IP Box would be zero.

An IP Box will encourage additional investment in R&D by raising the after-tax return on successful R&D projects. This delayed benefit contrasts with the SR&ED investment tax credit, which is paid when the R&D is performed. However, firms that can finance investment with internal cash flow or by accessing financial markets will react similarly to both measures if they provide the same benefit after adjustment for the time value of money.

I estimate that a 10 percentage point tax preference for IP income would be roughly equivalent to a 3 percentage point increase in the SR&ED tax credit for large firms. But the preferential IP rate would have a much lower net fiscal cost because more IP profits will be taxed in Canada.

Another advantage of an IP Box is that, properly designed, it will encourage additional commercialization activity in Canada. But this will only occur if income from all assets created by performing R&D in Canada qualifies for special treatment. If only royalty income and other explicit returns to IP assets qualify, firms would not need to undertake commercialization activity in Canada to benefit from the preferential rate. They could simply book the royalty income in Canada.

But some IP income is embedded in the price of products sold. If this implicit income qualifies for the preferential rate, firms will have an incentive to commercialize inventions in Canada.

Although it is not clear from the Finance Canada consultation paper, Canada can define qualifying assets and income broadly enough to encourage commercialization while following the OECD guidance on preferential tax regimes for IP income. Under these guidelines, income from patents and other assets that are functionally equivalent to patents qualifies for special treatment. The OECD guidance includes a list of assets that are functionally equivalent to patents, but the list is not exhaustive. In particular, it can be extended to include assets protected by trade secrecy, which would mean that all successful R&D projects will generate qualifying IP income.

A carefully designed IP Box would have two other features.

- First, a federal preference should be implemented as a deduction from taxable income. If implemented as a tax credit, the federal government would bear the entire cost of the program while provincial governments would receive a windfall tax revenue gain from the reduced outflow of IP profits.
- Second, qualified spending should include only R&D performed in-house or outsourced to unrelated parties.

An IP Box could apply to both existing and newly created intellectual property. Including existing IP would encourage repatriation of IP developed in Canada, with favourable impacts on tax revenues as well as commercialization activity in Canada. But there would also be a windfall tax reduction on IP profits now booked in Canada. Extending the tax preference to existing IP could be a sensible approach if IP profits booked in Canada are substantially smaller than profits shifted to other jurisdictions. Increased administration and compliance costs would also be a concern..

Overall, despite potentially high compliance costs, especially in calculating embedded IP income, the global minimum tax agreement would ensure an IP Box encourages R&D at a low net fiscal cost.

John Lester is a Fellow in Residence at the C.D. Howe Institute.

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