What's new in Canadian taxation for life sciences?

May 23, 2024

2024 has seen two significant Canadian taxation developments of interest to the life sciences sector:

- An announcement of accelerated tax depreciation for patents and rights to use patented information; and
- Federal government consultations for introducing a "patent box" regime to Canada and for revamping the scientific research & experimental development regime in the *Income Tax Act* (Canada) (ITA).

1. Accelerated depreciation for patents

Most expenses involved in acquiring or creating a patent are deductible for tax purpose only over a series of years. To encourage productivity-enhancing activity such as acquiring or creating patents, the federal budget of April 16, 2024 (Budget 2024) announced that the cost of patents and rights to use patented information will be given preferential treatment if the property is acquired on or after that date and becomes available for use before Jan. 1, 2027. The enhanced allowance provides a capital cost allowance rate of 100 per cent for the year in which the property becomes available for use. Eligible property that becomes available for use during 2027 would continue to benefit from the Accelerated Investment Incentive (an existing, less generous, program). This measure incentivizes expenditures on obtaining Canadian patents made in the next couple of years.

2. Changes to SR&ED Tax Incentives and introduction of patent box

As part of the federal government's efforts to bolster productivity by encouraging innovation and research and development, the federal government announced two tax consultations: one on the potential introduction of a patent box regime and another on the changes to the existing scientific research and experimental development (SR&ED) program. Initial consultation with the public concluded on April 15, 2024.

Budget 2024 has briefly addressed these consultations, and further announced a second consultation on how an additional $600 million funding to the SR&ED program should be utilized. The details of the second phase consultation has been released on April 25, 2024 and may be found here. Stakeholders have until May 27, 2024, to provide their comments and suggestions.

The existing SR&ED regime in the ITA

The SR&ED regime is the largest element of the federal government's support for businesses to carry out SR&ED in Canada, with over $13.7 billion of SR&ED expenditures claimed and $3.9 billion of tax credits provided in 2021 alone.

The regime provides tax incentives in two ways. First, qualifying SR&ED expenditures are fully deductible against a taxpayer's income (*i.e.*, in the year incurred), even if normally considered capital in nature and thereby not otherwise immediately deductible. Faster deductibility allows these expenses to reduce taxes owing faster than would otherwise be the case.

In addition, a subset of these qualifying SR&ED expenditures are eligible for "investment tax credits" (ITCs), being an actual deduction from taxes owing (not merely a deduction from income in computing taxes owing). A taxpayer that is a "Canadian-controlled private corporation" (CCPC) can claim an ITC of 35 per cent up to $3M of its eligible SR&ED expenditures for the year, and an ITC of 15 per cent of eligible SR&ED expenditures beyond that threshold.

Depending on the CCPC's taxable income and taxable capital, some or all of these ITCs are "refundable," meaning that the government will pay the ITC to the CCPC even if it does not have taxes owing to which the ITC could be applied. Non-CCPCs are entitled to a non-refundable ITC of 15 per cent of their eligible SR&ED expenditures. See here for more information on Canada's existing SR&ED tax rules.

The Canadian federal government is reviewing the SR&ED program to ensure it benefits Canada, in response to Canada's weak performance in research and development relative to its international peers. While the initial consultation proposed a cost-neutral approach, Budget 2024 has now announced a $600 million funding over four years and a second phase consultation to explore specific policy parameters, including ways to benefit Canadian public companies.

Patent boxes in Canada

Businesses that own Intellectual Property (IP) are more competitive, grow faster and bring substantial benefit to the economy. Canada lags its peers in attracting and retaining IP for commercialization. In fact, the gap in IP performance between Canada and other G7 countries has been widening over the past two decades.

IP by its very nature is a mobile source of income that is relatively easy to move from one jurisdiction to another. A patent box regime taxes income from certain types of IP at preferential rates. In doing so, it discourages the transfer of mobile IP, such as computer software, from its jurisdiction of development to a lower tax jurisdiction for

further commercialization. Patent box regimes are currently used in the U.K. and 13 EU member states, including France, Spain and the Benelux countries.

To date, the federal government has not adopted a patent box regime at the federal income tax level. However, Saskatchewan and Québec have recently enacted their own provincial patent box regimes.

In its consultation, the federal government mandated a patent box regime in compliance with the "nexus approach" agreed to by OECD countries. In general terms, the nexus approach allows taxpayers to benefit from patent box regimes only to the extent that they have incurred the underlying research and development expenditures that generated the IP assets. This is meant to prevent inappropriate tax competition between countries by not offering preferential treatment to IP developed in other countries (particularly those that do not have patent box regimes).

Consultation on the patent box has closed and the submissions are still under review by the federal government.

Takeaway

Canada's recent tax initiatives on SR&ED and patents to improve Canada's economy and productivity will be welcomed by the business community. Financial support through immediate expensing for expenditures to obtain patents will accelerate expenditures to create valuable intellectual property. Businesses that undertake research and innovation activities should closely monitor the development and outcome of these consultations.

In particular, the second phase consultation on the SR&ED tax regime has been announced on April 25, 2024 and will inform the use of the $600 million SR&ED funding announced in Budget 2024. **Interested parties should ensure that they make submissions by the May 27 deadline**. Comments are to be sent to SRED-PB-RSDE-RPB@fin.gc.ca with "SR&ED Review" as the subject line.

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