Felesky Flynn LLP
TAX COUNSEL

Insights Series: Tech Sector Income Tax Issues

This Felesky Flynn Insights Series focuses on tax issues relevant and specific to start-up businesses operating in the technology sector in Canada.

January 5, 2020

WHERE SHOULD CANADIAN BUSINESSES HOLD THEIR INTELLECTUAL PROPERTY?

Many jurisdictions around the world compete for intellectual property ("**IP**") (*e.g.*, patents, trademarks, brands, designs, secret formula, and know how) by charging low (or even nil) tax rates on income generated by it. These favourable tax regimes provide an incentive to locate the IP in that jurisdiction. Not surprisingly, traditional strategies for owning and utilizing IP in a tax-efficient manner typically involve holding the IP in a favourable foreign jurisdiction to benefit from competitive global tax rates.

However, some Canadian provinces are taking steps to improve their tax competitiveness while the trend globally is to restrict access to the most favourable rates unless sufficient "substance" accompanies the IP. These dynamics are altering the way that businesses view tax-efficient IP holding strategies.

This article discusses some of the key tax considerations when deciding whether to move IP offshore, or keep it in Canada.

I. OFFSHORE IP STRATEGY

Designing the appropriate offshore IP strategy usually begins with computing the cost/benefit of transferring the IP offshore. This is initially a modelling exercise taking into account the projected future tax savings less administrative costs, and comparing that result to the up-front expense (including taxes) of offshoring the IP.

1. Choosing an Appropriate Foreign Jurisdiction

The future tax savings of an offshore IP strategy depend upon the foreign jurisdiction chosen to locate the IP. In addition to the rate of tax levied by the foreign jurisdiction, if the ultimate indirect owner of the IP is Canadian, it is important to select a jurisdiction with which Canada has entered into a tax treaty (or tax information exchange agreement) or income from the IP generally will be subject to Canadian tax when repatriated back to Canada. Merely locating in a treaty jurisdiction is not sufficient to avoid Canadian tax, but it is usually necessary.

Since Canada has a very extensive treaty network, there are many low tax countries that are suitable from a purely Canadian perspective. However, it also is necessary to understand the tax treatment of payments for the use of the IP in various other countries where it is exploited. Often those other countries will impose withholding tax on payments, unless the holder of the IP is resident in a country with which that other country also has a treaty. This additional consideration substantially narrows the field, and often (but not always) removes typical "tax havens" from contention.

Certain European countries have treaties with Canada as well as many other countries around the world, and also offer a preferential tax rate for income from IP, making them ideal choices for holding IP. These favourable tax regimes, which are often referred to as IP boxes, patent boxes or innovation boxes, are designed to attract and retain corporations that operate IP-centric businesses by taxing income from IP development and exploitation at favourable rates.

However, due to pressure from the Organisation for Economic Co-operation and Development ("**OECD**"), the trend among these countries is to require "substance" in the particular jurisdiction in order to access the very best global rates. Thus, in most IP box jurisdictions, a corporation will be required to demonstrate a substance or nexus between the development of the IP and the exploitation of the IP in that foreign jurisdiction in order to benefit from the most preferential regime. This has largely followed the "modified nexus approach" established by the OECD. The modified nexus approach focuses on a connection between the expenditure, the IP and income arising from the IP. This approach generally requires a substantial level of research & development ("**R&D**") activity in the foreign jurisdiction.

Canadian businesses operating in the technology sector often only seriously consider where best to own their IP after it has achieved, or is at least approaching, commercialization. Given business realities and imperatives for start-ups, that approach is perfectly understandable, although not necessarily optimal. As a result of the trends described above, for IP that has the potential to be very valuable, it can be extremely advantageous to take steps during development to ensure that access to the most favourable tax regimes will be available when and if commercialization occurs. Waiting until development is complete may mean that the ability to access the optimal holding jurisdiction will be severely compromised.

Below we provide a brief overview of select foreign patent box regimes. We note that these regimes could be affected by the OECD's proposal under Pillar Two which seeks to impose a global minimum level of tax. To date, the minimum rate of tax has not been established by the OECD, but we speculate that it is likely to be set somewhere between 10% and 15%. If such a minimum rate ultimately is established, it would significantly increase the tax payable in each of the jurisdictions described below. In addition, for US-headquartered multinationals, generally it is not beneficial to obtain a foreign rate on IP below approximately 13% due to the US minimum global tax concept known as "global intangible low tax income", or GILTI. As a result of these

dynamics, the most attractive offshore patent box regimes of the world are increasingly difficult to access.

Ireland

Since 2016, Ireland has had a Knowledge Development Box ("**KDB**") regime that provides for corporate tax relief for income on qualifying assets. An Irish corporation that qualifies for the KDB may be entitled to a deduction equal to 50% of its qualifying profits (qualifying profits are calculated using a modified nexus formula) resulting in the corporation's qualifying profits being taxed at an effective rate of 6.25%. The relief available under the KDB is generally linked to the amount of qualifying R&D incurred in Ireland. Outsourced R&D payments to non-related parties are not considered.

Belgium

The Belgium innovation deduction provides Belgian corporations (and permanent establishments of foreign corporations) with a deduction of 85% of the net income from IP. This results in an effective tax rate of 3.8% in 2020. The innovation deduction applies to income from, *inter alia*, patents and copyrighted software. In order to qualify, there must be sufficient substance in Belgium and an essential link between the expenses incurred by the corporation, the IP and the related IP income. Similar to the Irish regime, outsourced payments to related parties are not considered.

Hungary

Hungary has an IP regime for royalties which taxes benefits from IP-related royalty profits at 4.5%. The benefits are limited by reference to the corporation's own R&D expenditures.

2. Transferring the IP Offshore

Once a favourable foreign jurisdiction is identified, a business must decide on the best way to transfer its IP to the jurisdiction. The preferred approach for the business will depend on various tax and non-tax considerations driven by the specific circumstances of the business. However, a common approach is for the Canadian corporation holding the IP to sell the IP to the entity in the foreign jurisdiction for fair market value consideration. This is a taxable disposition for the Canadian corporation, generally at capital gains rates.

Given that the sale of the IP generally results in a tax liability in Canada, businesses which may go offshore should consider transferring IP when the value is low. In the case of acquisitions of IP, it may be desirable to acquire it outside of Canada in the first instance.

II. CANADIAN IP STRATEGY

Although IP box regimes historically have been located outside of Canada, global trends toward requiring substance in the foreign jurisdiction and imposing minimum rates of tax have reduced the attractiveness and feasibility of offshoring IP. As well, certain Canadian provinces are picking up on the “substance approach” by introducing favourable IP box regimes. These regimes reduce taxes on the commercialization of IP, but only if there is a sufficient nexus between the development of the IP and the province. Currently there are two provinces in Canada that have beneficial tax rates specifically for IP, both of which are discussed below. As well, and although not specific to IP, Alberta’s general corporate tax rates are increasingly competitive and are close to the specialized Canadian IP rates, without any conditions.

1. Saskatchewan

Saskatchewan offers eligible corporations a reduced corporate provincial rate of 6% for ten consecutive years for eligible corporations that commercialize their qualifying IP in Saskatchewan. Qualifying IP requires the taxpayer to demonstrate new economic benefits to Saskatchewan, such as incurring a minimum of $3 million of R&D in Saskatchewan, among other things. An eligible corporation that benefits from Saskatchewan’s IP regime will pay a combined federal and provincial corporate rate of 21%.

2. Quebec

In Quebec, for taxation years commencing after December 31, 2020, a new incentive deduction for the commercialization of innovations is being implemented. This deduction enables a corporation that commercializes a qualified intellectual property asset developed in Quebec to benefit from an effective provincial tax rate of 2% on the qualified portion of its taxable income attributed to that qualified intellectual property asset. An eligible corporation that benefits from Quebec’s IP regime will pay a combined federal and provincial corporate rate of 17%.

3. Alberta

Alberta does not currently have a specific IP box regime. However, it is notable that Alberta’s combined general corporate rate in 2021 is 23%. Although that rate is higher than the special regimes in Quebec and Saskatchewan, there are no specific requirements in Alberta to access the rate. As well, given the absence of any “exit tax” on transferring IP within Canada (so long as appropriate steps are taken to make it tax-deferred), Alberta can be an attractive regime within Canada for holding IP, especially where the special regimes in other jurisdictions are not available.