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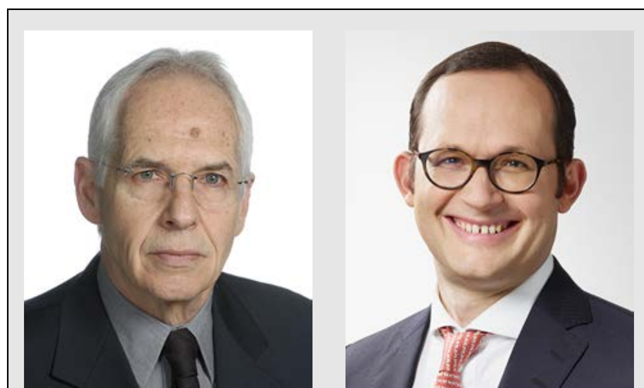

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In this article, the authors discuss Quebec's proposed innovation box, which could create the lowest corporate tax jurisdiction in North America, and compare the proposal with action 5 of the OECD's base erosion and profit-shifting initiative, intellectual property boxes in Europe, and the U.S. foreign-derived intangible income regime.

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As early as the 1970s but with a growing frequency since the turn of the century, European countries have started adopting special tax regimes known variously as patent boxes, innovation boxes, or intellectual property boxes.[1] These regimes are designed to incentivize research and development by taxing revenues from some forms of IP more favorably than other income.

By contrast, historically the IP box concept has not been adopted in either Canada or the United States. Canada, in particular, has been providing front-loaded incentives that subsidize the actual carrying out of R&D instead of favoring the backloaded approach of IP boxes.

However, the 2017 U.S. Tax Cuts and Jobs Act (P.L. 115-97) introduced a new broad-based incentive regime applicable to foreign-derived intangible income in IRC section 250. More recently, in its 2020 budget the Quebec provincial government proposed the enactment of a new regime that may provide the lowest corporate tax rate (including federal, state, local, and provincial taxes) for both domestic and foreign markets, in either Canada or the United States.

These developments present an opportunity to review the evolution of IP box regimes in Canada, Europe, and the United States against the backdrop of the OECD base erosion and profit-shifting initiative.

The Rise of the IP Box and BEPS Action 5

As noted at the outset of this article, after the turn of the century IP boxes proliferated in Europe. In 2010, 14 EU countries offered various types of IP box regimes.[2] In response, over the years the OECD and the EU developed the view that IP box regimes that do not require that the IP being exploited — whether by being licensed, sold, or embedded in products or services that are sold or provided — be developed by the owner comprise beggar-thy-neighbor harmful tax policies that should be repealed or modified.

The OECD's concern was clearly seen in Canada. A Canadian company that carries on

[1] *See* "R&D Tax Update: Canada's First Patent Box Regime — An Incentive for Domestic R&D Commercialization," Deloitte Canada, Apr. 28, 2016 (referring to France and Ireland establishing patent boxes in the early 1970s). For simplicity, we use "IP box" in this article.

[2] OECD, "Countering Harmful Tax Practices More Effectively, Taking Into Account Transparency and Substance, Action 5 — 2015 Final Report," at Table 6.1 (2015).

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R&D is normally eligible for tax credits.[3] If the IP resulting from the R&D is promising, nothing prevents the Canadian company from offshoring that technology to a jurisdiction with a favorable regime. While a transfer by the Canadian company of its IP abroad is a taxable transaction, ideally the timing of the sale would be such that the gain on the IP would be absorbed by the company's losses and unused tax credits generated by the R&D activity. Thereafter, the IP could be enhanced and, if successful, exploited in an IP box with favorable tax rates. This would lead to a mismatch between the R&D tax incentives offered by the Canadian government and the ultimate stream of income that generates tax receipts benefiting another country's treasury.

Accordingly, the OECD developed the position that there should be a nexus between developing IP and exploiting it. This view is reflected in paragraph 30 of the OECD's action 5 final report in the following formula:

> The nexus approach determines what income may receive tax benefits by applying the following calculation:

$$\frac{\text{Qualifying expenditures incurred to develop IP asset}}{\text{Overall expenditures incurred to develop IP asset}} \times \text{Overall income from IP asset} = \text{Income receiving tax benefits}$$

Paragraph 31 explains that:

> A qualifying taxpayer that did not acquire the IP asset or outsource the development of that IP asset to a related party would therefore have a ratio of 100 percent.

Paragraph 39 goes on to say:

> Qualifying expenditures must have been incurred by a qualifying taxpayer, and they must be directly connected to the IP asset. . . . They would not include interest payments, building costs, acquisition costs, or any costs that could not be directly linked to a specific IP asset.

Further, paragraph 42 explains that:

> IP acquisition costs are an exception since they are included in overall expenditures and not in qualifying expenditures. . . . Overall expenditures therefore include all qualifying expenditures, acquisition costs, and expenditures for outsourcing that do not count as qualifying expenditures.

Finally, in this respect, paragraph 52 says:

> The nexus approach would exclude acquisition costs from the definition of qualifying expenditures, as mentioned above, and only allow expenditures incurred after acquisition to be treated as qualifying expenditures. Acquisition costs would, however, be included in overall expenditures.

Table 6.1, cited above, notes that most of the regimes in place in Europe in 2010 were not compliant with the requirements of the action 5 final report released in 2015. Fourteen of the 28 EU member states have IP box regimes, as do four non-EU European countries, with rates ranging from 0 percent (applicable in some circumstances in San Marino and Hungary) to 13.95 percent in Italy.[4] Presumably, these regimes are all compliant with the OECD nexus approach. Interestingly, the United Kingdom was ahead of the curve when it announced in 2007 that a patent box with a 10 percent rate to be phased in between 2013 and 2017 would require that the "company must also own or exclusively licence-in patents" and "must also have undertaken qualifying development for the patent."[5]

The U.S. Experience: FDII

The TCJA brought a form of IP-related incentive into U.S. tax law that is quite different from the European IP boxes attacked by BEPS action 5. IRC section 250 subjects so-called FDII to tax reduced by 37.5 percent (21.875 percent after 2025) of the excess of the relevant foreign-source income — that is, income from selling products to, providing services to, or licensing property to foreign persons — over 10 percent of the basis in

[3] Canadian-controlled private corporations are eligible for enhanced and refundable R&D tax credits, and the maximum amount of income eligible for reduced rates is C $500,000 a year.

[4] Elke Asen, "Patent Box Regimes in Europe," Tax Foundation, June 20, 2019.

[5] HM Revenue & Customs, "Use the Patent Box to Reduce Your Corporation Tax on Profits," Gov.UK (Jan. 1, 2007).

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tangible property used in carrying on the relevant business. Therefore, the effect at the U.S. federal level (before 2026, and ignoring state and local taxes) is to reduce the effective tax on relevant profit, if one assumes nominal tangible property, from 21 percent by 7.875 percent to 13.125 percent. For a U.S. corporation operating in a no-tax state such as Ohio (and leaving aside foreign taxes), that is clearly the lowest tax rate in Canada and the United States, and it is about half the roughly 27 percent rate a multinational enterprise in Ontario or Quebec would generally pay on taxable income. However, as is discussed in the next section, the proposed Quebec IP box would change the ranking for domestic-source IP-related income. Furthermore, as the assumed level of tangible property increases or as state and local taxes are factored in, the advantage stemming from FDII decreases. For example, if one still assumes nominal tangible assets but locates the corporation in Philadelphia, the effective tax rate would be 62.5 percent of 33.82 percent, or 21.13 percent.[6]

Quebec's IP Box Proposal

Overview

As noted above, IP boxes have not been part of Canadian federal tax law and — until now — have been seen only briefly in provincial corporate tax law. British Columbia had an IP box regime between 2006 and 2017 applicable only to foreign-source IP income.[7] In 2016 Quebec adopted a limited IP box that only applied to the sale or rental of products that integrated patented inventions developed in Quebec. The regime — which is being repealed to make way for the proposed IP box — reduced from 11.8 percent to 4 percent the Quebec portion of the aggregate federal and provincial corporate tax rate of just under 27 percent (as noted above).

In its 2020 provincial budget,[8] Quebec announced that it will reduce its corporate tax rate to 2 percent (from 11.5 percent) on patent royalties and on up to 75 percent of profits from specific other forms of specified IP-related income, provided the relevant taxpayer has carried out R&D in Quebec and the IP being commercialized results in whole or in part from R&D carried out in Quebec. However, the latter R&D need not be the same as the former R&D. If that is correct, it would appear that the proposal would not preclude the purchase of the qualifying IP, which runs contrary to the OECD's recommendations in the action 5 final report.

The government describes the new policy and its basic objectives on page A20 of the budget's "Additional Information" packet:

> To encourage the competitiveness of Quebec businesses while fostering the retention and valorization of intellectual properties developed in Quebec, a new tax measure will be introduced. This measure will take the form of a deduction in calculating the taxable income of a qualifying innovative corporation for a taxation year. The incentive deduction for the commercialization of innovations in Quebec (hereinafter, the "IDCI") will apply as of 2021.
>
> This deduction will enable a corporation that commercializes a qualified intellectual property asset developed in Quebec to benefit from an effective tax rate of 2 percent on the qualified portion of its taxable income attributable to that qualified intellectual property asset. Currently, the corporate income tax basic rate is 11.5 percent in Quebec.

The proposal has not yet been formally submitted to the legislature.

Substance of the Proposal

The key aspects of the proposal are seen (1) in the formula to be used to calculate the deduction

[6] The current combined Philadelphia city (6.25 percent) and Pennsylvania state rate (9.99 percent) of 16.24 percent (slightly different than discussed in Nathan Boidman, "Reaction to Trump Plan Ignores Impact of U.S. City and State Taxes," *Tax Notes Int'l*, May 8, 2017, p. 503) is deductible for federal purposes, resulting in the 33.82 percent overall rate.

[7] For details regarding the regimes discussed in this paragraph, see Deloitte Canada, *supra* note 1.

[8] *See* Quebec, "Your Future, Your Budget: Budget Plan" (Mar. 2020); and Quebec, "Your Future, Your Budget: Additional Information" (Mar. 2020).

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from the qualified income, which leaves a residual taxable amount of qualified income that at the standard rate of 11.5 percent results in an amount of tax that is 2 percent of the qualified income before the deduction, and (2) in the descriptions surrounding and the explanations of the formula.

The formula for the deduction, each part of which is addressed herein (but without reference to the letters used in the formula), reads as follows:

[(A x B/C) - D] x (E/F) x G, in which:

A is net income (before the deduction) subject to tax in Quebec.

B and C are measures of gross income.

D is the 10 percent or 25 percent reduction of the income otherwise eligible for the explained in the next section.

E and F are measures of qualified and nonqualified R&D.

G is the 82.6 percent factor explained in the next section.

The key factors set out in the Additional Information package are as follows:

(1) A corporation will be eligible for the IP box if it carries on business in Quebec through a permanent establishment (as defined in the Quebec Taxation Act) in Quebec (and thus is subject to tax in Quebec) and the business "derives income from the commercialization of a qualified intellectual property asset to which it holds the rights." Such an entity is referred to as a qualified innovation corporation.

(2) Page A21 explains, a "qualified intellectual property asset" is:

a legally protected incorporeal property that is:

- an invention protected by:

- a patent or a certificate of supplementary protection,

- or by planter's breeder's rights; or

- software protected by copyright.

Also, to qualify as a qualified intellectual property asset, the property must result from R&D activities carried out in whole or in part in Quebec.

(3) Page A23 specifies that the income from that qualified property must be one of the following:

- a royalty, that is, a payment for the use or the concession of the use of a qualified intellectual property asset;

- income from the sale or lease of a property incorporating a qualified intellectual property asset;

- income from the supplying of a service intrinsically related to a qualified intellectual property asset;

- an amount obtained as damages from judicial remedies relating to a qualified intellectual property asset.

(4) The taxpayer must incur qualified R&D expenditures related to Quebec, which are to be calculated:

on a cumulative basis, according to a moving average including the particular taxation year and the preceding six years. For greater clarity, the expenditures preceding that period must not be included in the calculation of the ratio despite the fact that R&D activities relating to the creation of the qualified intellectual property asset may have occurred before the beginning of that period.[9]

This seems to mean — to pose an extreme example — that if a corporation incurred qualified R&D expenditures in 2021 but did not incur any such expenditures in the following six years, it would still be considered to have made qualifying expenditures in each year from 2021 through 2027 for purposes of these rules, and it might qualify for the 2 percent IP box benefits for each of those years.

[9] A footnote (note 26 on page A24) to the paragraph following this quote states, "The rules applicable to the calculation of the refundable R&D tax credits will apply to the various elements of the calculation of the nexus ratio, with the necessary adaptations."

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(5) Qualified expenditures regarding R&D in Quebec include the following (described in more detail on page A24):

i. salaries and wages to employees in Quebec;

ii. subcontract Quebec R&D-related payments to affiliated companies and 50 percent of those payments to affiliated subcontractor for R&D-related work in Quebec and 50 percent of similar payments to unaffiliated subcontractors;

iii. 80 percent of specified R&D-related payments to Quebec-based universities; and

iv. a formula-based portion of payments to unaffiliated non-Quebec subcontractors.

Calculation of the IP Box Benefit

As noted above, the proposed incentive would apply Quebec corporate tax to the qualified IP box income at a 2 percent rate rather than the usual 11.5 percent rate.[10] The rate would be achieved by allowing a deduction against the qualifying income that is otherwise subject to the 11.5 percent rate of a portion of the income so that taxing the residual amount at 11.5 percent will produce an amount of tax equal to 2 percent of the qualifying income. That portion is 82.6 percent (arrived at by dividing 11.5 less 2 (or 9.5) by 11.5).

The budget provides a formula, based on all the factors above, to calculate the amount that after applying the 82.6 percent factor becomes (comprises) the deduction, which the budget refers to as an IDCI in Quebec. The formula is conceptually simple: It takes the corporation's net income otherwise subject to tax in Quebec and extracts the portion, if any, of gross income not related to commercialization of a qualified IP asset.

The remaining (qualifying) portion would be treated in one of two ways. If the gross income from the commercialization of qualified IP assets consists only of royalties or an amount obtained as damages from judicial remedies, then the remaining (qualifying) portion is reduced to the extent of and by reference to any portion of the company's R&D that is not related to Quebec. What remains would be multiplied by the 82.6 percent factor to arrive at the IDCI. In this case, the 2 percent tax rate would be fully achieved; but that is not true in the second situation.

The second way the formula treats the remaining (qualifying) portion arises when the gross revenue from commercialization does not solely comprise royalties or infringement damage awards but instead, at least to some, sales of products or provision of services imbedding Quebec-developed IP. In those cases, the proposal would apply a factor that seems to be borrowed from the format for computing FDII.

In particular — not unlike the deduction of 10 percent of the basis in tangible property when computing FDII — to reflect the role of non-IP assets, the budget at pages A22 and A23 proposes a reduction of the remaining (qualifying) portion by "an estimate of a routine return," elaborating on that as follows:

> In determining the qualified profits from a qualified intellectual property asset, the element corresponding to the letter D [in the formula] is designed to subtract from the qualified profits, an estimate of the routine return incorporated in the income that is not attributable to a qualified intellectual property asset.

This "routine return" deduction is stated at page A22 to be the greater of (1) 25 percent of the portion of the net income attributed to gross income from commercialization of a qualified IP asset as compared with the balance of the gross income, and (2) 10 percent of the gross income attributable to commercialization of a qualified IP asset reduced by the portion of the net income (less the amount of current R&D expenditures deducted in the tax year by the taxpayer) determined by reference to the gross income from the commercialization of a qualified IP asset and the gross revenue that is not from such commercialization.

It is sufficient to say that the reduction will be at least 25 percent. Assuming just that reduction and that no other reductions apply, then — instead of paying only 2 percent Quebec

[10] There is another special lower rate that may apply on the first C $500,000 of taxable income in a year. *See supra* note 3.

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corporate tax — for each C $100 of qualified IP income (other than royalties), the taxpayer will pay 2 percent on C $75 and 11.5 percent on C $25, or C $4.37 or 4.37 percent of the pretax C $100.

Finally, there appears to be nothing in the proposal that would deny the new IP box benefit to a company simply because it did not develop the IP that is commercialized but instead acquired it, provided *inter alia* that it did carry on qualified R&D in the year the benefit is claimed or during the previous six years.

Comparing FDII and the Proposed IP Box

There are two comparisons that may be made between the FDII provisions introduced by the TCJA in 2017 and Quebec's recent IP box proposals.

First, at the substantive level there really is no comparability between a regime that provides tax reductions for any type of income as long as the source is foreign based — as FDII does — and one that provides tax reductions only for IP-related income but that allows customers to be domestic as well as foreign.

The second comparison is strictly quantitative: Given the tax rate reductions provided by FDII and the Quebec IP proposals, what state or province offers the lowest combined federal and local corporate tax rate? The short answer is that it depends, for the following reasons:

- if a business looks mainly to foreign markets, does not require substantial tangible property, and is based in a state that does not impose corporate tax, the FDII rate (before 2026) of 13.125 percent is the lowest anywhere in Canada or the United States;
- if the business involves the exploitation of patents through licensing (both domestic and foreign), for those companies that base the business in Quebec and meet the other requirements outlined above, the overall rate of 17 percent — 2 percent for Quebec and 15 percent federal[11] — should be lower than the rates arising anywhere in Canada or the United States; and
- Quebec will also be preferred if the exploitation involves sales of IP-embedded products or the rendering of IP-embedded services (that attracts the routine return carveout in the form of the 25 percent variant, not the larger 10 percent variant) that results in an Quebec rate of 4.37 percent and total rate of 19.37 percent — a rate that would be lower than any other rate on domestic profits.[12]

The foregoing comparisons assume the Quebec taxpayer would not be eligible for the lower Canadian rates available to some Canadian corporations that are not controlled by nonresidents or by specified publicly traded corporations.[13]

Conclusion

After the turn of the century, European countries led the way in providing income tax incentives for IP exploitation using IP boxes. These regimes have spawned two apparently conflicting developments.

First, the OECD and EU-led harmful tax competition initiative that was incorporated in action 5 of the BEPS recommendations seeks to rein in IP box regimes by subjecting them to the nexus requirement.

Second, we now see IP-box-type incentives gaining a toehold in North America, first at the federal level in the United States through the FDII regime introduced in 2017 by the TCJA and then at the provincial level in Canada through the newly proposed IP box in Quebec. Surprisingly, neither regime seems fully aligned with the BEPS action 5 nexus approach.

It remains to be seen if Quebec's IP box gains any traction at the federal level in Canada or in other large Canadian provinces. ■

[11] The federal rate of 15 percent is derived from a base rate of 25 percent reduced by a provincial abatement of 10 to 15 percent when the corporation is subject to provincial tax (as in the situation discussed herein).

[12] For the sake of considering the complete North American scene, it should be noted that Mexico does not have an IP box and with a general 30 percent corporate tax rate would not be competitive with Quebec or the U.S. in any state when FDII applies or most states when it does not.

[13] *See supra* note 3.

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