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Tax Alert — Canada

Incentive deduction for the commercialization of innovations in Quebec: are you ready?

EY Tax Alerts cover significant tax news, developments and changes in legislation that affect Canadian businesses. They act as technical summaries to keep you on top of the latest tax issues. For more information, please contact your EY advisor or EY Law advisor.

In its 10 March 2020 budget, Quebec announced the introduction of a taxable income deduction for the commercialization of innovations in Quebec (IDCI). In brief, the IDCI is a deduction that will allow a qualified innovative corporation to benefit from a reduced effective tax rate of up to 2% on the qualified portion of its taxable income attributable to qualified intellectual property assets. By reducing the effective tax rate applicable to commercialization income from intellectual properties to a maximum of 2%, the deduction is intended to foster the retention and valorization of intellectual properties developed in Quebec or, in other words, generate tangible investments in the commercialization of the results obtained from scientific research and experimental development (SR&ED) activities carried out in Quebec.

Although the new deduction cannot be claimed yet, as it will apply for corporate taxation years beginning after 31 December 2020, its entry into effect is fast approaching and the upcoming months can be used by corporations to gather the relevant data to prepare their claims or implement processes to be able to generate such data (some of which will be from prior years).

This Alert summarizes the new deduction based on the additional information provided by Finance Quebec in the budget documents. As of the date of this Tax Alert, draft legislation has not been released in respect of this new tax measure.

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Who may claim the deduction?

Only qualified innovative corporations may claim the new deduction. A qualified innovative corporation for a taxation year is a corporation that meets the following conditions:

- Has an establishment in Quebec
- Carries on a business in Quebec
- Derives income, from that business, from the commercialization of a qualified intellectual property asset (QIPA) to which it holds the rights
- Is not a corporation exempt from tax nor a Crown corporation or a wholly controlled subsidiary of a Crown corporation

A QIPA is a property that meets the following two requirements:

- Is a legally protected incorporeal property that is:
    - An invention protected by a patent or a certificate of supplementary protection (applied for after 17 March 2016 and obtained under the *Patent Act* or any other law of a jurisdiction other than Canada to the same effect), or by plant breeder's rights (applied for after 10 March 2020 and obtained under the *Plant Breeders' Rights Act* or any other law of a jurisdiction other than Canada to the same effect); or
    - A computer program made after 10 March 2020 and protected by the *Copyright Act* (or any other law of a jurisdiction other than Canada to the same effect)
- Results from SR&ED activities carried out in whole or in part in Quebec

A corporation will be deemed to hold a patent, certificate of supplementary protection, or plant breeder's rights if it has duly filed an application with the competent authorities and the application is pending. If the application is denied, a special recovery tax would apply, which is explained further below.

Calculation of the deduction

The deduction is calculated by applying the following formula:

[Qualified profits from the commercialization of a QIPA] x [Quebec nexus ratio] x [Tax benefit rate]

Qualified profits from a QIPA

This first component of the formula is intended to represent an approximation of the value added or profits attributable to the QIPA and is calculated by applying the following formula:

$$\frac{[\text{Net income (A)}] \times [\text{Gross income from QIPA commercialization (B)}]}{[\text{Total gross income (C)}]} - [\text{Routine return estimate (D)}]$$

Where

A = Net income for tax purposes of the qualified innovative corporation for the taxation year

B = Gross income of the qualified innovative corporation from the commercialization of a QIPA for the taxation year

C = Total gross income of the qualified innovative corporation for the taxation year

D = Estimate of the routine return incorporated in the net income that is not attributable to a QIPA; the estimate, which is applicable only where variable B is not a royalty or damages from judicial remedies, is the higher of:

- 10% x {B – [(A + H) x (B/C)]}
- 25% x [A x (B/C)]

Where H is the amount of SR&ED expenditures of a current nature deducted in the taxation year by the qualified innovative corporation.

Gross income of the qualified innovative corporation from the commercialization of a QIPA (Variable B above) must meet the following two requirements:

- Be reasonably attributable to an establishment of the corporation located in Quebec
- Constitute one of the following:
  - A royalty (i.e., a payment for the use or the concession of the use of a QIPA)
  - Income from the sale or lease of a property incorporating a QIPA
  - Income from the supplying of a service intrinsically related to a QIPA
  - An amount obtained as damages from judicial remedies relating to a QIPA

Quebec nexus ratio

The second component of the formula is intended to take into account the extent of the SR&ED activities carried out in Quebec by the qualified innovative corporation and is calculated by applying the following formula:

$$\frac{\text{[Qualified amount of SR\&ED expenditures related to Quebec (E)]}}{\text{[Overall amount of SR\&ED expenditures (F)]}}$$

Where

E = Aggregate of the following amounts paid by the qualified innovative corporation for the taxation year:

- ***Own SR&ED wages*** – Wages paid to the corporation's employees of an establishment located in Quebec in respect of SR&ED work that the corporation carried out
- ***Non-arm's length subcontracts*** – Portion of the consideration paid under a contract, in respect of SR&ED work carried out on behalf of the corporation, to a non-arm's length subcontractor, that can reasonably be attributed to the wages paid to employees of an establishment of the subcontractor located in Quebec
- ***"R&D university"*** – 80% of the portion of expenditures otherwise eligible for the refundable "R&D university" tax credit under section 1029.8.6 of the Quebec *Taxation Act* that are paid under a contract with a non-related eligible university entity, eligible public research centre, or eligible research consortium, that can reasonably be attributed to the SR&ED expenditures made in Quebec
- ***Arm's length subcontracts (Quebec)*** – 50% of the portion of the consideration paid under a contract, in respect of SR&ED work carried out on behalf of the corporation, to an arm's length subcontractor, that can reasonably be attributed to work carried out by the employees of an establishment of the subcontractor located in Quebec
- ***Arm's length subcontracts (outside Quebec)*** – 50% of the portion of the consideration paid under a contract, in respect of SR&ED work carried out outside Quebec on behalf of the corporation, to an arm's length subcontractor, multiplied by the proportion of the corporation's business carried in Quebec for the year

F = Aggregate of the following amounts paid by the qualified innovative corporation for the taxation year:

- ***Own SR&ED wages*** – Wages paid to the corporation's employees in respect of SR&ED work that the corporation carried out
- ***Non-arm's length subcontracts*** – Portion of the consideration paid under a contract, in respect of SR&ED work carried out on behalf of the corporation, to a non-arm's length subcontractor, that can reasonably be attributed to the wages paid to employees of the subcontractor
- ***Arm's length subcontracts*** – 50% of the portion of the consideration paid under a contract, in respect of SR&ED work carried out on behalf of the corporation, to an arm's length subcontractor, multiplied by the proportion of the corporation's business carried in Quebec for the year

The Quebec nexus ratio, which cannot exceed 100%, is calculated on a cumulative basis, according to a moving average that includes the particular taxation year and the preceding six years. Expenditures preceding that seven-year period are not included in the ratio calculation even if the SR&ED activities relating to the creation of the QIPA may have occurred before the beginning of the seven-year period. The Quebec nexus ratio calculation may be done with a cumulative period of less than seven years where the corporation is new or has pursued SR&ED activities for less than seven years — in these circumstances, the ratio is calculated by taking into account only the years available.

Example

Facts

ResearchCo, which has a 31 December year-end, started its operations on 1 March 2012 and started pursuing SR&ED activities on 1 July 2016. ResearchCo's qualified amounts of SR&ED expenditures related to Quebec and overall amounts of SR&ED expenditures were respectively as follows:

	Qualified amount of SR&ED expenditures related to Quebec	Overall amount of SR&ED expenditures
2016	$10,000	$12,000
2017	$21,000	$25,000
2018	$22,000	$27,000
2019	$23,000	$29,000
2020	$5,000	$7,000
2021	$24,000	$31,000

Tax consequences

ResearchCo's Quebec nexus ratio for purposes of the deduction for the corporation's 2021 taxation year will be 79.5%, calculated as follows: [($10,000/$12,000) + ($21,000/$25,000) + ($22,000/$27,000) + ($23,000/$29,000) + ($5,000/$7,000) + ($24,000/$31,000)] / 6.

The ratio is calculated using the data from the 2021 taxation year, as well as only the five preceding taxation years since ResearchCo only started pursuing SR&ED activities in the 2016 taxation year.

Tax benefit rate

The third and last component of the formula is a factor that enables the qualified innovative corporation to claim a deduction that equates to applying an effective tax rate of up to 2% to the qualified profits from the commercialization of a QIPA. The factor is calculated by applying the following formula:

$$\frac{\text{[General corporate income tax rate for the year – 2\%]}}{\text{[General corporate income tax rate for the year]}}$$

As a result, given that the Quebec general corporate income tax rate is 11.5% for 2021, the factor for 2021 will be 82.61%.

Example

Facts

For the 2021 taxation year, InnovCo has $100,000 as qualified profits from the commercialization of a QIPA and its Quebec nexus ratio is 100%. InnovCo's taxable income before the deduction for the commercialization of innovations in Quebec is $300,000 for the year. InnovCo is not entitled to the small business deduction and is subject to the general corporate income tax rate of 11.5%.

Tax consequences

InnovCo's income tax payable will be $25,000 for the 2021 taxation year (i.e., [$300,000 – ($100,000 x 100% x 82.61%)] x 11.5%). As a result, the qualified profits from the commercialization of a QIPA will be taxed at an effective rate of 2% (i.e., $100,000 x 2% = $2,000) and the remaining taxable income at 11.5% (i.e., $200,000 x 11.5% = $23,000).

How to claim the deduction

The new deduction will likely be claimable on Line 265/266 in the calculation of taxable income on the corporate income tax return CO-17 with the relevant code (not known yet) inserted in box 265i/266i. An accompanying prescribed form (which has not been released yet) will likely have to be completed and filed with the CO-17 return.

Special tax and integrity measures

A qualified innovative corporation will be subject to a recovery special tax for a taxation year in the following situations:

- The application for legal protection is denied and can no longer be appealed, or was invalidated according to the procedure provided for in the relevant legislation.
- The application for legal protection has not resulted in the issuing of the relevant document by the competent authority within five years after the application was filed (unless the corporation can demonstrate that the additional delays are not principally attributable to itself).
- A reassessment cancels SR&ED expenditures of the corporation that were included in the calculation of the Quebec nexus ratio.

In these situations, the special tax will correspond to the amount of tax the corporation saved for the taxation year by having claimed the deduction. However, in the situation where a reassessment cancels SR&ED expenditures, the special tax would apply only to the extent of the denied SR&ED expenditures.

In addition to the special tax, Quebec's Department of Finance has indicated that it may introduce integrity rules prior to the implementation of the deduction in 2021. No rules have been introduced as of yet.

Learn more

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