Ontario Bioscience Innovation Organization

TAX INCENTIVES FOR GROWING HEALTH SCIENCE COMPANIES

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Executive Summary

The global drive to build knowledge economies has probably never been stronger and regional governments are designing ever more programs and policies to compete for talent, investment and the economic and social benefits that come with success. The area of tax and tax incentives is an effective tool and is widely deployed. In 2015, the Ontario Bioscience Innovation Organization convened a working group ('OBIO Tax Policy Working Group', OTPWG) of health science industry leaders and tax experts from academia and the private sector to examine Canada's tax incentives and their effectiveness in stimulating growth in the health science industry. Access to capital is well documented as the sector's greatest challenge and the group identified two major roles for tax policy in alleviating part of this challenge: attracting investment into Canada's health science companies and maximizing a company's ability to leverage each dollar for growth, job creation and successful commercialization of intellectual property.

OTPWG identified three recommendations for the Federal Government to encourage investment into Canadian health science small and medium enterprises (SMEs):

- Investor tax credits on investment in Canadian health science companies (SMEs).
- Capital gains exemptions on investments in Canadian health science SMEs that are incremental to the $800,000 lifetime exemption for investments in Canadian Controlled Private Corporation (CCPCs).
- Create a "patent box" regime that would attract global entities to Canada by reducing the normal corporate tax rate applied to income derived from intellectual property connected to novel or improved products, patented inventions developed in Canada, and services or related innovative processes that occur within and benefit Canada.

The OTPWG also identified recommendations for the Federal government to enable Canadian SMEs to leverage their investment dollars for company growth:

- Amend the Income Tax Act so that a taxpayer's Scientific Research and Experimental Development Tax Incentive Program (SR&ED) qualifying expenditures are not reduced by

government-sourced funding, whether grant or loan. 2. Delete the phrase "or as any other form of assistance" or modify it to be specific and 3. Upon repayment of any loan, the investment tax credits (ITCs) should be refundable.

- Codify the existence of scientific and technological uncertainty in R&D work that must be experimentally validated for safety and efficacy because of government regulation (i.e. Health Canada requirements) and make this phase of development eligible for SRED.
- Allow foreign contract payments for R&D services that would otherwise be ineligible as SR&ED expenditures if such services cannot be reasonably procured from a Canadian supplier.
- Expand refundability of the scientific research and experimental development (SR&ED) regime to address cash deficiencies in pre-revenue companies.
- Reinstate eligibility of Capital expenditure for SR&ED tax credits for health science companies to support purchase of specialized equipment and the creation of research and manufacturing jobs in industry.

The group also made recommendations for the province of Ontario:

- Capital gains tax credit or exemption on investments in Ontario health science companies.
- Restore the Ontario Innovation Tax credit (OITC) rate to 10% which was applicable prior to 2016.
- Implement R&D Wage subsidies, payroll rebates or wage tax credits to support job creation in the private sector;
- Eliminate *associated non-resident companies* from the taxable income and taxable capital threshold test for the OITC to encourage investment by multinationals into local companies.
- Create a Patent Box regime for Ontario to attract global entities.

The recommendations of the OTPWG are respectfully submitted to assist the Government in updating its tax policies to conform with the goal of supporting innovation industries. The health science industry offers extensive benefits to Canada both for the economy and for the people. It also faces unique challenges. Policies that help Canadian companies overcome these challenges will deliver significant pay offs as the industry grows, creates quality jobs and solves our healthcare challenges.

Introduction

Every year there are studies measuring, and articles reporting on, the effects of tax policies on regional and national levels of innovation, research and development, and economic growth. A *2011 review*[1] by the Science Technology Industry section of the OECD summarized the goals and potential benefits of tax incentives for R&D. The majority of these continue to be relevant today for countries seeking to drive growth, innovation and productivity while creating industry jobs in R&D and downstream manufacturing and business functions. The review discusses a number of options, among them tax incentives, subsidies, and patent rights and the report recommends that the design of incentives be determined by country's innovation performance, perceived market failures in R&D, industrial structure, size of firms and the nature of corporate tax systems.

The report further states "Studies show that, depending on their design, tax incentives can increase private research spending by an amount equal to the loss in tax revenue on average. Most studies also find that social returns to such R&D far outweigh private returns. However, the effectiveness of fiscal incentives to R&D depends very much on the design of tax measures relative to policy objectives."

Canada has been widely seen as *performing poorly in innovation, productivity and business enterprise expenditures on R&D (BERD) relative to peer countries*[2] and is currently preparing an innovation agenda to address these gaps. The recent downturn in global commodity prices, and its impact on the Canadian economy, has exposed the lack of diversity in Canada's economy. Our resource sector has been, and will continue to be, an important factor in Canada's economic strength, but as the Liberal Government has stated, it is important that Canada now focus on other areas of the economy to provide a buffer against cyclical commodity prices, expand economic activity throughout all parts of Canada, and grow Canada's capacity in the technologies of this new century. On January 20, 2016, in Davos Switzerland, the Prime Minister said: "We need policies that encourage science, innovation and research"[3].The human health science industry is an important area of unrealized opportunity to further Canada's knowledge economy and to deliver social and economic benefits to the country as a whole and to each of its regions.

In 2016, OBIO released a report entitled "*How Canada should be Engaging in a $9 trillion Health Economy*"[4] and recommended an industry specific strategy to ensure success. The report was based on interviews with leaders of the Canadian health science industry and on background research and ratings of Canada's performance by global organizations. The primary research determined that financial issues, including access to capital and cash flow, continue to be the number one challenge for SMEs which dominate Canada's locally headquartered industry. Consistent with this finding was a desire for tax policies that incentivize investment into Canadian Health science companies and support growth and ongoing operations in Canada through programs that help extend runway i.e. make the most out of the dollars they bring in and buy time to the next round of investment.

In the same report, multinational companies recognized that Canada's corporate tax policies are generally competitive with other jurisdictions, however, there were concerns over erosion of incentives to invest in research here or to invest in local companies. Finally, foreign capital is critical for taking health technology from an invention to a product that has been tested and approved by regulatory agencies to be used by medical practitioners to help patients and benefit society. Tax policies can influence the decision by a foreign investor to move a company or leave it where it is headquartered and should be used strategically to address Canada's competitive performance on measures of business enterprise and industrial R&D and to create more opportunities for companies to create jobs, stay here and grow.

There is support for the effectiveness of using tax policies to drive R&D from many sources including, think tanks, academics and private sector research. A recent *survey of business leaders conducted in the UK*[5] by Management Today and Forest Brown found almost all place a high priority on innovation however the majority face barriers to innovation mainly for financial reasons. For businesses that had applied for tax credits, the study found that 57% of respondents stated that R&D tax credits had led to maintained R&D activity in the UK, 47% said their credits were re-invested in hiring new staff and 39% said R&D activities had been increased. The authors concluded that these findings are a clear signal that the policy is achieving its intended outcome of stimulating business R&D indirectly – encouraging innovation.

In response to the tax issues raised during this primary research, OBIO convened a 'Tax Policy Working Group' comprising industry leaders and subject matter experts from the tax divisions of law firms, accounting firms and academia. This group met throughout the latter half of 2015 and during 2016 to discuss Canada's tax environment for the research intense health science sector and to make recommendations for modifications to targeted programs and policies. The group considered tax policies from a National and Provincial perspective and considered two key goals, attracting investment into the health science industry in Canada and enabling companies to maximize the runway, create jobs and move technologies farther along the development pathway for every dollar raised. In addition, it discussed technical issues within existing programs such as SR&ED and how the needs of the health science industry might be better addressed.

Recommendations

The principal recommendations of the OBIO Tax Incentives Working Group are:

Government of Canada

1. To attract investment to Canada's health science industry:
    - Investor tax credits on investment in Canadian health science SMEs.
    - Capital gains exemptions on investments in Canadian health science SMEs that are incremental to the $800,000 lifetime exemption for investments in CCPCs. The types of risk and the long duration of development from discovery to marketed treatment make the health science industry a challenge for some investors when compared with IT or the resource sector. An added incentive to attract risk capital to health sciences would benefit the growth of the Canadian industry.
    - Patent Box: The creation of a "patent box" regime would attract global entities to Canada by reducing the normal corporate tax rate applied to income derived from intellectual property connected to novel or improved products, patented inventions developed in Canada, and services or related innovative processes that occur within and benefit Canada. The creation of a "patent box" regime would bring Canada in line with several other countries in the developed world that have implemented similar progressive tax policies. France, the UK, Spain, Ireland, Switzerland, Spain, Belgium and China have all moved to implement similar reductions to corporate tax rates applicable to certain income earned by companies that create patents or develop new ideas and then move on to the next stage of commercialization. By providing a clear and attractive path along which novel ideas can be brought to market, Canada would be primed for explosive growth at the leading edge of commercial health sciences technologies that until now have largely been moved abroad. Patent Box strategies also act as incentives for manufacturing technologies and strengthening the ecosystem. Taxing income derived from new technologies at a lower rate would elevate Canada to the same plane as other advanced economies thereby fostering a culture of innovation in Canada that nurtures forward thinking.

2. To help companies stretch financial resources and enable young companies to stay and grow in Canada:
    - Amend the Income Tax Act so that a taxpayer's SR&ED qualifying expenditures are not reduced by government-sourced funding, whether grant or loan. 2. Delete the phrase "or as any other form of assistance" or modify it to be specific and 3. At a minimum, upon repayment of any loan, the ITCs should be refundable. The availability of (ITCs) is the benefit with greatest impact to the continued viability of Canada's health science industry, particularly small, R&D-stage companies.

R&D stage companies expend resources on SR&ED while not generating revenue or taxable income and many are dependent on refundable ITCs as an important source of cash flow to continue to fund research activities and employ researchers. One important factor in determining the amount of refunded ITCs is whether a company has received "government assistance", defined as "assistance from a government, municipality or other public authority as a grant, subsidy, forgivable loan, deduction from tax, investment allowance or as any other form of assistance" subsection 127(9) of the Income Tax Act . The investment environment in Canada has meant that the health science industry has been heavily dependent on public sources of funding and approximately half of the companies in the OBIO study reported that they had received federal assistance, and close to half had received provincial. The eligible expenditures for SR&ED tax credits are reduced, dollar for dollar, by any "government assistance" received by the company in a particular tax year. Recent court rulings have interpreted the phrase “any other form of assistance” to capture forms of government financing beyond those actually intended in the SR&ED program. This means that most forms of support given to R&D-stage companies by government agencies including FedDev Ontario, Industrial Research Assistance Program (IRAP), Atlantic Canada Opportunities Agency (ACOA), and the Ontario Centres of Excellence should be considered “government assistance” for income tax purposes. One impact of the court decision is that when government assistance is repaid, the company can then claim the ITCs, however, they are no longer refundable and are not useful to the majority of Canadian health science companies which are pre-revenue. The loss of refundable status has a detrimental effect on Canada’s ability to build a health science industry and attract investment. For health science companies with product development timelines up to 7 years, the loss of refundable status can have the same effect on a company as the loss of the credit as many companies are unable to repay the government assistance for many years.

- Codify the existence of scientific and technological uncertainty in R&D work that must be experimentally validated for safety and efficacy because of government regulation (i.e. Health Canada requirements). Focusing solely on novel or innovative is inconsistent with the regulated nature of research in the health science industry. Currently, CRA does not generally allow R&D on drugs and medical device that are in development for therapeutic use to be claimed as SR&ED; the CRA can dismiss such work as standard practice with no uncertainty, despite the fact that companies incur very significant costs to prove safety and efficacy and many products fail in the final stages of proof.

- Allow foreign contract payments for R&D services that would otherwise be ineligible as SR&ED expenditures, if such services cannot be procured from a Canadian supplier. The nature of health science research is such that highly specialized facilities, animal models, cell lines, biochemical processes and other regulated requirements may not be available in Canada but might be necessary to the research and development of a technology. Precedence for this allowance exists in other jurisdictions; for example, Australia has amended their tax credit criteria to allow companies to claim research costs incurred on overseas activities if they meet specific conditions. This amendment has been viewed positively by foreign investors as a reason to leave the Australian start-ups in Australia. Canadian companies with advanced health technologies face similar needs and would benefit from similar tax treatment.

- Expand refundability of the scientific research and experimental development (SR&ED) regime. While many companies in the health science sector are entitled to fully refundable ITCs, many more public companies and private companies who are successful at attracting foreign investment are not able to access the full advantages of conducting innovative research in Canada. The SR&ED regime should be modified to allow for partial refundability for all businesses that conduct SR&ED in Canada, and full refundabilty for small public corporations. This would allow all companies, particularly small public corporations, to invest greater amounts of capital in innovation in Canada.

- Reinstate eligibility of capital expenditure for SR&ED tax credits for health science companies. The health science industry has a need for expensive research equipment in order to develop scientific intellectual property into products and bring them to market.

Government of Ontario

1. To attract investment to Ontario's health science industry:
    - Capital gains tax credit or exemption on investments in Ontario health science companies: One of the most pressing challenges that health science SMEs face is access to risk capital at the early stages. Once funds from the government, family and friends are exhausted, individual arms-length investors are a key source of capital for early-stage companies. The establishment of a tax credit for capital gains in high-risk industries like the human health technology industry will allow more projects to clear the investment hurdle rate and allow for an increased number of investments.

      A capital gains tax credit or exemption supports and encourages business investors by providing a financial incentive, albeit sometime in the future. The tax

benefit will be realized only if the investment yields a realized return. This strategy encourages investment only in those companies that investors think will succeed and will yield a capital gain, thus encouraging careful selection, management support and contribution. Taking into consideration that only a small portion of the government's revenue is raised through capital gains taxes, eliminating this tax on capital gains from investments in private bioscience companies makes practical sense and will generate more productive capital.

A health science capital gains tax exemption would be incremental to the current lifetime capital gains tax exemption of $800,000 on the sale of shares in CCPCs.

A Provincial capital gains tax credit or exemption would be attractive to investors and encourage additional investment into the health science sector. The same would be true for a federal capital gains tax exemption and the Ontario Ministry of Finance is encouraged to also promote a Federal capital gains tax exemption for individual investors in private health science innovation companies.

- Patent Box: The creation of a "patent box" regime for Ontario would have the same benefits as discussed above for the Federal Government. In the event there is no national approach, Ontario would be better positioned to compete with provinces like Quebec and Saskatchewan which have already taken steps to introduce a patent box incentive to attract and retain foreign investment and downstream manufacturing of health science technologies.

2. To stretch financial resources and enable young companies to stay and grow in Ontario
    - Restore the Ontario Innovation Tax credit (OITC) rate to 10% which was applicable prior to 2016. The recent reduction in the OITC rate in Ontario from 10% to 8% reduces its competitive standing in Canada to near the bottom and may cause investors to alter R&D spending decisions and look at setting up operations in other provinces.

    - Implement R&D Wage subsidies, payroll rebates or wage tax credits. While there are a number of programs for interns and youth job creation, the OBIO industry consultation revealed that in order to build health science companies, the industry needs experienced talent and talent that extends beyond the research function. Wages can represent up to 50% of a company's annual costs and financial support in this area would allow companies to create jobs, hire experienced people and compete for talent;

    - To preserve Ontario's competitiveness in attracting capital to sustain highly skilled, high paying R&D jobs in Ontario, we recommend that for certain types of entities the Government eliminate associated non-resident companies from the taxable income and taxable capital threshold test for the OITC. Currently, the 8%

refundable OITC is generally available on $3 million (the expenditure limit) of SR&ED expenditures incurred by Ontario companies that conduct SR&ED in Ontario, provided that (1) the taxable capital of the taxpayer (and all associated corporations on a worldwide basis) in the prior year was less than $25 million and (2) the taxable income of the taxpayer (and all associated corporations on a worldwide basis) is less than $500,000. However, the OITC is eliminated once the prior year taxable capital or taxable income of the taxpayer and its associated corporations exceeds $50 million or $800,000, respectively. The elimination of the OITC based on these thresholds reduces the attractiveness of investments in SR&ED activities by MNEs into the province of the Ontario.

At a minimum, Ontario should consider an exemption on the first $500 million of the taxable capital of associated corporations outside of Canada (again allowing refundability on the first $3 million of spend). We note that under the existing thresholds, if unchanged, many companies may no longer qualify for the OITC due to the significant decline in the Canadian dollar relative to the foreign currency that the taxable capital of a non-resident associated company is calculated on.

Further Ontario should consider extending the taxable capital or income thresholds to maintain refundability up to $240,000 (if OITC is at 8% or $300,000 if OITC rate is at 10%) to the extent that qualifying SR&ED expenditures meet or exceed specified minimum in the province of Ontario; and after investment by a non-resident MNE, allow a reduced rate of refundability based on a minimum spend on SR&ED in the province of Ontario. Current federal rules allow refundability for CCPCs only in excess of the $3 million expenditure limit (i.e. 40% of 15% regular ITC).

- Make capital expenditures eligible for OITC tax credits for health science companies in order to assist in the acquisition of specialized equipment and support R&D and manufacturing jobs in Ontario.

There is a case to be made that the long timelines, risk, regulated research requirements and sizable need for capital to bring products to market make the health science industry unique. Both Canada and Ontario have been recognized for publicly funded (mainly basic) research in the health sciences but not for building and sustaining a competitive health science industry. The industry is largely made up of SME's and divisions of multinational corporations. The main challenge to building Canadian headquartered companies is financial, and tax policies represent an important tool for alleviating these challenges and keeping Canada competitive in the global drive to attract health science investment, experienced talent, production infrastructure and intellectual property. We encourage the Federal and Provincial Governments to recognize the potential for job creation, economic growth, social benefits and diversification offered by the

human health sciences industry and to ensure tax policies are aligned with industry's needs. The uniqueness of the industry is well suited to specific programs and updates to existing ones and we encourage the Government to implement these recommendations in a timely manner.

About Ontario Bioscience Innovation Organization (OBIO®)

The Ontario Bioscience Innovation Organization (OBIO®) founded in 2009, is a not-for-profit, membership-based organization engaged in strategy, programming, policy development and advocacy to further the commercialization of Ontario's human health technologies positioning Ontario as a leader in the international marketplace. OBIO advances this goal through collaborative partnerships with industry, the investment community, academia, the health system and government.

For more information please visit www.obio.ca and follow OBIO on Twitter @OBIOscience

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