

How the Italian Patent Box regime works

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Giulia Cipollini

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In brief

Italy has enhanced in 2015 its first Patent Box regime, a special tax benefit allowing reduced taxation for income derived from the direct use or licence of intellectual property ('IP') assets by companies and commercial entities which perform research and development ('R&D') activities. The programme is new to Italy but follows the recent European trend to assess appealing tax measures in order to attract foreign investments and relocate IP assets. Some European countries – France, Spain, United Kingdom, Luxembourg, the Netherlands, Belgium and Ireland – have already developed a Patent Box system. Differing from most of them, the Italian Patent Box has wider and peculiar advantages targeted specifically to the Italian market.

Measure of the tax incentive

The tax relief consists of an exclusion from the taxable base – for both corporation tax (IRES, with an ordinary rate of 25.7%) and regional tax (IRAP, with an ordinary rate of 3.9%) purposes – of a percentage of the income sourced from the usage of intellectual property. The percentage of income excluded is set at 30% in 2015, increasing to 40% in 2016 and 50% from 2017 onwards. The regime is optional, lasts irrevocably for five years and can be renewed.

Background rules and international guidelines

The Italian Patent Box regime has been introduced with 2015 Stability Law (Law no. 190, December 23, 2014) and practically enhanced with a Decree issued on July 29, 2015 by the Ministry of Economic Development, in conjunction with the Italian Ministry of Economy and Finance. In addition, the Italian Tax Authority has published various official documents in order to advise best practices on accounting matters and operational procedures (lastly, '*Circolare dell'Agenzia delle Entrate*' no. 11/E and dated April 7, 2016).

The Italian IP Box legislation follows the OECD principles, in particular the Action 5 – Final Report on 'Countering harmful tax practices more effectively, taking into account transparency and substance' which requires an effective exchange of information between Tax Authorities and the presence of substantial activity where the taxpayer undertook the core income generating activities.

Who is eligible to benefit from the Italian Patent Box?

All the holders of business income deriving from the direct exploitation or the licence of IP assets and who performed R&D activities in order to maintain, enhance or develop their IP assets, are entitled to benefit from the tax advantage. These beneficiaries are probably companies, commercial entities and permanent establishments ('PE') within the Italian territory of foreign subjects. Italian branch of foreign companies can claim for the regime under the conditions that they are resident in a country which has in force a double tax agreement and have developed with Italy an effective exchange of information.

Furthermore, the OECD principles and in particular the 'nexus approach' rule, provide that all the beneficiaries of the incentive shall be the real holders of business income originating from IPs and who bore the R&D costs related to the relevant IP assets.

Only entities dealing with bankruptcy or liquidation procedures are excluded from the Patent Box regime.

What types of IP are covered by the Italian Patent Box?

The concept of intellectual property set by the law considers a wide range of assets. Differing from most of the European Patent Box regimes

mainly targeted on patents, the Italian Government also broadens the benefit to trademarks, know-how and design models. The qualifying intangible assets entitled for the Italian patent box regime include:

- trademarks;
- industrial patents, utility models, biotech inventions, patents for plant varieties, semiconductors and topographies;
- business, commercial, industrial and scientific information and know-how that can be held as secret and which are capable of legal protection;
- formulae and processes;
- design models that are legally protected; and
- software protected by copyright.

It is worth noting that the OECD Action 5 excludes marketing-related IP assets (such as trademarks) from receiving benefits after 30 June 2016. For that reason it would be preferable to apply for the regime before the 30 June 2016 deadline in order to take benefit from all its advantages.

What types of R&D expenses are included in the Italian Patent Box?

The regime covers traditional R&D activities such as fundamental and applied researches, but is also extended to a large number of investments which includes, for instance: studies and actions on brand development and design of products, processes and services; activities carried out in order to realize software protected by copyright; preventive research, test, market survey and other studies (counterfeiting measures included); and finally, communication and promotion activities, able to increase the distinctive features and the prestige of a brand.

How do companies calculate Patent Box profits?

In practice, the tax relief consists of an exclusion from the eligible income of a percentage – 30% in 2015, 40% in 2016 and 50% from 2017 onwards – of the income sourced from the usage or licence of intellectual property.

The income eligible for the exemption is determined by multiplying the relevant IP income for the so called 'nexus ratio'. The relevant IP income is differently calculated in relation to its sources (eg capital gains, direct inward use or licence). The nexus ratio is the product of the division between qualifying R&D expenses and overall R&D expenses. Qualifying expenses are the sum of all the direct and indirect R&D costs borne by the company in order to maintain, develop or enhance the relevant IP asset. Overall expenses includes the sum of qualifying expenses plus the cost of production or acquisition of the relevant IP asset.

Where the IP is licensed out, the relevant IP income is equal to the royalty earned in the relevant tax period less any direct or indirect costs attributable from a fiscal point of view to the IP asset. The measure of the benefit is directly calculated by the taxpayer and set within the income tax return. In the case of intergroup royalties, the beneficiary of the patent box regime can also opt for the determination of the relevant IP income with the Italian Tax Authority by applying to the discretionary ruling procedure. Conversely, when the income sources from the direct exploitation of the IP assets, the amount eligible for the exemption is determined through the mandatory ruling procedure before the Italian Tax Authority. The calculation is carried out by assuming the existence of an autonomous company branch which licenses the IP to the taxpayer in order to extrapolate the so called 'implicit royalty' according to the fair value principle and the nexus approach rule provided by the OECD Report.

IP income concerned for the Italian Patent Box regime

As anticipated, the Italian patent box regime provides different procedures in order to claim and calculate the tax relief in relation to the source of income involved.

1. Royalties.

In the case of licensing of IP rights to autonomous third parties, the measure of the tax benefit is directly self-assessed (with respect to each fiscal year) by the beneficiary within the income tax return. However, when the IP rights are licensed out to companies of the group, the taxpayer can select whether to proceed by self-liquidation within the income tax return or, alternatively, by applying to the discretionary ruling procedure before the Italian Tax Authority in order to determine the eligible income.

2. Profits originating from the direct use within the business of IP assets.

In this case the relevant IP income shall be defined with the Italian Tax Authority by applying to the mandatory ruling procedure.

3. Capital gains arising on the transfer of IP ownership.

The Ministerial decree literally provides that such profits are 100% exempt upon condition that at least 90% of the gain is reinvested within the second fiscal year following the year in which the transfer occurred, for the maintenance or development of other assets comprised in the Patent Box regime. However, the Italian Tax Authority recently pointed out that the exemption at issue is not 100% but should be declined according to the ordinary percentage set for the Patent Box regime (namely, 30% for 2015, 40% for 2016 and 50% for 2017 onwards). The divergence between the formal wording of the provision and the interpretation given by the Italian tax authority originates uncertainty. Finally, where capital gain arises from an intercompany transfer of IP assets, it is possible to define the eligible income by applying to the discretionary ruling procedure in front of the Italian Tax Authority instead of the autonomous determination within the income tax return.

How to claim for the regime

The Patent Box regime is applicable starting from fiscal year 2015. As it is an optional programme, the beneficiary elects ('exercise the option') into the regime by completing a form and sending it to the Tax Authority through specific software for fiscal years 2015 and 2016, or by opting the

regime within the income tax return from 2017 onwards. At present more than 4,500 filings have been submitted before December 31, 2015 in order to start benefit from the tax incentive from FY 2015.

For whoever holds business income deriving from the licence of IP rights, the exercise of the option starts the five-year period of patent box regime. Conversely, the holder of business income deriving from the direct exploitation of IP rights must also send a specific written application to the Italian Tax Authority in order to give effects to the telematics option exercised, start the five-year period of benefit and apply to the mandatory ruling procedure.

The Italian Tax Authority recently confirmed that whether the Patent Box regime should not result convenient for the company which exercised the option or/and submitted the written application to the tax ruling procedure, it is anyway possible to set-aside the patent box regime without any consequences for the taxpayer.

Ruling procedure before the Italian Tax Authority

Both the mandatory and the discretionary ruling procedure aims at setting with the Italian Tax Authority the suitable methods and criteria of calculation of the relevant IP income. The ruling procedure starts with a written free form application addressed to the Italian Tax Authority which needs to specify:

- general information on the taxpayer;
- the subject of the ruling (direct use, licence or capital gains);
- the type of the relevant IP assets;
- the R&D expenses involved; and
- the signature of the legal representative of the taxpayer.

Within 30 days from the application to the ruling procedure, the Italian Tax Authority verifies the request and can: (i) reject the application in case that the relevant requirements are not met; or (ii) accept the application and go further to the next stage.

In case of acceptance, the company has 120 days starting from the ruling application to provide the Italian Tax Authority with documents and reports which shows:

1. a detailed analysis of the IP assets structure involved in the procedure;
2. the link of complementarity between IP assets that contribute together in the realisation of products, process or services;
3. the R&D activities carried out and the accurate description of their link with the development and maintenance of the relevant IP assets' value;
4. methods and criteria adopted to calculate the eligible income derived from the IP assets. Please note that this last requirement is not mandatory for small and medium enterprises (SMEs).

The encounter with the Italian Tax Authority starts with a formal call from the Authority in order to discuss the contents of the ruling application and related documents. This consultation brings to a five-year binding agreement effective both for the taxpayer and the authority which can be renewed at least 90 days before its deadline by sending a formal application to the Tax Authority.

It is worth noting that in case of inter-company transactions or royalties, it has not been clarified yet if the tax ruling covers transfer pricing issues as well. However, when inter-company transactions or royalties occurred with foreign companies, it is possible to set the TP profiles by applying to a specific ruling procedure in front of the Italian Tax Authority ("advanced agreement for companies with cross-border activities") provided by art. 31-ter of the Presidential Decree no 600, September 29, 1973.

Considerations

The Italian Government is offering a hospitable and appealing tax framework to foreign and domestic investors willing to sponsor and develop in Italy innovative and technological ideas. The purpose of the Italian Patent box regime is to encourage the relocation in Italy of IP assets held abroad, support protection measures for 'made in Italy' trademarks and promote best tax and IP planning for companies. The broad scope of the regime which takes into account a huge number of IP rights highlights Italy among the other European patent box programmes. Some clarifications arising from the practical operation of the regime have yet to be provided but the Italian tax office believes in the success of this promotional legislation. Overall, the Italian patent box tax relief and the recent opening-measures undertaken by the Italian Government in order to attract inward investments, can grant to Italian companies and Italian branch of foreign entities, a great opportunity to develop, enhance and maintain their IP investments in Italy.

Authors

Giulia Cipollini

PARTNER | MILAN

Private client and tax

 +39 02 8821 4222

 giulia.cipollini@withersworldwide.com