VASAPOLLI & ASSOCIATI
Consulenza Tributaria Societaria e Legale

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THE ITALIAN PATENT BOX

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1. ABSTRACT

Italy has decided to become internationally competitive while also offering to Italian and foreign companies the opportunity to benefit from a tax relief program for income derived, directly or indirectly, resulting in the exploitation of intellectual properties of enterprises.

In particular, the "Patent Box" was introduced with the Stability Law 2015 in Italy. There are similar regimes already adopted in other EU countries however they are under examination by the OECD to verify that they are not harmful tax practices in connection with Action 5 of its Action Plan on Base Erosion and Profit Shifting (BEPS).

The Italian parliament approved an elective regime which grants a partial exemption from Corporate income tax (IRES & IRAP) on income derived from qualifying intangible assets i.e. Intellectual property, know-how, patents & trademarks. The exemption will increase gradually from 30% in 2015, 40% in 2016 to 50% in 2017 and beyond. The patent box serves a dual purpose, on one hand, it can reduce taxable base erosion and profit shifting (BEPS), and on the other hand, to promote Italian investments by foreign companies.

2. THE ITALIAN PATENT BOX

2.1 Who can benefit from this

The subjects that can benefit from the Patent box are:

- Italian resident companies;
- Italian branches of non-resident companies, as long the foreign companies are residents of a white list country and the existence of a double taxation treaty.

2.2 The benefits

Income deriving from the use of qualifying intellectual property (IP), industrial patents to trademarks, as well as formulas and processes information relating to experience acquired in the industrial, commercial or scientific activity, legally enforceable, would benefit from a 50% exclusion from Corporate income tax. Facilitation effect also for Regional Tax (IRAP).

(However the exemption will increase gradually from 30% in 2015,40% in 2016 to 50% from 2017 and beyond).

2.3 Ownership conditions

The exemption would apply to income stemming from either fees and royalties received under licensing or from direct use of IP.

2.4 How does it work

The regime is an optional scheme binding for a period of five years.

In case of direct use or income from intercompany transactions, to determine the appropriate income derived from IP rights it is necessary to agree with the Italian Tax authorities through "International Ruling" procedures.

Excluded income is determined on the basis of the ratio between the sum of costs of research and development incurred for the maintenance, growth and development of the intangible asset and 30% of IP acquisition costs compared with the sum of overall costs incurred for its production and 100% of IP acquisition costs.

To illustrate this point, qualifying expenditures relating to the development of trademarks are essentially advertising costs.

The capital gains from the sale of IP assets eligible are excluded provided that at least 90% of the consideration from the sale are reinvested, before the close of the second tax year, after the maintenance or development of other eligible intangible assets. If the sale takes place to determine the intercompany gain back the applicable procedure similar to that of the International Ruling.

A continuous investment in research & development needs to be done.

The regime facilitation will allow users to benefit from an effective rate IRES income resulting from the use of intangible assets of 13.5% (instead of 27%) and of a rate overall IRES/IRAP 15.7% (instead of 31.4%).

3. Italian Patent Box: benefits in accordance of action 5 BEPS

As explained by the explanatory memorandum of the Stability Law 2015, the legislation in question draws direct reference by new indications OECD as part of efforts to prevent harmful tax competition between States and summarized in the document: "*Countering Harmful Tax Practices More Effectively, taking into Account Transparency and Substance, Action 5: 2014 Deliverables*".

The Italian Patent Box, therefore, has been governed under first outlined "*nexus approach*".

As is apparent from the document in question the "nexus approach" provides that the determination of the share of income generated from IP assets that can benefit from the tax benefits is proportional to the ratio between;

- costs qualified for the development of the intangible asset as the numerator and
- The total costs incurred for the development of the property as the denominator.

The documents clarifies that *"Qualifying expenditures"…" must be directly connected to the IP asset. Jurisdictions will provide their own definitions of qualifying expenditures, and such definitions must ensure that qualifying expenditures only include expenditures that are necessary for actual R&D activities. …..They would not include interest payments, building costs, acquisition costs, or any costs that could not be directly linked to a specific IP asset*".

The "*Overall expenditures*" placed in the denominator of the formula instead "*must be the sum of all expenditures that would count as qualifying expenditures if they were undertaken by the taxpayer itself. This in turn means that anything that would not be included in qualifying expenditures even if* *incurred by the taxpayer itself (e.g., interest payments, building costs, acquisition costs, and other costs that do not represent actual R&D activities) cannot be included in overall expenditures and hence does not affect the amount of income that may benefit from an IP regime. IP acquisition costs are an exception, since they are included in overall expenditures and not in qualifying expenditures*" .

4. WHAT IS ACTION 5 BEPS

The BEPS project consists of a global action to prevent and limit the erosion of the tax base by the companies that operate on a global scale through the transfer for purposes of the elusive business profits to jurisdictions with more favorable taxation.

This scheme is a direct application of guidelines issued by the OECD as part of what is known as BEPS (Base Erosion and Profit Shifting) Project.

In the document OECD/G20 Base Erosion and Profit Shifting Project – Explanatory Statement – Deliverables 2014 " the OECD has shown the first set of reports and recommendation presented in reference to seven of the fifteen actions provided by BEPS Action Plan, approved OECD in July 2013.

Specifically, the OECD has published :

➢ Two final report on the "*Digital Economy (Action 1)*" and the "*Feasibility of a Multilateral Instrument (Action 15)*";

➢ An interim report regarding "***Harmful Tax Practices (Action 5)***";

➢ Four Draft Rules and more precisely:

- Hybrid mismatch arrangements (Action 2)
- Treaty abuse (Action 6)
- Transfer pricing of intangibles (Action 8)
- Transfer pricing documentation and a country-by-country reporting template (Action 13)

In particular the document "*Countering Harmful Tax Practices More Effectively, taking into Account Transparency and Substance, Action 5: 2014 Deliverables*" provides :

The review of the existing framework concerning preferential arrangements pertaining to the area of Intellectual property (IP) in view of the strengthening of the requirements of substantial activity and transparency",

The review of preferential schemes identified by the OECD member countries and the definition of a strategy to allow the participation of non-members;

The revision of the existing framework in terms of preferential arrangements involving the area of intellectual property (IP) is a consequence of the consideration made by the OECD that "*Fostering innovation is an important element of growth strategies because intangibles such as patents have become one of the key value drivers of many business models. A preferential regime is useful in supporting growth and innovation in a country if it attracts real activity. It is not so if it merely encourages companies to shift profits from the location in which the value was actually created to another location where they may be taxed at a lower rate.*"

According to the cited document the preferential tax regimes are consistent with the principles of the BEPS Project must therefore be based on the concept of the "substantial activity" that must be verified through the "nexus approach".

As stated by the OECD in the document under review :" *This approach looks to whether an IP regime makes its benefits conditional on the extent of R&D activities of taxpayers receiving benefits. The approach seeks to build on the basic principle underlying R&D credits and similar "front-end" tax regimes that apply to expenditures incurred in the creation of IP.... It is not the amount of expenditures that acts as a direct proxy for the amount of activities. It is instead the proportion of expenditures directly related to development activities that demonstrates real value added by the taxpayer and acts as a proxy for how much substantial activity the taxpayer undertook....... In other words, the nexus approach allows a regime to provide for a preferential rate on IP-related income to the extent it was generated by qualifying expenditures. The purpose of the nexus approach is to grant benefits only to income that arises from IP where the actual R&D activity was undertaken by the taxpayer itself.* " .

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