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## a closer look

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## The Upcoming Implementation Of The Italian Patent Box Regime

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### Introduction

Several press articles in recent weeks have anticipated the upcoming enactment of the Ministerial Decree which will eventually implement the Italian Patent Box regime. The Ministry of Economics and Finance announced on July 29, 2015, that the competent ministries have signed the decree, and therefore its publication in the Official Gazette is imminent.

At the end of 2014, the Italian Parliament approved the Budget Law for 2015, which, *inter alia*, introduced for the first time in Italy a Patent Box tax regime, similar to those already in place in many other European countries, which is relevant for both Corporate Income Tax (IRES, 27.5 percent rate) and the Regional Tax on Productive Activities (IRAP, ordinary rate at 3.9 percent). This new regime is aimed at providing an effective tax incentive for enterprises to create, relocate and maintain intangible assets in Italy.

The Italian Patent Box is actually a very attractive and broad regime: it determines a 50 percent



exemption (30 percent in 2015, 40 percent in 2016) on income derived from the exploitation of a wide range of qualifying intangible assets, after the application of a certain ratio based on the costs borne for the development, acquisition, enhancement and maintenance of such intangibles. The incentive is determined according to a formula which can be summarized as follows:

$$\frac{\text{Income receiving tax benefits (50\% on an ongoing basis)}}{\text{Overall Income from IP asset}} = \frac{\text{Qualifying expenditures incurred to develop IP asset}}{\text{Overall expenditures incurred to develop IP asset}}$$

Furthermore, the Patent Box grants a full exemption from taxation over the capital gains arising from the sale of the same qualifying intangible assets, under the sole condition that 90 per cent of the consideration obtained from such sale be reinvested in the maintenance, enhancement or development of other qualifying intangible assets.

The Patent Box regime is optional and requires a five-year irrevocable election.

Although other jurisdictions may have implemented similar IP regimes that are more favorable than the Italian one in terms of tax rate reduction, the appeal of the Italian Patent Box regime lies in the broadness of its potential scope of application.

### **Scope Of Application**

From a subjective standpoint, any taxpayer carrying out a business activity in Italy, either as a tax resident or through a permanent establishment located therein, is eligible for such regime. The sole requirement is a substantial one: carrying out a qualifying research activity which leads to the creation of a qualifying IP asset. If non-qualifying research only is carried out, or no qualifying IP is obtained, no benefit is granted. The true strength of this regime, however, resides in its wide range of qualifying intangibles:

- Industrial patents, biotech inventions, utility models, patents for plant varieties, and semiconductors' topographies;
- Business, commercial, industrial and scientific information and know-how which can be held as secret and whose protection can be legally enforced;
- Formulas and processes;
- Designs and models, legally protected;
- Software protected by copyright;
- Trade marks, including collective trade marks, either registered or in the process of registration.

### **OECD Grandfathering Clause On Non-Compliant IP Regimes: Trade Marks**

Special attention should be paid to trade marks, especially from an Italian perspective. Many Italian

enterprises have built their success on high-end products whose value is often due not only to intrinsic high quality, but also to their famous and prestigious trade marks. Such trade marks have often been developed and maintained through intensive and costly marketing activities which have greatly increased the added value of the products sold. Notable examples in the Italian industry include fashion, automotive and food.

However, it should be kept in mind that the Organisation for Economic Co-operation and Development (OECD) since 2013 has been implementing the so-called BEPS Action Plan, an action plan conceived in order to devise solutions widely agreed at the international level to tackle base erosion and profit shifting (BEPS) practices. Within the enactment of the BEPS Action Plan, the OECD is also addressing issues related to harmful tax competition among states through IP regimes, by setting a common standard of rules and principles which shall be implemented by all OECD countries in their domestic legislation by 2021 (Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance, BEPS Action 5; Agreement on Modified Nexus Approach for IP regimes, so called "Modified Nexus Approach" of March 8, 2015; plus a third, final document, which was expected in July but is still pending).

The Italian Patent Box regime has been shaped already in compliance with the (non-final) guidelines provided by the OECD so far. The only feature of the Italian rules which is not in line with the OECD

principles is the inclusion of trade marks within the scope of intangibles qualifying for the incentive.

Nevertheless, such extension of the Patent Box regime to trade marks should benefit from a five-year grandfathering clause, which allows the states to apply their current non-compliant IP regimes until June 30, 2021, when all states will be required to have implemented fully compliant rules (the so-called "abolition date"). Italy-based undertakings will therefore have a one-off opportunity to benefit from the Italian Patent Box regime also in respect of trade marks for the limited timeframe of 2015 to 2021. To take advantage of such benefit, taxpayers must take *timely action*, since OECD documents (Modified Nexus Approach) also provide a foreclosure to "new entrants" starting June 30, 2016, which will likely require taxpayers to provide their opt-in for the Patent Box before that date. A decree addressing the formalities for the election filing is expected. Since under current regulations even the opt-in for 2015, as a matter of principle, would be made within the tax return for 2015 (due, as a general rule, by September 30, 2016), it is likely that the Government will provide special election procedures in order to allow taxpayers to file in 2015 so as to fully benefit (with effects starting from fiscal year 2015) from such transitional regime extended to trade marks. For those cases where the ruling request is mandatory, it will be crucial that both the election and the ruling submission are filed within 2015 (see next paragraph for the effects of the ruling).

## First Part Of The Formula: Computation Of Income Derived From The IP

For the purposes of the computation of the tax benefit, several aspects are relevant. The first part of the above-mentioned formula requires the taxpayer to determine the portion of income generated through the exploitation of the intangible. There are still some uncertainties regarding how the taxpayer will be required to compute the IP income over the relevant opt-in period. The decree will have to clarify whether the income to be considered each year is just the income realized in that year, or whether it has to be computed (similar to the costs) on a cumulative basis (net of the portion incentivized in previous years). In the latter case, which would seem the most reasonable, any loss on the IP realized in a given year will evidently (and automatically) reduce the cumulative computation, thus ruling out any doubt that such a loss had to be neutralized in the fiscal year in which it was suffered. This latter issue could make the option potentially problematic, especially considering that for newly created IP, loss-making periods often precede the profitable ones, and, in some cases, the latter may not materialize at all.

As regards the actual computation of the IP income, this task can be relatively simple when the intangible is licensed to third parties, since the royalty paid to the IP holder constitutes the primary item to be considered. However, since the tax incentive applies to net income, the taxpayer is also required to identify the relevant costs connected with the royalty revenue. More complex calculations are

required when the IP is exploited internally; in these hypotheses, it appears that the use of transfer pricing methods is required in order to provide a reliable computation of the portion of income internally generated which can be attributed to the IP. The Italian Legislator is aware that these hypotheses are the most sensitive ones and therefore has established that an advanced ruling is mandatory (while in the case of IP exploitation through inter-company licensing, it is merely optional).

A ruling process can be fairly time consuming. In addition, an escalation in the workload of the ruling team can be expected because of the wide relevance of the new regime. For this reason, while the tax benefit can only be taken after the ruling is granted, the benefit will be retroactive to the fiscal year in which the ruling request is filed. This is why filing within 2015 is recommended for companies that want to fully exploit the Patent Box benefits.

### **Second Part Of The Formula: The Cost Ratio**

The identification of the income derived from the exploitation of the IP is only the first task. In compliance with the guidelines developed at the OECD level, it is necessary to apply a cost ratio to the IP income. Such ratio is aimed at reducing the amount of (or barring) the tax incentive when the taxpayer bears the following non-qualifying costs related to the intangible (which will be conventionally named as "tainted costs"):

- R&D costs outsourced to companies or other entities belonging to the same group as the taxpayer;

- Costs of acquisition of the intangible from related or unrelated third parties.

The ratio, in fact, is computed as follows:

- The denominator includes *all* the costs incurred by the taxpayer for the purpose of acquiring, developing and maintaining the IP considered;
- The numerator includes the same kind of costs included within the denominator, but *tainted costs* are computed only up to an amount equal to *30 per cent* of the other qualifying costs.

Therefore the costs to be considered within the denominator and the numerator are the same in nature and differ only in their allowed amount. This means that if the taxpayer, for instance, does not bear any tainted cost (or up to an amount not exceeding 30 per cent of the other qualifying costs), the ratio will be 100 per cent. In this case, the tax exemption (up to 50 per cent of the IP income) will apply to the full amount of the income that is deemed to be derived from the exploitation of the IP considered.

The guidelines developed at the OECD level require taxpayers to consider all the costs incurred in order to acquire, develop and maintain the IP for the purposes of the computation of the cost ratio. It is thus necessary to take into consideration the expenditures incurred during the entire life of the IP asset, not only those incurred and recognized within the income statement of the tax year considered. This mechanism is aimed at creating a nexus between the IP development and the tax incentive,

and avoiding possible duplications of the benefit (tainted cost related to IP for which other taxpayers could have received an incentive).

To this end, taxpayers will have to implement effective and analytic cost-tracking and tracing methods within their accounting systems in order to keep detailed track of such costs and their imputation to a certain IP. This sort of compliance is extremely important, especially for bigger enterprises, which often hold several intangibles, because the determination of the Patent Box tax incentive must be made severally for each IP (however, if several intangibles are used in connection with a single process or product, they are treated as one IP for the purpose of determining both the IP income and the cost ratio).

Looking at the whole life of the IP requires taxpayers to also consider costs incurred before the implementation of the Patent Box regime. Clearly this sort of analytic cost-tracking and tracing cannot be implemented retroactively by taxpayers; therefore, for an interim period (apparently up to and including 2017), taxpayers will be allowed to determine a *single cost ratio*, based on all the IP-related costs, applicable to all the intangibles held. In addition – and for the same reason – such retrospective computation should occur only up to a specific *cut-off date* (apparently back to and including 2012). These measures should reduce the complexities related to a computation of several ratios for each IP, in absence of an adequate cost-tracking and tracing system before the Italian Patent Box regime enters into force.