Italian Revenue Agency comments on the Patent Box regime

Tax Alert
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Introduction

Under the Patent Box regime(1), a percentage(2) of 'qualifying income'(3) attributable to the 'use' of certain eligible intangible assets or IPs (i.e. software protected by copyright, patents, registered or pending trademarks, designs and models, processes, secret formulas, and industrial, commercial or scientific knowledge, including know-how) is excluded from the corporate income tax and regional tax base.

Resident entrepreneurs and non-resident companies/entities(4) are eligible for the incentive, which is available for income arising from the tax year following that in progress on 31 December 2014 (i.e. 2015 for calendar-year taxpayers). Once elected, the arrangement lasts for five years and cannot be revoked.

Following the principles of the OECD(5) and the example of other EU Member States, the regime rewards enterprises undertaking and bearing the costs of R&D that may increase the value of certain IPs and moving IPs to Italy or keeping them there(6).

Last month, the Italian Revenue Agency (the 'Agency') published a 94-page circular(7) (the 'Circular'), clarifying and commenting on the regime, as summarized below.

(1) Introduced by the 2015 Budget Law (article 1 [paragraphs 37-45] of Law no. 190/2014) and amended by article 5 of the 'Investment Compact' Decree (Decree no. 3/2015, converted into Law no. 33 of 24 March 2015).

(2) For calendar-year taxpayers: 30 percent in 2015, 40 percent in 2016 and 50 percent from 2017.

(3) Qualifying income is calculated, in accordance with the OECD 'modified nexus approach', by multiplying the income attributable to the eligible IP by the ratio of qualifying R&D expenditure to the total expenditure incurred to develop the intangible asset. The qualifying expenditure can be increased by up to 30 percent by including the costs of acquiring the asset or the intercompany costs of R&D contracts for the asset.

(4) Provided that they (i) are resident in a treaty country allowing an effective exchange of information with Italy, and (ii) have a permanent establishment in Italy to which the intangible assets are 'attributable'.

(5) See the final Report on BEPS Action 5 of 5 October 2015.

(6) Certain clarifications were contained in the Implementation Decree (approved on 30 July 2015 by the Ministry of Economic Development together with the Ministry of Economy and Finance) and by the Italian Revenue Agency in Circular no. 36/E of 1 December 2015 (see our Tax Alerts of 2 December 2014, 2 February 2015, 3 November 2015 and 21 December 2015).

(7) Circular no. 11/E of 7 April 2016.

How the election must be made

The incentive can be used for one or more IPs, and not necessarily for all the intangible assets held by the same beneficiary. If an enterprise wishes to apply the incentive to another IP in a subsequent year, it must make a separate election.

For 2015 and 2016 (for calendar-year taxpayers), an electronic election form must be submitted to the Italian Revenue Agency by the end of the relevant calendar year. Delays in submitting the form are allowed, provided that:

- submission is made by the income tax return presentation deadline (e.g. 30 September 2016 for tax year 2015);
- if a tax ruling is required, the taxpayer submits a ruling application by the end of the year (e.g. by 31 December 2015 for tax year 2015);
- the taxpayer and its IP/IPs are actually eligible for the incentive;
- the taxpayer pays the minimum €250 penalty for failing to submit its election form on time.

Implications of failing to submit a ruling application

Mandatory ruling

Tax law requires that income attributable to an intangible asset used directly by an entrepreneur must be determined in agreement with the Agency via a ruling procedure.

In this case, election is effective from the tax year in which the application is filed (and not from the year in which an agreement is reached). Thus, an entrepreneur wishing to benefit from the regime from tax year 2015 had to submit not only the election form but also a ruling application by 31 December 2015, followed by supporting documentation within 150 days (by 30 May 2016).

If the mandatory ruling application is not submitted by the end of the year concerned, or if the supporting documentation is submitted late, the Patent Box regime ceases to apply, though there are no penalties.

Optional ruling

The ruling is optional when determining the:

i. income attributable to an intangible asset that is used indirectly (e.g. licensed) within a group;

ii. gain realized from an intragroup sale of an intangible asset[8].

In this case, it is enough to elect the regime, which is effective immediately, and the taxpayer itself calculates the income attributable to the IP. If the taxpayer then decides to apply for a tax ruling, the incentive remains in place even if the ruling application is not submitted on time. However, the taxpayer cannot determine the qualifying income until an agreement with the Agency has been signed.

Switching

The Circular also addresses the effects of switching from a situation in which a ruling is mandatory to one in which it is not (e.g. as a result of a business reorganization), and vice versa.

Eligible IPs

The 2016 Budget Law widened the scope of the Patent Box regime. It clarified that if two or more qualifying intangible assets (even if not in the same IP category) belonging to the same taxpayer are complementary, so that the realization of a product or process depends on their joint use, those intangible assets form one individual asset for the purpose of the Patent Box regime. The Agency has now clarified that this interpretation applies retroactively from tax year 2015.

The Circular also provides a detailed description of each type of eligible IP. It then clarifies that the following are excluded from the incentive:

i. copyrights, except for copyrighted software

ii. lists of names, such as client or supplier lists.

Eligible R&D costs

The Circular provides a detailed description of R&D costs that, when incurred to maintain, enhance or develop eligible IPs, qualify for the incentive.

How the eligible tax base is calculated

The eligible tax base is calculated as the product of qualifying income attributable to the eligible IP multiplied by the 'nexus ratio'.

Eligible income

If there is 'direct use' of IP, eligible income is the deemed royalty included in the sale price of products and services, minus any direct and indirect (tax) costs of creating, developing, maintaining and/or improving the IP.

This deemed royalty is the income that independent third parties would potentially earn on the market using the IP under the same conditions. As mentioned above, when IP is used directly by an entrepreneur, eligible income must be agreed with the Agency through a ruling.

If there is indirect use of IP, a ruling application is possible if the IP is licensed within the group. Instead, if the IP is licensed or granted to third parties, a ruling is not allowed and the taxpayer itself must determine the eligible income.

If an Italian enterprise licenses IP to a foreign entity in the same group (a parent, subsidiary or sister company), it may apply for an international ruling to assess the arm's length value of the income and costs.

The eligible income attributable to the IP is calculated according to chapter VI of the OECD Transfer Pricing Guidelines, as recently amended by Actions 8-10 of the

(8) Under certain conditions, the capital gain may be exempt from income taxes.

(9) As per article 31-ter of Presidential Decree no. 600/73.

Base Erosion and Profit Shifting (BEPS) project. The preferred methods are the comparable uncontrolled price (CUP) method and the profit-split method. In particularly complex cases, the use of more than one method is advisable.

Nexus ratio

The nexus ratio is calculated in accordance with the OECD Modified Nexus Approach (see footnote 3), based on the ratio of the qualifying R&D tax costs of enhancing, maintaining and developing the IP to the total cost of producing it. The Circular provides the following clarifications.

- Intragroup R&D costs recharged with a margin can be included in the numerator of the ratio, if the intermediation margin is excluded.
- R&D costs incurred within a cost contribution arrangement can also be included in the numerator.
- Costs must be included on an accruals basis as per article 109 of the Italian Income Tax Code, regardless of the accounting principles adopted by the taxpayer (local GAAP or IAS/IFRS), and without taking amortization into account.

Tracking and tracing

In the first 3 years (2015-2017) of the Patent Box regime, the relevant costs are those incurred in the year in which the benefit is taken and in the previous three years. They can be considered as a whole, without being allocated to the individual intangible assets, unless the taxpayer prefers (and is able) to calculate the costs for each IP. If R&D costs for eligible IPs cannot be separated from R&D costs for ineligible IPs, the taxpayer may also include the costs for the ineligible IPs. From 2018, only costs incurred during the year will be eligible and will have to be used individually for each single qualifying IP.

Calculation of the benefit

The benefit is available for both corporate income tax (IRES) and regional tax (IRAP). For reasons of simplicity, the reduction is the same for both, regardless of the different mechanisms by which the two taxes are calculated.

Business reorganizations

In a merger, demerger or contribution of a business concern, the effects of an elected Patent Box regime are shifted to the transferee[10]. The Circular provides the following clarifications.

- If the reorganization involves a business or branch of business and not an individual IP, the transferee can use the transferor's costs for the Patent Box even if the transferor did not opt for the regime before the effective date of the business reorganization.
- However, until 30 June 2016, due to the OECD 'grandfathering clause', this rule also applies in mergers, demergers or contributions involving a single IP (the transferee may exclude, from the nexus ratio, the purchase cost incurred by the transferor and, consequently, benefit from a higher ratio).
- Any higher accounting value of the IP, resulting from the allocation of a merger or demerger surplus, is not included in the calculation of the ratio.
- The higher value attributable to the IP in the case of transfer of residence to Italy (as determined according to article 166-bis of the Italian Income Tax Code) is not included in the ratio. Only the original cost borne by the enterprise abroad must be included.

Q&As

The Agency has replied to several common queries. Some of the answers are summarized below.

- Fundamental research
  Fundamental research costs must be included in the nexus ratio from the year they are used, i.e. when the research is 'applied'.
- Unsuccessful research
  Unsuccessful R&D costs must not be included in the nexus ratio but excluded from both the numerator and the denominator.
- Trademarks
  The Circular confirms that trademarks, either separately or jointly with other complementary IPs, are eligible IPs, and that R&D costs include the promotion, communication and presentation of trademarks to enhance their reputation and visibility.

(10) Article 5 of the Implementation Decree.

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