Executive summary

On 7 April 2016, the Italian Revenue Agency (IRA) issued Circular n. 11 (the Circular), which provides significant and extensive guidance on the Italian Patent Box Regime.1

The Circular addresses several operational issues that required clarification. As background, the Patent Box regime is an elective regime granting a 50% exemption (reduced to 30% for 2015 and 40% for 2016) from corporate income tax (IRES, generally levied at 27.5%)2 and regional tax (IRAP, generally levied at 3.9%) on income derived from the direct exploitation, licensing or disposal of qualifying intellectual property (IP). The regime is eligible for taxpayers who perform research and development (R&D) activities and is characterized by a five year lock-in period. The election is renewable. A ruling is mandatory in the case of internal use of any qualifying IP while it may be electively sought in the case of royalty income derived in intercompany transactions. The option for the regime and the associated ruling (if any) must be filed before the end of the relevant FY. As of the date of the ruling filing, taxpayers have 120 days to file supporting documentation. For taxpayers who elected the regime as of FY2015, to allow adequate time to prepare the supporting documentation, the relevant deadline has been extended by 30 additional days (i.e., the additional documentation shall be presented not later than 150 days after the submission of the ruling request).3
Detailed discussion

The set of recommendations contained in the Circular aims at clarifying some of the most controversial issues resulting from the implementation of the Patent Box regime. The following summarizes some of the key clarifications.

Qualifying IP

Know-how may be elected as qualifying IP under strict parameters. In particular, it must be supported by a specific self-declaration issued by the taxpayer certifying the essential features of the IP including a detailed description of the know-how, its economic value and secrecy.

Customer lists (e.g., directories of customers and suppliers) as well as other IP, such as literary or scientific works, radio and TV formats, music or art works and in general copyrights (excluding software), are expressly excluded from the Patent Box regime.

Benefit computation for direct use of IP

In the case of direct use of IP, the computation of the related income benefitting from the Patent Box, should be made on the basis of the accounting data booked in the profit and loss statement and as adjusted for corporate income tax purposes.

Preferred valuation methodologies

The Comparable Uncontrolled Price (CUP) and the Profit Split Method (PSM), with specific reference to the Residual PSM approach, are addressed as the preferred and more reliable methods to compute the IP related return qualifying for the Patent Box benefit.

Any relevant transfer pricing (TP) considerations supporting the computation of the IP income should be duly supported by an adequate analysis describing functions, risks and assets involved in the exploitation of the IP.

The taxpayers may also refer to valuation techniques based on the financial practice. However, an adequate justification should be provided to demonstrate the unreliability of the mentioned preferred criteria, and that the income computation obtained by using an alternative methodology is in line with the Organisation for Economic Co-operation and Development (OECD) principles.

For complex cases where the adoption of only one valuation method does not allow a reliable result, the use of multiple methods is suggested.

It is worth noting that, even when applying one of the above methods within a Patent Box ruling procedure, the arm’s length value of any involved cross-border intercompany transaction is out of the scope of the said ruling. However, it is explicitly clarified that in such cases the taxpayer may activate the ordinary Advance Pricing Agreement (APA) procedure in order to define the arm’s length price.

Nexus ratio

The content of the ruling should not include the nexus ratio or the underlying computation criteria.

Any eligible costs included in the nexus ratio should correspond to the total of the relevant expenses incurred in any given year. In this respect, the driving criterion is the time imputation principle set forth by the Italian income tax code (Tuir) and specifically under Article 109 (both for local accounting principles and International Financial Reporting Standards/International Accounting Standards adopters). This implies that any quantitative differences provided under tax rules (e.g., tax deduction limitations) should not be taken into account. Likewise, differences resulting from the adopted accounting criteria should not be considered (e.g., choice of capitalizing an IP-related cost and cost amortization timeline).

Tax adjustment

The tax benefit computed for IRES purposes is also valid for IRAP.

Tax losses

If the economic exploitation related to the IP results in a tax loss (e.g., the costs related to the IP exceed the corresponding revenues), the tax benefits granted by the Patent Box regime are postponed to the first year in which the qualifying IP generates a taxable income. This recapture mechanism also applies to IP losses generated prior to the Patent Box election and incurred as of FY2015 (i.e., time of entry into force of the regime).

Mergers & Acquisitions

Corporate reorganizations carried out for the sole purpose of simplifying the application of the Patent Box regime should not be considered as abusive provided that there are no other tax advantages involved. A reorganization aimed at obtaining an indirect use of qualifying IP (e.g., creation of an IP company) so to avoid the mandatory ruling provided for its direct use should not constitute an undue tax benefit.
The Patent Box election is transferred to the company resulting from the reorganization together with the relevant R&D costs which keep the same nature and timing that they had at the level of the transferor. Likewise, the relevant R&D costs are also transferred to the resulting company where the Patent Box election is directly made by the latter after the reorganization. The resulting company should have substantial R&D activity.

Q&A section
The Circular includes a final section with answers to specific questions on the Patent Box regime posed by businesses and professional associations.

Endnotes
2. IRES is reduced to 24% as of FY2017.
3. Dispatch by the Director of IRA of 23 March 2016 (Provvedimento Prot. 2016/43572).
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