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Implementation rules issued for new patent box regime

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Implementation rules for Italy's new patent box regime were published in the official gazette on 21 October 2015, following the issuance of a decree on 30 July 2015 (for prior coverage of the regime, see the *World Tax Advisor* article dated 27 February 2015). The patent box rules apply as from 2015 for calendar-year taxpayers.

The patent box regime, introduced by the finance law 2015, is designed to encourage the development of intellectual property (IP) in Italy. It grants a partial exemption from corporate income tax (IRES) and the local tax on productive activities (IRAP) for income derived from certain intangible assets. For 2015, an exemption equal to 30% of income from the licensing or direct exploitation of qualifying intangible assets is available, with the percentage increasing to 40% in 2016 and 50% as from 2017.

Implementation rules

The provisions in the decree generally are in line with the "nexus approach" described in the OECD final report on action 5 (countering harmful tax practices more effectively, taking into account transparency and substance) of the base erosion and profit shifting (BEPS) project (but see below with respect to trademarks) (for prior coverage of the final report on action 5, see the tax alert dated 8 October 2015).

The implementation rules provide as follows:

- Both Italian resident entities and Italian branches of nonresident entities are eligible to elect into the patent box regime. Branches of nonresident entities, however, must be resident in a country that has concluded a tax treaty with Italy that contains a full exchange of information clause, and the IP must be attributable to such branches.
- The election into the patent box regime may be exercised by the holder of the economic right to use the IP; this makes the regime available to owners of the IP, as well as to licensees, provided they carry out R&D activities.
- Companies subject to bankruptcy procedures, forced liquidation or similar procedures are not eligible for the regime.

- The option to elect into the regime must be exercised according to instructions to be provided by the Director of the Revenue Agency. As from 2017, the election will be able to be made in the annual tax return.
- Once an election for the patent box regime is made, it will be irrevocable for a five-year period, although it may be renewed.
- If the income eligible for the exemption is determined through the ruling procedure (which involves obtaining a specific ruling from the tax authorities, and is mandatory in the case of a "direct" use of the IP and optional in the case of an intercompany license of the IP), the election is effective as from the fiscal year in which the ruling is issued.
- In the case of extraordinary transactions (mergers, demergers, business contributions), the transferee will assume the rights connected to the election made by the transferor (as well as the costs incurred by the transferor).
- R&D activities carried out for the development, maintenance and improvement of the value of IP (i.e. the activities that make a taxpayer eligible for the regime) include: fundamental and applied research; design; the conception and realization of software protected by copyright; preventive research; testing; market surveys; actions taken to protect and renew IP rights; and presentation, communication and promotion activities (with respect to trademarks).
- Income derived from the following IP is eligible for the patent box regime: (1) industrial patents that have been granted or are in the process of being granted; (2) software protected by copyright; (3) trademarks, including collective brands, that have been registered or are in the process of being registered (although the inclusion of trademarks under the patent box could be repealed in the future, since this is inconsistent with the OECD recommendations under action 5 of the BEPS project); (4) models and designs that are capable of being legally protected; and (5) business and technical-industrial know-how.
- Where the IP is used directly, "qualifying income" is the embedded IP income from the sale of products and the use of processes, net of the direct and indirect expenditure related to IP assets that is relevant for tax purposes. In the case of an indirect use of the IP, qualifying income is equal to the royalties earned in the year, net of all IP-related direct and indirect costs relevant for tax purposes. Income derived from compensation and refunds (for contractual and noncontractual liability) relating to the infringement of contracts and IP rights also is eligible for the exemption provided by the patent box.
- There must be a direct nexus between the R&D activities and the qualifying IP, as well as a direct nexus between the qualifying IP and the qualifying income. The qualifying income must be determined through asset-by-asset tracking based on an adequate cost accounting system.
- The "nexus ratio" is the ratio between qualifying expenditure (R&D expenditure carried out by the taxpayer and R&D expenditure for unrelated party outsourcing, increased by costs for outsourcing to related parties and the acquisition costs of the IP (limited to 30% of the qualifying expenditure)) and overall expenditure (all of the above-mentioned costs, without the 30% cap on related party and acquisition costs). Interest expenses, expenses relating to immovable property and any costs that cannot be directly linked to any IP asset are not relevant for purposes of the calculation.
- Where a payment is made from a related party to an unrelated party without any margin, the payment will be included in qualifying expenditure. In accordance with this rule, R&D costs for the development,

maintenance and improvement of the IP carried out by the taxpayer under a cost-sharing agreement, limited to the amount of income arising from the same cost-sharing agreement, will be included in qualifying expenditure.
- For the first three years the patent box regime applies (2015-2017), the nexus ratio will not be calculated on an IP-specific basis, but on an overall basis, and relevant costs will include the costs incurred in the relevant year and the prior three years. As from 2018, the ratio will be calculated separately for each IP asset, and the costs to be considered will be those incurred as from 2015.
- If a product is strictly linked to the joint use of more than one IP asset, such IP assets are considered as one asset.
- To be eligible for the regime, the relevant R&D agreements must be concluded with parties resident in EU member states, or countries that allow for an adequate exchange of information.

Time-sensitive action items

Despite a few “gray areas” in which additional guidance is expected to be issued by the tax authorities (e.g. the treatment of losses arising from the regime and the quantification of the income from the direct use of IP), affected groups with IP in Italy should assess the potential benefits of the regime, taking the following time-sensitive items into account:

- If the qualifying income is determined through the tax ruling procedure (as discussed above), the ruling must be issued by 31 December 2015 for a taxpayer to obtain benefits for 2015; and
- The current inclusion of trademarks in eligible IP likely is not compliant with the OECD recommendations under BEPS action 5, and could be subject to repeal. A “grandfathering” provision potentially could be included in any modification of the current rules.
