Italy

Italian Patent Box Regime: Thinking Outside the Box or Just More Harmful Tax Competition?

Simone Zucchetti and
Andrea Pallotta[*]

Issue: International Transfer Pricing Journal, 2016 (Volume 23), No. 1
Published online: 7 January 2016

The authors examine the technical aspects of the new Italian patent box regime introduced in 2015 which provides for a partial exemption of income arising from qualifying intellectual property rights. Topics considered include historical development, current requirements and international aspects of the Italian patent box regime, comparing it to regimes applicable in other countries. This article consists of two parts, the second of which is primarily focused on the valuations techniques relevant to qualifying IP assets and will appear in a future issue of this journal.

1. Introduction: Patent Box Regimes and the OECD

1.1. Background and scope of Action 5: 2015 Final Report

Over the last decade, patent box regimes providing for preferential treatment for the profits generated by "qualifying intangibles", whilst promoting research and development (R&D) activity, have increasingly been introduced in EU Member States (e.g. Belgium, Cyprus, France, Hungary, Liechtenstein, Luxembourg, Malta, the Netherlands, Portugal, Spain and the United Kingdom). As from 2015, Italy[1] has also adopted a patent box regime designed so as to be in line with the modified nexus approach as adopted and introduced at an international level in Action 5 (*Countering Harmful Tax Practices More Efficiently, Taking into Account Transparency and Substance*)[2] under the OECD's BEPS Project. The Action 5 Final Report (issued on 5 October 2015), the contents of which are closely coordinated with the European Code of Conduct for Business Taxation, attempts to provide a response to the harmful practices arising from the mobility of corporate activities and the relevant taxable income.[3]

In most countries that have adopted patent box regimes, just like in Italy, the tax incentive takes the form of a partial exemption or notional deduction of qualifying income (as defined below). However, unlike input tax incentives, which are provided at the outset of the innovation process (in other words, upon incurring qualifying expenditures), patent box regimes intervene at the back end of such process (when income is received). This causes patent box regimes to be regarded as less effective in promoting R&D than traditional input tax incentives (e.g. tax credits for R&D activity).[4]

Existing patent box regimes have, in fact, been repeatedly criticized by scholars around the world as deficient instruments to suitably promote R&D. Several studies have revealed how, as patent box regimes target income derived from new ideas and not from the underlying research,[5] these regimes do not constitute an appropriate incentive to stimulate innovation. Moreover, from a systemic perspective, a patent box regime is regarded as inefficient, given that the relevant preferential tax treatment accrues in essence from projects which most certainly involve and develop R&D, but that nevertheless are susceptible to being successful in any case, regardless of the applicable tax regime; indeed, many of

---

* **Studio Tremonti, Vitali, Romagnoli, Piccardi e Associati.**

1. IT: Law 190 of 23 Dec. 2014 (Legge di Stabilità 2015), art. 1 (37)-(45); *Decreto attuativo* of 30 Jul. 2015, published in the Official Gazette of 20 Oct. 2015.
2. OECD, *Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance – Action 5: 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project (OECD 5 Oct. 2015), International Organizations' Documentation IBFD.
3. For requirements for a regime to be deemed to be harmful, *see* OECD, *Harmful Tax Competition: An Emerging Global Issue* (OECD 1998).
4. Italian qualifying taxpayers may benefit from tax credits in relation to expenditures incurred in the field of R&D, under art. 3 of Law Decree 145 of 23 Dec. 2013, as amended by art. 1 (35) of Law 190 of 23 Dec. 2014 and Ministerial Decree "Attuazione del credito d'imposta per attività di ricerca e sviluppo" of 27 May 2015.
5. The relevant tax incentives are, generally, also extended to capital gains realized on the disposal of qualifying IP assets under specific domestic rules, as is indeed in the case with the Italian patent box regime (*see* section 3.1.).

these projects would have gone forward even without the preferential tax treatment. In other more explicit terms, such an incentive could entail a useless loss of tax revenue for the adopting state.[6]

On the other hand, it is more than clear that such regimes represent a significant opportunity for taxpayers. In addition, the fact that most EU jurisdictions have already adopted a patent box regime *de facto* obliges countries around the globe – especially EU Member States – to all be aligned when proposing themselves as preferential locations for foreign investors, making the presence of a patent box regime almost mandatory for any country that wishes to attract foreign investment.

1.2. The substantial activity requirement

Action 5 specifically requires "substantial activity" to be effectively and actually carried on in order to access a preferential regime.[7] This requirement contributes to the second pillar of the BEPS Project, namely to align substance with its relevant taxation (and therefore income), ensuring that taxable profits can no longer be artificially (or not) shifted away from the country in which the value was originally created, in favour of a country offering a preferential tax regime. In other terms, the substantial activity requirement counters, in a more efficient way, all those international tax practices that would ultimately permit the relocation of the taxable base in a country other than the country of origin, merely by reason of the preferential tax treatment offered. In particular, the substantial activity requirement forces a response to the question as to whether a particular (patent box) regime encourages solely tax-driven transactions, without involving any substantial activity.

The OECD Forum on Harmful Tax Practices has considered various approaches to verify the implementation of the substantial activity requirement. Indeed, the mandate originally granted to the OECD was simply finalized as addressing harmful tax competition. It is thus fair to say that the modified nexus approach (which will be analysed in depth below) only aims at providing a minimum common framework to tackle harmful tax competition at a global level.

Therefore, the benefits provided by patent box regimes are linked to qualifying R&D expenditure incurred by the taxpayer itself. This focus on qualifying expenditures seeks to ensure that patent box regimes are solely applicable to those prospective beneficiaries that actually engage in qualifying R&D activity. Such expenditures are relevant not only from a quantitative perspective, but mainly from a qualitative perspective, as they constitute a measurement of the activity effectively carried out by the prospective beneficial taxpayer.

1.3. The modified nexus approach and primary purpose of tackling harmful tax competition

The modified nexus approach results from a Germany-United Kingdom proposal[8] presented in November 2014 and subsequently approved by the other OECD member countries (in February 2015) in order to clearly determine and resolve all the raised concerns, while also reinforcing the (now, old) concept of the nexus approach. This newer approach provides more safeguards against profit shifting and ensures that there is equal treatment across all businesses sectors, consistently with existing OECD rules. One could even say that the modified nexus approach indirectly improves the consistency of patent box regimes from a policy perspective, regardless of the fact that the primary purpose of the formulation of the modified nexus approach was to tackle harmful tax competition.

It is now commonly recognized that intellectual property-intensive industries are vital promoters of growth[9] and often benefit from preferential tax treatment that countries are free to offer in relation to R&D activities, given that such preferential treatment is granted in accordance with the principles set forth by the OECD Forum on Harmful Tax Practices. In fact, generally, a regime providing for a preferential tax regime on income derived from IP may give rise to base-eroding issues and very harsh competition amongst adopting countries.

Under the modified nexus approach, as addressed in the 2015 OECD report on the modified nexus approach,[10] guidance regarding the definition of qualifying IP assets is provided, bearing in mind that one of the premises for access to a preferential regime is that such assets have been developed with sufficient nexus. More specifically, the only IP assets

6. European Commission, *Study on the R&D*, at 21.
7. This requirement was already introduced in OECD, *Harmful Tax Competition: An Emerging Global Issue*, *supra* n. 3.
8. *See* OECD, *Action 5: Agreement on Modified Nexus Approach for IP Regimes*, OECD/G20 Base Erosion and Profit Shifting Project (OECD 2015).
9. OECD, Directorate for Science, Technology and Innovation, Committee on Digital Economy Policy, *Enquiries into Intellectual Property's Economic Impact* (10 Aug. 2015). This report indicates that the contribution from IP-intensive industries is very significant and essential (77 million workplaces, corresponding to 35% of the total workforce).
10. *Supra* n. 8.

deemed to be qualified are patents and functionally equivalent IP assets that are legally protected and subject to approval and registration processes. This approach explicitly rejects all those IP assets from which marketing-related benefits are derived (e.g. trademarks). Furthermore, the same approach states that a system of tracking and tracing R&D expenditures would be not merely practical, but indeed essential, for tax authorities and companies. Thus, adopting countries wishing to implement an IP regime must apply domestic law in line with the modified nexus approach.

At the genesis of Action 5, there were three viable approaches that could have been implemented:

- the *value creation approach*: requiring that taxpayers undertake a certain number of significant development activities. This approach received no support;
- the *transfer pricing approach*: benefits are granted to all the income generated by IP assets, provided that the prospective beneficiary has located a certain degree of material functions in the jurisdiction providing the preferential treatment. In other terms, the taxpayer must be the legal owner and ultimate user and must bear the economic risks of the assets giving rise to the tax benefits. This approach was opposed by the majority of OECD member countries; and
- the *nexus approach*: the preferential tax regime may apply as long as there is a direct nexus between the income for which the benefits are granted and the expenditures contributing to that income.

Therefore, as can be inferred from the very conceptual basis of the modified nexus approach, and comparing the reasons for which the other approaches were not chosen, the goal of the OECD was clear: in order for IP qualifying income to be granted preferential treatment, a significant proportion of the actual R&D activities must have been undertaken by the qualifying taxpayer itself. It is now clear that qualifying expenditures act as a proxy for the substantial activity requirement (analysed above). More specifically, it is the proportion of expenditures directly related to development activities that proves the real value added by the taxpayer.[11]

The modified nexus approach allows a regime to provide preferential tax treatment of IP-related income to the extent that such income was generated by qualifying expenditures, and thus where the actual R&D activity was undertaken by the taxpayer itself.[12] That being said, the whole point of the regime is to be able to define extensively a "qualifying expenditure", bearing in mind that within the modified nexus approach, countries may allow for an uplift of the qualifying expenditure.[13]

2. European Patent Box Regimes

As anticipated, IP assets are, by definition, assets characterized by the highest degree of mobility and, as such, are the most easily transferable production factors, able to be effortlessly shifted to countries that offer a preferential tax regime.[14]

The first aspect to consider when designing a patent box regime is, logically, the identification of all intangible assets that could benefit from the related tax incentives. The main distinction among the assets to which the preferential tax regime may apply is represented by those assets that can be characterized as (i) trade intangibles and those assets that are defined as (ii) marketing-related intangible assets. However, one of the main criticisms levelled at countries that have implemented a patent box regime concerns the extension of incentives also to this second category of assets, which includes trademarks (as in Italy and Luxembourg),[15] in addition to patents and patentable inventions.

11. The position of intangible assets in the creation of added value is becoming increasingly paramount so that, as indicated by the OECD in a 2013 Report, investment in innovation currently contributes to an increase of the average growth in labour productivity ranging from 20% to 34%. OECD, *Supporting Investment in Knowledge Capital, Growth and Innovation* (OECD 2013).
12. This requirement reduces the income subject to favourable treatment based on the ratio between R&D expenses actually incurred and the totality of R&D expenses connected to the IP asset. In other terms, only the costs directly and actually incurred are relevant, and solely with reference to "successful" activities. This means that indirect costs, purchase costs and costs from related third parties are not deemed to be relevant for the purpose of accessing preferential tax treatment.
13. Accordingly, such uplift needs to be restricted to the extent that expenditure in the context of outsourcing and acquisitions has actually taken place, and is in any case limited to a certain percentage of qualifying expenses.
14. In past years, it has been increasingly asserted by the OECD that tax issues related to the location of foreign companies holding intangible assets need to be reconnected to the "transfer pricing" discipline, rather than to the phenomenon of "relocation abroad" (i.e. the location of the residence of a company as a legally protected freedom of establishment).
15. The Luxembourg Minister of Finance presented a tax bill to the Luxembourg parliament on 13 Oct. 2015 and the draft state budget for 2016 on 14 Oct. 2015. One of the most notable amendments is the abolition of the Luxembourg patent box regime, with a grandfathering period of five years.

On the one hand, the narrow approach group (which includes Belgium[16], Netherlands[17], Spain[18] and the United Kingdom[19]) has a better policy to encourage investment in R&D and innovation activities, focusing especially on patents and intangible assets (and, generally, not IP acquired from third parties, but rather solely on that produced by the beneficiary of the preferential treatment). As there are development conditions under this approach, no potential measures confronting the "harmful tax competition" would thus be required.

On the other hand, the potentially harmful approach group (which includes Cyprus, Hungary, Italy, Liechtenstein, Luxembourg[20] – only for now, however, as Luxembourg recently manifested its intention to deny its patent box regime to trademarks – Malta, Nidwalden canton[21] (Switzerland)) is indeed criticized on these grounds. More specifically, the policy of this group exclusively aims at attracting income derived from IP assets, without there being any requirement regarding the actual carrying out of the R&D activity by the beneficiaries. The regimes of these countries are mainly regarded as a means of attracting highly mobile capital and relocating corporate income, rather than promoting innovation.

In general, trade intangibles, and possibly designs and models, are indeed regarded as having a stronger link to the substantial activity requirement, and are thus more in line with the goal to increase investment in the research sector. As will be seen in detail below, difficulties can still arise in connection with the establishment of the direct link between qualifying expenditures and qualifying income.

The Action 5 Final Report reviews 43 preferential regimes, concluding that all the 16 analysed IP regimes are inconsistent – in whole or in part – with the modified nexus approach.[22]

3. Italian Policy Design and Incentives

Italian policy objectives are essentially a response to the high-level mobility of IP, and of the relevant income subject to preferential treatment. The 2015 Budget Law (*Legge di Stabilità*)[23] and the Implementing Decree (*Decreto attuativo*) of 30 July 2015[24] establish that qualifying taxpayers are those taxpayers that earn business income in Italy.

From an Italian policy perspective, the government's aims include the intention to:

- promote the placement or maintenance in Italy of certain (legally protectable) intangibles, guaranteeing benefits based on the incurring of R&D expenditures;
- prevent the allocation abroad of qualifying IP assets, making the Italian market more attractive to domestic and foreign investment; and
- follow the OECD recommendations on preventing aggressive tax practices.

In this context, one can see why the election for this regime lasts five years and may even be renewed by qualifying taxpayers.[25]

---

16. Belgian qualifying IP assets include patents and supplementary protection certificates. Means of acquisition are internal development of IP and improvements to acquired IP; qualifying income sources are licensing of IP and direct exploitation of qualifying IP. The preferential tax treatment results in 80% exemption of qualifying income. BE: Programme Law of 27 Apr. 2007, Official Gazette of 8 May 2007, arts. 86-93.
17. Dutch qualifying IP assets include patents and intangibles derived from qualifying R&D activity. Means of acquisition are internal development of IP and improvements to acquired IP; qualifying income sources are licensing of IP, direct exploitation of qualifying IP and disposal of IP. Preferential tax treatment results in an exemption equal to 20/25 of qualifying income (5% actual rate). NL: Income Tax Law (*Wet op de inkomstenbelasting*), 2001 (ITL), art. 3.2.
18. Spanish qualifying IP assets include patents; formulas and processes; drawings and models; and know-how. Means of acquisition is internal development of IP; qualifying income sources are licensing of IP and disposal of IP. The preferential tax treatment results in a 60% exemption of qualifying income. ES: Law 16/2007 of 4 July 2007, amending art. 23 CIT Law.
For the Basque patent box, which has an even greater reach than the Spanish patent box, *see* Foral Regulation 5/2008 of Biscay, Foral Regulation 8/2008 of Guipuzcoa and Foral Regulation 14/2008 of Alava, which introduced a new article (art. 22-bis) in the CIT regulations.
19. UK qualifying IP assets include patents, supplementary protection certificates and regulatory exclusivity rights. Means of acquisition are internal development of IP and improvements to acquired IP; qualifying income sources are licensing of IP, direct exploitation of qualifying IP and disposal of IP. Preferential tax treatment results in an exemption equal to 11/21 of qualifying income (10% actual rate). UK: Finance Act 2012, sec. 19, sch. 2.
20. Luxembourg qualifying IP assets include trademarks (although not for long); patents; copyrights; software; drawings; and models. Means of acquisition are internal development of IP and improvements to acquired IP; Luxembourg qualifying income sources are direct exploitation of qualifying IP assets; licensing of IP; and disposal of IP. Luxembourg preferential tax treatment results in an 80% exemption of qualifying income. LU: Loi du 21 décembre 2007, published on 27 Dec. 2007.
21. CH: Federal Direct Tax Act (Bundesgesetz über die direkte Bundessteuer/Loi fédérale sur l'impôt fédéral direct, DBG/LFIFD), arts. 29(1)(d) and 63(1)(d); CH: Nidwalden Tax Act, Guideline of the Cantonal Tax Office Nidwalden of 17 Jan. 2011, art. 85.
22. OECD, *Action 5 Final Report*, *supra* n. 2, at 63.
23. *Legge di Stabilità*, art. 1 (37)-(45) (regulating the patent box regime).
24. Published in the Official Gazette of 20 Oct. 2015.
25. *Decreto attuativo*, art. 4(1).

3.1. Preferential treatment

Provided that the qualifying taxpayer (as defined above) carries on R&D activity and incurs qualifying expenditures (essentially, advertising costs and/or R&D activity-related costs, including through research contracts with other companies – even companies belonging to the same group, universities, comparable research entities and bodies), the preferential tax regime applies in two instances,[26] as follows:

- in case of qualifying income from the direct or indirect use of qualifying IP assets: 50% exemption (reduced to 30% and 40% for fiscal years 2015 and 2016, respectively); and
- in case of capital gains from the disposal of qualifying IP assets: 100% exclusion, provided that there is reinvestment within the second tax period following disposal of at least 90% of the received consideration in the maintenance or development of IP.

The incurring of costs relevant to qualifying activities is an objective prerequisite to enjoying benefits under the patent box regime.[27] Qualifying research and development activities include:

- basic research, i.e. experimental or theoretical work undertaken to acquire new knowledge, if subsequently used in applied research and design;
- applied research;
- designing, i.e. the activities involving conception and design of products, processes and services, including their external appearance and all activities related to brand development;
- the design and implementation of copyrighted software;
- preventive research and market research, as well as other studies and interventions finalized upon the adoption of anti-counterfeiting systems; storage; acquisition and retention of rights; the renewal of rights and the protection thereof, also by means of associations and in relation to the prevention of counterfeiting and the handling of contractual and legal disputes; and
- presentation, communication and promotion activities that will enhance the distinctiveness and/or reputation of the trademark, and contribute to the knowledge, commercial success, image of the product or service, design, or other protectable assets.[28]

The nexus approach does not aim at excessively complicating those cases where R&D activity is carried on by outsourcing such endeavour, given that in entrepreneurial reality it is not uncommon to have the R&D activity externalized to more competent and expert third parties. In fact, these costs related to such outsourcing are deemed to be qualifying expenditures when the outsourcing is entrusted to independent third parties, as well as – it is believed – a subsidiary that utilizes third-party activities and then recovers the relevant costs from other group companies.

3.2. Qualifying expenditures

Qualifying expenditures must all relate to actual R&D activity. The definition of "qualifying expenditure" is provided by domestic law, and will therefore vary from country to country. The term "overall expenditures" should be construed in such a way that, if the qualifying taxpayer incurred all expenditures itself, the ratio, as described below, would be equal to 1 (as a consequence, 100% of the income from the IP asset would benefit from the preferential tax treatment). Overall expenditures thus include all qualifying expenditure, acquisition costs, and expenditure for outsourcing that is not deemed to be a qualifying expenditure.

3.3. Which income?

3.3.1. Generally

These incentives are applicable not only to internally developed, but also to acquired qualifying IP assets, which may either be used directly by the prospective beneficiary or licensed to third parties. More specifically, Italian qualifying income is that derived from the following qualifying IP assets:[29]

- industrial patents (licensed or in the process of being licensed);
- intellectual property (software covered by copyright);

---

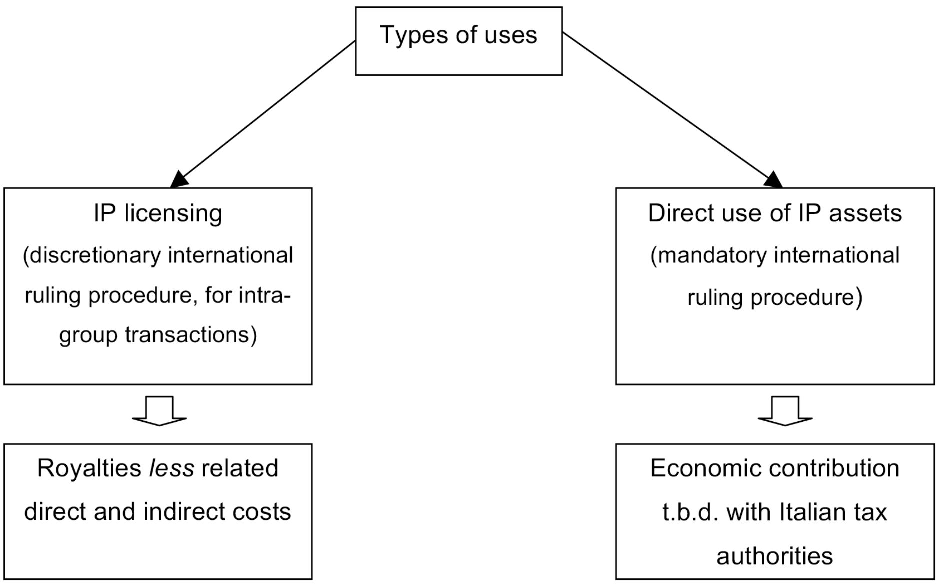
26. *Decreto attuativo*, art. 7(1).
27. *Decreto attuativo*, art. 2(1).
28. *Decreto attuativo*, art. 8.
29. It is possible to cherry pick the IP assets the relevant income from which would be subject to preferential tax treatment.

- drawings and models (legally protectable);
- legally protectable processes, formulas and information relevant to experience acquired in the industrial, commercial or scientific field; and
- trademarks (registered or in the process of being registered).

In enumerating the qualifying IP assets relevant for the Italian patent box regime, the authors generally followed the order given by the OECD, leaving "trademarks" for last, as that category represents one of the main discrepancies between the Italian and the OECD approaches.

One may enjoy the benefits of the Italian patent box regime by either directly using the qualifying IP asset (in which case the taxpayer would have to pursue the international ruling procedure[30]) or by licensing the IP (if to third unrelated parties, no ruling is required; if the licensing is to a party belonging to same group, an international ruling is merely discretionary).[31] This can be illustrated as shown in Figure 1.

Figure 1



In the case of licensing, qualifying income is that derived from royalties related to the right to use the intangible assets, net of all direct and indirect costs relevant for tax purposes pertaining to each tax year. In the case of direct (internal) use, it will be necessary to identify for each intangible asset that falls under the elected application of the patent box regime, the "economic contribution" resulting therefrom which may benefit from the incentives.

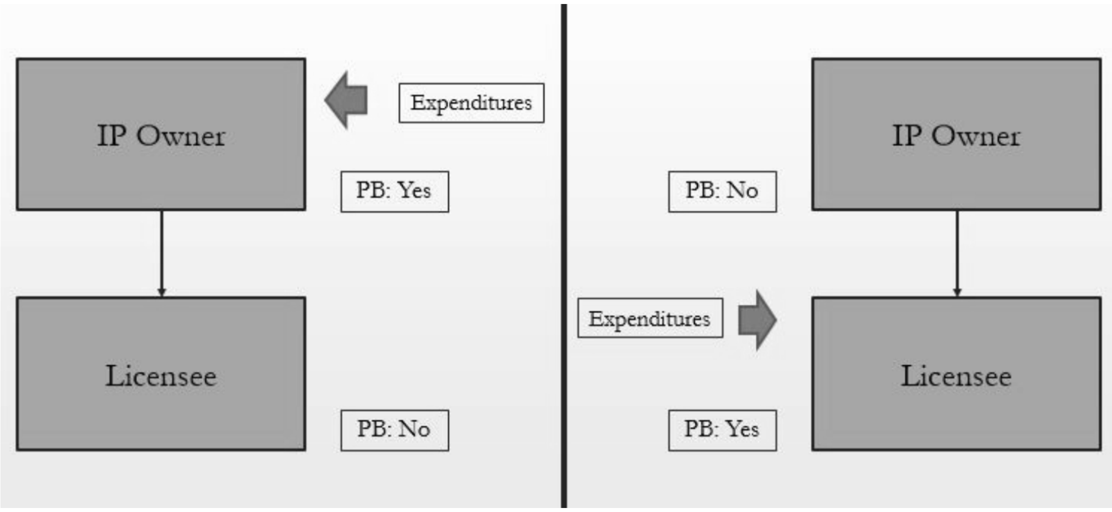
---

30. Under art. 8 of Law Decree 269 of 30 Sept. 2003.
31. Upon direct use of qualifying intangible assets, the determination of the relevant economic contribution must be identified on the basis of a special international ruling procedure. (The procedure under art. 8 of Decree 269/2003 was superseded by a new, substantially identical, one under art. 31-*ter* of Presidential Decree 600/1973). Such procedure is merely optional in the case of intercompany licensing and in the case of capital gains. The ruling procedure guarantees the determination, in advance and in a manner binding upon the Italian tax authorities, of the exact criteria for the identification of patent box benefits.
In accordance with the provisions set forth in the Italian tax authorities' Commissioner's Decision 2015/154278 of 1 Dec. 2015, the steps of the procedure, in very short, are as follows: the ruling is sent to the office of the competent Italian tax authorities (the Office); within 30 days of receipt, the Office invites the company to appear, through its legal representative or its attorney, in order to verify the completeness of the provided information, formulate any request regarding additional documentation deemed necessary and define the terms of the procedure. Such invitation may be extended to more meetings, but must, in any case, be concluded within 180 days from receipt of the ruling (although, given this time-limit, the procedure may still take considerably longer).
During the procedure, officials and employees of the Office may have access to the company's premises, within a time schedule preliminarily agreed with the prospective beneficiary, for the sole purpose of acquiring direct knowledge of useful and relevant information (the taxpayer will receive notice of the minutes of said meetings). The procedure is concluded with a joint signing of an agreement by the head of the competent Office and the legal representative or other person with power of attorney of the company. This agreement takes effect from the tax year in which the request for the ruling was made. It is binding on both parties and remains in force for five years.

The patent box regime also applies to amounts obtained as compensation and restitution of profits by reason of an asserted contractual or tort liability regarding the intangible assets and related rights.[32]

In any case, should a taxpayer opt to apply the patent box regime by licensing the owned IP, the prospective beneficiary must incur qualifying expenditures in order to benefit from the preferential tax treatment. This can be illustrated as shown in Figure 2.

Figure 2



Where losses occur from the utilization of qualifying IP assets, in case the patent box regime has been chosen, the Italian tax authorities have issued clarification[33] on how the Italian patent box benefits shall be deferred to the tax periods in which the qualifying intangibles actually start to generate beneficial income. In fact, such prior losses will be used, through a sort of “recapture” mechanism, to reduce the income subject to preferential tax treatment (upon full depletion of the latter).

3.3.2. Computation of qualifying income

The share of income subject to preferential tax treatment is to be determined based on a ratio.[34]

The *numerator* of the ratio consists of expenditures related to R&D activities, relevant for tax purposes, for the maintenance, growth and development of intangible assets incurred (i) directly by the beneficiaries, (ii) by universities or research institutes and similar establishments, (iii) by companies, including innovative start-ups, other than those that directly or indirectly control the prospective beneficiary, are controlled by the latter or are controlled by the same company that controls the prospective beneficiary of the regime (except where the incurred costs towards unrelated third parties are charged back by the subsidiaries).

The *denominator* of the ratio consists of the costs referred to in the numerator, increased by (i) the costs arising from transactions with companies that control, directly or indirectly, the prospective beneficiary, are controlled by the latter or are controlled by the same company that controls the prospective beneficiary, incurred to develop, maintain and enhance qualifying activities (as defined above) and (ii) the cost of acquisition, including those costs incurred through licensing the right to use the IP asset, of the intangible asset supported in the relevant tax year.

The amount computed when determining the numerator is increased by an amount corresponding to the difference between the latter and the denominator. This amount can reach up to 30% of the numerator (the so-called “uplift”). Thus, qualifying income is computed as follows:

32. *Decreto attuativo* art. 7(4).
33. *See* Italian tax authorities’ Circular letter of 1 Dec. 2015, n. 36/E, at 5 and 6.
34. The costs to be considered in the calculation of the ratio are those incurred during the reporting period – regardless of the relevant tax regime or accounting treatment.

Computation of the qualified income

Income receiving tax benefits =

Income deriving from IP asset × $\frac{\text{qualified expenditure incurred to develop IP asset (A)}}{\text{overall expenditure incurred to develop IP asset (B)}}$

Uplift

Given that: (B) – (A) = (C) and that (A) + (C) = min[1,3A; (A) + (C)

Qualified income =

Income deriving from the IP asset × $\frac{(A) + (C)}{(B)}$

Regarding the type of costs that form the numerator and denominator of the ratio, while Italian law expressly provides that such costs must be relevant for Italian tax purposes, the OECD seems to follow a different approach. In fact, the Action 5 Final Report states that the costs to be considered in the calculation of the ratio are those incurred during the reporting period, regardless of the tax regime and the accounting treatment thereof:

> Qualifying expenditures will be included in the nexus calculation at the time they are incurred, regardless of their treatment for accounting or tax purposes. In other words, expenditures that are not fully deductible in the year in which they were incurred because they are capitalized will still be included in full in the nexus ratio starting in the year in which they were incurred.[35]

In computing qualifying expenditures, Italy permits the inclusion of retrospective costs, as well. In fact, for 2015, 2016 and 2017, the relevant expenses are those incurred during the tax period covered by the presented tax return (2015) and those recorded during the three previous tax periods (2012, 2013 and 2014). These expenditures are included in their *totality* (without distinction per single item of IP), although, from 2018, things will change, such that the ratio (A/B) will have to be calculated, instead, *per single asset*.

In addition, from 2015, Italian beneficiaries must adopt adequate systems of tracking and tracing regarding the relevant income and expenditure. The goal is to enable the tax authorities to verify the correctness of computations related to tax incentives.

3.4. Valuation techniques relevant to qualifying IP assets[36]

There could be several techniques (if applicable) that may be applied to determine the arm's length consideration for intangibles or rights in intangibles.[37]

35. OECD, *Action 5 Final Report*, *supra* n. 2, at 27, para. 39.
36. This topic will be further developed in the second part of this article, to be published in a future issue of this journal.
37. OECD, *Aligning Transfer Pricing Outcomes with Value Creation – Actions 8-10 Final Reports*, OECD/G20 Base Erosion and Profit Shifting Project (OECD 5 Oct. 2015), at 100-116, International Organizations' Documentation IBFD.

In fact, where reliable comparable uncontrolled transactions can be identified, the CUP method could be applied. If the CUP method is used, particular focus must be on the comparability of the transferred intangibles or rights in intangibles transferred in controlled, as well as in uncontrolled, transactions. Some economically relevant characteristics or comparability factors can be found in the Final Reports on Actions 8-10 (specifically, under Action 8).[38] It is clear that the identification of reliable comparables in these cases can be very difficult – if not impossible.

In some circumstances, a transactional profit split method can be utilized to determine the arm's length conditions for a transfer of intangibles or rights in intangibles where it is not possible to isolate reliable comparable uncontrolled transactions for such transfers. In evaluating the reliability of the method, however, one must have adequate data regarding combined profits, allocable expenses and the factors used to divide combined income. Where limited rights in fully developed intangibles are transferred in a licence or similar transaction, and reliable comparable uncontrolled transactions cannot be found, a transactional profit split method is often adopted to evaluate the respective contributions of the parties to earning combined income (subject to due limitations).

Where reliable comparable uncontrolled transactions for a transfer of one or more intangibles cannot be identified, one may also utilize alternative valuation techniques generally adopted in the financial sector to estimate the arm's length price for intangibles transferred between associated companies.

4. Divergence between Italian Law and the OECD Recommendations

When considering the Italian patent box regime, the issue related to trademarks is a particularly delicate one, as the regime is not in line with the above-mentioned OECD recommendations that expressly exclude trademarks (together with the other marketing-related IP assets) from qualifying intangibles that may benefit from the relevant incentives.

Upon reading the Action 5 Final Report, it appears that the reason for this exclusion should be identified, on the one hand, in the view that such assets do not require the same level of innovation as other relevant registered or registrable intangibles. On the other hand, if a tax benefit were to be granted in relation to income derived from trademarks, all income of the company would be indiscriminately subsidized, even if no effective "value-creating" activity were carried out by the prospective beneficiary. This circumstance would eventually run counter to the objectives of the Action 5 and, more generally, the BEPS Action Plan.

Other EU Member States have their own regimes favouring trademarks (e.g. Luxembourg, even if, as anticipated, not for too long). It follows that, until expiration of the transition period established by the Agreement on Modified Nexus Approach for IP regimes, in all those countries, the income derived from brands will be incentivized (upon conclusion of the transition period).[39] That being said, under that Agreement, OECD member countries established that new favourable regimes must immediately comply with the new OECD Guidelines. However, existing regimes will begin a process of legislative amendment until the end in June 2016.

In order to protect taxpayers benefitting from pre-existing tax regimes, OECD member countries are allowed to introduce grandfathering rules. Under such rules, all taxpayers benefitting from an existing regime may retain such entitlement until an abolition date that may not be later than 30 June 2021.[40] Such a transition period before the definitive shutdown of existing harmful IP regimes favours not only new taxpayers not previously benefitting from the regime, but also those taxpayers that already benefitted from the regime and already had their position approved by local authorities. In Italy, such abolition date is, so far, unclear. The main concern for Italian taxpayers is obviously related to the exclusion of trademarks from qualifying IP assets.

---

38. OECD, *Actions 8-10 Final Reports*, *supra* n. 37, at 15 et seq. (section D.1. of ch. I of the OECD Transfer Pricing Guidelines).
39. OECD, *Action 5: Agreement on Modified Nexus Approach for IP Regimes*, *supra* n. 8, at 4.
40. OECD, *Action 5: Agreement on Modified Nexus Approach for IP Regimes*, *supra* n. 8, at 4.