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Case Study: Patent Box in Italy: Light and Shadow of a Special Tax Regime

PROPERTY RIGHTS ALLIANCE

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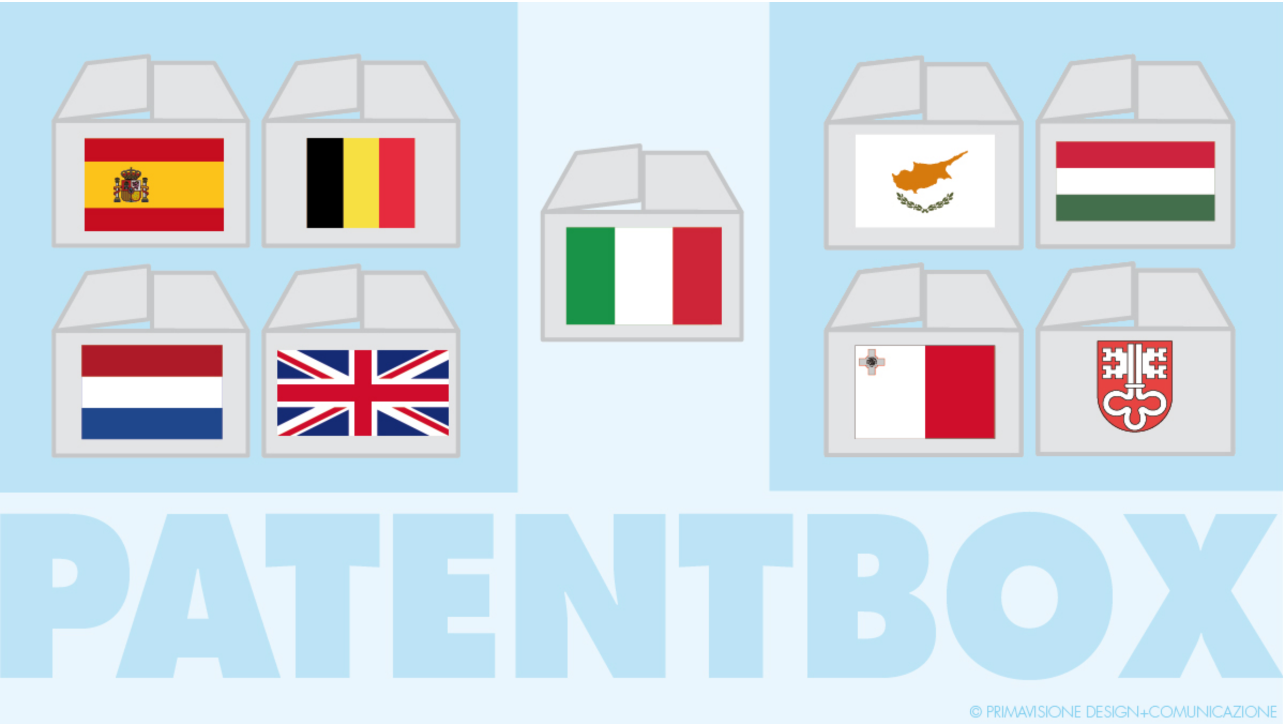

(Source: http://www.patentbox-italy.it/wp-content/uploads/2016/11/patent-box-tipologie.jpg)

Patent Box in Italy: Light and Shadow of a Special Tax Regime

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ABSTRACT: In 2015 Italy implemented the 'Patent Box,' an optional tax system for income arising from the use of IP rights. The first European country to introduce such an incentive was Ireland in 2000. Then France, Belgium, Hungary, Luxembourg, the Netherlands, Spain and the United Kingdom followed. As part of its Base Erosion and Profit Shifting project, the OECD has recommended the implementation of a common approach aimed at ensuring that only the income created in one country can benefit from that country's corresponding tax relief, proportionate to the investment made there. Despite its name, however, the Italian patent box applied not only to patents and know-how, but also to copyright (at least partially), designs and trademarks (the latter, however, were excluded in 2017). Furthermore, the Italian Ministry of Economic Development issued implementation rules aimed at facilitating use of this system by SMEs. However, the Ministry of Economy and Finance took an inconsistent approach, which multiplied the burdens of those who want to benefit from the system by requiring analytical documentation of costs incurred for the creation of every single intellectual property product – often an impossible task. It has thus lost the opportunity to encourage Italian companies to re-shore their IP rights and manufacturing activity. IP revenue and production of many important Italian companies remain parked in foreign subsidiaries, leading to a reduction in the amount of tax revenue, rather than increasing the taxable income in Italy. This has created disappointment and garnered distrust from Italian tax authorities.

KEYWORDS: PATENT BOX, TAX, IP RIGHTS, OECD, ITALY

Introduction

The Italian tax designed to incentivize IP, better known as “Italian Patent Box,” came into being in 2014. It was originally conceived of as an “IP Box” proper, being an optional system of incentivized taxation for revenue deriving from the use not only of patents but also of a number of further IP rights. In fact, notwithstanding that the name suggests that it deals with patents only, the Patent Box was conceived (and still it is, at least partially) as an “IP box”, because it applied not only to patents and know-how, but also to copyright (however only in part), *design* and even trademarks.

Introduced by Law No. 190 on 23 January 2014 (Article 1, paragraphs 37-43) and then improved by the Law No. 33 on 24 January 2015, (Article 5) converting Law Decree No. 3 on 24 January 2015 (which broadened the application of the system, thereby reducing also the circumstances in which *international ruling* – i.e. the specific petition to the Italian Revenue Agency pursuant to Article 8 of the Law Decree No. 269/2003 – is mandatory in order to take advantage of the benefit), the Patent Box is a measure of tax relief for the revenues which flow from the exploitation and the assignment of IPRs. Few months later the issuing of the Implementing Decree (Decree 27 May 2015, published in OJ General Series No. 174 on 29 July 2015) approved by the Ministry of Economic Development together with the Ministry of Economy and Finance finally made this tax incentive available during 2015, as it laid down the main rules for implementation as an optional system of taxation for these incomes.

However, this decree was still incomplete and the Patent Box only actually became fully operative in 2016, with the issuing of Circular No. 11/E on 7 April 2016, drawn up by the Revenue Agency together with the Ministry for Economic Development, which was responsible for introducing the Patent Box.

The last change occurred in 2017 when Article 56 of Decree Law No. 50, on 24 April 2017, published in OJ, General Supplement No. 95 on 24 April 2017 (later converted, with minor changes on the relevant article, in Law No. 96, on 21 June 2017, published in OJ, General Series No. 144, on 23 June 2017) removed trademarks from the list of IP rights which may benefit from this package of fiscal incentives and also limited the access thereto of know-how, albeit providing for a transitional system in favor of those companies which had already exercised the three year option to take advantage of the incentives.

The functioning of the Italian system

Since the patent box system implemented in Italy is set up as an optional system of taxation, it requires a formal statement of accession, which is valid for a period of five years, and is limited to persons belonging to the categories specified in Article 2 of the Implementing Decree, “*provided that they perform research and development activities*” as defined in Article 8 of the same decree. From a practical point of view, it is divided into two basic benefits:

a) The exclusion from the taxed revenues of a share of up to 50% (before 2017 the exclusion was up to 30% in 2015 and up to 40% in 2016) of the income derived from the exploitation of IP rights, determined based on the relationship between cost and revenue identified by Article 9 of the above cited decree. It is worth noting that in case of direct exploitation, the income share, which benefits from the exclusion, must be necessarily determined through a procedure that gives rise to a sort of agreement with the Italian Tax Agency, i.e. the already mentioned *international ruling*. Instead, this procedure is optional in the case of income derived though licensing IPRs to companies of the same group, and it is not applicable at all when licenses are assigned to entities out of the group.

b) the exclusion from taxation of the gains deriving from the assignment of IPRs, provided that at least 90% of said gains are reinvested in the two subsequent years in research and development activities for further intangible assets. The meaning of these activities is defined in Article 8 of the decree and is reasonably wide: it includes technological research, (both basic and applied), new product tests for commercialization, design, anti-counterfeiting activities, litigation, as well as a series of promotional activities extremely important for trademarks and branding. In this case, the application of the *ruling* is indicated (optionally) only when the gain is accrued as part of transactions with the holding company or with subsidiaries or affiliates companies (Article 10, paragraph 3 of the Decree).

It is to be emphasized that the law does not draw distinctions between the different activities carried out and the expenses borne, so long as they are headed to the maintenance or development of immaterial goods different from the ones assigned. In other words, the only condition that the law imposes to receive the benefit of capital gains tax exclusion is the reinvestment of 90% of the relevant compensation before the expiration of the second successive tax period to the one during which the assignment took place for the development and maintenance of "other" qualified immaterial goods, e.g. immaterial goods that are part of the number of the eligible ones. Therefore, the current expenditure, including on advertisements, as they arise from the activities mentioned under paragraph 4.2 of the Circular of dated 7 April 2016 should be included to benefit from the incentive, and any claim of ineligibility simply lacks justification. It is doubtful what the qualification of these immaterial rights like "other ones" exactly mean: the unique rational interpretation is the one that refers to the IP rights, both new and pre-existent, and equally to the rationale underlying the incentives, other than the ones that have been assigned. However, the Circular on 7 April 2016 interpreted the regulation in a completely unfair way, by providing (under paragraph 4.7) that it deals with immaterial goods "different from the ones owned by the beneficiary while realising the capital gain, and consequently clearly new. Needless to say, without sticking to the circular, there may be the risk that the Revenue Agency provides the recovery of taxation for the income and, so, it may be advisable to follow that interpretation. However, if the 90% of reinvestment is not reached with the expenses over the "new" immaterial goods, there would be room to argue the possibility of applying the incentive anyway to cover expenses of maintenance and investment, relative to pre-existent immaterial goods, of course facing the risk of dispute with the Agency.

Furthermore, the regime of total exclusion of taxes over incomes is purely about the capital gains realised through the pure assignment of the qualified IP rights. Therefore, if in one or more cases IP rights were assigned together with other goods or rights, the value of the latter could not be included and benefit of the incentive. Therefore it would be advisable to be very precise in the drafting of the agreements of assignment to avoid objections.

In addition, paragraph 3 of Article 6 of the Decree, states that if "among the specific categories of IP rights identified by paragraph 1, "*… two or more rights, owned by the same person, are connected by means of a complementarity link so that the finalization of a product or a process is subject to joint use of these rights, such IP rights are considered jointly as a single one*": this clarification is undoubtedly appropriate, since it is normal that the same good might incorporate a plurality of IPRs, although the most common situation concerns a single good in which rights belonging to different categories (such as a trademark, design or patent) combine reciprocally: it seems that in this situation expenses and revenues of each right involved should be considered separately, which may prove to be extremely difficult. All these aspects should therefore be clarified by the *ruling*. For this reason, micro, small and, medium-sized enterprises are provided with simplified procedures, established by an act released by the Revenue Agency's Director (Article 12 of the Decree).

(Source: http://www.patentroad.it/wp-content/uploads/2016/12/Patent-Box-dibattito-in-Europa-730x410.png)

The Italian Patent Box in the OECD frame and the ratio underlying the subsequent exclusion of trademarks

Generally speaking, a tax incentive system for income arising from the use of intellectual property rights (IPRs) was aimed at dissuading the pervasive phenomenon of IP rights' registration, especially patents, in the name of companies established in countries with a particularly favorable fiscal regime, in order to reduce the taxation of the income from the exploitation (or assignment) of IPRs.

The first European country introducing such incentives was Ireland in 2000, followed by France, Belgium, Hungary, Luxembourg, the Netherlands, Spain and, in 2013, the United Kingdom. As part of the BEPS project (*Base Erosion and Profit Shifting*), the OECD had therefore recommended the implementation of a common approach, aimed at ensuring that only the incomes created in a specific country might benefit from tax relief – proportionately to the investments actually provided there. The Italian legislation has been clearly inspired by this approach, in particular with regard to the rather complex method to determine the income which the incentives apply to direct exploitation of IP law.

Inclusion of trademarks among those rights, which may enjoy the incentives in Italy, was strongly criticized. It openly ran counter to directives of the OECD, whose Action Plan 5 states that the incentives – which the OECD proposed to harmonize – should only be granted in relation to patents and to rights functionally equivalent thereto. Indeed, in the first version of the Italian Patent Box as introduced with Law No. 190 (Article 1, paragraphs 37 to 43) on 23 January 2014, a compromise had been sought, with trademarks being admitted to the extent they were functionally equivalent to patents. The wording, however, had no rational significance, also because the OECD Action Plan 5 expressly stated that marketing-related intangibles, and first and foremost distinctive signs, could not be considered functionally equivalent to patents, in that they were deemed incompatible with the nexus approach upon which the fiscal incentive was based. Just a few months after introduction of the first version, the patent-equivalent trademarks formula was cancelled by Article 5 of Law 24.1.2015, No. 33, which converted Decree Law 24.1.2015, No. 3. It had, however, included trademarks *tout court* in the Patent Box, therefore running counter to the directives of the OECD which gave states only a limited time to comply therewith.

This compliance has been effected in Italy by the very recent Article 56 of Decree Law No. 50/2017, which removed trademarks from the list of IP rights which may benefit from the "Patent Box", also re-drawing the perimeter of application of the benefit in relation to know-how, also much debated for the same reasons of compatibility with OECD directives: while the previous rule admitted "*company know-how and technical-industrial experience, including commercial or scientific know how and experience which may be protected as legally safeguarded confidential information*" to the system, the new text speaks of "*processes, formulas and know-how relating to experience acquired in the industrial, commercial or scientific fields*", thus seemingly limiting its scope to know-how which is more "structural", albeit not restricted, only to technical aspects.

The new rules, however, will penalize only in part the holders of rights which had already exercised the three years option to take advantage of the incentives, such holders can continue to avail themselves of it until the end of the three-year period, by means of a transitional system which is differentiated so as to take account of financial years possibly not coinciding with calendar years.

The Patent Box and the IPRs Management

Beyond the abovementioned difficulties, the Patent Box Law makes it possible to carefully manage the IPRs within a company with significant benefits on the fiscal side. In fact, a reduction in income tax, in particular, from revenue derived from licensing activity, and exemptions from capital gains tax through the transfer of IPRs reinvested in the development of similar IP development. this is particularly important for those enterprises that produce creative works daily: these are not only the innovation enterprises but also those that operate in the fashion or design sectors. Of course, pursuant to the illustrated system, the fiscal aspects are important as well as further elements to be taken into consideration, and namely the direct consequences coming from the registration of the IPRs in the name of a specific enterprise and the tangible assignments derived from their IPR intergroup-transfer and from contractual relationships: these elements should be considered as well, both under the corporate law (even personally) and IP law liability.

The new system emphasizes the fact that the use of the IPRs among companies of the same Group needs to be regulated – not only according to the principle of free circulation of these rights within the group, but each tangible assignment must also be provided with detailed and accountable justifications.

Although the formulation used by the legislator (which refers to "goods" and "property" in regard of these rights) appears to pave the way to a full assimilabity of IP rights to property rights, one cannot help but point out that actually the concept of "intellectual property", currently being implemented, also at an international level, ultimately differentiates property rights from material goods, as Friedrich von Hayek stressed. The "immaterial" property in all its guises results essentially in an exclusive right, restricted to the uses of the object of the right complying with its economic function as acknowledged by the law in regard of each typology of IP rights. Thus it results in the right of the holder to «prevent all third parties not having his consent» from making said uses in a time and a space that may vary depending on the typology of right considered. Consequently, a competitive edge among the other operators takes is created, depending on the extent, limits, and scope of said exclusive rights.

This fundamental issue, even more than the new rules on Patent Boxing, underlines how unwise it would be to manage of IP rights within the framework of a Group of enterprises on the mere principle of the free circulation of IP rights in the context of the same Group. As a matter of fact, this solution doesn't take into account– first and foremost from the point of view of the financial and accounting autonomy and the liability of each single company – of the mutual relations of debits and credits among the different companies, that deserve to be properly regulated and valorised contractually, especially by means of framework agreements. From this point of view, the management of technological innovation is emblematic, as its creation or acquisition by third parties is the effect of relevant research investments, or takes place for valuable consideration. Furthermore, in the first case it may involve (in Italy on the basis of Article 64 of Italian Code:

Industrial Property, which has corresponding rules also in many other countries) obligations towards employee-inventors that are related to the value of innovation and that are incurred by the employer, irrespective of whether it is or it is not the registered owner of the patent. In this way, it would not appear justified to provide the IPR freely or assign of these rights to other enterprises of the Group without due consideration of economic flows in the opposite direction.

(http://www.patentboxruling.it/Portals/232/EasyDNNNews/858/702462c20241EDNthumb858latest-technologies-in-computer-patent-box.jpg)

The Patent Box between relocation and back-reshoring

In particular, with regard to the innovation enterprises – but also for those products whose added value consists in a trademark or in a design – the question has to be whether (and under what circumstances) the benefits deriving from the possibility to reduce the production costs by relocating the manufacturing activities in foreign countries, are unwound (and sometimes overcome) by the match between the opportunity to emphasize, on the market, the Italian origins of the products as an added value and the possibility to use these new incentives.

They do not relay, in fact, directly with the IP rights, but just assume them, even the agreements entered into by domestic enterprises with foreign manufacturers. These agreements are more and more frequent nowadays, as the economic globalisation is translated into both trade globalisation and globalisation of economic factors, and therefore into de-territorialisation and dematerialisation of the economy. It is quite clear that once again in the context of these agreements it is notionally possible to make use of the assignment or licence the relevant IP rights, in particular of the intra-group.

In this case, account should be taken also of custom implications too. For obvious reasons, indeed, custom authorities used to say that, when the imported product incorporates a trademark, patent, design, or a copyright, the value of this intangible component of the product is to be added to the custom value of the imported good. However, this praxis of custom authorities may be questionable, at least as far as the royalties paid for using IP rights are calculated on the sales made in the country of destination of the goods. Actually, the EU Custom Code (EU Regulation No. 952/2013) clearly indicates that the amount paid as royalties for the use of licensed IP rights should be included in the custom value of the goods imported in Europe only if its payment is a condition the sale of the goods from the foreign exporter to the European importer, that does not occur if the license is due only on the products effectively sold to the final consumers in Europe.

However, besides these issues, strictly in an Italian or European context, it is crystal clear that many products have important territorial characteristics that may be emphasized and made valuable in terms of reputation on the market. Hence, the new rules on Patent Box may help to make it economically more convenient to bring at least a part of the “relocated” manufacturing back “home.” This kind of incentives appears, consequently, preferable to punitive actions to enterprises which delocalise their production, regardless of the positive values, especially for consumers, that in many cases relocation may have, especially in regards to lower prices.

Again, probably a unique solution economically viable and applicable in all the different cases does not exist and, therefore, the better choice may be a match between relocation and re-shoring of manufacturing and researching activities, a highly debated issue in Italy. This would be beneficial especially if the latter is combined with an active management of the Group, which is able to take advantages of all the opportunities provided, especially if this intergroup-management of the IPRs portfolio is combined with new methods of distributions, capable to take advantage of the strengths of both the off-shoring and re-shoring. Therefore, the assessment of the strategies to be adopted for the best use of this new tax regime requires an analysis that would involve experts of tax law, IP law, experts with knowledge of revenue authorities.

The light and shadows of the Italian Patent Box

The decision of the Italian government to comply with OECD instructions was actually largely foreseen and, even though it reduces the objective scope of incentives (and, for know-how, raises problems with regard to interpretation of the ambiguous new wording), it renders them to a certain extent more attractive for companies, since it makes the Italian system more compatible with the OECD guidelines upon which it is based (deviating, however, in certain respects of which this was most certainly the most critical), thus strengthening the credibility, also at the international level, of the Italian system.

Actually, many problems of interpretation of the Italian rules (mainly with regard to trademarks, but also for other IP rights) arose from the very beginning. In particular, the limitation of the IPRs that might benefit from these incentives enacted by Decree of Article 6 of 27 May 2015 was questionable because with regard to trademarks the article takes into consideration only "*registered or still pending*" marks and not the unregistered trademarks (while the primary rule refers generally to trademarks).

Furthermore, among the "creative works" indicated in the primary rule (i.e. every kind of copyrighted works) the Decree took into consideration only the *software*, even if it could be maintained that also copyrighted design is included, because the Decree refers to "*legally protectable designs and models*", an expression that may include registered and unregistered designs, and design protected by copyright. This limitation does not seem to be legitimate and probably it will not be applied, because a secondary source, i.e. the Implementing Decree cannot prevail over a primary source (i.e. the law). Again, a compromise was found by the Circular No. 11/E of 7 April 2016, that expressly included both software and copyrighted designs among the incentivized rights.

Acceding to these optional fiscal incentives, however, continues to be held back by the accounting burdens required by the system. In many ways this is most problematic for SMEs, as cost may actually exceed the benefits. The 2016 Circular offers extremely reasonable practical solutions in order to allow taxpayers to identify those rights which may benefit from the incentives and to prove the existence of the legal requirements of protectability of those rights which are not based on patenting or registration, in particular know-how, admitting broad use of self-certification. In particular, with regard to know-how, the Circular expressly recalls the definition contained in the EC Regulation No. 772/2004, on 27 April 2004 on Technology Transfer Agreements, according to which the know-how is referred to as a package of non-patented practical information resulting from experience and testing, which is: (i) secret, that is to say, not generally known or easily accessible, (ii) substantial, that is to say, significant and useful for the production of the contract products, and (iii) identified, that is to say, described in a sufficiently comprehensive manner so as to make it possible to verify that it fulfils the criteria of secrecy and substantiality." In this way, they have been excluded from the statements and contractual terms that just define confidential as any and all of the information used by a company or where reference is generically made to the duty of confidentiality existing upon the employees (in Italy according to Article 2105 Civil Code). It is always necessary to identify with precision the specific information to be protected.

However, it imposes adoption of analytical systems of management accounting to determine costs and revenue which may be attributed to each single right and for the calculation of the *nexus ratio* (which, when qualified costs and overall costs are the same, would actually be superfluous). Although there is a transitional system which, for the first three years of application of the incentives, broadly admit recourse to aggregate amounts, these burdens – particularly onerous and, in some cases of implementation, bordering on the impossible (we may think of the difficulty of distinguishing research investments, subdividing them into research which has or has not led to IP rights, which are often inextricably linked) – have in no way contributed to spread of the system, particularly among less structured companies.

Furthermore, some interpretations of the law that are given by the Revenue Agency are clearly contrary to the law and penalize taxpayers unjustly. In particular, paragraph 6.3 of the 2016 Circular specifies that the amount of capital gains deriving from the assignment of immaterial goods should be assessed in compliance with the requirements for eligible income from the direct or indirect exploitation of the immaterial good, and hence they should be calculated in the same way that is required for ordinary eligible income, i.e. basically, from the product between the capital gain and the "nexus ratio", will arise the share in the eligible income that will not contribute to the formation of the total income. Once again, the Circular's complexity appears to be improper and in opposition to the underlying rational (and even in wording!) of the relevant rule, which allows the benefit of these incentives the total sum of capital gains accrued through the assignment of the immaterial goods. As a matter of fact, if these capital gains were simply considered as an "income", determined on the basis of criteria required for the first incentive, it would follow that the taxpayers would benefit of it, regardless of the reinvestment. There are also other cases where the correct interpretation of the law seems contrary to the one that would result from the Circular.

One could have the impression that the Revenue Agency, different from the Ministry of Economic Development, didn't believe that the Patent Box was an appropriate instrument for encouraging enterprises to bring back to Italy their IP rights now parked in their foreign subsidiaries. Therefore, the Agency appears to have staked on "reducing the damages" to the public purse, discouraging the use of the Patent Box, especially for the Small and Medium Entities (SMEs), and interpreting strictly the extent of the incentive, every time it was possible.

It has thus lost the opportunity to encourage Italian companies to re-shore their IP rights and manufacturing activity. Instead, since IP revenue and production of many important Italian companies remain parked in foreign subsidiaries, the Italian Patent Box just led to a reduction in the amount of tax revenue, rather than increasing taxable income in Italy.

This seems to make it advisable to have a general re-think of the provisions for implementation of these rules, so that the Italian Patent Box can be implemented in such a way that all its positive consequences may be enjoyed including re-entry into Italy of IP rights parked overseas and allow the taxable base to be increased, levelling off the costs of incentivization for the financial administration. Such a reform, ideally, would become a best practice which may be added to other Italian areas of excellence in IP rights matters, which are also not well-enough known or practiced by companies. Think of the efficiency and rapidity of civil law cases in this matter, in which injunctions on ongoing infringement take only a few weeks or a few months to be issued and decisions on their merits including compensation and marginal profit disgorgement orders, in which sums running into the millions are no longer the exception but the rule, take around two years to be granted.