New Italian laws include numerous changes relevant to US MNCs

January 30, 2015

In brief

The Italian Budget Law for 2015, effective January 1, 2015, introduces several tax law changes relevant to multinational companies (MNCs). In addition, recently enacted Law Decree no. 3, dated January 24, 2015, while still subject to Italian parliament approval, favorably changes the Italian patent box regime.

The most important changes from a cross-border perspective include:

- A new patent box regime that partially exempts income derived from qualifying intangible assets from the corporate income tax (IRES), generally levied at 27.5%, and the local tax (IRAP), generally levied at 3.9%.
- Amended criteria to identify tax-haven jurisdictions in order to apply the anti-tax-haven and controlled foreign company (CFC) rules. The anti-tax-haven regime limits and increases the burden of proof for expensing costs charged by related or unrelated undertakings resident or located in tax havens. The Italian CFC rules provide for a CFC's income inclusion in the hands of the Italian controlling person under certain circumstances.
- Renewed option (with amendments) to step-up the outside tax basis of Italian shares held by either Italian individuals or non-Italian resident persons.

Other important changes include:

- A new research and development (R&D) tax credit to replace the old credit. The new tax credit equals either 25% or 50% of the qualifying R&D expenditures in a given year to the extent those expenditures exceed average qualifying R&D expenditures in 2012, 2013, and 2014. The R&D tax credit cannot exceed Euro 5 million per year.
- An improved labor cost deduction for IRAP purposes. However, the unrestricted deduction does not apply to labor costs for temporary employees. The old rules still significantly limit those deductions.
- Repeal of the IRAP rate abatement, moving the IRAP rate back to 3.9%. This change applies retroactively to 2014.
- New rules for amending tax returns or tax payments.

In detail

Patent box regime

Italian resident companies and Italian branches of non-residents that carry out R&D activity, either directly or by outsourcing it to universities or other research institutes or equivalent institutes, may elect to apply the Italian patent box regime. The regime exempts a portion of the income derived from the exploitation, either direct or by licensing, of 'qualifying intangible assets.'

Recently enacted Law Decree no. 3, dated January 24, 2015, is already effective but subject to confirmatory approval by both houses of the Italian parliament within 60 days. The Decree extends access to the patent box regime to companies that outsource the R&D activity to unrelated entities.

The general exemption is 50%, but is limited to 30% for 2015 and 40% for 2016.

Non-residents with an Italian branch can elect to apply the regime only if they reside in a country with which Italy has concluded a tax treaty and that allows adequate exchange of information.

The election is effective for five years and cannot be revoked during that period.

Qualifying intangible assets include patents, know-how such as industrial, commercial, or scientific information, formulas and processes that are eligible for legal protection, and trademarks that are functionally equivalent to patents.

Law Decree No. 3 extends the regime to all other trademarks.

The regime follows the OECD nexus approach. Accordingly, only a portion of the income derived from the intangible qualifies for the exemption. This portion is determined by multiplying the income derived from the intangible asset by the ratio of qualifying R&D expenditures, i.e., the expenditures related to the maintenance, improvement, and development of the intangible asset over the total expenditure to create that asset.

Law Decree no. 3 clarifies that taxpayers may only include 'tax–relevant' expenditures in the calculation. Furthermore, the numerator is increased by an amount equal to the costs incurred to either acquire the qualifying intangible asset or to outsource R&D activity to related parties. This add-on cannot exceed 30% of the numerator.

Taxpayers must request a specific ruling from the Italian tax authorities to benefit from the regime when the qualifying intangible is either used directly by the company or licensed to a related party. Law Decree no. 3 makes the ruling unnecessary when the qualifying intangible is licensed to a related party, whether that party is resident in Italy or abroad.

The proceeds from the disposal of qualifying intangible assets are 100% exempt from tax, provided that at least 90% of those proceeds are reinvested in the maintenance or development of other qualifying intangible assets by the end of the second tax period following that of the disposal. The taxpayer must request a specific ruling if the transfer is between related entities.

An inter-ministerial decree will provide specific guidance regarding practical application of the regime.

Amended criteria for identifying tax haven jurisdictions to apply the anti-tax haven regime

The Italian anti-tax-haven regime imposes an increased burden of proof on taxpayers seeking to deduct costs charged by a related or unrelated party resident or located in a tax haven.

The Budget Law empowers the Ministry of Economy and Finance to amend the tax haven list by limiting determining factors to one: whether the jurisdiction has an adequate exchange of information system with Italy. Therefore, a jurisdiction's effective level of taxation no longer help determine whether the jurisdiction should be on the tax haven list.

Therefore, countries that allow adequate exchange of information with Italy — such as Ecuador, Mauritius, South Korea, Philippines, Singapore and United Arab Emirates — no longer will be included on Italy's tax haven list.

Amended criteria for identifying tax haven jurisdictions to apply the Italian CFC rules

The Italian CFC rules generally provide that if the CFC of an Italian person is resident or located in a tax haven, its income is subject to inclusion by the Italian controlling person and therefore subject to tax in Italy.

The Budget Law amends one criterion for tax haven list inclusion, by providing that a jurisdiction's effective tax rate must be lower than 50% of the Italian rate. Further, special tax regimes that result in an effective tax rate lower than 50% of the Italian rate are now covered by the CFC rules. This includes regimes enacted by countries that generally have tax rates higher than 50% of the Italian rate. The Italian tax authorities will issue a non-comprehensive list of these special tax regimes.

This amendment should reduce the number of countries included on the tax haven list. Under previous law, the corresponding criterion to identify tax havens was an effective tax rate just 30% lower than the Italian rate. On the other hand, special tax regimes granted by countries that historically were not considered tax havens could be covered by the new rules.

Italian shares step-up option

Non-Italian residents can elect to step-up the outside basis of shares in Italian resident companies by paying a substitution tax at the rate of 4% on non-qualified shareholdings and 8% on qualified shareholdings.

A shareholding is qualified if:

- it grants 20% or more of the ordinary shareholders' with voting rights, or
- it represents 25% or more of the company's share capital.

The election is subject to the following conditions:

- the shares must not be issued by a publicly traded company
- the shares must be held on January 1, 2015
- the basis for the substitution tax is the value of the shares as of January 1, 2015, as certified by a sworn appraisal prepared no later than June 30, 2015
- the substitution tax must be paid by June 30, 2015, or in three annual installments(plus interest).

R&D tax credit

Italian companies that carry out qualifying R&D activities can benefit from a tax credit computed as a percentage of the R&D expenditures in excess of the company's average R&D expenditures in 2012, 2013, and 2014. This tax incentive will remain in effect from 2015 through 2019.

Broadly, qualifying activities include most usual R&D activities. There is an exception for those activities that lead to ordinary and recurring improvements in already existing products and production lines, unless they lead to new patent registrations.

The credit percentage is 25% for depreciation of laboratory equipment and for technical expertise related to industrial or biotech intellectual properties. The percentage increases to 50% for costs related to 'highly qualified' personnel and R&D activities outsourced to universities or other similar research institutions.

The tax credit cannot exceed Euro 5 million a year per taxpayer, and requires qualifying R&D costs of at least Euro 30,000 per year.

The R&D credit will not be subject to the corporate income tax.

Taxpayers should be able to take advantage of both the R&D credit and the exemption under the patent box regime in the same tax year.

Labor cost deduction and IRAP

For IRAP purposes the Budget Law allows a full deduction for labor costs related to employees hired on a permanent basis. For temporary employees, the IRAP deduction limits still apply.

IRAP rate

The Budget Law resets the IRAP rate to 3.9%, retroactive to 2014.

Tax return amendments and late payments

The Budget Law modifies the terms by which taxpayers are entitled to amend tax returns and make late tax payments. Spontaneous amendments allow taxpayers to benefit from reduced penalties. Commencement of an audit no longer precludes taxpayers' ability to amend tax returns or tax payments. Only notices of assessment or tax redetermination prevent the possibility of amending tax returns or tax payments.

Furthermore, corrections that allow taxpayers to benefit from reduced penalties can now be made without time limits. Previously they had one year from the deadline to file the tax return or the make the payment. Late corrections were subject to full penalties. Penalties are now reduced as follows:

Fraction of the minimum penalty	**Terms for correction (from the deadline to file the tax return or to pay the taxes due)**
1/150 per day (late payments only)	Within 14 days
1/10 (late payments only)	Within 30 days
1/10 (omitted tax returns only)	Within 90 days from the filing deadline
1/9	Within 90 days
1/8	Within 1 year
1/7	Within 2 years
1/6	After 2 years
1/5	After the audit report

Finally, taxpayers may still agree with the notice of assessment. In this case, penalties are reduced to 1/3 of the minimum.

The takeaway

The addition of the patent box regime and the R&D credit to the well-established notional interest deduction should make the Italian tax system more competitive.

Also, the ability to fully deduct for IRAP purposes the labor costs related to employees hired on a permanent basis should further reduce the tax rate on Italian companies, especially those in labor-intensive businesses.

Finally, the amended criteria for identifying tax havens should reduce the impact of both the anti-tax-haven regime and the Italian CFC rules. Nevertheless, taxpayers should study carefully the expanded CFC rules that now include the special tax regimes granted by non-tax havens.

Let's talk

For a deeper discussion of how this might affect your business, please contact:

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