

## Guidance Explains Partial Deduction Of Regional Tax for Corporations

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# COUNTRY DIGEST

## Guidance Explains Partial Deduction Of Regional Tax for Corporations

Italian tax authorities on April 14 released Circular Letter No. 16 providing guidance on the criteria for claiming a partial deduction of the regional tax on productive activities (IRAP) when computing corporate income tax.

Under the general tax rules, IRAP would not be deductible, either in whole or in part. The partial deduction was introduced in Law 2/2009 of January 28, 2009.

For a manufacturing company, IRAP is based on gross revenue, less the cost of materials and some business expenses, such as rent and depreciation. The IRAP tax base is not reduced for labor costs and interest expenses.

There has been much controversy over the nature of IRAP as an income tax for purposes of its creditability against U.S. taxes under the pending 1999 Italy-U.S. income tax treaty. The legislative intent behind Law 2/2009 is to allow taxpayers the benefit of a deduction amount that approximates what a taxpayer's deduction would have been if IRAP had been imposed on net income.

As a result, IRAP is now deductible, on a cash basis, in an amount equal to 10 percent of the tax deemed attributable to the taxpayer's labor costs and interest expenses.

According to the April 14 circular, a taxpayer does not need to have incurred both labor costs and interest expenses provided that either one of those expense items is included in the determination of the tax base for the year to which the payment refers. The 10 percent portion is determined regardless of the amount of payroll or interest expenses actually incurred by the taxpayer, as long as the expenses are ordinary and necessary for the business.

Assume that during 2008, the aggregate IRAP paid by Alpha Corporation was €100,000, out of which €80,000 was the balance due for 2007 and €20,000 was in estimated payments for 2008. Further assume that Alpha Corp. had neither payroll nor interest expenses in 2007, but had payroll expenses in 2008. On its 2008 corporate income tax return, Alpha can deduct €2,000 of IRAP (10 percent of €20,000), regardless of the actual amount of its payroll expenses. Because neither labor costs nor interest expenses were included in the determination of the IRAP base for 2007, no portion of the 2007 balance paid in 2008 can be deducted.

Under the Italian system, circulars are binding for the Revenue Department, but taxpayers and tax courts may challenge them. ♦

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