Italian regional production tax (IRAP)

This analysis takes its cue from the need to compare the tax burden on limited companies in the various countries of Europe as part of our survey on medium-sized enterprises. In Italy, unlike in other European countries, a regional production tax is in force (IRAP, or "Imposta regionale sulle attività produttive") which is based not on net income before tax but on the value added produced by a company. Given that value added is defined as the difference between operating revenues and costs before interest income and expense, and in particular before labour costs, are deducted, part of the tax affects values other than the company's pure income, which potentially produces discriminatory effects. Moreover, IRAP is payable also in the event of a loss being reported, which makes the tax pro-cyclical.

Tax

IRAP was instituted under Italian Legislative Decree 446/97. It affects companies exercising productive activities, and is applied to a tax base calculated from the value of net production deriving from activity performed locally. In industrial and commercial companies' balance sheets, this base is equal to the difference between the value and costs of production as shown in the companies' statutory financial statements, excluding items no. 9 (labour costs), 10*c* and 10*d* (writedowns to fixed assets and receivables), 12 (risk provisions) and 13 (other provisions); when the tax was first introduced, labour expenses were not deducted at all, regardless of the item under which they were classified.

The criteria initially established for calculating the tax base have been revised over time, in particular in order to reduce the penalizing effect that it had on highly-labour intensive companies. Lump-sum deductions were introduced per employee: €5,000 for each permanent employee until 2007 and €4,600 as from 2008 (€10,000 and €9,200 respectively in the regions of southern Italy), as well as deductions for expenses in respect of apprentices and staff employed on work training contracts. At present the entire cost of staff employed in research and development may be deducted (this has been the case since 2005), as may the entire amount of pension and social security contributions. There are also other forms of relief of various kinds. If the activity is carried on in several regions, the value is divided up according to the remuneration payable to staff in each region.

The proceeds from the tax are attributed to the individual region net of a share to be paid to the Italian state by way of compensation for costs in respect of the activities of control, payment and certification. The regions then distribute a share of the proceeds to each province and municipality. The basic rate of IRAP is presently 3.9%, with the possibility of individual regions varying this by up to 0.92% more or less (the rate was 4.25% until 2007). IRAP is not deductible for the purpose of calculating Italian corporate income tax (IRES); the possibility of deducting a lump-sum share, equal to 10%, was introduced in 2008 ideally referring to the attribution of a part of labour costs and interest expenses.

IRAP replaced several different taxes, the most significant of which in terms of tax yield were a local income tax (ILOR, "imposta locale sui redditi", the rate for which in 1997 was 16.2%), and the tax on companies' assets. Taken together, these two taxes in 1997 produced revenues of €18.7bn, while IRAP in 1998, the first year of its existence, generated €26.9bn.[1]

IRAP does not have a pre-determined use. It serves the general finances of the region. According to the data contained in the most recent Bank of Italy report, the tax yield in 2009 was €31bn, out of total current income for the local administrations of €93bn. Other major sources of income for local entities are the surtaxes added to income tax IRPEF (regional surtax €7.7bn, municipal surtax €2.9bn), municipal property tax (€9.6bn), and regional car taxes paid by households (€4.5bn) and companies (€1.1bn). There are also some provisions stipulating that IRAP rates be raised "automatically" in the event of shortfalls in the healthcare budget (e.g. pursuant to Article 13 of the protocol agreement entered into between the Italian government and regions on 3 December 2009 instituting external administration for regions in deficit).

As mentioned, IRAP is a tax which does not merely affect companies' income but the entire value added. The body instituted to issue fair and proper accounting standards for use in companies' financial reporting stipulated in 1998 that expenses in respect of IRAP be treated as "taxes on income for the period"; similar provision was made in a document issued in July 2005 by the Italian Accountancy Body ("Organismo Italiano di Contabilità", or OIC) which has taken on the role of standard-setter previously assumed by the National Council of Chartered Accountants. This appears to support the argument that this tax cannot be passed on, unlike with, for example, value-added tax (IVA).

Calculation of the tax rate from companies' financial statements

Returning to the issue of comparison, the notes to the accounts prepared by Italian companies do not always show the amount of IRAP separate from that of the other income taxes, and it is not possible to estimate the amount accurately, given the deductions made by the company (which are very complicated, as described above).

The purpose of this analysis is to assess the indicator we use to express the tax burden on corporate income, that is the tax rate. Our method involves: i) producing a database consisting only of profitable companies; ii) use what the regulations require to be classified as "taxes on income" (i.e. IRES and IRAP; the former payable only if a profit has been made) as the tax expense; iii) relating the amount of tax expense thus calculated to the pre-tax profit earned.

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[1] Other taxes suppressed include national health service contributions, contributions for healthcare assistance to pensioners, the share of the contribution for mandatory insurance against tuberculosis, ICIAP ("imposta comunale per l'esercizio di imprese, arti e professioni"), and the government concession tax for granting VAT numbers.

Comparison between the manufacturing medium-sized enterprises operating in Germany, Italy and Spain and the large European manufacturing multinationals shows the following data for 2006:

Tax rate in 2006	Manufacturing MSEs			Large European manufacturing multinationals
	Germany	Italy	Spain	
% income tax/pre-tax profit	25.8	48.3	25.6	25.4

NB: base rates in Italy for 2006: IRAP 4.25% (3.9% in 2009), IRES 33% (27.5% in 2009, save for companies operating in the oil, hydrocarbon research and electricity industries).

Almost all Italian companies calculate their tax rate using the method described above. For example, for their 2009 financial statements: Eni reported "Italian" tax of €1,724m, €219m of which by way of IRAP, calculating an aggregate tax rate of 56% (three-quarters of which is due to non-Italian taxes paid on mining activities); Enel declared a tax rate of 27.8%, paying tax of €2,520m, €376m of which in IRAP; Parmalat calculated €77.4m for IRES and €5.4m for IRAP, declaring an effective total tax rate of 18.3% (on its Italian activities only); Prysmian calculated 25.3%, on aggregate taxation of €85m, €10m of which by way of IRAP; Atlantia declared a tax rate of 33.4%, booking €375.7m in tax, €100m of which was IRAP; Mediaset reported €142.5m in tax, €36.5m of which IRAP, and declared a tax rate of 31.8%; Campari calculated a tax rate of 30.7% with €60.8m in tax charges, €5.4m in IRAP; and so forth. Fiat did not disclose an effective tax rate, as its accounts for the 2009 financial year reflected a loss; however, in the years in which it was profitable, it still disclosed only a tax rate for IRES, stating that "no account is taken of IRAP because this tax, as its taxable base is not pre-tax profit, would generate distortive effects from one financial year to another". IRAP paid by Fiat amounted to €103m in 2008 (22% of its total income tax) and to €66m in 2009. To summarize, save for very few exceptions, the companies usually declare a tax rate by referring it to total taxation, including IRAP, as a percentage of pre-tax profit.

Nonetheless, we may ask what the rate of presumed distortion might be if we wanted to calculate the tax rate by considering only the share of IRAP attributable to net profits. As said, the calculations are very complex, and indeed impossible if made on the basis of information available for 2006 for "externals" to the company. But a crude principle might be adopted whereby the value added calculated from disclosed financial statements is used as the basis for IRAP. For the universe of approx. 4,500 medium-sized Italian companies, we took the 2007 data from the most recent Mediobanca-Unioncamere census; excluding the loss-making companies, the calculation basis refers to approx. 3,600 companies employing around half a million staff. To proceed with the calculation, it was necessary to estimate the share of taxation attributable to IRES and the share which refers to IRAP. Two parallel methods were adopted: on the one hand, IRES was estimated by applying the nominal 2007 rate of 33% to pre-tax profit, with the difference being ascribed to IRAP; and on the other, IRAP was estimated by applying the nominal rate of 4.25% to value added, with the difference being ascribed to IRES.

The databases were as follows:

Value added (base for est. IRAP) (VA)		**30,475**	€m		
Other items (balance)		-21,290	€m		
Profit before tax (PBT)		**9,185**	€m		
Income tax		**-4,015**	€m		
Net profit		5,170	€m		
Estimate of tax constituents:		from IRES			from IRAP
IRES	*33% PBT*	3,031		*Difference*	2,720
IRAP	*Difference*	984		*4.25% VA*	1,295
Total income tax as above		**4,015**			**4,015**

According to these databases, value added (the tax base for IRAP) is divided between the three main constituents as follows: cost of labour €19,577m (equal 64% of the total), interest expense (net) €1,881m, and profit before tax for the remaining €9,017m, to give a total value added of €30,475m as above. If we now calculate the amount of tax attributable to IRAP according to the two methods described previously, bearing in mind that in the case where this amount was obtained as the difference (that is, after deducting IRES at 33%), the actual tax rate turns out to be 3.2% rather than 4.25% (or €984m out of €30,475m):

Estimated IRAP:	Nominal tax rate 3.2%	Nominal tax rate 4.25%
Labour costs	626	832
Net interest expense	60	80
Profits	298	383
Total IRAP as above	**984**	**1,295**
Profit before tax	**9,185**	**9,185**
- IRAP on labour costs	626	832
- IRAP on interest	60	80
New profit before tax (A)	**8,499**	**8,273**
IRES	3,031	2,720
IRAP	298	383
Total income tax (B)	**3,329**	**3,103**
Tax rate B/A as %	***39.2***	***37.5***

The calculations suggest that the actual tax burden on medium-sized companies in 2006/2007 may be estimated at around 40%. However we choose to consider IRAP, then, a significant gap still exists in the tax rate between Italy on the one hand and Germany and Spain on the other.

Calculation of tax rate from 2009 financial statements

For 2009, a specific survey has been conducted on companies which publish details of IRAP. The companies surveyed represent 76% of those reporting profits before tax, as recorded in the Mediobanca publication *Financial Aggregates. Annual Statistical Survey of 2,025 Leading Italian Companies*. There are more than a thousand such companies. Excluding amounts relating to deferred and other charges, the figures broke down as follows:

FY 2009	IRAP	IRES		IRAP as % of IRES	Average IRAP rate	Tax rate
	€m			%	as % of VA	%
Italian-owned companies:						
Medium-sized enterprises	128	314		40.8	3.4	35.1
Medium/large companies	406	1,018		39.9	3.3	28.6
Larger groups	1,494	4,863		30.7	4.1	27.6
Non-Italian-owned companies	701	2,319		30.2	3.6	33.0
Total for companies publishing details	**2,729**	**8,515**		**32.0**	**3.8**	**29.2**
Total for all profitable companies	N/A	N/A		N/A	N/A	30.0

It is worth noting that despite taking into account the fact that the sets of companies considered here are different, the tax rate in 2009 is lower than that in 2006, due to the reduction in the tax rates of both IRES and IRAP. For the set of profitable companies included in the 2,025 aggregate, the tax rate declined from 32.4% in 2006 to 30% in 2009, and for medium-sized enterprises it fell from 43.4% to 34.8%.[2] Outside Italy, too, there has been a tendency to reduce fiscal pressure: the tax rate for European manufacturing multinationals in 2009 is around 23%, compared with 25.4% in 2006.

Stripping the tax rate of the share attributable to labour and financing costs, we arrive at an estimate of the fiscal pressure which is attributable directly to profits alone (tax rate B). This tax rate B has been estimated on the basis of the average actual rate for IRAP as derived from the balance-sheet data (IRAP expense as a percentage of value added). The difference between the "perceived" fiscal pressure (tax rate A) and the "pure" fiscal pressure (tax rate B) for the set of companies considered here may be estimated at just over 3 percentage points, the difference between 29.2% and 25.9%. The gap between medium-sized enterprises and larger companies is still wide for tax rate B as well, at around 6 percentage points (30.2% for the former and around 24% for the latter):

[2] The difference from the percentage indicated previously in the European comparison is due to the different number of companies considered: here a sub-set is being examined, whereas previously it was an entire universe.

FY 2009	Labour cost as % of total sales	Breakdown of value added				Average IRAP rate as % of VA	Tax rate	
		Labour costs	Interest expense less interest income	Profits (remaining share)			A	B
Italian-owned companies:		%						
Medium-sized enterprises	10.7	62.8	5.4	31.8		3.4	35.1	30.2
Medium/large companies	12.8	64.1	5.9	30.0		3.3	28.6	24.0
Larger groups	9.5	40.3	16.5	43.2		4.1	27.6	24.7
Non-Italian-owned companies	11.0	48.8	6.3	44.9		3.6	33.0	29.7
Total for companies publishing details	**10.6**	**47.9**	**11.3**	**40.8**		**3.8**	**29.2**	**25.9**

The weight of IRAP in total fiscal pressure depends on many factors: firstly, on the size of the labour cost component, then on the tax rate applied by the regions where the company has its local units, and lastly by the structure of its profit and loss account, in particular on the cost and income items included between the value added and the pre-tax profit lines. To assess the different impact which IRAP can have in greater detail, we also reclassified the companies considered in the tables above according to the weight which labour costs have when considered as a percentage of pre-tax profit. This led to them being sub-divided into six different categories of the same size in terms of volume of value added. The results of the analysis are shown in the table below:

Categories of firms in FY 2009	Labour cost as % of pre-tax profit	Breakdown of value added				Average IRAP rate as % of VA	Tax rate	
		Labour costs	Interest expense less interest income	Profits (remaining share)			A	B
	x	%						
I	0.2	23.3	8.9	67.9		4.2	18.5	17.6
II	0.5	30.0	12.0	58.0		4.1	32.8	30.8
III	0.8	39.2	15.3	45.6		3.9	34.7	31.8
IV	1.3	42.7	20.3	37.1		4.0	39.7	34.6
V	2.4	66.2	3.7	30.1		3.3	37.8	32.1
VI	7.9	82.4	6.2	11.4		3.1	51.9	34.3
Total for companies publishing details	**1.0**	**47.9**	**11.3**	**40.8**		**3.8**	**29.2**	**25.9**

The data shown here raise various issues. The first involves perceived fiscal pressure. Given that, as we have seen, most companies treat IRAP as a tax on income, the tax rate used ends up being the "perceived" tax rate (A), which includes IRAP in its entirety and as mentioned is higher than the "pure" tax rate (tax rate B); the average gap between them is more than 3 percentage points, but for half of the categories we selected (which include two-thirds of the companies) the difference ranges from between 5 and over 17 points. Seen in this light, there are two different worlds: the first, which corresponds to the first three categories, where IRAP accounts for just 20% of the total fiscal pressure (IRAP + IRES), and the second, which corresponds to the second three categories, where the impact of IRAP rises to 33% of income tax expense. The second issue raised by this data regards the detail of the disparity. The average tax burden figure, calculated at 29.2%, is largely meaningless, given that more than 80% of all companies have a higher tax burden than this. Out of this sub-set, 40% have a tax burden of between 29.2% and 40%, 33% of between 40% and 60%, and the other 27% have a tax rate of over 60%, with highs of over 80% in half of the cases. But the disparities also involve the lower limits, given that more than half of the 20% of companies with a tax rate below the general average in fact have a tax rate of below 18.5% (the average rate calculated for the first category).

As is to be expected, then, fiscal pressure increases as the importance of the labour factor increases, and reduces as the share of value added represented by profits grows. The category of firms which shows the most favourable "perceived" tax rate (18.5%) distributes less than one-quarter of its value added to labour with two-thirds accounted for by profits, whereas for the hardest-hit category the labour component exceeds 80% while profits represent just over one-tenth.

The data for the "pure" tax rate (tax rate B) reflect much lower levels of variability and the tax burden, excluding the first category, ranges between 30% and 35%. This leaves, obviously, the effect of the different tax rates combined with the differences in profit-and-loss structures, along with that of items not subject to IRES.

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