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### WORKING PAPER

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#### **MEETING DOCUMENT**

|          |                                                                                                                                                                |
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| From:    | General Secretariat of the Council                                                                                                                             |
| To:      | Code of Conduct Group (Business Taxation)                                                                                                                      |
| Subject: | (Draft) Progress Report by the Code of Conduct Group (Business Taxation) to the ECOFIN Council of December 2018<br>Annex: Slovakia's patent box regime (SK007) |

Delegations will find attached a document in view of the meeting of the the Code of Conduct Group (Business Taxation) on 15 November 2018.

## Slovakia's patent box regime (SK007)

### I/ AGREED DESCRIPTION

The following description was agreed by the Code of Conduct Group on 12 April 2018:

| Slovak Republic                                                 |                                                                                                                               |                                                                                                                                                                                           |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                           |
|-----------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 1. Please provide below the basic information about your regime | a. Name of the regime                                                                                                         |                                                                                                                                                                                           | Patent-box (§13a and §13b of the Income Tax Act)                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                          |
|                                                                 | b. Year of introduction/relevant legislation                                                                                  | Year                                                                                                                                                                                      | 2018 (as of 1 <sup>st</sup> January)                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                      |
|                                                                 |                                                                                                                               | Please attach to this template (or provide a link to) the legislation which introduces your new IP regime (if in a language other than English or French, please provide a translation).) | Annex to the questionnaire (Compilation of legislations)                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                  |
|                                                                 | c. Benefits under your regime (e.g. a reduced rate or a deduction, an exception, or some other reduction in the taxable base) |                                                                                                                                                                                           | <p>Benefits are granted by exemption of income (part of income).</p> <ul style="list-style-type: none"> <li>- exemption up to 50% of the eligible royalties income (remuneration for granting the right to use/exploit patented assets – patents, utility models, copyrighted software) (§ 13a para. 1)</li> <li>- exemption up to 50% of the eligible embedded royalties income (income derived from the sale of products for the production of which a patent or utility model was fully or partially used) (§ 13b para. 4)</li> </ul> <p>Benefits are time-limited to the tax periods in which depreciations/write-offs from capitalised costs on patent, utility model or copyrighted software are reported in tax-deductible expenses. (§ 13a para. 3/ § 13b para. 3)</p> <p>If the taxpayer derived income before capitalisation of costs on patent, utility model or copyrighted software, benefit is limited only to a certain amount/part of income. This part is calculated by applying the following formula:</p> <p>Qualifying Part of Income = Overall Income * Capitalised costs/ Overall costs for not more than 5 previous tax years (§ 13a para. 11)</p> |
|                                                                 | d. Effective tax rate under your regime                                                                                       |                                                                                                                                                                                           | Assuming maximal benefit, the lowest effective tax rate could be half the statutory corporate income tax rate, i.e. currently 10.5% (of royalties income).                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                |
|                                                                 | e. Statutory rate in your jurisdiction that would apply in the absence of the regime                                          |                                                                                                                                                                                           | 21%                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                       |
|                                                                 | f. Stated purpose of your regime                                                                                              |                                                                                                                                                                                           | The main purpose is to retain and increase the existing                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                   |

| Slovak Republic                                                         |                                                                                                                                           |                                                                                                                                                                               |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                         |
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|                                                                         |                                                                                                                                           |                                                                                                                                                                               | volume of R&D activities in the Slovak Republic and to encourage new/potential entrepreneurs to undertake such activities in the Slovak Republic. It is intended to support the “added value” sector of economy by development of new patents, other qualified innovative IP assets and products that use patented assets.                                                                                                                                                                                                              |
| 2. Please describe the scope of qualifying taxpayers under your regime. |                                                                                                                                           |                                                                                                                                                                               | <p>Generally, qualifying taxpayers are all those taxpayers who develop qualifying IP assets (incur expenditures) and are liable to tax in the Slovak Republic. (§ 13a paras. 1 and 2/ § 13b paras. 1 and 2)</p> <p>In practice, those taxpayers are:</p> <ol style="list-style-type: none"> <li>1. Taxpayers with unlimited tax liability (i.e. Domestic companies), and</li> <li>2. Taxpayers with limited tax liability (i.e. Slovak PEs of foreign companies).</li> </ol>                                                            |
| 3. What types of IP assets can qualify for benefits under your regime?  |                                                                                                                                           |                                                                                                                                                                               | <p>Qualifying IP assets are:</p> <ol style="list-style-type: none"> <li>1. patents or utility models, and</li> <li>2. copyrighted software. (§ 13a para. 1/ § 13b para. 1)</li> </ol> <p>* Assets that are in process of patent/utility model application (not legally protected yet) can benefit from the regime. If application is eventually rejected, the taxpayer is obliged to submit an additional tax declaration and to pay back provided benefits and relevant sanctions. (§ 13a paras. 9 and 10/ § 13b paras. 10 and 11)</p> |
| 4. Third category of IP assets                                          | a. Are you planning on allowing the third category of IP assets described in paragraph 37 of the Action 5 Report to qualify for benefits? | Yes/no                                                                                                                                                                        | No                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                      |
|                                                                         |                                                                                                                                           | (i) Please describe how you will limit the taxpayers benefiting from the third category.                                                                                      |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                         |
|                                                                         |                                                                                                                                           | (ii) Please describe what IP assets will qualify under this category, and the reason why they will fit with the specific requirements in paragraph 37 of the Action 5 Report. |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                         |
|                                                                         |                                                                                                                                           | (iii) Please describe the transparent certification process                                                                                                                   |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                         |

| Slovak Republic                                                                                                                                                      |                                                                                                                                                   |                                                                                                                                          |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                    |
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|                                                                                                                                                                      |                                                                                                                                                   | (undertaken by a competent government agency that is independent from the tax administration) under your regime.                         |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                    |
|                                                                                                                                                                      |                                                                                                                                                   | (iv) Please describe the procedures you have implemented to ensure annual reporting to the FHTP and spontaneous exchange of information. |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                    |
| <p>5. What income will qualify for benefits?<br/>Please describe how you are ensuring that the amount of income is not equal to the gross income from IP assets.</p> |                                                                                                                                                   |                                                                                                                                          | <p>Qualifying income:</p> <ol style="list-style-type: none"> <li>Royalties,</li> <li>Embedded royalties.</li> </ol> <p>*Only net income is eligible for benefits.</p> <p>Pursuant to provision of § 17 para. 40, expenditures incurred on income that is not part of taxable base because it is exempted under this regime are not tax-deductible. It means that if 50% of income is exempted, the same proportion of expenditures is not included in tax base, i.e. 50% of related costs are not tax-deductible. It involves all sorts of expenditures, including marketing and distribution costs.</p>                                                                                                                                                           |
| 6. Embedded IP income                                                                                                                                                | a. Does your regime allow embedded IP income to qualify for benefits?                                                                             | Yes/No                                                                                                                                   | Yes                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                |
|                                                                                                                                                                      | b. If yes, please describe how you are ensuring that non-IP income (e.g. marketing and manufacturing returns) does not also qualify for benefits. |                                                                                                                                          | <p>With respect to embedded royalties income, eligible income shall be calculated by subtracting all real direct and real indirect expenditures related to manufacturing, management and marketing functions, including the related overheads and profit margins which the supplier would apply to independent persons (ALP). For purposes of this legislation, functions of "sales" ("odbyt" - Slovak version of legislation"/translated as "sales") include also functions of promotion, brokering of sales and marketing. Profit margin related to the function of sales includes also profit margin related to the business name of the taxpayer, trademark or other related intangible assets.</p> <p>This method separates non-IP income from IP related</p> |

| Slovak Republic                                                                       |                                                                                                                                                                                       |        |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                 |
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|                                                                                       |                                                                                                                                                                                       |        | income, i.e. income that is entitled for tax benefits.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                          |
| 7. Tracking and tracing                                                               | a. Have you designed tracking and tracing requirements to ensure that income that is not from qualifying IP assets or that is not qualifying IP income does not qualify for benefits? | Yes/No | Yes                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                             |
|                                                                                       | b. If yes, please describe your regime's tracking and tracing requirements.                                                                                                           |        | <p>In accordance with this legislation, the taxpayer is obliged to keep records and, in the event of a tax administration request, to submit this evidence:</p> <p><u>Royalties income</u></p> <ol style="list-style-type: none"> <li>1. costs sorted by type,</li> <li>2. capitalised costs sorted by type,</li> <li>3. costs on intangible assets (full or partial) procured from other persons. (§ 13a paras. 7 and 8)</li> </ol> <p><u>Embedded royalties income</u></p> <ol style="list-style-type: none"> <li>1. costs sorted by type,</li> <li>2. capitalised costs sorted by type and relevant depreciation plan (of qualifying assets),</li> <li>3. costs on intangible assets (full or partial) procured from other persons.</li> <li>4. calculation of product price,</li> <li>5. number of products benefitting from the regime,</li> <li>6. technical solution with a description of the IP assets utilization in process of production. (§ 13b paras. 8 and 9)</li> </ol> <p>Also, the legislation provides for enhanced transparency. On an annual basis, the Tax Administration publishes a list of taxpayers receiving benefits from the regime (name, address and tax identification number), the amount of provided benefits (per every taxpayer) and tax period of received benefit, patent number or patent application. (§ 13a para. 6/ 13b para. 7)</p> <p>In addition to the Income Tax Act, the Act on Accounting requires legal entities to keep accounting, including all statutory bookkeeping records which contain, inter alia, records on costs incurred to develop intangible assets. With respect to the provisions of the Tax Procedure Code, these records may be subject to tax audit undertaken by tax administration.</p> |
| 8. Please explain how losses associated with the IP income will be treated under your |                                                                                                                                                                                       |        | There is no separate tax loss system for this regime, since we build up on different solution based on non-deductibility                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                        |

| Slovak Republic                                                                                                                                                    |                                                                                                                                           |        |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                     |
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| regime. The explanation should include how your regime ensures that the requirement under footnote 14 to paragraph 47 of the Action 5 Report is met.               |                                                                                                                                           |        | <p>of part of expenses (same as p. 5). Section 17 para. 40 of this legislation provides that expenses (costs) incurred on the income that is not included in the tax base shall not be treated as tax expenses, i.e. these expenses are not tax deductible. (<i>§ 17 para. 40</i>)</p> <p>Example: If we exempt 50% of royalty income, the same portion of related expenses (including marketing, distribution and sales expenses) is not deductible for tax purposes. The basic idea is to entirely avoid tax losses arising from this regime.</p> |
| 9. If you are not a Member State of the European Union, have you designed your regime to be consistent with footnotes 16 and 19 on page 42 of the Action 5 Report? |                                                                                                                                           |        | Slovak Republic is a Member State of the European Union.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                            |
| 10. Related-party outsourcing                                                                                                                                      | a. Does your regime limit benefits based on outsourcing to related parties?                                                               | Yes/No | Yes                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                 |
|                                                                                                                                                                    | b. If yes, please explain how your regime limits benefits based on outsourcing to related parties.                                        |        | All outsourcing costs and acquisition costs (including vis-a-vis unrelated parties) effectively limit the benefit. Therefore, any costs incurred on outsourcing or acquisition are regarded as part of the overall costs and the part of income corresponding to the proportion of outsourced or acquired IP is excluded from benefit under the regime. ( <i>13a para. 4/ § 13b para. 5</i> )                                                                                                                                                       |
| 11. Acquisitions of an IP asset                                                                                                                                    | a. Does your regime limit benefits based on acquisitions?                                                                                 | Yes/No | Yes                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                 |
|                                                                                                                                                                    | b. If yes, please explain how your regime limits benefits based on acquisitions. Following this question, please proceed to Question 13.  |        | Same as 10b. All outsourcing costs (including unrelated party) and acquisition costs effectively limit the benefit. Therefore, any costs incurred on outsourcing or acquisition are regarded as part of overall costs and the part of income corresponding to the proportion of outsourced or acquired IP is excluded from benefit under the regime.. ( <i>13a para. 4/ § 13b para. 5</i> )                                                                                                                                                         |
| 12. Related-party outsourcing and acquisition of an IP asset in line with footnotes 16 and 19 on page 42 of the Action 5                                           | a. Does your regime limit benefits based on the location of the R&D activities in the case of related-party outsourcing and acquisitions? | Yes/No | No. The same limitation applies (see p. 10b and 11b above) regardless of location.                                                                                                                                                                                                                                                                                                                                                                                                                                                                  |

| Slovak Republic            |                                                                                                    |                                                                                                                                                                               |    |
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| report                     | b. If yes, please explain how your regime limits benefits based on the location of R&D activities. |                                                                                                                                                                               |    |
| 13. Rebuttable presumption | a. Does your regime treat the nexus ratio as a rebuttable presumption?                             | Yes/No                                                                                                                                                                        | No |
|                            | b. If yes, please answer to the following questions (i) through (iii)                              | (i) Please describe how departures from the application of the nexus ratio will be limited to the exceptional circumstances described in paragraph 48 of the Action 5 Report. |    |
|                            |                                                                                                    | (ii) Please provide examples of situations where your jurisdiction expects taxpayers to rebut the presumption.                                                                |    |
|                            |                                                                                                    | (iii) Please describe the procedures you have implemented to ensure annual reporting to the FHTP and spontaneous exchange of information.                                     |    |

## II / FINAL ASSESSMENT

The following assessment was agreed by the Code of Conduct Group on 24 July 2018:

|                                | 1a | 1b | 2a | 2b | 3 | 4 | 5 |
|--------------------------------|----|----|----|----|---|---|---|
| SK – Slovak Republic IP regime | X  | ?  | X  | ?  | X | ? | X |

In accordance with the 24 November 2016 report of the Code of Conduct Group to the Council, the following draft assessment has been prepared with regard to paragraphs 1 to 5 of the Code, based on the OECD questionnaire and accompanying English translation of the legislation - hereafter referred to as the "agreed description" - provided by the Slovak Republic authorities. The measure was assessed against all Code criteria, and on the basis of the modified nexus approach.

### Explanation

#### **Significantly lower level of taxation:**

*“Within the scope specified in paragraph A, tax measures which provide for a significantly lower effective level of taxation, including zero taxation, than those levels which generally apply in the Member State in question are to be regarded as potentially harmful and therefore covered by this code”*

The new Slovak Republic IP regime (the IP regime) was introduced on 1 January 2018.

The IP regime provides for an exemption of up to 50% eligible royalty income, and an exemption of up to 50% eligible embedded royalty income.

The IP regime can result in an effective tax rate of 10.5%, which is 50% the ordinary tax rate on royalties of 21%.

This rate is significantly lower than the rate generally applying. **The IP regime is therefore potentially harmful within the meaning of paragraph B of the Code.**

#### **Criterion 1:**

*“whether advantages are accorded only to non-residents or in respect of transactions carried out with non-residents”*

Criterion 1 contains two elements. The first element is whether the measure is exclusively available to non-residents or transactions with non-residents (criterion 1a). The second element is whether it is only or mainly used by non-residents or for transactions with non residents (criterion 1b).

1a) Criterion 1a concerns the *de jure* application of the measure.

The IP regime is available to all those taxpayers who develop qualifying IP assets (incur expenditures) and are liable to tax in the Slovak Republic.

1b) Criterion 1b is used to complement the assessment under criterion 1a which only looks at the literal interpretation of the measure. It takes account of the *de facto* effect of the measure. Where the majority of taxpayers (or counterparties to transactions) benefitting

from the measure are in fact non-residents the measure will fall foul of criterion 1b.

In light of the recent introduction of the IP regime it is unlikely that either statistical or impact data is available at this stage, or representative enough to reflect the comprehensive effects of this new IP regime. In addition, the agreed description<sup>1</sup> in the format used lacks this data.

This horizontal issue concerned almost all assessments of new IP regimes adopted by Member States following the modified nexus approach. Our suggestion in this respect was that the group reserves the possibility of arriving at a potentially different outcome in a future assessment, based on information that is more complete.

#### **Criterion 2:**

*“whether advantages are ring-fenced from the domestic market, so they do not affect the national tax base”*

As regards criterion 2 the division between criteria 2a and 2b is made in the same way as in the case of criterion 1 (i.e. *de jure* interpretation and *de facto* analysis). In general, a measure is caught by criterion 2 if the advantages are ring-fenced from the domestic market so that they do not affect the national tax base. In most cases, the evaluation against criterion 2 closely follows that of criterion 1.

2a) What has been written under criterion 1a applies analogously to criterion 2a.

There are no rules preventing domestic taxpayers from benefiting from the IP regime, nor are there rules that exclude domestic transactions from the benefit of the IP regime.

2b) On the basis of the explanations provided above and the marking under criterion 1b, the evaluation of criterion 2b follows the same reasoning. In light of the recent introduction of the IP regime, it is unlikely that either statistical or impact data is available at this stage, or representative enough to reflect the comprehensive effects of this new IP regime. In addition, the agreed description<sup>2</sup> in the format used lacks such data.

This horizontal issue concerned almost all assessments of the new IP regimes adopted by Member States following the modified nexus approach. Our suggestion in this respect was that the group reserves the possibility of arriving at a potentially different outcome in a future assessment, based on information that is more complete.

#### **Criterion 3:**

*“whether advantages are granted even without any real economic activity and substantial economic presence within the Member State offering such tax advantages”*

In November 2014, the Group agreed, in co-ordination with developments at the OECD, on the modified nexus approach as the appropriate method to ensure that patent boxes require sufficient substance. Therefore, under this agreed approach, criterion 3 for the Code has to be interpreted in line with the modified nexus approach. The key elements of the modified nexus approach are: Scope (qualifying IP assets), Nexus ratio, Tracking and tracing, Rebuttable presumption and Treatment of losses.

<sup>1</sup> For this particular exercise, the Member State's reply to the OECD questionnaire for the FHTP and legislation.

<sup>2</sup> For this particular exercise, the Member State's reply to the OECD questionnaire for the FHTP and legislation.

**1. Scope:** *Under the modified nexus approach, the only IP assets that can qualify should be patents and other IP assets that are functionally equivalent to patents if those IP assets are both legally protected and subject to similar approval and registration processes where such processes are relevant. IP assets that are functionally equivalent to patents are (i) patents defined broadly (utility models, IP assets that grant protection to plants and genetic material, orphan drug designations, and extensions of patent protection), (ii) copyrighted software<sup>3</sup> and (iii) the 3rd category of assets that share features of patents (non-obvious, useful and novel), are substantially similar to the IP assets of the first two categories, and are certified as such in a transparent certification process by a government agency that is independent from the tax administration<sup>4</sup>.*

The types of IP assets that can qualify for benefits under this regime are (1) patents or utility models, and (2) copyrighted software.

The Slovak Republic IP regime does not provide for the third category of assets.

The scope of the Slovak Republic IP regime appears to be in line with the modified nexus approach.

## **2. Nexus ratio:**

The tax advantage granted under the Slovak Republic IP regime is an exemption of 50% of the eligible royalty income. Where the development costs include the results of R&D from another person, the exemption is applied only to a part of the overall income. This is calculated by applying the nexus formula to the total income, in order to arrive at the income receiving benefits. The overall income is multiplied by the ratio of: the sum of total development costs (excluding R&D procured from another person – referred to as qualifying expenditures in the language of the Action 5 report) **and** the sum of the overall development costs (overall expenditures). The amount arrived at is the income that can receive the tax benefit.

- **Qualifying Expenditure:** The exclusion of outsourcing costs and acquisition costs limit the income that can benefit. This is achieved through the use of the nexus formula. Qualifying Expenditure excludes R&D procured from another person. According to the description: any costs incurred on outsourcing or acquisition are regarded as part of the overall costs, and the part of income corresponding to the proportion of outsourced or acquired IP is excluded from benefit under the regime.

- **Overall Expenditure:** This includes qualifying expenditure plus outsourcing costs and acquisition costs – “*the sum of development costs*”. According to the description: any costs incurred on outsourcing or acquisition are regarded as part of the overall costs.

- **Overall Income:** Only net income is eligible for benefits. Qualifying income includes royalties and embedded royalties.

- **Embedded royalties:** *The separation of embedded royalties from other income must use a “consistent and coherent method” according to the nexus approach. If embedded royalties are allowed into patent boxes, there should be a clear method for identifying them. Transfer*

<sup>3</sup> Other copyrighted assets may not be included.

<sup>4</sup> This category should be limited to taxpayers that have no more than EUR 50 million in global group-wide turnover and that do not themselves earn more than EUR 7.5 million per year in gross revenues from all IP assets.

*pricing principles are identified as one possibility*

According to the agreed description, the eligible income from embedded royalties is calculated by subtracting all real direct and indirect expenditures related to manufacturing, management and marketing functions, including the related overheads and profit margins which the supplier would apply to independent persons. In other words, the Arm's Length Principle is used. The use of this method separates non-IP income from IP related income, which is the income that is entitled for tax benefits. Therefore, transfer pricing principles are applied.

In summary, the nexus ratio of the Slovak Republic IP regime appears to be in line with the modified nexus approach.

### **3. Tracking and tracing:**

*MS must require companies to track expenditure, IP assets and income. When such tracking would be unrealistic and require arbitrary judgements, MS may allow the application of the nexus approach so that the nexus may be between expenditure, products arising from IP assets and income (product-based approach). It requires tracking of all QE and OE at the level of the product.*

According to the agreed description, the taxpayer is obliged to keep records and, in the event of a request from the tax administration, to submit this evidence. For royalties income, the records the taxpayer must keep include: 1. costs sorted by type, 2. capitalised costs sorted by type, 3. costs on intangible assets procured from other persons.

For embedded royalties income the records include: 1. costs sorted by type, 2. capitalised costs sorted by type and relevant depreciation plan (of qualifying assets), 3. costs on intangible assets (full or partial) procured from other persons, 4. calculation of product price, 5. number of products benefitting from the regime, 6. technical solution with a description of the IP assets utilization in process of production.

As well as the obligations imposed by the Income Tax Act, the Slovak Republic *Act on Accounting* requires legal entities to keep accounting records, including all statutory bookkeeping records which contain records on costs incurred to develop intangible assets. With respect to the provisions of the Tax Procedure Code, these records may be subject to tax audit undertaken by tax administration.

The tracking and tracing obligations of the Slovak Republic IP regime appears to be in line with the modified nexus approach.

### **4. Rebuttable presumption<sup>5</sup>:**

Under the Slovak Republic IP regime, the nexus ratio may not be treated as a rebuttable presumption.

### **5. Treatment of losses<sup>6</sup>:**

*Where the profits from particular IP assets are taxed at a lower rate in a patent box, then the losses should be treated in the same way and not deducted outside the box at a higher rate.*

<sup>5</sup> According to the OECD BEPS Action 5 report, jurisdictions can treat the nexus ratio as a rebuttable presumption. This should be limited to exceptional situations that meet, at a minimum, the following requirements: the taxpayer should first use the nexus ratio to establish the presumed amount of income that could qualify for benefits; the nexus ratio should (excluding the up-lift) equal or exceed 25%; the taxpayer should demonstrate that because of exceptional circumstances, the application of the nexus ratio would result in an outcome inconsistent with the nexus approach (burden of proof on the taxpayer).

<sup>6</sup> Note 14 to Action 5 Report: Jurisdictions should also use any tax losses associated with the IP income in a manner that is consistent with domestic legislation, and that does not allow the diversion of those losses against income that is taxed at the ordinary rate.

Tax losses are deductible on basis of the *reduced value method*, which means that IP losses may be used against ordinary income as long as they are used at the IP regime rate. The regime provides that expenses that are incurred on income that is not part of the tax base are not deductible for tax purposes. As an example, if 50% of royalty income benefits from the exemption, the same portion of related expenses (50%) is not deductible for tax purposes. This means that losses that might arise are reduced by 50%.

This method of dealing with losses ensures symmetry of treatment of losses and appears to be in line with the modified nexus approach.

Criterion 4:

*“whether the rules for profit determination in respect of activities within a multinational group of companies departs from internationally accepted principles, notably the rules agreed upon within the OECD” –*

- General transfer pricing rules:

The Income Tax Act, Section 17, para 5; makes reference to the Arm's Length Principle in Slovak Republic law. The Income Tax Act, Section 18 provides for transfer pricing methods to be used in respect of transactions between related parties.

The arm's length principle is relevant to the following features of the IP regime: i) the reduction of the tax base by a fixed percentage; ii) the calculation of royalty profits; iii) the application of "safe harbour" rules; and iv) the asymmetrical treatment of losses.

i) The reduction of the tax base by a fixed percentage: *In principle, reducing a company's arm's length profits by a fixed amount means that the final result does not reflect the arm's length principle. This is a question about the circumstances in which fixed reductions of the tax are acceptable and is therefore part of the overall assessment that the Group needs to make.*

The lower effective tax rate under the Slovak Republic IP regime is applied by allowing an exemption of the tax base equal to 50% of qualifying income. This feature of the IP regime could be understood as a technical measure aimed to achieve the tax benefit, which is ultimately to grant a reduced tax rate to qualifying IP income.

ii) The calculation of royalty profits: *where transfer pricing rules exist, the profits that go into a patent box will reflect the arm's length principle because they are just a part of the company's total profit. In principle this applies both to royalties and embedded royalties. If the IP regime covers also the latter category, its identification within the sale price of a product should rely on transfer pricing principles.*

What has been written above under criterion 3 on the same topic applies analogously to criterion 4.

(iii) Safe harbour rules: *The adoption of safe harbours is not in accordance with internationally agreed principles; safe harbours are not recommended in the Transfer Pricing Guidelines.<sup>7</sup>*

This IP Regime does not appear to provide for such safe harbour rules.

<sup>7</sup> *Transfer pricing guidelines, p. 167.*

iv) The asymmetrical treatment of losses: *where the profits from particular IP assets are taxed at a lower rate in a patent box then the losses should be treated in the same way and not deducted outside the box at a higher rate.*

The Slovak Republic IP regime ensures symmetry of treatment of losses. What has been written under criterion 3 above on the same topic applies analogously to criterion 4.

The Slovak Republic notified its measure on 29 December 2017. For consistency reasons, we propose to treat this the same as the other previously notified IP regimes by leaving the new guidance out of this assessment.

#### **Criterion 5:**

*“whether the tax measures lack transparency, including where legal provisions are relaxed at administrative level in a non-transparent way”*

All preconditions necessary for the granting of a tax benefit should be clearly laid down in publicly available laws, decrees, regulations *etc.* before a measure can be considered transparent.

The nexus approach contains commitments to additional transparency in three areas. These concern the third category of qualifying assets, new entrants to existing IP regimes after 6 February 2015, and the rebuttable presumption rule. Commitments regarding new entrants to pre-existing regimes are not subject to the present assessment and are part of a separate monitoring process. The commitments in the 2015 Report cover both the report of certain information to the Forum on Harmful Tax Practices and the spontaneous exchange of information between competent authorities. In any event this regime was not an “existing regime” on 6 February 2015.

#### Third category of qualifying assets:

The Slovak Republic IP regime does not allow the third category of assets of IP assets described in paragraph 37 of the OECD BEPS Action 5 Report to qualify for benefits.

#### Rebuttable presumption:

The Slovak Republic IP Regime does not treat the nexus ratio as a rebuttable presumption.

In addition, the Slovak Republic legislation provides for enhanced transparency. On an annual basis, the Tax Administration publishes a list of taxpayers receiving benefits from the regime (name, address and tax identification number), the amount of provided benefits (per every taxpayer) and tax period of received benefit, patent number or patent application.

#### **Overall assessment:**

The Slovak Republic IP regime contains no significant deviation from the Code of Conduct criteria. In light of the assessment made above under all Code criteria, the Slovak Republic IP regime should be considered overall **not harmful** from a Code of Conduct point of view.

In principle, reducing a company's arm's length profits by a fixed amount means that the final result does not reflect the arm's length principle. This is a question about the circumstances in which fixed reductions of the tax base are acceptable.

As for the other Member States that have notified their IP regimes, this aspects is left out of this assessment in order to maintain a consistent EU approach to IP regimes.

## Informal translation of the Slovak legislation

1. Sections 13a and 13b shall be inserted under the Section 13, reading as follows:

### "Section 13a

- (1) The income (revenue) of the taxpayer specified in Section 2(d) (2) from the compensation for the provision of right of use or for use
  - a) of an invention protected by patent<sup>74ba</sup>) or a technical solution protected by utility model,<sup>74bb</sup>) which are the result of research and development<sup>1)</sup> undertaken by the taxpayer, including the invention that is subject to the patent application and technical solution that is subject to the utility model application, is exempt from tax in an amount of 50 % of this compensation;
  - b) of a computer program (software) that is a result of the taxpayer's development<sup>1)</sup> activity and is subject to copyright under a special regulation<sup>74bc</sup>), is exempt from tax in an amount of 50 % of this compensation.
- (2) Exemption under paragraph 1 may also be applied to a taxpayer specified in Section 2(e) (3), who performs activity in the territory of the Slovak Republic through a permanent establishment, if their invention protected by a patent or technical solution protected by a utility model or a computer program (software) is functionally connected to that permanent establishment.
- (3) Exemption under paragraph 1 shall be applied during the taxable periods in which depreciation of the capitalized development costs<sup>1)</sup> incurred on development of the invention protected by a patent, technical solution protected by a utility model or the computer program (software) is reported as a tax-deductible expense.
- (4) If the development costs<sup>1)</sup> of the invention protected by a patent, technical solution protected by a utility model or the computer program (software) or the capitalized development costs<sup>1)</sup> of the invention protected by a patent, technical solution protected by a utility model or the computer program (software) include intangible results of research and development procured from another person, the exemption in amount according to paragraph 1 may be applied, during the period under paragraph 3, only to a part of income which is calculated by multiplying the income (revenue) by the coefficient, which is calculated as the quotient (ratio)
  - a) of the sum of development costs<sup>1)</sup> of the invention protected by a patent, technical solution protected by a utility model or the computer program (software) and the capitalized development costs<sup>1)</sup> of the invention protected by a patent, technical solution protected by a utility model or the computer program (software), excluding the intangible results of research and development procured from other person, and
  - b) of the sum of development costs<sup>1)</sup> of the invention protected by a patent, technical solution protected by a utility model or the computer program (software) and the capitalized development costs<sup>1)</sup> of the invention protected by a patent, technical solution protected by a utility model or the computer program (software).
- (5) If the taxpayer, who started to apply the exemption according to paragraph 1, ceased to exist as a result of dissolution without liquidation, its legal successor is not allowed to continue to apply the exemption. If the contributor of a contribution in kind applied the exemption according to paragraph 1 and the subject of the contribution in kind is an invention protected by a patent, technical solution protected by a utility model or computer program (software), the recipient of a contribution in kind is not allowed to continue to apply the exemption.
- (6) The Financial Directorate of the Slovak Republic (hereinafter referred to as the "Financial Directorate") shall, within three calendar months following after the expiration of the deadline for submitting the tax return, publish the following data on the taxpayer who has applied the exemption according to paragraph 1 in the list of tax entities pursuant to a special regulation<sup>120l</sup>):

- a) Business/trade name and registered office,
  - b) Taxpayer's identification number,
  - c) The amount of the claimed exemption and the taxable period in which it was claimed,
  - d) The identification number of patent, utility model or patent application or utility model application, including the register where the patent or utility model has been registered or enrolled, or the name of the computer program (software).
- (7) For the purposes of exemption according to paragraph 1, the taxpayer is obliged to keep records/evidence on
- a) Development costs<sup>1)</sup> by type incurred on the invention protected by a patent, technical solution protected by a utility model or the computer program (software),
  - b) Capitalized costs by type incurred on the development<sup>1)</sup> of the invention protected by a patent, technical solution protected by a utility model or the computer program (software),
  - c) Costs by type incurred on the intangible results of research and development procured from other person and that were incurred in connection with the development of an invention protected by a patent, technical solution protected by a utility model or a computer program (software).
- (8) The taxpayer is obliged to submit to the tax administrator or Financial Directorate the records/evidence according to paragraph 7, within eight days from delivery of a request at the latest.
- (9) The taxpayer loses the entitlement for exemption according to paragraph 1 in the particular taxable period and is obliged to submit an additional tax return for each taxable period they applied the exemption according paragraph 1 if
- a) The patent was cancelled, revoked or transferred<sup>74bd)</sup> to another owner, or their patent application was rejected,
  - b) The utility model was deleted or transferred<sup>74be)</sup> to another owner, or their utility model application was rejected.
- (10) The taxpayer is obliged to submit additional tax return according to paragraph 9 within the deadline under special regulation<sup>128)</sup>; the additionally calculated tax shall be due within the same deadline.
- (11) If the taxpayer, who receives income (revenue) according to paragraph 1 decides to capitalize the development costs<sup>1)</sup> of an invention protected by a patent, technical solution protected by a utility model or computer program (software) after the taxable period when such income (revenue) began to flow, the exemption according to paragraph 1, prior to application of the procedure according to paragraph 4, shall be applied to the part of income (revenue) calculated by multiplying the income (revenue) by the coefficient, calculated as the quotient (ratio)
- a) of the capitalized development costs<sup>1)</sup> of the invention protected by a patent, technical solution protected by a utility model or the computer program (software), and
  - b) sum of the development costs<sup>1)</sup> of the invention protected by a patent, technical solution protected by a utility model or the computer program (software), which the taxpayer incurred maximum for five taxable periods immediately preceding the taxable period of capitalization of the development costs<sup>1)</sup> and the capitalized development costs<sup>1)</sup> of the invention protected by a patent, technical solution protected by a utility model or the computer program (software).
- (12) If the income (revenue) according to paragraph 1 is derived by several taxpayers who meet the conditions according to paragraph 1, exemption according to paragraph 1 may be applied to each such taxpayer to the extent corresponding to the share they have participated in the research and development<sup>1)</sup> of the invention protected by a patent, technical solution protected by a utility model or the computer program (software).
- (13) The taxpayer, who applies the exemption according to paragraph 1 for the first time in the taxable period in which depreciation of the capitalized development costs<sup>1)</sup> of the invention protected by a patent, technical solution protected by a utility model or the computer program

(software) is claimed as a tax-deductible expense, is obliged to apply such exemption during the following taxable periods, when they continue to claim depreciation of the capitalized development costs<sup>1)</sup>) as a tax-deductible expense.

#### Section 13b

- (1) The income (revenue) of a taxpayer specified in Section 2 (d) (2) derived from the sale of products, in the production of which an invention protected by a patent or a technical solution protected by a utility model which are a result of research and development<sup>1)</sup>) performed by the taxpayer has been wholly or partially used, is exempt from tax in an amount according to paragraph 4, provided that these products are:
  - a) procured from persons whom the taxpayer as the owner enabled to use the invention protected by a patent or a technical solution protected by a utility model, or
  - b) created by the taxpayer's own activity<sup>1)</sup>.
- (2) Exemption under paragraph 1 may also be applied to a taxpayer specified in Section 2 (e) (3), who performs activity in the territory of the Slovak Republic through a permanent establishment, if their invention protected by a patent or technical solution protected by a utility model is functionally connected to that permanent establishment.
- (3) Exemption according to paragraph 1 shall apply during the taxable periods in which depreciation of the capitalized development costs<sup>1)</sup>) incurred on development of the invention protected by a patent or technical solution protected by a utility model is reported as a tax-deductible expense.
- (4) Exemption according to paragraph 1 shall be applied in an amount of 50 % of the part of income (revenue) from the sale of products which falls on the sales price of the product upon deduction of the actual direct costs and actual indirect costs related to the functions of manufacturing, administration and sales, including attributable overhead costs and profit margins which the supplier would apply in relation to independent persons in terms of the functions performed and market conditions. For purposes of this provision, functions of sales include also functions of promotion, brokering of sales and marketing of the products sold, and the profit margin associated with functions of sales also includes a profit margin related to the taxpayer's business name, trademark or other intangible assets associated with those functions of sales.
- (5) If the development costs<sup>1)</sup>) of the invention protected by a patent or technical solution protected by a utility model or the capitalized development costs<sup>1)</sup>) of the invention protected by a patent or technical solution protected by a utility model include intangible results of research and development procured from another person, the exemption in amount according to paragraph 4 may only be applied during the period according to paragraph 3 to a part of income (revenue) calculated so that the product of the number of sold products and the sales price upon deduction of actual direct costs and actual indirect costs related to the functions of manufacturing, administration and sales, including attributable overhead costs and profit margins which the supplier would apply in relation to independent persons in terms of the functions performed and market conditions shall be multiplied by the coefficient calculated as the quotient (ratio)
  - a) of the sum of development costs<sup>1)</sup>) of the invention protected by a patent or technical solution protected by a utility model and the capitalized development costs<sup>1)</sup>) of the invention protected by a patent or technical solution protected by a utility model, excluding the intangible results of research and development procured from another person, and
  - b) of the sum of development costs<sup>1)</sup>) of the invention protected by a patent or technical solution protected by a utility model and the capitalized development costs<sup>1)</sup>) of the invention protected by a patent or technical solution protected by a utility model.
- (6) If the taxpayer, who started to apply the exemption according to paragraph 1, ceased to exist as a result of dissolution without liquidation, their legal successor is not allowed to continue to

apply the exemption. If the contributor of a contribution in kind applied the exemption according to paragraph 1 and the subject of the contribution in kind is an invention protected by a patent or technical solution protected by a utility model, the recipient of a contribution in kind is not allowed to continue to apply the exemption.

- (7) The Financial Directorate shall, within three calendar months following after the expiration of the deadline for submitting the tax return, publish the following data in relation to the taxpayer who has applied the exemption according to paragraph 1 on the list of tax entities pursuant to a special regulation<sup>120l)</sup>:
- a) Business/trade name and registered office,
  - b) Taxpayer's identification number,
  - c) The amount of the claimed exemption and the taxable period in which it was claimed,
  - d) The identification number of patent, utility model or patent application or utility model application, including the register where the patent or utility model has been registered or enrolled.
- (8) For the purposes of exemption according to paragraph 1, the taxpayer is obliged to keep records on
- a) Product price calculation,
  - b) development costs<sup>1)</sup> by type incurred on the invention protected by a patent or technical solution protected by a utility model,
  - c) Capitalized costs by type incurred on the development<sup>1)</sup> of the invention protected by a patent or technical solution protected by a utility model and their depreciation plan,
  - d) Costs by type incurred on intangible results of research and development procured from another person that were incurred in connection with the development of an invention protected by a patent or technical solution protected by a utility model,
  - e) Number of products, the sales income (revenue) of which the exemption has been applied to,
  - f) The technical solution including description of the invention protected by a patent or technical solution protected by the utility model used for the product manufacturing.
- (9) The taxpayer is obliged to submit to the tax administrator or Financial Directorate the records/evidence according to paragraph 8, within eight days from delivery of a request at the latest.
- (10) The taxpayer loses the entitlement for exemption according to paragraph 1 in the particular taxable period and is obliged to submit an additional tax return for each taxable period they applied the exemption according paragraph 1 if
- a) The patent was cancelled, revoked or transferred<sup>74bd)</sup> to another owner, or their patent application was rejected,
  - b) The utility model was deleted or transferred<sup>74be)</sup> to another owner, or their utility model application was rejected,
- (11) The taxpayer is obliged to submit additional tax return according to paragraph 10 within the deadline under specific regulation;<sup>128)</sup> the additionally calculated tax shall be due within the same deadline.
- (12) If the taxpayer, who receives income (revenue) according to paragraph 1 decides to capitalize the development costs<sup>1)</sup> of an invention protected by a patent or a technical solution protected by a utility model after the taxable period when such income (revenue) began to flow, the exemption according to paragraph 1, prior to application of the procedure according to paragraph 5, shall be applied to the part of income (revenue) calculated by multiplying the income (revenue) by the coefficient, calculated as the quotient (ratio)
- a) of the capitalized development costs<sup>1)</sup> of the invention protected by a patent or a technical solution protected by a utility model, and
  - b) sum of the development costs<sup>1)</sup> of the invention protected by a patent or a technical solution protected by a utility model, which the taxpayer incurred maximum for five taxable periods immediately preceding the taxable period of capitalization of the

development costs<sup>1)</sup>) and the capitalized development costs<sup>1)</sup>) of the invention protected by a patent or a technical solution protected by a utility model.

- (13) If the income (revenue) according to paragraph 1 is derived by several taxpayers who meet the conditions according to paragraph 1, the exemption according to paragraph 1 may be applied to each such taxpayer to the extent corresponding to the share they have participated in the research and development<sup>1)</sup>) of the invention protected by a patent, technical solution protected by a utility model.
- (14) The taxpayer, who applies the exemption according to paragraph 1 for the first time in the taxable period in which depreciation of the capitalized development costs<sup>1)</sup>) of the invention protected by a patent or a technical solution protected by a utility model is reported as a tax-deductible expense, is obliged to apply such exemption during the following taxable periods, when they continue to report depreciation of the capitalized development costs<sup>1)</sup>) as a tax-deductible expense."

The footnote to reference 1 reads as follows:

<sup>1)</sup> Act No. 431/2002 Coll. on accounting

The footnotes to references 74ba to 74bc shall read as follows:

<sup>74ba)</sup> For example, the Communication of the Federal Ministry of Foreign Affairs No. 296/1991 Coll. on the Deposit of the Instrument of Accession of the Czech and Slovak Federal Republic to the Patent Cooperation Treaty Negotiated in Washington on June 17, 1970 as amended, Act No. 435/2001 Coll. on Patents, Supplementary Protection Certificates and on Amendment of Some Acts (the Patent Act) as amended.

<sup>74bb)</sup> Act No. 517/2007 Coll. on Utility Models and on Amendment of Some Acts.

<sup>74bc)</sup> Act No. 185/2015 Coll. on Copyright as amended by the Act No. 125/2016 Coll.

<sup>74bd)</sup> Section 48 Act No. 435/2001 Coll.

<sup>74be)</sup> Section 47 Act No. 517/2007 Coll."

2. Section 17 shall be amended by the paragraph 42 and read as follows:  
"(42) When applying exemption according to Section 13a or Section 13b, the expenses (costs) incurred on the income (revenue) according to Section 13a or Section 13b are excluded from the tax base to the same extent to which such income (revenue) is exempt from tax."
3. After Section 52zk, there shall be inserted Sections 52zn and 52zo which, including their titles, shall read as follows:

#### "Section 52zn

Transitional provisions to Regulations effective from 1 January 2018

(6) Provisions of Section 13a in the wording effective from 1 January 2018 will be applicable for the first time in connection to the taxable period starting at the earliest on 1 January 2018. Provisions of Section 13a in the wording effective from 1 January 2018 shall also apply to the taxpayer, who receives income (revenue) in the taxable period starting at the earliest on 1 January 2018 from compensations for the provision of right to use or for the use of the invention protected by a patent or technical solution protected by a utility model, which were the result of research and development<sup>1)</sup>) performed by the taxpayer, including the invention that is subject to the patent application and the technical solution that is subject to the utility model application, or

the computer program (software) which was the result of the taxpayer's own activity and subject to copyright under a special regulation,<sup>74bc</sup>) that were transferred by other person back to the taxpayer after 31 December 2017.

(7) Provisions of Section 13b in the wording effective from 1 January 2018 will be applicable for the first time in connection to the taxable period starting at the earliest on 1 January 2018. Provisions of Section 13b in the wording effective from 1 January 2018 shall also apply to the taxpayer, who receives income (revenue) in the taxable period starting at the earliest on 1 January 2018 from the sale of products in the production of which an invention protected by a patent or a technical solution protected by a utility model which are a result of research and development<sup>1)</sup> performed by the taxpayer has been wholly or partially used , including the invention that is subject to the patent application and the technical solution that is subject to the utility model application, that were transferred by another person back to the taxpayer after 31 December 2017.