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Germany Joins List of OECD Countries Offering R&D Tax Incentive

After decades of prodding from regional and global businesses and industry associations, Germany is finally implementing an R&D tax incentive program similar to those offered by most countries that make up the OECD. The German government has been under pressure to introduce an R&D incentive in recent years amid concerns that the country's businesses aren't keeping up with digitalization and new technology.

The Research Allowance Act (Forschungszulagengesetz), approved on November 29, 2019, by the German Federal Council (Bundesrat) and due to enter into effect on January 1, 2020, is a tax incentive that hopes to breathe new life into spending on technology among small and medium-sized businesses while strengthening Germany as a business location for companies of all sizes. It was passed in the face of a slowing economy and fears that the country is losing ground in the global race for corporate investment and settlement.

Many U.S. companies already have R&D interests based in Germany thanks to the industry clusters Germany has built utilizing a high-quality workforce. Until now, however, unlike many developed countries, Germany's tax system has not directly rewarded business investment in R&D. While almost all of the 36 OECD countries have already shifted from directly funding R&D to providing tax incentives, Germany has lagged behind, making it one of just five OECD countries that don't currently have R&D tax incentives.

Long anticipated, the new incentive would basically come in the form of a cash subsidy of 25% of what a company spends on R&D salaries and wages, up to EUR 500,000 each year. The subsidy itself will not be subject to taxation, and it is refundable if it exceeds the taxpayer's tax liability. Refundable tax credits are normally only available to small medium enterprises (SMEs), making it an intriguing differentiator for Germany, as does the fact that it permits an ex-post application for funding and improved predictability due to legal entitlement to the R&D tax credit.

Some site selection professionals are concerned that it isn't a big enough enticement, falling short of tax incentives offered by neighboring countries like France and the UK. However, this new incentive will be made available to a broad range of R&D activities and will complement the highly developed German public grant system that the country currently uses to target specific R&D initiatives. Companies conducting research in Germany may now "stack" the tax incentive with both national and EU R&D grants for greater funding possibilities. Lucrative small and mid-sized business sectors that often lack large R&D budgets (or the resources to take on German or EU public grant application processes) will find this a welcome boon, as will multinationals when seeing the combination of opportunities via the subsidy, advanced public grant system and the wide spectrum of R&D activities covered.

Important Points to Consider

Put simply, the new R&D tax credit is available for personnel expenses and fees for subcontracting related to any activity that relies on a technical discipline to improve a product or process. Funding is open for three types of projects: (1) a company's own R&D projects, (2) cooperative projects (e.g., with universities) and (3) contract research. Note: only 60% of the amount paid for contract research will be accepted as eligible costs.

- **Eligible taxpayers:** All taxpayers that are subject to unlimited or limited income taxation in Germany are eligible for the allowance if they are not tax-exempt. The Act does not differentiate between sole proprietors, corporations and partnerships. Non-resident taxpayers can be eligible if they have a sufficient nexus to Germany (e.g., a non-resident company with a permanent

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establishment in Germany). The allowance is granted irrespective of the company's taxable profits. In practice, this means that profit-making taxpayers will receive a tax credit against their personal or corporate income tax, and loss-making taxpayers will receive the allowance as a cash subsidy.

- **Eligible R&D activities:** Eligible R&D activities are three pronged and include (1) fundamental research, (2) industrial research and (3) experimental development within the meaning of EU regulations. These activities will need to have started after January 1, 2020. Activities aiming at market development or to improve production systems are not eligible.

- **Form of conduct of R&D:** Eligible R&D activities may be carried out either (1) in house by the taxpayer itself and/or (2) by means of contract research. Contract research can be funded if the contractor (third party or affiliated company) is based in Germany or in any other EU/EEA member state. As regards contract research, the new law offers tax planning opportunities, particularly in a cross-border context. Furthermore, R&D activities can also be performed by a cooperation between one or more beneficiaries and at least one other company or an institution for research and dissemination of knowledge (e.g., a university).

- **Eligible expenses:** The assessment base includes (1) the wages that are subject to German wage tax and (2) expenses for securing the employees' future (e.g., contributions to statutory pension funds). However, these expenses are eligible only to the extent the employees are conducting research and development activities in eligible R&D projects. For contract research, the assessment base includes 60% of the remuneration paid by the taxpayer to the contractor.

- **Allowance amount:** The research allowance amounts up to 25% of the eligible expenses. The total amount of research allowances and other state aid granted for an R&D project may not exceed EUR 15 million per company (on an individual basis) and per R&D project over time.

- **Application:** The research allowance application has two stages. First, the taxpayer must make a technical request for the issuance of a R&D certificate showing that the R&D project is eligible. Second, the application for the research allowance itself must be submitted electronically to the local tax office. This application must be supported by documentation of the eligible activities and expenses.

- **Method of payment:** The research allowance will be set by an assessment notice. It will be credited in full against the income tax determined in the tax assessment following the application. In a loss-making situation, the research allowance will be fully paid out as a cash subsidy.

- **Deadlines:** The research allowance can only be claimed for R&D projects whose work is started after the entry into force of the Research Allowance Act (day after publication in the Federal Law Gazette, but not before January 1, 2020). Eligible expenses must be incurred after December 31, 2019.

How Should You Prepare?

Businesses that already have R&D activities in Germany—or are considering establishing R&D in Germany—need to:

- Clarify what the definition of R&D activities means in their business practice

- Determine which of their activities are eligible for funding and how they can be documented

- In the case of expected annual R&D expenditures greater than EUR 2 mn:
  - Determine which may also qualify for grant funding
  - Determine the least burdensome expenditures to document (i.e., large projects with dedicated teams and/or project codes already in place to track researchers' time)

Companies will need to apply for a certificate by a certifying body (outside the finance administration) confirming that the conducted activities qualify as R&D based on the EU definition. R&D certificates and research allowance claims can be applied for at almost any time, but it is probably best to do so during the year in real time to avoid a last-minute rush. Following these steps will help you make sure you collect and submit all the information required.

- **Step 1:** Review ongoing projects, existing processes, organizational tools, project lists and tracking systems to take stock of your organization and internal processes. This will help you assess potential R&D projects and narrow the list to those that are most likely to qualify.

- **Step 2:** Gather information for the technical request for the issuance of the R&D certificate during the year. Based on discussions with your technical leads, collect the information required to prepare the technical request for each R&D project.

- **Step 3:** Collect the financial information necessary to support your research allowance claim in collaboration with your financial, tax and incentives leads. Compile costing information based on the eligible R&D activities and projects in itemized documentation to demonstrate eligible expenses on a project-by-project basis.
- **Step 4:** Prepare and submit the technical request and research allowance claim in German once the information for both has been compiled and reviewed.
- **Step 5:** Keep your tax and incentives teams prepared to assist in any tax audit and appeal proceedings if the authorities challenge the technical request for the R&D certificate and/or the research allowance claim.

R&D incentive regimes are evolving at a rapid pace around the globe, with many countries acknowledging the importance that tax incentives play in supporting innovation, establishing new industries and growing knowledge economies. Businesses that take advantage of these incentives will be able to reduce the cost of research or drive more innovation at the same cost. Working with an experienced tax, site selection and incentives team to help you maximize your new German tax credit in conjunction with grant programs will provide an advantage by minimizing the time spent on the application process and ensuring all relevant funding sources are considered.

CONTACT

Karen Chelstowska
Managing Director, Site Selection and Incentives Advisory, Duff & Phelps
+1 469 547 8637
karen.chelstowska@duffandphelps.com

Varsha Ramlal
Funding and Innovation Consultant
The European Funding Alliance
+31 (0)6 19653945
v.ramlal@thefundingcompany.nl