Germany Readies R&D Tax Incentive Program

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In this article, the authors examine recently released draft legislation that would introduce a new research and development tax incentive regime into German law.

On April 17 the German Ministry of Finance published draft legislation providing tax incentives for research and development (Entwurf eines Gesetzes zur steuerlichen Förderung von Forschung und Entwicklung, or FZulG).[1] This grant-based proposal represents a major change in German policy and is intended to foster innovation and, in time, grow the economy.

Germany is one of only a few countries in the OECD that currently do not offer any expenditure-based R&D tax incentives: Germany only grants specific R&D subsidies. This is surprising given the large amount of R&D performed in Germany. Other countries without special R&D tax incentives include Bulgaria, Cyprus, Estonia, Finland, Latvia, Luxembourg, and Switzerland. In recent years, most large economies have implemented some form of R&D incentives such as tax credits, tax allowances, or preferential tax regimes.[2]

Instead of offering tax incentives, Germany previously dedicated itself to eliminating any preferential intellectual property regimes that it considered harmful, particularly patent boxes. In that vein, Germany proposed that preferential IP regimes should only apply when the IP was developed in the same jurisdiction — aligning preferential treatment with substantial business activity in the OECD's modified nexus approach.[3] Preferential regimes that follow the modified nexus approach are not considered harmful. The German legislature also introduced a provision into the Income Tax Act (Einkommensteuergesetz, or EStG) limiting the deductibility of royalties when the expenses are paid to a recipient in accordance with a harmful preferential tax regime that leads to an effective taxation of the royalties of less than 25 percent in the hands of the recipient (the license barrier rule). That provision, section 4j EStG, applies to royalties derived after December 31, 2017. As the OECD announced on January 29, 2019,[4] many harmful preferential tax regimes — including regimes in third countries — have been amended or abolished.

However, the German Ministry of Finance seems to have had a change of mind. As IP and value creation become increasingly important to both taxpayers and tax authorities, Germany is now considering using tax incentives to promote R&D. It is no surprise that the publication of the

[1] Ryan Finley, "German Government Submits SME-Focused R&D Allowance Law," *Tax Notes Int'l*, Apr. 22, 2019, p. 366.

[2] For an overview of the various tax incentives in OECD countries, see OECD, "Main Features of R&D Tax Incentives in Selected OECD, EU and Partner Economies, 2018" (Apr. 2019).

[3] *See* OECD, "Action 5: Agreement on Modified Nexus Approach for IP Regimes" (2015).

[4] OECD, "OECD Announces Progress Made in Addressing Harmful Tax Practices (BEPS Action 5)" (Jan. 29, 2019).

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draft legislation coincides with a slowdown in the German economy. According to notes accompanying the draft legislation, the incentives are necessary to strengthen Germany's appeal as a business location as well as to create a level playing field in international competition.

I. Requirements of the Draft R&D Incentive

Rather than proposing tax allowances or a tax credit for R&D expenditure, the draft legislation proposes an R&D grant similar to investment grants, which are a form of nonrepayable project grant. As the legislative notes accompanying the bill explain, this is because the incentive should be available regardless of whether an applicant is profitable in a given year.

As this section will explain, the draft legislation requires the granting of an R&D incentive when an eligible applicant (see Section I.A, *infra*) applies for the incentive (Section I.B, *infra*) and the R&D meets the criteria specified in the bill (Section I.C, *infra*). When an applicant meets these requirements, the taxpayer can automatically claim the incentive — that is, the incentive is not subject to the tax authority's discretion.

A. Eligible Applicants

Section 1(1) of the draft legislation provides that any taxpayer that pays income tax or corporate income tax and that is not tax-exempt could apply for the R&D incentive. For partnerships, the partnership itself is the applicant rather than the separate partners. The legislative notes to the draft legislation reiterate that the incentive is potentially available to all businesses that perform R&D activities.

According to section 2(4) of the draft legislation, eligible R&D projects can involve a single applicant, an applicant in cooperation with an independent company or research body, or an R&D contract with a third party.

B. Application for Incentive

Under the proposal, a taxpayer must apply to receive the R&D incentive. The taxpayer must submit the application after the relevant year and must describe the R&D project with sufficient detail to allow the competent tax authority to review it.

In accordance with section 6 of the proposed bill, along with the application, the applicant must provide a certificate for each R&D project confirming that it falls within the scope of eligible R&D projects. Thus, the applicant must file for a certificate before applying for the incentive. The government has yet to determine which authority will issue those certificates. However, the legislative notes indicate that the chosen authority, rather than the tax authority, will assess whether the activities performed are actually eligible R&D activities.

C. Expenses for Eligible R&D Projects

According to section 2(1) of the draft legislation, any R&D project that involves basic research, industrial research, or experimental research can claim the incentive. These terms are defined in an appendix to the draft legislation. The legislative notes explain that the definitions stem from the OECD's Frascati Manual on R&D.[5] Basic research is defined as any experimental or theoretical activity performed to acquire new fundamental knowledge without any direct commercial application. Industrial research is aimed at developing new products, services, or know-how or enhancing existing products. Experimental research involves the use of existing scientific or technical research to develop new products, services, or know-how.

Further, R&D projects must be clearly targeted toward a predefined goal. If various projects cannot be separated, they are deemed to be one project. However, the draft legislation also states that an incentive cannot be claimed when a product or know-how has already been developed and the main goal of additional research is only market development.

The incentive is based on eligible expenses. Section 3(1) of the draft legislation defines eligible expenses as wages that are directly paid to employees of the applicant, are subject to German wage withholding tax under section 38(1) EStG, and involve employees performing R&D

[5] *See* OECD, "Frascati Manual: Guidelines for Collecting and Reporting Data on Research and Experimental Development" (last updated Oct. 8, 2015).

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activities for eligible R&D projects as defined above. If wages are not withheld because of a double tax agreement with another EU member state, a member of the European Economic Area, or Switzerland, the expenses can still qualify as eligible expenses under section 3(2) of the draft legislation. Notably, since German wage tax is also withheld when a German employer or permanent establishment pays for R&D activities performed abroad, the draft legislation could potentially apply in those cases as well — even if Germany has no subsequent taxing rights in the product researched or developed abroad.

The legislative notes also indicate that the applicant must document information regarding the employees involved in the project and the nature of their work.

Section 8 of the draft legislation provides that applications can only include eligible expenses that an eligible applicant pays after December 31, 2019, and only R&D projects that start after the enactment of the legislation are eligible.

II. Calculation and Amount of the Incentive

The basis of assessment for calculating the R&D incentive is, as sections 3(3) and 3(4) of the draft legislation detail, the wages paid for R&D activity multiplied by 1.2. The maximum basis is €2 million per applicant per business year. The same maximum basis — that is, one shared basis — applies to affiliated companies, as defined in section 15 of the Stock Corporation Act (Aktiengesetz). However, if multiple applicants that are not affiliated companies are cooperating on a project, the full maximum basis applies to each applicant.

In accordance with section 4(1) of the draft legislation, the actual incentive — the grant — amounts to 25 percent of the assessment basis. Thus, the maximum amount of the proposed R&D incentive would be €500,000 per business year.

Section 12 of the draft legislation explains that the R&D incentive is not included as part of the recipient's taxable income, it does not affect the deductibility of the respective expenses as business expenses, and the amount of the grant is not taken into account when calculating the recipient's tax rate.

The incentive will be formally assessed. The government will pay the assessed amount within one month from the announcement of the assessment. Procedurally, as section 12 of the proposal notes, the R&D incentive grant will be treated as a tax refund.

The Ministry of Finance expects the new legislation will cost about €1.145 billion in 2021, and the costs will likely increase gradually over time.

III. Next Steps

As of the time of this writing, the legislation is only a draft proposal. The draft legislation must pass both legislative bodies before it could be enacted. Substantial revisions could occur during this legislative process.

It seems likely, however, that the draft legislation will eventually be enacted. In response to the cooling economy, late last year German Economy Minister Peter Altmaier proposed cuts to business taxation in Germany,[6] an idea that thus far has been turned down by the coalition party. Against that background, the R&D tax incentive could be a small compromise to stimulate the economy.

The government does not regard the draft legislation as state aid according to the EU law because the grants are generally available to all taxpayers.

IV. Conclusion

According to the legislative notes, the German government's goal is for the proposal to increase overall R&D expenditures to 3.5 percent of the GDP. In 2017 Germany's gross domestic spending on R&D amounted to approximately 3 percent of the GDP, which was already higher than the corresponding rate for most of its main direct economic competitors — namely, China, France, the United Kingdom, and the United States — with the exception of Japan, where R&D accounted for approximately 3.2 percent of GDP.[7]

Germany has certainly noticed that all of the listed countries directly incentivize domestic R&D, although it remains to be seen whether all of the provisions comply with EU law. In contrast

[6] *See* Teri Sprackland, "German Economy Minister Calls for Corporate Tax Cut," *Tax Notes Int'l*, Nov. 26, 2018, p. 925.

[7] *See* OECD, "Gross Domestic Spending on R&D" (2019).

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with those countries' preferential regimes, the draft legislation focuses on German wage tax. Linking the R&D incentive to German wage tax paid ensures that, at least in most cases, R&D — that is, the value creation — is performed within Germany. However, as noted above, the incentive might also apply to some R&D activities performed — and, thus, value created — outside Germany.

Some observers may question whether the relatively small amount of the proposed tax incentive would actually encourage businesses to shift R&D activities to Germany. The proposed R&D tax incentive could, however, be of particular interest to venture capitalists and start-up companies, for which the grants could offer a locational advantage and might facilitate start-up funding. ■

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