

Exactera

Why Puerto Rico's R&D Tax Credit Is a Game-Changer



A Unique Legal and Economic Setting

Less than 10 years ago, Puerto Rico was on the brink of economic collapse. Today, only two years since exiting the largest U.S. municipal bankruptcy in history, the Commonwealth is firmly on the arduous road to revitalization. One of the main engines of that trajectory has been an extremely generous program of tax credits and incentives aimed at wooing economic activity on the island and attracting investment from the mainland. Increasingly, corporate taxpayers are taking note.

The island has a unique legal and economic framework that could potentially amount to a best-of-both-worlds scenario. Overseen by the New York Fed, Puerto Rico offers the same operational security, stability, and protections (including for intellectual property such as patents) as the mainland. Moreover, U.S. federal law applies, the U.S. dollar is the official currency, and capital can move freely back and forth from the island. Yet the Commonwealth is also a fiscally independent territory with its own system of taxation: to the IRS, income sourced and taxes paid in Puerto Rico are generally treated in the same manner as income derived in and taxes paid to a foreign country. Puerto Rico also offers lower operating costs compared to many mainland U.S. states, and its location in the Caribbean facilitates access to markets in both North and South America.

Most relevant of all: Puerto Rico offers an unusually lucrative research and development credit—worth up to 50% of all qualifying expenses, dollar for dollar. In this white paper, we will delve into the intricacies of its unique R&D incentives program, compare it with U.S. benefits, and offer some strategic perspectives for businesses considering conducting moving their R&D operations to Puerto Rico.





Unwinding the Downward Spiral

The Commonwealth's economic meltdown didn't happen overnight. A staggering \$72 billion debt burden had been accumulating for over a decade due to a combination of fiscal mismanagement, government inefficiency, and the phasing out of federal tax breaks that once attracted multinational manufacturers (especially the pharmaceutical industry) to the island. Furthermore, a quirk in the tax code designated Puerto Rico's bonds as triple-tax-exempt for all U.S. investors, hastening the debt's downgrade to junk level. By 2017, an unfunded \$55 billion pension liability forced the island into an unprecedented bankruptcy. In response, a radical restructuring was overseen by a new body created by the U.S. Congress to help the Commonwealth stabilize its finances and regain access to capital markets.

Puerto Rico, it seemed, could not catch a break. The economic calamity was soon compounded by a chain of natural ones: a pair of devastating hurricanes, which inflicted \$90 billion in damages and destroyed the entire electrical grid; a series of powerful earthquakes that further destabilized the island; and the COVID-19 pandemic, which displayed a disproportionately high fatality rate compared to the U.S. By 2020, nearly 12 percent of the island's population (mostly its younger and more dynamic segments) had decamped to the mainland while back at home, unemployment and poverty spiked, taxes were raised, and benefits were cut.

Recognizing the urgent need for a "change of vision" to arrest the downward spiral—and to drastically improve the island's economic competitiveness—the Commonwealth reworked and consolidated its patchwork of existing incentives and passed an ambitious, sweeping new law, known as Act 60 (the so-called "Incentives Code"). Signed into law by the governor in July 2019, Act 60 is explicitly aimed at attracting new businesses, harmonizing tax rates across industries, and consolidating and simplifying the processes needed to obtain the incentives. Act 60 was amended in 2022 by Act 52 (the "Puerto Rico Public Finances Stabilization Act"), which added more compliance requirements. More details on Act 52 follow below.

It's fair to say that these two pieces of legislation— in tandem with the Commonwealth's emergence from bankruptcy in 2022— have reshaped the island's economic landscape.

The question is: How does it all shape up for companies seeking to benefit from R&D credits?

Comparing Benefits: Apples to Oranges—and Back Again

To compare Puerto Rico's R&D tax benefit with that of the U.S. is a bit like comparing apples to oranges—except that you get a much bigger bite out of a much bigger apple immediately in Puerto Rico, while those oranges in the U.S. can only be eaten over time.

It's hard to argue with a volume-based, dollar-for-dollar, 50% reduction in the current-year tax bill for money spent on R&D—especially when you consider that most domestic Puerto Rico corporations are taxed on their worldwide income at a nominal rate of 37.5% (with an alternative minimum tax, or AMT, of either 18.5% or 23%). The deal is further sweetened by an additional credit of 2–12% for technology transfer payments made to resident entities like local research universities. Under additional conditions laid out in the Act 60 Incentives Code, certain companies could even benefit from a 4% corporate income tax, among other bonuses. To qualify for the 50% R&D credit, businesses must first apply for and receive a tax exemption decree (also known as a "Certificate of Compliance") from the Department of Economic Development and Commerce (DEDC). A key stipulation is that the entire credit must be reinvested in local R&D activities.

In the United States, prior to 2022, companies were allowed to deduct their qualifying R&D expenditures in the current year. The Tax Cuts and Jobs Act (TCJA) of 2017 brought significant changes: now, the credit is incremental—based on the excess of current-year Qualified Research Expenditures (QREs) over a base amount. Firms that invest in R&D today must capitalize and amortize these costs over a period of five years (15 years if the research was conducted outside the U.S.). But the TCJA did bring a huge new benefit to U.S. companies: it reduced the corporate tax rate from 35% to 21%, eliminating its previous, tiered structure. This had the practical effect of offering a greater net benefit of its allowable credit, under Sec. 41(a)—from 65% to 79%. (The TCJA also eliminated the Sec. 55 AMT for corporations, enabling more taxpayers to use the R&D tax credit.) Additionally, unlike in Puerto Rico, there are no limitations on the usage of those R&D credits once they are realized.

To put some crude numbers to a crude comparison (converting oranges back to sort-of apples), consider two identical fictional companies, each with \$1 million in respectively qualified R&D spending. One operates in the U.S. and one in Puerto Rico. Under Act 60, the Puerto Rican company would receive \$500,000 in credit to reduce tax liabilities, reinvest in R&D, or apply for a refund (at 85% of the credit's value). Notably, this credit can also be transferred or sold to other taxpayers, thus adding flexibility to the company's potential cash flow.

The U.S. system is more complex. Under Section 41(a), our fictional company would start by calculating its "base amount" based on historical R&D spending (e.g., average of the previous three years). Let's assume that the historical average comes to \$800,000. With \$1 million spent this year, the incremental excess R&D spending amounts to \$200,000. At the regular statutory rate of 14%, the gross credit would total \$28,000. Importantly, this credit can only be used to reduce the claimant's tax burden, meaning a smaller, more restricted credit than in Puerto Rico.

In sum, the Puerto Rico company would enjoy a benefit nearly 18 times more generous than its fictional U.S. twin during this first year. For a company trying to decide where to conduct its R&D—and especially on having the cash flow to continue to fuel it—the magnitude of Puerto Rico's generosity certainly makes for a powerful argument.

However, the twofold benefits of the U.S. system—a spreading out over time of the deductibility and (especially) a reduced corporate tax rate—not to mention a panoply of individual state incentives, are significant as well. Of course, no company makes consequential decisions like this in a vacuum. So, let's look deeper into the nuts and bolts.

Details, Details

1 | What constitutes R&D?

The definition of eligible R&D activities in Puerto Rico's Act 60 closely resembles that described in the Internal Revenue Code's Section 41, albeit with slightly different wording.

Both define R&D as endeavors aimed at advancing knowledge or capability within a scientific or technological field by resolving scientific or technical uncertainties. These uncertainties refer to problems that cannot be immediately solved by subject matter experts without applying the scientific method—defining the problem, formulating hypotheses, experimenting, observing, and recording the findings. The ultimate goal of R&D activities is to generate new knowledge that contributes to the creation of new products, improvements to existing products, or the development of new commercial services or processes.

Both also require detailed and contemporaneous documentation to substantiate the eligibility of those R&D activities. In the U.S., while a good-faith intention to make a profit is required, the expectation of profit need not be reasonable. There is no mention of required outcomes in Puerto Rico.

2 | What activities and expenses qualify?

In Puerto Rico, a wide range of expenses qualify for the credit. These include operational expenditures directly related to R&D operations— from materials and equipment to salaries, even extending to investments in R&D-exclusive infrastructure. Clinical trials for new drugs or medical devices are also included, as are costs associated with developing and implementing renewable energy technologies. Moreover, expenses related to acquiring intellectual property (e.g., patents, trademarks) are covered by the incentive.

By contrast, R&D credits in the U.S. are more narrowly focused on specific criteria—from wages for employees directly engaged in R&D, to supplies used exclusively for researching and developing new technologies or patents, to contract research expenses paid to third parties for qualified R&D activities. Land, land improvements, or depreciable property are not creditable under Section 41.

3 | What's the compliance picture?

Act 52 of 2022 adjusted some aspects of compliance. First, taxpayers must now apply for a Certificate of Compliance from the DEDC every two years. This certificate, signed by a "Compliance Professional" (such as a CPA or a lawyer licensed in Puerto Rico), validates compliance with DEDC regulations. Second, taxpayers could previously claim the entirety of the R&D tax credit in the year the investment was made. Now, they must do it in (at least) two parts: the first half is available in the year the credit application is accepted, with the remainder available in tax years thereafter. This has the effect of delaying receipt of the full benefit.

One thing has not changed: Detailed, contemporaneous reports documenting your experimentation methodology, results, evaluation, and conclusions are essential. Those expenses will be scrutinized. A small price to pay for such a rich reward.



Seizing the Opportunities

The unique legal and fiscal structure that Puerto Rico represents has always made it an outlier within the United States—capable to a remarkable degree of enabling and magnifying either challenging or positive outcomes. One need not look into the distant fog of history for examples of what a lack of prudent governance and fiscal discipline (and a spell of bad luck), can do to a jurisdictionally and politically uncoupled territory.

But consider this: in just a few years, Puerto Rico has emerged from the shadows of near-economic collapse and natural disaster to become a promising global destination for R&D investments. This is a remarkable transformation that bodes well for the island's future in an era where innovation is one of the most important drivers of success.

With a tax credit program that is not only generous but also designed to facilitate ease of business, many companies will likely find that the treasure trove contained in the provisions of Puerto Rico's new Incentives Code—and the ability it affords to stretch their R&D budgets further—more than justify taking a close look at the opportunities now on offer in the Caribbean.

