



EYCA TAX ALERT

**Proposed Costa Rican Tax Reform
(File N° 18.261)**

November, 2011

Agenda

- Current Status
- Amendments regarding Corporate Income Tax
- Amendments regarding Employee Income Tax
- New Rules on Income from Movable and Immovable Property and Capital Gains
- Amendments to Withholding Tax Rules on Remittances Abroad
- Worldwide Taxation of Passive Income
- Amendments to General Sales Tax (VAT)
- Amendments to Other Taxes



Current Status

- ▶ Fast track procedure (Section 208-bis) has been approved for purposes debating and voting the proposed bill.
- ▶ A congressional subcommittee is currently reviewing the bill and making amendments to the proposed legislation.
- ▶ The bill should be subject to a first vote in mid December/early January.
- ▶ If the bill is approved, it will be sent to the Costa Rican Constitutional Court (part of the Costa Rican Supreme Court). The Supreme Court judges will have a 1-month period to review the text and determine whether or not the proposed legislation is accordance with the Costa Rican Constitution and whether or not the proposed legislation was approved in accordance with Constitutional Procedures.
- ▶ If the Constitutional Courts approves the proposed legislation, the bill will be subject to a second and final vote.
- ▶ If the bill is approved in this second vote, it must be approved by the country's President and published in the Official Gazette to become enforceable.
- ▶ Certain provisions may include grandfathering rules.



Amendments regarding Corporate Income Tax



Amendments regarding Corporate Income Tax

- ▶ **Asset Revaluation**: The proposed text would allow companies to revalue their fixed assets on a yearly basis pursuant to an annual inflation index. The new basis should be used for purposes of computing depreciation expenses for corporate income tax purposes.
- ▶ **Non Taxable Income**: the following items are excluded from corporate income tax:
 - ▶ Dividends and other profit distributions received which are subject to tax under the new chapter on income from movable and immovable property and capital gains.
 - ▶ Dividends and other profit distributions provided they derive from securities which are part of the company's trade and provided the company carries out taxable activities.
 - ▶ Gains subject to tax under the new chapter on income from movable and immovable property and capital gains; except where such gains derive from assets that are part of the taxpayer's trade or where such type of gains are part of the taxpayer's habitual activity.



Amendments regarding Corporate Income Tax

- ▶ **Deductible Expenses**: The following amendments are made regarding deductible expenses:
 - ▶ NOL carryforward during a 3 year period (regardless of the taxpayer's activity). Rule clarifies that NOLs may not be used to offset the portion of the taxpayer's taxable income originated from gains on the transfer of assets which were acquired within the prior 12-month period.
 - ▶ Donations may be considered deductible expenses, provided they do not 10% of the taxpayer's net income (before deducting such donations).



Thin Capitalization Rule

In summary:

- **General Rule:** Interest expense that exceeds 40% of the taxpayer's net income (excluding interest expense) is not deductible.
- **Safe Harbor Rule:** If the taxpayer's debt-to-equity ratio is equal to or less than 3:1, the general rule does not apply.



Transfer Pricing Rules

- ▶ Arm's length principle applicable on related party transactions.
- ▶ Rules are applicable only where agreed pricing results in lower taxation in Costa Rica or deferral of taxes.
- ▶ Rules clarify that Tax Authorities may apply substance over form principle along with transfer pricing rule to re-characterize and revalue related party transactions where the form and value agreed is not consistent with the arm's length principle.
- ▶ In summary, parties are considered related where:
 - ▶ One party controls the other party or owns at least 25% of its share capital or voting shares.
 - ▶ 5 or less persons control both parties and own (directly or indirectly) at least 25% of both party's share capital or voting rights.
 - ▶ Both parties are part of single "unit of decision". Specific rules set forth when two parties are deemed to be a single unit of decision (e.g., when one person owns the majority of voting rights, has the right to appoint the majority of directors, etc.).
 - ▶ Specific rules apply for purposes of imputing participations among family members.



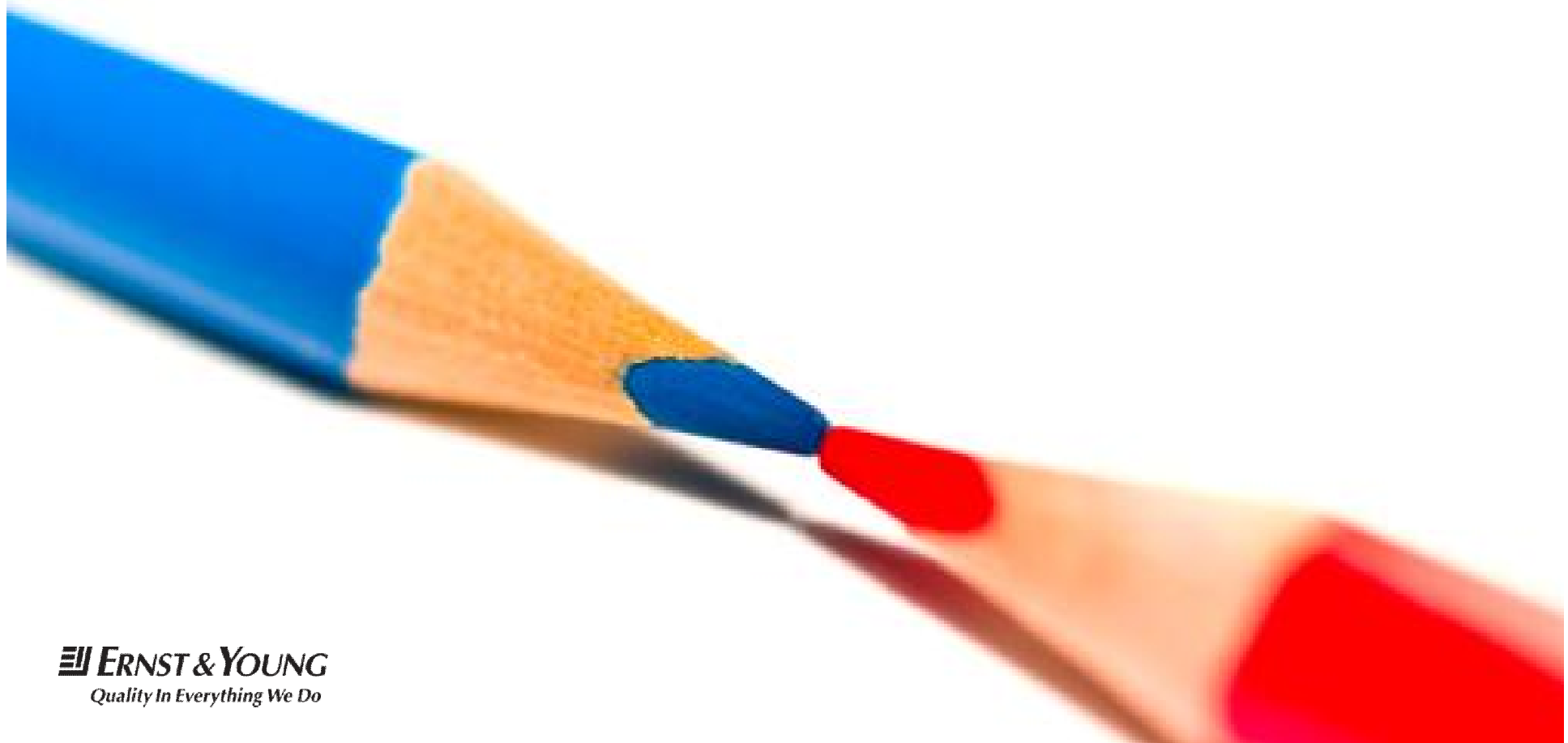
Amendments regarding Self Employed Individuals

Amendment to Rate Schedule (applied on annual net income):

- ▶ First CRC 4.800.000 (aprox. USD \$9,400) are exempt.
- ▶ Following CRC 4.000.000 (aprox. USD \$7,800) are subject to a 15% rate.
- ▶ Following CRC 4.000.000 (aprox. USD \$7,800) are subject to a 25% rate.



Amendments regarding Employee Income Tax



Amendments regarding Employee Income Tax



- ▶ Amendment to progressive rate schedule (applicable on gross monthly compensation received): Existing brackets of 0%, 10% and 15% are maintained; however, a new bracket of 20% is established for compensation in excess of CRC 4.000.000 (approximately USD \$7,800).

New Rules on Income from Movable and Immovable Property and Capital Gains



Rules on Capital Gains

- ▶ **Taxable Event**: Costa Rican source income derived from capital and capital gains from assets or rights owned by taxpayers and that are not otherwise subject to corporate income tax or withholding taxes on remittances abroad.
- ▶ **Taxable Income**: Income from immovable property, income from movable property and capital gains.
- ▶ **Tax Rate**: 15%.
- ▶ **Returns**: Returns for this tax will need to be filed on a monthly basis.



Income from Movable and Immovable Property

Income from Immovable Property

Income from:

- Leases
- Subleases
- Creation or transfer of rights to use and usufruct of immovable property.

Income from Movable Property

Income from :

- Loans of any kind
- Leasing, subleasing or creation or transfer of right of use and usufruct of movable property.
- Annuities from investments and income from insurance agreements.
- Dividends and other distributions of after-tax profits.

Capital Gains and Capital Losses

- ▶ Variations in the value of the taxpayer's equity as a result of any alterations of such equity are considered capital gains or capital losses.
- ▶ No such variations should be deemed to take place where a taxpayer transfers property to a passive trust (e.g., trust used as collateral).
- ▶ Reductions of capital: no capital gain or loss should be deemed to occur where a corporate taxpayer reduces its capital and returns it to its shareholder(s).
 - ▶ However, where a corporate taxpayer has retained earnings, any distributions to its shareholders will be deemed to be dividend distributions until such retained earnings are reduced to zero.



Capital Gains and Capital Losses

- ▶ Gains from the transfer of shares and other forms of participation in a legal entity, will not be treated as such to the extent the investment was booked as a permanent investment, provided the transferor is a corporate income taxpayer.

Corporate Reorganizations

- ▶ Where corporate reorganizations occur through different mechanisms such as purchases of shares, capital contributions paid in-kind, mergers, demergers, bulk sales, etc., gains from such reorganizations may be exempted pursuant to rules to be stated via regulations, based on the principles of tax neutrality, continuity of the business provided there is a valid business reason for the reorganization.
- ▶ In all cases covered by this rule, the historical cost basis of the assets transferred must be maintained.



Exemptions

Some of the most relevant exemptions include:

- ▶ Dividend distributions to corporate income taxpayers.
- ▶ Capital gains generated by corporate taxpayers on the transfer of shares (provided such gains are not considered derived from the taxpayer's ordinary trade) will not be treated as such to the extent and up to the amount of the transferred entity's retained earnings.
- ▶ Where a legal entity receives a dividend which is not exempted from this tax, any further distributions by the taxpayer of such profits to its own shareholders is not considered subject to tax.
- ▶ Capital gains generated by an individual on the transfer of its home.
- ▶ Inheritance and donations received.

Taxable Amount

Income from Immovable Property

- ▶ The taxable amount is gross income from immovable property less a fixed 15% deduction.
- ▶ Taxpayers with at least one employee may opt out of this chapter and choose to have its taxable income from immovable property under corporate income tax rules.

Income from Movable Property

- ▶ Gross income received from movable property.

Capital Gains

- ▶ Taxable income is the difference between the transferred asset's cost basis and the gross compensation received in exchange.
- ▶ In certain cases where there is no compensation received in exchange for the transfer, the asset's fair market value is used.

Amendments to Withholding Tax Rules on Remittances Abroad



Withholding Tax Rules on Remittances Abroad

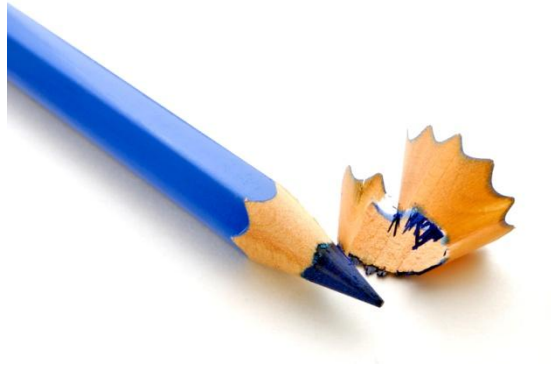
- ▶ A single rate of 15% withholding taxes will apply on any payments of Costa Rican source income to non-residents regardless of the type of payments made (as opposed to the different rates that apply currently depending on the type of income paid).
- ▶ The following are the only exceptions to the rule:
 - ▶ For transportation and telecommunications: 5.5%.
 - ▶ Insurance and related payments: 5.5%.
 - ▶ For wages, salaries and professional services: 20%.



Section 61 Withholding Tax Exemption

This section is repealed, therefore Tax Authorities should no longer grant withholding tax exemptions under this rule.

No grandfathering rules are being proposed.



Section 59 Withholding Tax Exemption on Interest Payments

This section is repealed, therefore payments of interest and other financial expenses to qualified banks will no longer be exempted from withholding taxes.

A 6-month transition period would be granted where such payments would remain exempted from withholding taxes.





Worldwide Taxation of Passive Income

Worldwide Taxation of Passive Income

- ▶ In summary, the worldwide principle of taxation would apply for purposes of taxing income considered “passive income”.
- ▶ Dividends, interests, royalties, income derived from immovable property and capital gains will be taxed, provided they arise from assets that are not considered part of the taxpayer’s taxable activities.
- ▶ This tax would be triggered when such income is: (i) “satisfied” to the beneficiary or (ii) credited to a bank or financial institution subject to regulation by the Costa Rican Banks supervision agency, SUGEF.
- ▶ The taxpayer may use taxes paid abroad (up to 15%) to offset its local income tax on such income as a mechanism to avoid double taxation.



Amendments to General Sales Tax (VAT)

- ▶ General Sales Tax changes to a Value Added Tax applying to all goods and services. (some exemptions may apply)
- ▶ New rate: 14%. Other rates apply to certain goods and services (e.g., education services, goods from the “canasta básica”, etc.).
- ▶ Credits available for VAT paid on the purchase or importation of any goods or services necessary to produce taxable goods or services (as opposed to current rule where only VAT paid on the purchase of goods or services physically incorporated are creditable).
- ▶ Proportionality rules for purchase of goods and services used to produce taxable goods and services as well as non-taxable goods and services.




Other Amendments

Other Amendments

- ▶ The transfer tax for immovable property is increased from 1.5% to 3%.
- ▶ The transfer tax for registered movable property (including vehicles) is increased from 2.5% to 3%.
- ▶ The rate of excise tax applicable on the importation of certain “luxury” vehicles increases 10 points for each item of tariff.
- ▶ Tax on Luxury Vehicles: Owners of luxury vehicles (value greater than 57 minimum wage-salary) will have to pay an incremental 50% of the duty established in section 9 of act N° 7088 (Circulation Rights).





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