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Global Tax Alert

News from Americas Tax Center

Costa Rica enacts tax reform

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On 4 December 2018, Costa Rica enacted a tax reform bill, Law on the Strengthening of Public Finances (Law), which was approved by the Congress in a second and final vote on 3 December 2018. The Law seeks to strengthen the country's finances through four pillars:

i) The replacement of the current sales tax law with a value added tax (VAT)

ii) Amendments to the current income tax law and the inclusion of specific treatment for capital income and capital gains

iii) Reforms to the Law of Salaries of the Public Administration

iv) The establishment of a fiscal rule to limit public spending

Replacement of the sales tax with a VAT

The Law establishes a VAT for the sale of goods and the supply of all types of services within Costa Rica, regardless of the method used to provide the services. Currently, services, for the most part, are not subject to the sales tax. The Law requires the taxpayer to pay the VAT by the 15th calendar day of each month with the corresponding tax return.

The VAT provision will be effective six months after the first day of the month following the publication of the Law in the *Official Gazette*.

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Rates and exemptions

The Law includes a 13% general VAT rate, 35 exemptions to the VAT, 12 situations in which the VAT does not apply, and three reduced rates (4%, 2% and 1%).

The VAT does not apply to the following goods and services, among others:

- Exports
- The purchase of goods and services from Free Trade Zone regime companies
- Land transportation when the entity providing the transportation has a concession and uses a rate regulated by the Regulatory Authority of Public Services (*ARESEP*)
- Interest and commissions on all types of loans
- Rentals below 1.5 base salaries (i.e., the "base salary" determined by the Costa Rican Public Administration to calculate this amount)
- Private education

The Law maintains the exemption on the purchase of goods and services intended to be used by Free Trade Zone regime companies. This aspect was particularly controversial during the final discussions of the bill.

Goods and services that are sold, provided or acquired by the Costa Rican Social Security Administration (CCSS) and local authorities (*Municipalidades*) will not be subject to VAT. The transfer of real property and registered movable property subject to transfer tax, and the transfer of equity or various business lines in cases of corporate reorganizations, among others, will not be taxable with the VAT.

A reduced rate of 4% will apply to private health services provided by authorized health centers or health science professionals. Until the Ministry of Treasury establishes a system for returning the tax paid to the person paying for those services, the VAT will not be collected.

A reduced rate of 4% also will apply to the purchase of tickets to travel to or from Costa Rica. The reduced rate would be calculated on 10% of the value of the ticket.

A 2% reduced rate will apply to pharmaceuticals, supplies, machinery, equipment and reactive agents needed for production. The Law includes an apparent contradiction because this reduced rate also applies to private education services, which are exempt from VAT in the Law.

A 1% reduced rate will apply to sales, imports or the clearance of agricultural items included in the list of basic foods, as well as to sales, imports or the clearance of items related to machinery, equipment, services and materials that are needed to make certain goods and services available to the end consumer.

Application of tax credits

As a general rule, taxes paid in the acquisition of goods and services used in taxable transactions will be creditable when they are directly and exclusively related to the taxpayer's activity. Even though they are exempt, exports will create a right to a tax credit.

Under situations in which a taxpayer conducts operations with and without the right to a tax credit, the Law requires the taxpayer to apply the tax credit rules in proportion to the tax credit stipulated in the Law. Likewise, when a taxpayer has operations subject to the reduced tax rate referred to in Section 11 of the Law, the applicable tax credit will be equal to a percentage of the reduced rate.

The Law allows a taxpayer to claim the credit on its return when it first originates or on successive returns for four years (i.e., the statute of limitations established in the Tax Code). When there are credit balances in favor of the taxpayer, the Law allows the credit to be transferred to the following months. If the taxpayer determines that in the three successive tax years it will not generate sufficient income to absorb the entire credit, the Law allows the taxpayer to request a refund or offset per the provisions of the Tax Code.

When a taxpayer conducts operations with state institutions that are exempt from VAT by virtue of the tax immunity granted to public or private bodies, or conducts exempt export operations, that generate a tax credit above 75% of its total operations entitled to a credit, the taxpayer will be allowed to opt for the procedure that will be established by the Ministry of Treasury for purposes of guaranteeing the expedited and efficient recovery of the credit.

Amendments to the Income Tax Law

The Law amends the Income Tax Law to prevent the erosion of the taxable base, and to introduce a new taxation regime for capital income and capital gains.

Global income

One of the most substantial changes is the reform to Section 1 of the Income Tax Law (Corporate Income Tax), which globalizes income tax. A taxable event is the recognition or accrual of income, in cash or in kind, continuous or occasional, arising from a profitable activity of Costa Rican source, as well as any other income or benefit of Costa Rican source that is not excluded.

Capital income and capital gains from lucrative activity are treated as arising from profitable activity provided that they arise from goods and rights owned by the taxpayer and subject to lucrative activity.

The concept of lucrative activity is similar to the definition in Section 1 bis of the Income Tax Law. Under that definition, all activity that is necessary and used to obtain returns is considered a profitable activity.

The Law does not treat: (1) "elements" destined for private use; (2) assets from participation in the entity's own funds; and (3) the transfer of capital to third parties, as profitable activities, if they are part of a public offer or issued by entities supervised by the Council for Supervision of the Financial System (CONASSIF), unless the taxpayer can prove an effective connection with the profitable activity through the procedure determined by the tax authority.

Additionally, entities subject to the oversight and inspection of Superintendencies associated with CONASSIF would not be subject to the provisions on the proportional deduction of expenses.

Foreign exchange gain

The Law amends Section 5 on taxing the foreign exchange gain. Therefore, currency exchange differences in assets or liabilities that result between the moment the operation is conducted and (1) the date the income is recognized or the liability is paid, or (2) the close of the tax year, would be subject to income tax and would constitute a taxable gain or deductible loss, as applicable.

Ordinary capital gains

The Law excludes capital gains from gross income, unless they are derived from goods or rights that are part of the taxpayer's activity, or when they constitute an ordinary activity, in which case they would be taxed per the provisions of the corporate income tax. The Law establishes a new definition for "ordinary." Under the new definition, "ordinary" means an activity that a person or company is dedicated to for commercial purposes, publicly, and continuously or frequently.

Deductible expenses

The Law amends Section 8 to allow all companies to deduct their losses over the three following tax years. Agricultural companies are allowed to deduct their losses over five years.

For financial entities supervised by the Superintendencies associated with the CONASSIF, amounts used to create estimations, reserves or provisions authorized by the Superintendencies, or that must be kept compulsorily are deductible. The Superintendencies and CONASSIF are required to consider the Ministry of Treasury regulations that they deem to have tax effects.

Non-deductible expenses

Expenses corresponding to operations directly or indirectly conducted with persons or entities residing in countries or territories that the Tax Administration considers as non-cooperating are excluded from the deductible expenses. Notwithstanding the foregoing, expenses can be recognized if the Tax Administration determines that the taxpayer proved that the expenses correspond to an operation or transaction actually made.

For these purposes, the Law defines non-cooperating jurisdictions as those jurisdictions: (i) where the corporate income tax is less than 40% of the applicable Costa Rican corporate income tax rate (i.e., currently 30%) or (ii) that do not have a Tax Information Exchange Agreement or a Double Taxation Treaty with a provision for the exchange of information.

Also, expenses associated with hybrid mismatches that taxpayers perform with related parties overseas are not deductible when: (1) these expenses do not generate taxable income or tax-exempt income for the related party; or (2) these expenses are also deductible for the related party domiciled overseas.

Interest limitation rule

The Law creates an interest limitation rule under which interest expenses that exceed 20% of the taxpayer's earnings before interest, taxes, depreciation and amortization (EBITDA) will not be deductible for corporate income tax purposes.

Interest expenses from debts with the Development Banking System (*SBD*, in Spanish), with entities subject to the oversight and inspection of any of the Superintendencies registered with the National Council of the Financial System (*CONASSIF*, in Spanish), or with banks or financial entities overseas duly supervised by an oversight body or agency in the country of origin, are excluded from this limitation.

The Law authorizes the tax authorities to increase the interest expense deduction if a taxpayer requests an increase and has complied with all of the requirements of a resolution.

This provision is effective in the second tax year following the date of enactment. The deduction is limited to 30% for the first two tax years and will then be adjusted downward by two percentage points each year until reaching 20%.

Capital income and capital gains regulations

The Law includes a new chapter to regulate the taxation of capital income and capital gains of Costa Rican source. Capital gains and losses that result from foreign exchange differences originated in assets or liabilities resulting at the moment the transaction is conducted and the income is recognized or the liabilities paid and that are not subject to the corporate income tax, will be regulated under this chapter.

Taxation

Capital income is classified as "movable capital" or "gaining equity." "Gaining equity" includes the income from leases, subleases, creation or assignment of rights and powers of use and enjoyment of property. Likewise, income from "movable capital" is income, in cash or in kind, obtained from the transfer of funds to third parties.

Capital gains and losses are the result of the variations in the taxpayer's equity.

Exemptions

The new chapter includes a number of exemptions. Specifically, dividend distributions and shares are exempt from the capital gains tax. A dividend distribution is exempt when a partner is another corporation domiciled in Costa Rica that develops an economic activity and is subject to capital gains tax or when it is a controlling entity of a regulated financial group or conglomerate.

Corporate reorganizations

In cases of corporate reorganizations, the capital gain is unrealized based on the principles of business and tax neutrality. Nevertheless, there should be a valid economic reason for the reorganization and the historical values of the assets or rights transferred should be maintained in order to determine possible capital gains or losses in subsequent distributions.

Taxable income

The Law establishes that the difference between gross income and deductible expenses is the taxable income for "gaining equity." Gross income is the total amount of the consideration. In regard to deductible expenses, the taxpayer is allowed to deduct 15% from the gross income, without providing proof of the expenses and with no possibility of taking another deduction for those expenses. The 15% deduction increases to 20% for non-financial investment funds regulated by the Law to Regulate the Securities Market.

For "movable capital," the taxable income is the total amount paid for the "movable capital" with no deduction for expenses allowed.

The taxable income from capital gains is comprised of the difference between the acquisition values of the assets or rights and the amount received on the transfer of those assets or rights for transfers with consideration. Under all other assumptions (e.g., transfers without consideration), the taxable income is the market value of the assets or rights that are included in the taxpayer's assets or equity.

Tax rate

The Law establishes a tax rate of 15% for capital income and capital gains. For the first sale of goods and rights acquired before the tax reform was enacted, the Law allows taxpayers to choose whether to pay a reduced capital gains tax of 2.25% on the sale.

The 15% rate also applies to the returns from securities in national currency, issued by the Popular Bank and Community Development (*Banco Popular y de Desarrollo Comunal*), as well as the securities issued by savings and loans unions.

The Law establishes a 7% rate for returns from securities in national currency issued by the National Financial System for Housing.

The Law limits the exemption for returns from the savings of the members of the savings and loans unions to 50% of a base salary (i.e., the minimum salary amount fixed by law each year); if that amount is exceeded, the Law requires 8% to be withheld.

For surpluses paid by employee solidarity associations (i.e., worker associations with savings and loans unions), the following scale applies: (i) 5% up to the equivalent of a base salary; (ii) 7% on the excess of one base salary and up to two base salaries; (iii) 10% on the excess of two base salaries.

Tax settlement and payment

The Law requires the tax to be settled and verified within the first 15 days of the month following the triggering event.

Changes to the salary tax rate table

The Law modifies the rate scale of the salary tax as follows: (i) 15% is withheld on amounts above Costa Rican colón (¢)1,199,000.00 and up to ¢2,103,000.00; (ii) 20% is withheld on amounts over ¢2,103,000.00 and up to ¢4,205,000.00; and (iii) 25% is withheld on amounts above ¢4,205,000.00.

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