

SPECIFIC TAXES

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General Overview

The Costa Rican tax system is based on Consumption Taxes (Sales Tax, Excise Taxes, and Import Duties), Income Tax, and Real Estate Tax and other Municipal Taxes. Many other specific taxes apply on certain transactions or selected industries (e.g. transfer taxes or taxes on gambling activities). The relative importance of income tax has steadily increased over the years, when compared with indirect taxes, especially sales tax.

There have been projects to modify the Costa Rican tax system for almost a decade, but this reform has never been approved. Faced with this situation, the Tax Administration has come up with increasingly aggressive interpretations of the tax law, especially regarding the definition of Costa Rica source income that is subject to taxation.

Corporate Income Tax General Rules

Gross income includes earnings, benefits and rents, whether in cash or in kind derived from a Costa Rican source. Companies may deduct from gross income all costs and expenses necessary to produce taxable income or to protect their investments. Partnerships are treated as corporations independent of their partners and are liable for corporate taxes on net profits.

As a general rule, capital gains and losses on non-depreciable assets or shares of other companies are excluded from gross income for income tax purposes (if they do not derive from the normal activity of the taxpayer). Branch income is taxed at the same rate applied to corporations and foreign source income is not taxed. Nevertheless, there is a trend in case law to try to tax foreign source income based on “enterprise’s activity” concept.

The tax treatment of capital gains generated by the sale of shares has evolved due to administrative case law. It is advisable to request tax advisory in these situations.

Corporate Income Tax Rates

With the exception of qualified and limited Free Zone Companies and other entities as provided by article 3 of the Income Tax Law, corporate net profits are taxed according to a 30% rate. Companies with an annual gross of under US\$ 66,000 approximately are subject to a reduced tax of 10 % and those earning up to US \$ 132,000 approximately are subject to a reduced tax rate of 20%.¹ The tax is levied on net income before dividends or reserve distributions.

¹ The amounts included herein are those in force and effect for the 2009 tax year. These amounts are expected to vary as of October 1st, 2009, however to the date in which this information is prepared (September 30, 2009) the corresponding Order has not been published.

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Taxes on dividends

According to Costa Rican law, upon accrual or payment of a dividend, whichever occurs first, the company must withhold 15% of the amount credited or paid. The 15% withholding tax rate does not apply if:

1. Payments are made in shares of the distributing entity;
2. Payment is made to another Costa Rican corporation subject to income tax; or
3. Foreign tax credits are not allowed by the recipient country.

If the distributing company is registered in a local stock exchange and

the shareholder acquired the shares through the stock exchange, the applicable withholding tax rate decreases to 5%.

The amounts withheld must be deposited with Tax Authorities within the first 15 calendar days of the month following the date of credit or payment of the dividend.

Deductions

Table 1 shows a summary of the deductions corporations can take against gross income.

Taxpayers may request an authorization to use a different depreciation method. This new method would

Table 1

Corporate Deductions Allowed Against Gross Income

- Expenses necessary to produce taxable income are deductible provided they are duly recorded, deemed necessary and the obligation to withhold (if applicable) has been met.
- Bad debts provided legal requirements and jurisprudence requirements are met.
- Payments to residents or nonresidents for rents, royalties, technical or financial advisory services, trademarks, franchises and similar items, provided the proper withholding is made (with the limitations established above). If such payments are made from a local entity to its parent Company, the amounts are limited to 10% of gross income of the local entity.
- Taxes paid, except income, sales and consumption taxes or related penalties.
- Interest payments on business loans, as well as the costs of obtaining said loans.
- Loss of assets and casualty losses not covered by insurance.
- Contributions to a recognized cultural or charitable institution.
- Local insurance premiums.
- Foreign exchange losses, except when related to the acquisition of fixed assets.

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only be acceptable if this authorization is granted.

Depreciation and Other Allowances

- Unless authorized by the Tax Authorities, depreciation rates cannot be higher than those prescribed by the Regulations to the Income Tax Law. A company can choose either the straight line or the sum-of-the-year-digits methods of depreciation. However, once chosen, that method must be used consistently. Accelerated depreciation is allowed in certain circumstances.
- Annual depletion allowance is granted to companies that use natural and depletable resources.
- Organizational and pre-operational expenses can be amortized in five years.
- Operational losses can only be carried forward up to three years by companies engaged in industrial operations and five years for agricultural operations. Companies that engage in other activities are not allowed to carry forward their losses. The amount to be carried forward or used as a deduction is up to the discretion of the taxpayer. Amounts not used during the allotted time periods are lost.

Special Accelerated Depreciation Method applicable only for tax year 2009

As part of the measures implemented by the Government to contend the negative effects of the global economic crisis, the Tax Administration issued the Resolution Num. DGT-04-2009 dated February 27, 2009,

through which it authorizes taxpayers to electively apply an accelerated depreciation method.

This accelerated depreciation method is an intensive sum-of-digits method, which applies an acceleration factor of 60% on the defined useful lives of the assets listed in Schedule 2 of the Regulations to the Income Tax Law. This method is also applied for assets with useful lives defined by the Tax Administration on a case-by-base basis, except when the useful lives were established at the time special depreciation methods were authorized at the taxpayer's request.

No prior authorization is necessary to apply this method. However, the following requirements must be met: the assets must be acquired or constructed, real or movable property, be new, be owned by the taxpayer, and be acquired or constructed during 2009 (January 1 to December 31, 2009).

Although use of this depreciation method is optional for the above assets, once selected, it must be applied for the remaining useful life of the asset. This method would not be applied to rental cars, which must be replaced every three years in accordance with Law on Incentives for Tourism Development Num. 6990.

Foreign Remittances

Costa Rican source income accrued or paid to non-domiciled entities is subject to withholding taxes. Foreign remittances such as royalties, leasing, technical advisory services, salaries and other services (e.g.

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transportation, communications, and insurance related expenses) are subject to withholding taxes ranging from 5% to 50%.

Payments or accruals made by subsidiaries or branches to parent companies for royalties, franchises, trademarks and similar, and advisory services, are limited to a maximum of 10% of gross sales of the subsidiary or branch. Interest payments made to non-domiciled entities are subject to a 15% withholding tax rate. The withholding requirement is waived if the lender is a financial institution or bank duly recognized by the Costa Rican Central Bank as a First Order Bank or financial institution or in the case of financing made by suppliers of goods imported into the country.

Sales Tax

The general sales tax is an imperfect value added tax which is levied on the sale and import of goods and the rendering of specified services (e.g. insurance, restaurants, repair shops and photocopiers). The tax is applied in such a way that, through a system of shifts and credits, the tax is charged only once on the various transactions in chargeable goods. This means that the tax is computed by the subtraction method, i.e. crediting taxes paid on purchases (regarding inputs physically incorporated in the production of taxable goods) against tax liabilities arising from sales.

The filing of the tax return and the corresponding payment must be made, at the latest, the fifteenth calendar day of the month that follows the date in which the sale took

place. The normal sales tax rate is 13%. A 10% rate applies to the sale of wood and a 5% rate to the consumption electric energy for residential purposes.

Municipal business license tax and minor municipal taxes

Costa Rica has no state or city income taxes. There are, however, minor municipal taxes, as the municipal business license tax, construction tax and charges for local services provided. These municipal taxes vary from one municipality to another.

Stamp Taxes

Stamp taxes are levied on most legal documents. The normal rate is 0.5%.

Education & Culture Stamp Tax & Tax on Equity

An education and culture statutory stamp tax is imposed annually, with fees ranging from ₡750 to ₡9,000, based on the capital stock of the company.

Real Estate Tax

This tax is applicable to real estate, land, buildings and permanent structures. The tax is managed, assessed and controlled by local governments (Municipalities) of the administrative district where the property is located. The taxable base is the value of the property registered with the Municipality. The tax rate is 0.25%.

Housing Program Tax

The Social Assistance Tax to Strengthen Housing Programs was created through Law Num. 8683 of

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November 19, 2008. That law establishes a tax on property or rights of use and enjoyment of residential property due on January 1 of each year.

Progressive tax rates ranging between 0.25% and 0.55% are applied to properties valued at more than ₡100,000,000. Properties with a construction value of less than that amount are exempt from the tax.

The tax year runs from January 1 to December 31. The tax becomes due on January 1 and is payable within 15 days. Every three years and within the first 15 calendar days of January of the corresponding tax year, taxpayers must file an affidavit to adjust the assessed value of the property as required by the Tax Authorities. Owners of properties exempt from the tax are not required to declare.

This tax is not a deductible expense for income tax purposes. It is effective for 10 years from the date of entry into force of the Regulations to the Property Tax Law (September 29, 2009)

Import Tariffs

At the time of Costa Rica's entry into the General Agreement on Tariffs and Trade (GATT) in 1990, the country had a maximum duty of 55% on imported goods of Import Tariff (Derecho Arancelario a la Importación (DAI)).

Under GATT, this rate was lowered to (currently) a maximum of 15% for final goods and a minimum of 0% for raw materials and capital assets. Intermediate assets that are not produced in Central America have a DAI of 5%.

This rate is increased to 10% if similar assets are produced in the Central American region. As an exception, there are some goods that are subject to tariffs that exceed the normal 15% maximum, such as milk, certain farming products, and others. Furthermore, luxury items may be subject to combined tariffs and taxes (such as the selective consumption tax and specific taxes, among others) with rates of up to 100%. A detailed explanation of how imports are taxed is beyond the scope of this book. AmCham strongly recommends consulting qualified professionals if you are considering importing goods.

Investment & Tax Treaties

Costa Rica has bilateral investment treaties already in effect with different countries. Among those are treaties with Canada, Chile, Great Britain (not in force), France, Spain, Germany, Switzerland, Korea, Venezuela, Paraguay, Argentina, the Czech Republic and the Netherlands. There are bilateral investment treaties signed but not yet ratified with Bolivia, Ecuador, Finland, and Belgium-Luxemburg. The bilateral investment treaty with Poland is pending signature and the bilateral investment treaties with the following countries are under negotiation; Austria, Barbados, Brazil, Denmark, United States of America, Greece, Ireland, Jamaica, Italy, Norway, Peru, Portugal, Romania, Sweden and Uruguay.

Costa Rica and the United States signed a Tax Information Exchange Agreement, which was passed on February 1, 1991 and came into force on February 2, 1991. The

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agreement satisfies the conditions set forth in the US Caribbean Basin Initiative.

In addition, Costa Rica and Spain signed an Income Tax Treaty in March 2004; however, Congress has not yet ratified this treaty. Other Income Tax Treaties are under negotiation (e.g. Switzerland).

Trade Agreements

CAFTA is a trade agreement signed on August 5, 2004 between the United States of America and the Central American countries and Dominican Republic. The Costa Rican Congress is currently in the process of approving the legislation necessary for this treaty to come into effect.

The Caricom Trade Agreement is a negotiation agreement between the Caribbean Island Communities and Costa Rica to improve the access and trade between their markets. Caricom Trade Agreement is in effect as of November 15, 2005.

Central America is currently negotiating a free trade agreement with the European Union.

Other agreements include those with Canada, Chile, Mexico, Panama, and Dominican Republic.

Export Subsidies

The most important export subsidy applicable in Costa Rica is the Free Zone Incentive System. This system is a combination of benefits and tax incentives granted by the State to companies dedicated to handling, manufacturing, processing, trading, producing, repairing or providing

goods or services destined to be exported or re-exported to third markets. Also companies dedicated to scientific or technological development can be located and operate under this system.

Initially, those benefits were supposed to be abolished on December 31, 2002, nonetheless, the World Trade Organization agreed to an extension in order to allow affected countries to adapt their economic system to the new scheme. The application of export subsidies, such as income tax exemption granted to companies under the Free Trade Zone Regime, has been extended until December 31, 2015. Service companies are not included in this time limitation.

Bill of Law to

amend Free Zone Law

On April 21, 2009, the Minister of the Presidency submitted to the Congress a bill of Law entitled "Amendment to the Free Zone Law, Num. 7210, dated November 23, 1990", which is handled under the legislative file Num. 17340.

The Bill seeks to remove the uncertainty on the commitment of Costa Rica to the Agreement on Subsidies and Countervailing Measures (ASCM) of the World Trade Organization (WTO) that intends to eliminate by 2015 some of the current incentives, specifically those granted subject to export performance. This agreement affects specifically the manufacturing sector.

In general terms, the Bill maintains the same benefits of the current Free

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Zone System (FZS) except for the income tax exemption. However, there are several categories and tax treatments that are included:

- a. Companies located in relatively developed areas will pay 6% income tax on their profits during the first 8 years of their operation in the FZS and 15% in the following 4 years.
- b. Companies located in relatively less developed areas will pay a 5% income tax on their profits during the first 12 years of their access to FZS and 15% in the next 6 years.
- c. Companies that exceed certain levels of investment or employment will keep the exemption from income tax in the same terms indicated in sections g) and l) of the

current Article 20 of the Free Zone System Law (FZSL).

- d. The Law grants the possibility to apply for a tax credit for reinvestment of profits, training expenses and others.

Through this Bill it is recognized the importance of the Free Zones System for attracting foreign investment to the country and the need that tax issues shall not affect competitiveness of this system in the future. Its importance is evident if it is considered that during the first quarterly period of the 2009 year, Costa Rica reported 247 active companies under the system, employing 53,000 people within the country. Therefore, maintaining a competitive Free Zone System is the ultimate goal of this Bill.