



MERGERS AND ACQUISITIONS

# Costa Rica

Taxation of Cross-Border  
Mergers and Acquisitions

2010 Edition

TAX

# Costa Rica

## Introduction

Despite the current international economic environment Costa Rica remains attractive to foreign investors for a number of reasons, including economic and political stability.

Unlike other Latin American countries Costa Rica, has not changed its tax legislation significantly in recent years. Major tax reforms were discussed for several years, but proposed modifications were not enacted. As a consequence Costa Rican tax legislation includes little regulation of merger and acquisition (M&A) transactions. The most important regulation, particularly of mergers, is incorporated in Costa Rican commercial law.

Despite this lack of regulation M&A activity may be subject to scrutiny by tax authorities to determine if taxpayers derived benefits mainly related to deductible expenses.

Since capital gains are not taxed in Costa Rica, they are excluded from gross taxable income, unless:

- the gain is related to a habitual activity; and
- tangible assets subject to depreciation are transferred.

The Costa Rican Commerce Code sets out in articles 220-224 the effects and necessary procedure of merging two or more Costa Rican entities. The procedure is as follows:

- First, the legal representatives of the merging companies should prepare a plan of merger, or adopt a merger resolution. The plan should include the terms, conditions, and any other relevant merger matters. The resolution should indicate the effective date of the merger and include the financial statements that will serve as the basis for the resolution.
- Subsequently, merging entities shall discuss and approve the plan of merger by holding extraordinary shareholders' meetings.
- Thereafter, the shareholders resolutions must be notarized by a notary public. A summary of the document must be published in the official gazette

and the corresponding testimony of the deed must be submitted to the public registry for registration.

## Asset Purchase or Share Purchase

As mentioned earlier in the chapter, capital gains are in principle excluded from gross taxable income in Costa Rica, but if the gain is derived from a for-profit activity or related with the disposal of depreciable assets the transaction would be taxed.

For this reason, the alternative of purchasing shares of a local entity is very common in Costa Rica, because it may have more beneficial tax consequences than buying assets. Depending on the circumstances, this is usually more true for the buyer than for the seller. Income is subject to tax in Costa Rica if it is generated by performing an activity, using a good, or investing funds within the country. Capital gains are normally not taxed, unless they are generated from the transfer of tangible and depreciable assets, or as a result of a habitual activity for the seller. Since shares are not depreciable assets, their transfer should not be subject to income tax, but if the seller has executed similar transactions in the past, it may be deemed that the seller is performing an habitual activity and is thus subject to income tax. In this case income tax would be imposed on the difference between book value and the selling price.

### Purchase of Assets

The most important consequence of purchasing assets is increasing the tax base for depreciation and potential capital gains, but, from the standpoint of the seller, any gain derived from the transaction would be subject to taxation if depreciable assets are disposed of or it may be deemed that the seller is engaged in a habitual activity.

### Purchase Price

There is no transfer pricing legislation in Costa Rica or any other tax provision requiring an appraisal of the assets to support the sale price. However, for tax purposes, it is advisable to allocate the purchase price among the assets acquired.

### *Goodwill*

Article 9 of Costa Rican Income Tax Law stipulates that goodwill paid for a business as a going concern cannot be deducted or amortized for income tax purposes.

### *Depreciation*

The purchase price of the assets may be used to determine the depreciation expense of tangible assets that generate taxable income and the depreciation of permanent improvements. However, fixed assets must be depreciated at rates established in annex II of the Income Tax Law Regulations.

Depreciation on the value of real estate is not accepted.

### *Tax Attributes*

Tax losses cannot transfer on an asset acquisition.

### *Value-Added Tax (VAT)*

Value-added tax does not apply on sale of real estate or used assets.

### *Transfer Taxes*

A transfer tax of 1.5 percent is levied on the transfer of real estate. This tax is based on the declared value of real estate transferred or on the value reported to tax authorities, whichever is higher. Typically, both the buyer and the seller of real estate are jointly liable for the tax, except where the contracting parties have agreed otherwise. The tax is assessed on the date the transaction is executed. Taxpayers must pay the tax within a month of the execution date.

### ***Purchase of Shares***

Structuring an acquisition as a purchase of shares may lead to the forfeiture of depreciation on the purchase price, because the price of the shares cannot be allocated to the assets owned by the target entity.

### *Tax Indemnities and Warranties*

Any tax liability remains with the target entity, but may be extended to the purchaser company if the target entity is merged into the purchasing entity.

### *Tax Losses*

According to article 8G of Costa Rican Income Tax Law, tax loss carry-forwards are only available to industrial and agricultural companies. Net operating losses incurred by commercial enterprises may not be carried forward.

For agricultural and industrial companies, the carry-forward periods are five and three years, respectively. Industrial companies that began operations after 1988 are allowed to apply net operating loss carry-forwards for five years for losses incurred within the first five years of operations. Losses incurred after the initial five-year period may only be carried forward for three fiscal years.

It is important to note that the tax administration will only accept these loss carry-forwards if the losses are duly recorded in the accounting as deferred losses.

### *Pre-Sale Dividend*

Costa Rican legislation has no specific rules on pre-sale dividends, so there is nothing to prevent the target entity from distributing dividends among its shareholders prior to the transaction.

If the recipient of the dividend is an individual or a non-domiciled entity a 15-percent withholding tax would apply.

### *Transfer Taxes*

A stamp tax is due on private documents according to article 272 of the Fiscal Code at a rate of 0.5 percent. As a general rule, this fiscal stamp that taxes the documents is based on the nominal value of the transaction.

If the transaction is only supported through an endorsement of the shares and the corresponding registration in the company's shareholder register, the stamp tax would not be triggered. If a private contract is executed in addition to those documents, this contract would be subject to the stamp tax.

If the document is executed outside of Costa Rica, the tax is deferred until the time when the document needs to be filed with a government office in Costa Rica. Since these types of contract do not usually need to be filed with government offices, this tax may never have to be paid.

## **Choice of Acquisition Vehicle**

Under current commercial law the following potential vehicles are the most common in Costa Rica, but tax consequences may influence the selection.

- Corporation (Sociedad Anónima)
- Limited liability company (Sociedad de Responsabilidad Limitada, Ltdas)

Because of their structural flexibility corporations are the most common entity. Since local laws define a corporation as a bilateral agreement, they must be formed by at least two parties, but immediately after formation, 100 percent of the shares may be legally owned by a single party, without altering the legal status of the original corporation. To incorporate a legal entity, it is necessary to draft and execute a deed of incorporation before a notary public, publish notice of the incorporation in the official gazette, and register the incorporation deed in the public registry.

Founding parties (and any shareholders thereafter) may be individuals and/or any type of registered legal entity, regardless of citizenship and domicile.

A limited liability company is composed of partners whose liability is limited to their capital contributions. Incorporation procedures and costs for Ltdas are very similar to those of corporations.

The most significant differences between Ltdas and corporations are the following:

- Share capital: Ltdas divide their share capital into what local regulations call quotas as opposed to shares. Unless specifically provided for otherwise in the articles of incorporation, a transfer of quotas requires the unanimous consent of all partners.
- Management: Ltdas are run by one or more managers or assistant managers who hold power of attorney as provided for in the articles of incorporation. Managers may also be owners of the company.

### **Local Holding Company**

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A local holding company may be useful, since distribution of dividends among local entities is not subject to taxation.

However, Costa Rica tax legislation has no rules permitting tax consolidation.

### **Foreign Parent Company**

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An acquisition may be implemented using a foreign parent company, but any distribution of dividends from a local entity to a foreign parent would be subject to a 15 percent withholding tax (see Group Relief/Consolidation). Moreover, if the foreign parent company is a creditor of the local subsidiary interest payments abroad would also be subject to a 15-percent withholding tax. A tax waiver is available (see withholding tax on debt and methods to reduce or eliminate)

Most remittances abroad would be subject to taxation according to territoriality principle (see Withholding Tax Rate Chart).

### **Non-Resident Intermediate Holding Company**

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Given the fact that Costa Rica has no treaties for the avoidance of double taxation with other states, a non-resident intermediate holding company does not avoid taxation on the distribution of dividends and other taxes that may apply on remittances abroad.

### **Local Branch**

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Current legislation requires all legal entities to register with the public registry. There is no difference in the tax treatments of a subsidiary and a branch.

### **Joint Ventures**

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Costa Rican commercial and tax legislation include no rules specific to joint ventures. From a tax standpoint a joint venture is no different from its parties if its structure is a contractual agreement. If the joint venture takes the form of a jointly-owned company, the parties involved would be treated as shareholders of a new entity.

## **Choice of Acquisition Funding**

The tax consequences of an acquisition funded by debt or equity are explained later in the chapter.

### **Debt**

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The deductibility of interest for income tax purposes is the main advantage of funding an acquisition with debt. Taxpayers may also be able to deduct other financial expenses, such as commissions.

In the case of foreign currency liabilities the local entity will be required to compute the conversion into local currency at the end of the fiscal year and the resulting exchange differential accrued during the tax year will be recognized as deductible loss if such liabilities are related to the entity's ordinary course of business.

As a general rule the deductibility of expenses is subject to the following requirements:

- the expenses must be necessary to obtain taxable income;
- the company must have withheld and paid the taxes established in the Income Tax Law, when required; and
- supporting documentation must be duly authorized by tax administration.

Tax authorities are empowered to reject any expenses treated as deductible if they consider that:

- expenses are not necessary for generating taxable income;
- expenses are excessive or unreasonable;
- expenses do not correspond to the income tax return being filled;
- there is inadequate supporting documentation for the expenses;
- expenses have not been properly booked in the accounting records; or
- withholding taxes have not been withheld (if applicable).

### ***Deductibility of Interest***

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From the perspective of the domiciled entity interest payable on a loan may be deductible for income tax purposes if there is a connection between the loan and the generation of taxable income in Costa Rica.

Therefore, it is important that the loan is and can be shown to be necessary for the business. Appropriate evidence for this might include financial statements demonstrating the necessity to finance the company's activities; develop new projects for which it has insufficient capital; or any other reason that satisfies the substance requirements. These requirements must be reasonable and proportional.

The tax authorities will look with particular interest at loans granted by related entities or shareholders.

The parties must be aware of all this, and ensure they have available the evidence to prove the substance and necessity of the transaction.

According to Costa Rican Income Tax Law a Costa Rican Partnership (Sociedad de Responsabilidad Limitada) may not deduct interest for income tax purposes if the loan was granted by its quota holders (cuotistas).

### ***Withholding Tax on Debt and Methods to Reduce or Eliminate***

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If the lender is a non-resident payments of interest from a domiciled party would be subject to a 15-percent withholding tax.

However, the tax authorities are empowered to grant a waiver if the lender can demonstrate that the interest

would be subject to taxation in its domicile and no credit would be given for the Costa Rican withholding tax.

If the lender is a non-resident, and no withholding tax was paid on interest received from the local borrower, the tax authorities may reject the interest deductibility from the latter and, in addition, charge the applicable withholding tax.

If the lender is a financial institution domiciled abroad payments of interest by Costa Rica domiciled party may be exempt from the withholding tax if the financial institution is registered with the Costa Rican Central Bank.

### ***Checklist for Debt Funding***

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- Non-domiciled creditors may obtain a tax waiver under certain circumstances.
- Foreign banks and other financial institutions registered with the Costa Rican Central Bank should be exempt from withholding tax on payments of interest.
- A Costa Rican partnership (Sociedad de Responsabilidad Limitada) may not deduct interest for income tax purposes if the loan was granted by its quota holders.

### ***Equity***

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Costa Rican commercial legislation includes no rules on equity contributions by shareholders, except share capital which is the only type of capital contribution regulated by the Mercantile Code. Share capital is stated (and eventually amended) in the entity's articles of incorporation. It is divided into common par value shares, each entitled to one vote. Shares must be registered, as local regulations prohibit bearer or non-par value shares. Article 18 of the Mercantile Code stipulates that the shareholders are obliged to include a share capital clause in the articles of incorporation, stating the amount of the share capital, and the form and term in which it should be paid.

Share capital can be increased or reduced as agreed by the shareholders. To effect such changes, the shareholders must amend the corresponding clause of the articles of incorporation at a Shareholders Meeting, register it in the minutes book of shareholders and later record it with the public registry.

However, it is common practice for shareholders to provide equity in the form of additional paid-in capital. Equity contributions through additional paid-in capital should be recorded in the minutes book of

shareholders. But need not be recorded with the public registry. It can be argued that additional paid-in capital is not a legal term, but, from an accounting perspective, it still has to be recorded as an equity contribution.

Share capital and additional paid-in capital are both registered as equity, but in different accounts.

Finally, additional paid-in capital is not necessarily intended to increase share capital. The contribution may remain recorded in the entity's accounts with no term or may be refunded to the shareholders. Since the additional paid-in capital contribution is not supported by shares (and, as a consequence, the shareholder funding the entity is not obtaining the voting and economic rights inherent to share capital), a substantial contribution of additional paid-in capital does not generate dividends or confer more voting rights.

### Hybrids

Costa Rican mercantile and tax legislation include no regulations on hybrid instruments, but it is possible to convert additional paid-in capital into a loan granted by the shareholders. This should not, however, be taken to imply that additional paid-in capital could be considered a hybrid instrument under Costa Rican legislation.

## Other Considerations

### Concerns of the Seller

Since capital gains are normally not subject to taxation (unless derived from habitual activities) the seller would normally strive to structure the transaction as a purchase of shares. Care must be taken, however, to ensure the transaction cannot be construed as a habitual activity.

### Company Law and Accounting

Costa Rican Mercantile Code stipulates the requirements under which local corporations and limited liability companies must operate.

From a tax standpoint duly registered entities acting as ordinary taxpayers should discharge the following formal duties:

- Register before the tax administration as an ordinary taxpayer at the moment business activities start.
- File the income tax return within the two months and 15 days of the end of the tax year.
- Keep duly audited accounting books. Article 53 of the Regulation of the Income Tax Law Accounting requires companies to maintain journal, ledger, and

balance and inventories books in Spanish and in chronological order, that comply with International Accounting Standards.

- Make quarterly advanced payments by the last working days of March, June, and September. These payments should be the tax of the preceding year or the average of the tax paid in the last three years, whichever is higher. If the taxpayer has not declared any income in the previous year, the quarter payment should be based on any other returns it has filed. In the case of a first filing, the taxpayer should provide an estimate of his/her annual income in January of each year. The 75 percent of the average thus computed should be divided into three equal parts to produce the quarterly advance payments due on the quarter dates. The annual tax return should be filed two-and-a-half months after the end of the tax year (usually, 15 December) and the tax should be paid after crediting the advance payments. Any excess tax paid as a result of this procedure could be used as a tax credit to offset liabilities generated from other taxes managed by the same tax administration. If no other tax is due, or a balance remains available after offsetting all other liabilities, the taxpayer can ask for a refund of that excess.
- Respond to any inquiry or information request by the tax authority. The tax administration is empowered to audit any taxpayer within the statute of limitations (three to five years depending on the circumstances of the taxpayer).

It is important to note that failure to register with the tax authorities does not exempt the entity from its tax obligations. The Standards and Procedures Tax Code determines the fines applicable in each case for non-compliance with the abovementioned obligations, in each case.

Current legislation stipulates that the accounting records and the local financial statements must be in local currency, Costa Rica Colon (CRC), but for the purposes of reporting to a non-domiciled parent company, the local company can translate its accounting records.

Additionally, according to article 81 of the Income Tax Law (ITL), if the local company keeps the income received in foreign currency, it is obliged to register it for tax purposes in national currency by using the reference exchange rate established by the central bank at the moment the operation took place or the income was received. Currency conversions executed through a bank in Costa Rica should be recorded, based on the

exchange rate employed in that transaction. For assets and liabilities kept in foreign currency, the branch will be required to compute the conversion into CRC at the end of the fiscal year and the resulting exchange differential accrued during the tax year will be recognized as taxable income or a deductible loss if such assets or liabilities are related to the company's ordinary course of business.

### **Group Relief/Consolidation**

According to article 18 of the Costa Rican Income Tax Law, the distribution of dividends from a domiciled entity is subject to a 15-percent withholding tax when paid to domiciled individual or to a non-resident parent company. However, no withholding tax would apply when dividends are paid to another local corporate entity that is also subject to corporate income tax.

Costa Rica tax legislation includes no rules on tax consolidation.

### **Transfer Pricing**

Costa Rican law includes no specific rules granting Costa Rica's tax administration power to assess whether transactions between affiliated companies are on an arm's length basis, but the tax administration has used the principle of economic reality, as stipulated in articles 8 and 12 of the Code of Norms and Tax Procedures, to make transfer pricing adjustments, on the grounds that the transaction was motivated solely by the wish to minimize the tax burden.

### **Foreign Investments of a Local Target Company**

Costa Rica's income tax system is based on the territoriality principle; any income obtained from activities performed, goods located, or funds invested within the national territory are subject to tax. As a consequence income obtained outside Costa Rica should not be subject to taxation.

On the other hand, income obtained locally and paid, credited (in the payer's accounting books), or made available in any way to non-resident entities is subject to a withholding tax on the gross amount remitted abroad. This tax liability is final. The rates vary according to the nature of the income concerned.

Costa Rica's tax system includes no controlled foreign companies (CFC) rules.

## **Comparison of Asset and Share Purchases**

### **Advantages of Asset Purchases**

- Purchase price can be depreciated in regard to fixed assets. Goodwill or intangible assets cannot be amortized for income tax purposes.
- No previous liabilities of the seller are inherited.
- It is possible to acquire only part of the assets.

### **Disadvantages of Asset Purchases**

- Not attractive for the seller (due to taxation on the transfer of assets).
- As a consequence the price may be higher.

### **Advantages of Share Purchases**

- In principle, the disposal of shares is not taxable
- The price could be lower.
- A transfer of shares does not trigger transfer tax on real estate.

### **Disadvantages of Share Purchases**

- Previous tax liabilities of the targeted company are inherited.
- Amortization of goodwill is not deductible for income tax purposes.
- There is no consolidation for tax purposes.

## **Withholding Tax Rate Chart**

Article 1 of the Income Tax Law defines as Costa Rican-sourced income any income obtained from the provision of services, goods located, or funds invested within the national territory.

Consequently the source of funds and form of payment are not relevant for tax purposes. If the income derives from activities performed within the country, it would be taxable.

The tax must be withheld at the time it is settled, credited, or made available to the non-domiciled person; it must be paid within 15 calendar days of the immediately following month.

Currently, Costa Rica has no treaties for the avoidance of double taxation with other states.

The following table shows the rates of withholding tax applicable to different types and sources of income.

<b>Item</b>	<b>Withholding Tax Rate (%)</b>
Transportation and communications.	8.5
Pensions, old-age pensions, salary, and any other payment associated with work.	10.0
Fees, commissions, and any other service supplied in the absence of a working relationship (professional service)	15.0
Any type of insurance premium.	5.5
Use of motion pictures, movies for television, recordings, playing records, comic strips, and, in general, any similar distribution of images or sounds, including the use of international news broadcasts.	20.0
Radio and television soap operas.	50.0
Profits, dividends, or social participations.	15.0 or 5.0*
Interests, commissions, and any other financial expenses.	15.0**
Financial, administrative and technical assistance; payments for licenses, formulae, trademarks, franchises, and royalties.	25.0
Any other Costa Rican source not considered above.	30.0

**Notes**

- \* The 5-percent withholding tax applies to distributions resulting from shares traded and acquired in a recognized local stock exchange
- \*\* Taxes are not applicable to interest, commissions, and other financial expenses paid by domiciled entities to banks abroad or financial entities registered with the Costa Rican Central Bank, including payments made for those purposes to foreign suppliers as a result of the importation of merchandise.

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