Taxation of cross-border mergers and acquisitions

Costa Rica

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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 have been discussed for several years, but proposed modifications have not been enacted.

As a consequence, Costa Rican tax legislation includes little regulation of merger and acquisition (M&A) transactions. The most important regulation, particularly for 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 undue 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.

— Tangible assets subject to depreciation are transferred.

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

— 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 serve as the basis for the resolution.

— The merging entities should then discuss and approve the plan of merger by holding extraordinary shareholders' meetings.

— According to a recent amendment to the Consumer's Defense Law, the plan of merging entities must be submitted to the Promotion of Competition Commission for approval countersigned by the Ministry of Economy, Industry and Commerce, in cases where the assets or revenue of the merging entities exceed a specific amount (approximately 15.9 million US dollars (USD)).

— A notary public then must notarize the shareholder resolutions. 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.

The effects of the merger for legal purposes may take place 1 month after the publication in the Gazette and registration with the Public Registry.

Asset purchase or share purchase

Although capital gains are excluded from gross taxable income in Costa Rica in principle, where the gain is derived from a for-profit activity or related to the disposal of depreciable assets for consideration above their book value, the transaction is taxable.

For this reason, the purchase of shares of a local entity is common in Costa Rica because it may have more beneficial tax consequences than buying assets. Depending on the circumstances, this is usually more beneficial for the seller than the buyer. Income is subject to tax in Costa Rica where it is generated by performing an activity, using goods 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

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of a habitual activity for the seller. Since shares are not depreciable assets, their transfer should not be subject to income tax.

However, where the seller has executed similar transactions in the past, the seller may be deemed to be performing a habitual activity and thus subject to income tax. In this case, income tax is imposed on the difference between the book value and selling price.

Purchase of assets

The most important consequence of purchasing assets is the increase in the tax base for depreciation and potential capital gains. For the seller, any gain derived from the transaction is taxable where depreciable assets are disposed of or where the seller is deemed to be engaged in a habitual activity.

Purchase price

Recently, the Treasury Department and Costa Rica's President issued Executive Decree N° 37898-H, which enacted transfer pricing rules in Costa Rica as of 13 September 2013. Along with the decree, Bill N° 18.679 Evasion Control Law is being discussed in the Congress, so the transfer pricing rules can be included in the Income Tax Law. Currently, the tax courts are applying the transfer pricing rules based on the stipulations of the executive decree.

Goodwill

Article 9 of the 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

Value added tax (VAT) 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 the value reported to the tax authorities, whichever is higher. Typically, both the buyer and 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 1 month of the execution date.

Purchase of shares

Depending on how the purchase of shares is executed and taking into account specific provisions in the regulations to the Income Tax Law, it may be possible to allocate the price paid for the shares to the underlying assets, thus increasing future depreciation for the acquirer. Otherwise, the acquisition as a purchase of shares may lead to the forfeiture of depreciation on the purchase price.

Tax indemnities and warranties

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

Tax losses

According to Article 8G of the 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 5 and 3 years, respectively. Industrial companies that began operations after 1988 are allowed to apply net operating loss carry forwards for 5 years when they start up operations. Losses incurred afterward may only be carried forward for 3 fiscal years.

The tax authorities only accept loss carry forwards where the losses are duly recorded for accounting purposes as deferred losses.

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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 before the transaction.

Where the recipient of the dividend is an individual or a non-domiciled entity, a 15 percent withholding tax (WHT) applies.

Transfer taxes

Under article 272 of the Fiscal Code, stamp tax is due on private documents at a rate of 0.5 percent, generally based on the transaction's nominal value.

Where the transaction is only supported through an endorsement of the shares and the corresponding registration in the company's shareholder register, the stamp tax does not apply. A private contract that is executed in addition to those documents is subject to the stamp tax.

Where 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 contracts 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, and 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. However, immediately after formation, a single party may legally own 100 percent of the shares 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 are very similar to those of corporations.

The most significant differences between limited liability companies and corporations are as follows:

- *Share capital:* Limited liability companies 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:* Limited liability companies 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. By contrast, corporations are headed by a board of directors, which must have at least a president, treasurer and secretary. Typically, the president holds unlimited power of attorney for the company, although the shareholders may limit this power.

Local holding company

A local holding company may be useful since distributions of dividends among local entities are not subject to taxation.

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

Foreign parent company

An acquisition may be implemented using a foreign parent company, but any distribution of dividends from a local entity to a foreign parent is subject to a 15 percent WHT (see group relief/consolidation later in this report). Moreover, where the foreign parent company is a creditor of the local subsidiary, interest payments abroad are also subject to a 15 percent WHT. Most remittances abroad are subject to taxation according to territoriality principle (see the WHT rate table at the end of this report).

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In addition, the deductibility of certain payments to a parent company, regardless of its domicile, is limited to no more than 10 percent of the subsidiary company's gross income. Such payments include payments for interest, royalties, franchises, trademarks and technical advisory services.

Non-resident intermediate holding company

Currently, Costa Rica has only one treaty for the avoidance of double taxation, which was signed with Spain. As a result, 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

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

Joint venture

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 where it is structured as a contractual agreement. Where the joint venture takes the form of a jointly owned company, the parties involved are treated as shareholders of a new entity. The tax courts have stated that tax returns from merging entities must be filed separately.

Choice of acquisition funding

The tax consequences of an acquisition funded by debt or equity are explained below.

Debt

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 is required to compute the conversion into local currency at the end of the fiscal year. The resulting exchange differential accrued during the tax year is recognized as a deductible loss where such liabilities are related to the entity's ordinary course of business.

The deductibility of expenses is subject to the following general 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 as required.
- Supporting documentation must be duly authorized by the tax authorities.

The tax authorities are empowered to reject any expenses treated as deductible where they consider that:

- The expenses are not necessary for generating taxable income.
- The expenses are excessive or unreasonable.
- The expenses do not correspond to the income tax return being filed.
- There is inadequate supporting documentation for the expenses.
- The expenses have not been properly booked in the accounting records.
- WHT has not been withheld (if applicable).

Deductibility of interest

From the perspective of the domiciled entity, interest payable on a loan may be tax-deductible where 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 might include financial statements demonstrating the need 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 closely scrutinize loans granted by related entities or shareholders.

The parties should ensure they have evidence on hand to prove the substance and necessity of the transaction.

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According to the Income Tax Law, a Costa Rican limited liability company may not deduct interest for income tax purposes where the loan was granted by its quota holders (*cuotistas*), as such a loan is considered similar to a distribution of dividends.

Withholding tax on debt and methods to reduce or eliminate it

Where the lender is a non-resident, payments of interest from a domiciled party are subject to a 15 percent WHT.

Where the lender is a non-resident and no WHT was paid on interest received from the local borrower, the tax authorities may reject the borrower's interest deduction and charge the applicable WHT.

Where a local financial institution subject to oversight by the General Superintendency of Financial Institutions pays interest to another financial institution subject to oversight in its country of residence, the WHT rate is 5.5 percent.

Interest paid to a foreign bank that forms part of a local financial group or conglomerate is subject to WHT at the following rates:

- 5 percent for the year 2014–15
- 9 percent for the year 2015–16
- 13 percent for the year 2016–17
- 15 percent for the year 2017–18 and later years.

Interest paid to a multilateral development bank or a bilateral or multilateral development agency, or any others exempted by law, are not subject to WHT.

Checklist for debt funding

- Interest paid to foreign banks and other financial institutions registered with the Costa Rican Central Bank should be exempt from WHT.
- A Costa Rican limited liability company may not deduct interest for income tax purposes if its quota holders granted the loan.

Equity

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. However, 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 be refunded to the shareholders. Since shares do not support the additional paid-in capital contribution (and so 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. It is possible to convert additional paid-in capital into a loan granted by the shareholders. However, this should not be taken to imply that additional paid-in capital could be considered a hybrid instrument under Costa Rican legislation.

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Other considerations

Concerns of the seller

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

Company law and accounting

The 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 with the tax authorities as an ordinary taxpayer at the moment business activities start.
- File an income tax return within 2 months and 15 days of the end of the tax year.
- Keep 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, in chronological order, in Costa Rican colones (CRC) and in compliance with International Financial Reporting Standards.
- Make quarterly advance payments by the last working days of March, June and September. These payments should be calculated on the taxable income of the preceding year or the average of the tax paid in the last 3 years, whichever is higher. Where the taxpayer has not declared any income in the previous year, the quarterly 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 their annual income in January of that 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 2.5 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. Where no other tax is due or a balance remains available after offsetting all other taxes, a refund may be requested, typically in the form of a tax credit balance that may be used to offset future tax obligations, including WHT.
- Respond to any inquiry or information request by the tax authorities. The tax authorities are empowered to audit any taxpayer within the statute of limitations (4 to 10 years, depending on the circumstances of the taxpayer).

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 these obligations.

As noted, current legislation stipulates that the accounting records and the local financial statements must be in Costa Rican colones (CRC). However, for the purposes of reporting to a non-domiciled parent company, the local company can translate its accounting records.

Additionally, in accordance with Article 81 of the Income Tax Law, where the local company carries out operations in a foreign currency that affect its taxable income, the company is obliged to record the transaction for tax purposes in national currency by using the reference exchange rate established by the Central Bank of Costa Rica at the moment the operation took place or the income was received, recording any exchange rate differential gain or loss as a taxable or deductible expense, respectively.

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

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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 WHT where paid to domiciled individual or to a non-resident parent company. However, no WHT applies where 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

As of 13 September 2013, Executive Decree N° 37898-H, which regulates transfer pricing in Costa Rica, is enforced. This Decree is based on the Organisation for Economic Co-operation and Development transfer pricing guidelines on transactions (goods and services) between related parties and follows the arm's length principle. The tax authorities are entitled to apply the comparability analysis/methodology and compel the taxpayer to apply a transfer pricing method that supports the estimated price of the transaction. The decree requires the taxpayer to file a transfer pricing analysis on the related parties' executed transactions annually.

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 from outside Costa Rica generally should not be subject to taxation, although some exceptions apply.

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 WHT 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 company rules.

Legal entity tax

In accordance with the newly published Legal Entity Tax Law, corporations, limited liability companies, branches of foreign corporations and individual limited liability companies that are or will be registered at the Costa Rican Public Registry are subject to an annual tax equivalent to 50 percent of the monthly base salary (approximately USD375) where they are registered as active. Those without commercial activities and inactive before the tax authorities pay the equivalent of 25 percent of the monthly base salary (approximately USD188).

Non-compliance with this tax for 3 consecutive periods is considered as cause for dissolution of the legal entity.

However, the Constitutional Chamber of the Costa Rican Supreme Court deemed that the Legal Entity Tax is unconstitutional for 2016, but did not apply this finding retroactively. Therefore, any non- compliance with the tax that was in effect may still be assessed within the 4-year statute of limitations period.

Comparison of asset and share purchases

Advantages of asset purchases

- Purchase price can be depreciated for fixed assets. Goodwill or intangible assets cannot be amortized for income tax purposes.
- No previous liabilities of the seller are inherited.
- 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), so the price may be higher.

Advantages of share purchases

- In principle, the disposal of shares is not taxable, so 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.
- No consolidation for tax purposes.

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Withholding taxes

Under Article 1 of the Income Tax Law, Costa Rican-sourced income is any income obtained from the provision of services, goods located or funds invested within the national territory. Article 23 of the Income Tax Law establishes which income is taxed at the source by means of tax withholdings, such as salaries, interest, other yields from securities and other passive financial investment income, dividends, payments of Costa Rican-source income paid to non-residents.

Therefore, WHT on remittances abroad arises whenever Costa Rican source income is paid, accredited or otherwise placed at the disposal of non-resident individuals or corporate entities. The source of funds and form of payment are not relevant for tax purposes. Income that derives from activities performed within the country is considered 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 only signed one treaty for the avoidance of double taxation. Law Num. 8888 dated 3 November 2010, published in the Official Gazette Num. 236 of December 6 2010, approved the convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and on capital signed between the Republic of Costa Rica and the Kingdom of Spain.

According to Article 2 of the convention, the treaty applies to taxes on income and capital currently in force, and to any identical or similar taxes that are imposed after the date of signing of the treaty. The treaty covers the following taxes:

— *Spain:* Income taxes on individuals, corporations and non-residents, net wealth tax and local taxes on income and capital, including real estate tax and business tax.

— *Costa Rica:* Income taxes included in Law Num. 7092 and the Securities Market Governing Law Num. 7732 and taxes on capital, including the tax on motor vehicles, boats and aircraft and real estate tax.

A tax treaty with Germany has been signed but has not been ratified by the Costa Rican Legislative Assembly or signed by the German government. When this treaty will enter into effect has not yet been announced.

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