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Recent Developments in International Taxation

Costa Rica

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Executive summary

There have not been any major tax reforms recently in Costa Rica. Nevertheless, there has been an important change to the criteria used to consider extraterritorial income as subject to tax in Costa Rica based on entities considered 'qualified' entities or 'non-qualified' entities.

Taxation of foreign source passive income

The Costa Rican (CR) tax system is based on the 'territoriality principle', whereby only income derived from CR sources is subject to income tax. Income tax is imposed on occasional and continual revenue derived from CR sources by legal entities and individuals within the national territory, regardless of the citizenship or residence of the recipient of such income. CR source income is defined as any income derived from services rendered, goods located and investments used within the CR territory.

In February 2023, the Council of the European Union (the 'Council') included Costa Rica in the list of non-cooperative jurisdictions based on the lack of taxation of passive income generated abroad. The Council considered that the territorial principle that governs the CR tax system promotes double non-taxation of income generated abroad. In addition, in order to be removed from said list, the country had to approve a reform that included the taxation of foreign source passive income in specific cases.

A bill of law to amend Article 1 of the Income Tax Law to tax foreign passive income was introduced to the CR Congress, and in September 2023, it was approved. The main purpose of this approval was for the country to be removed from the Council's blacklist, and essentially, it established that, exceptionally, passive income generated by CR companies abroad would be taxable with capital income tax with a 15 per cent rate.

For extraterritorial source income to be taxed, two essential requirements must be met: (1) the company that generates said income must belong to a multinational group; and (2) the company is considered 'not qualified'.

Regarding the first of these requirements, in accordance with Article 2 quater of the Income Tax Law, a CR entity belongs to a multinational group when the company is included in the consolidated financial statements of the group for presentation purposes, in accordance with

the accounting principles generally applied in the jurisdiction of the ultimate controlling entity of the group; would have been included if the entity were required to prepare such statements; should be included in them, if the equity interests in said entity were registered in a public securities market; or, configuring the inclusion hypotheses established in the previous paragraph, is excluded from the group's consolidated financial statements solely for reasons of size or relevance.

Additionally, to determine whether a company is considered 'qualified' or 'not qualified', economic substance analysis must be performed. In this sense, Article 2 bis of the Income Tax Law establishes that a qualified entity is understood to refer to 'taxpayers who have adequate economic substance in Costa Rican territory, during the fiscal period'. Likewise, this article indicates that an analysis of economic substance must be carried out for each investment made abroad and not for the company as a whole. Additionally, the following three requirements must be met simultaneously: (1) the employment of human resources consistent in number, qualification and remuneration to manage investment assets and adequate resources or infrastructure for the development of this activity in the national territory; (2) strategic decisions and bearing risks in the national territory; and (3) incurring expenses and costs in relation to the acquisition, holdings or disposal, as the case may be.

In addition to these three requirements, it is important to take into consideration the type of activity or investment that the CR company has abroad. This is important because Article 2 ter of the Income Tax Law indicates that entities whose main activity is investment in other companies, whether CR companies or companies abroad, will be considered, by themselves, qualified companies, even if they do not comply with the requirements indicated above.

Specific anti-abuse rule

Costa Rica incorporated a general anti-abuse rule into the Tax Code after a reform that entered in force in July 2019. However, the Council requested a specific anti-abuse rule to be included in the Income Tax Law, linked to the considerations to categorise a company as a 'qualified entity', and as such, not subject to taxation on foreign source passive income.