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USA Taxation of the American Owners of *Sociedads Anomina* and *Sociedads de Responsibilidad Limitada* Formed in Costa Rica

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Since the original writing of this memo, certain pending Costa Rican tax legislation was defeated. The existing Costa Rican law generally provides for no taxation on capital gains regardless of holding period. One of the proposed changes in the new law is the imposition of a 15% income tax on capital gains. Under either the current or the proposed new law, depreciable assets such as rental property are *not* capital assets. Further, gains from the habitual sale of otherwise capital assets are subject to the highest marginal income tax rates under either the current or the proposed new law. (Prior to 2018.)

Many people owning property or businesses in Costa Rica do so through the use of *Sociedad Anomina* and *Sociedad de Responsibilidad Limitada* formed under the laws of Costa Rica. The question always arises as to how USA owners of these Costa Rican enterprises are taxed.

First, one must have a general overview of how corporations, partnerships and their owners in the USA are subjected to the USA income tax regime.

Generally, a USA corporation incurs a USA income tax at a top marginal rate of 35%. When it pays a dividend to its owners, its owners pay a second income tax on the cash dividend received at a top marginal rate of 35%.[i] This results in an effective top marginal rate of nearly 58% on USA corporate earnings.[ii] In some cases, the effective top marginal rate on corporate earnings is 45% through the year 2010.

On the other hand, partnerships, limited liability companies and limited liability partnerships incur no USA income tax at the entity level. Rather, their income, gains, deductions, losses and other attributes are taxed one time within their owners' USA income tax returns. This results in a single income tax at a top marginal rate of 35% plus the additional tax benefits available to individual owners some of which are briefly outlined in footnote 1. The tax savings are considerable ranging from 10% to 43% without consideration of the time value of money.

When an enterprise organized under laws other than the USA is "controlled" by USA persons (individuals, corporations, partnerships, trusts, etc.), a special set of rules apply. USA persons are defined as its citizens regardless of residency including, among others, non-USA citizens holding a USA greencard. *See also*, www.ChappleBlondet.com under Resources for a memo concerning this issue after the issuance of new rules on 22 April 2005.

In order to determine the USA taxation of a non-USA enterprise, one must first determine if the non-USA enterprise is viewed as a "corporation" for USA income tax purposes. With respect to Costa Rica, a *Sociedad Anomina* or "SA" is always viewed as a corporation for USA income tax purposes. A *Sociedad de Responsibilidad Limitada* or "SRL" is viewed as a corporation for USA income tax purposes unless a certain election is filed with the USA Internal Revenue Service. If the election is filed, the SRL will be ignored as a separate legal entity for USA income tax purposes if it has only one owner. The electing SRL will be viewed as a partnership if it has more than one owner.

In the case of a SA, one must then determine whether it is controlled by USA persons. Control is a complex issue in terms of the USA tax law. Generally, for this purpose, a SA is controlled by USA persons[iii] if more than 50% is owned by USA persons for an uninterrupted 30 day period. The calculation of control is done twice – once using voting rights and a second time using fair market value. If either calculation exceeds 50%, the SA is viewed as controlled by USA persons. Ownership can be indirect as well as direct.[iv]

Assuming the SA is ***not*** controlled by USA persons, the USA owners include in their otherwise USA taxable income, dividends only when actually paid by the SA. In other words, the circumstance looks no different than the taxation of a USA corporation and its owners. Of course, in this circumstance the SA files no USA income tax return and pays no USA income tax. The SA does, however, pay income tax to Costa Rica and, generally, withholds 15% of any dividend sourced in current and accumulated earnings paid to a natural person or a legal entity organized outside of Costa Rica.

Assuming the SA is controlled by USA persons, a complex set of rules known as "Subpart F" come into play. Subpart F requires the current inclusion in the USA owner's USA taxable income of their pro-rata share of so-called Subpart F income belonging to the SA, whether or not that income is distributed to its owners in cash.

Specifically ***not*** included in Subpart F income is income arising from typical business operations such as a factory or trading business like Proctor & Gamble. Thus, for example, assume a USA person owns 100% of ABC Food Market, SA in Costa Rica. The USA owner would typically have no or very little Subpart F income included in their annual USA taxable income. Rather, they would include in their USA taxable income dividends from ABC Food Market, SA only when received in cash.

However, some items of Subpart F income include, but are not limited to:

- Dividends and interest received by the SA.

- Certain, but not all, rental income.

- Gains, net of losses, from the sale or exchange of property which does not produce current income.

Most American owned Costa Rican SAs do not operate food markets. Rather, these SAs own Costa Rican real estate and, often, nonincome producing real estate such as homes or unimproved land.

In other circumstances, Subpart F income is, typically, created in the USA controlled SA in the form of the gain upon the sale of true investment real estate, gain on sale of securities and interest or dividend income.

A person or legal entity which is a developer of real estate will typically be viewed as dealer for USA income tax purposes and a habitual seller for Costa Rican income tax purposes. Once this status arises, the income, gains and losses from the sale of real estate including raw land are no longer capital in nature. Thus, the gains no longer receive the preferential 15% USA income tax rate or the nontaxable status under Costa Rica's income tax law. Rather, these gains are subjected to the highest marginal income tax rates by both countries. On the other hand, the income arising from real estate development activity in Costa Rica in an SA or a nonqualified SRL controlled by Americans is not Subpart F income.

Gains arising from the sale of land or other capital assets, as defined in the USA law, owned by individuals or partnerships would typically be taxed at rates up to 15% assuming the asset is owned for **more than one year**. However, by operation of Subpart F, the gain associated with the sale of these same assets owned by a SA controlled by USA persons is taxed at the much higher rates up to 35%.

You should be aware that liquidation and dissolution of the Costa Rican SA with a transfer of its assets to an SRL with a special election does not solve the problem *per se*. The liquidation and dissolution process is treated as if the SA sold all of its assets net of liabilities at “true” or “fair market” value. This triggers all of the unrealized built in gains and the operation of the adverse impact of the Subpart F regime.

The USA also has certain income tax provisions known as the "foreign tax credit regime". In general, the USA allows its citizens and residents to credit all or a portion of certain income taxes paid to another country where that income earned outside of the USA is also subjected to income tax by the USA.[v] All of the foregoing must be addressed in each circumstance before one applies the foreign tax credit regime. However, the first condition to qualify for the benefits of the USA foreign tax credit regime is the taxpayer must be a USA person.[vi] A Costa Rican SA is not a USA person. Thus, no foreign tax credit is available for the Costa Rican income tax paid by the SA when the SA's income is, by mere sleight of legislative hand, subjected to USA income tax. Thus, 30% in income tax is paid to Costa Rica, 15% withholding tax is paid to Costa Rica ***and*** 35% is paid to the USA on ***all*** income. This results in an effective global income tax of about 61%.[vii] The only question is when – now through operation of Subpart F or later when the SAs earnings are paid to its owners in the form of a distribution in the nature of a dividend or upon liquidation.

In some circumstances, the Costa Rican withholding tax is creditable against USA income tax while in other circumstances it is not.

Costa Rica has two withholding tax regimes. The withholding rate in both cases is 15% on dividends sourced in the current and accumulated earnings of either a SA or a SRL.

One regime applies to residents of Costa Rica. A resident of Costa Rica is defined as a person who is physically present in Costa Rica for more than 180 days in a year regardless of one's status with respect to Costa Rica's immigration system. We refer to this as the inbound withholding regime. This 15% withholding on dividends paid is assessed on the individual owner and not on the SA or SRL. Thus, it is a creditable tax with respect to the USA foreign tax credit regime.

The second regime applies to people who are not residents of Costa Rica. We refer to this as outbound withholding. With respect to American citizens, Costa Rica may waive this withholding upon application of a request to do so before the dividend is paid. Because Costa Rica has discretion to waive this withholding, it is not creditable against an American's USA income tax.

An SRL which has not made the appropriate election with the Internal Revenue Service is treated exactly like an SA for all USA income tax purposes. However, an SRL ***with*** the appropriate election effectively becomes a USA taxpayer and, thus, the USA foreign tax credit regime is available to it by means of its adoption of the identity of its USA owners. Further, an electing or qualified SRL[viii] is not a corporation for USA income tax purposes, and, as such, the Subpart F regime does not apply to it. As a result, it pays income tax once at the higher of the Costa Rican or USA income tax rates. Under current law, there would be an effective global income tax at rates ranging from 15% to 35%, admittedly due as the income is earned.

The discussion above addresses only the USA Federal or national income tax. USA persons who remain residents in the USA may also be subjected to state and city income taxes. Often, the USA states' and cities' income tax regimes mirror the Federal or national regime but, thankfully, with lower rates.

Following is a chart showing the various outcomes assuming top marginal income tax rates apply for both USA and Costa Rican purposes:

	Outbound Costa Rican Withholding Waived		Outbound Costa Rican Withholding Not Waived		Inbound Costa Rican Withholding	
	SA and Nonqualified SRL SRL	Qualified SRL	SA and Nonqualified SRL	Qualified SRL	SA and Nonqualified SRL	Qualified SRL
Profit	1,000	1,000	1,000	1,000	1,000	1,000
30% Costa Rican income tax	300	300	300	300	300	300
Profit after Costa Rican income tax	700	700	700	700	700	700
Outbound remittance withholding (15%)	0	0	105	105	105	105
Net profit after Costa Rican taxes	700	700	595	595	595	595
Calculation of USA Federal income taxes:						
Profit before income taxes	1,000	1,000	1,000	1,000	1,000	1,000
Noncreditable Costa Rican withholding and income tax	300	0	405	0	300	0
Taxable profit	700	1,000	595	1,000	700	1,000
USA income tax before foreign income tax credit	245	350	208	335	245	335
Foreign tax credit	0	300	0	335	105	335
USA income tax	245	50	208	0	140	0
Net profit after all withholding and income taxes	455	650	387	595	455	595
Excess foreign income tax credit	0	0	0	55	0	55
Effective global income tax rate	55%	35%	61%	41%	55%	41%

Definitions and translations are critical to understanding. Perhaps, this should have been the first discussion in this letter. To translate SA or SRL as a "corporation" in American English[ix] is perfectly fine for conveyancing and general counsel in Costa Rica and the USA. However, those of us who are tax specialists need to use greater care:

1. A Costa Rican SA is, in fact, a “corporation” in American English.

2. A Costa Rican SRL is not a “corporation” in American English. Rather, it is a “hybrid entity”.

    a. With a certain election filed with the Internal Revenue Service within 75 days of its formation and obtaining a USA Federal identification number, it is a “partnership” in American English when it has ***more than one owner***.

    b. With a certain election filed with the Internal Revenue Service within 75 days of its formation and obtaining a USA Federal identification number, it assumes the identity of its owner when it has ***a single owner*** and is known as a “disregarded entity” in American English.

    c. Without the necessary election filed with the Internal Revenue Service, it is a “corporation” in American English.

The foregoing definitions of Costa Rican legal entities are specifically and explicitly defined within the USA regulatory law.

Global law is filled with exceptions and nuances. The issues in this letter are truly the subject of multiple treatises. Thus, it is not possible to cover all factual possibilities or the plethora of exceptions or other overriding rules which might exist with respect to specific taxpayers. **Extrapolating these general comments to specific circumstances should be done with great professional care**.

[i] Like Costa Rica, the USA uses graduated tax rate schedules for both individuals and corporations. The USA income tax rate schedules tend to rise in larger monetary increments than Costa Rica’s current system. In addition, there is the USA alternative minimum tax regime or “AMT” which also applies to both individuals and corporations. The AMT is a true flat tax or single rate regime applied to a different calculation of taxable income. All Americans pay the

higher of the two calculations. In addition, the net gains from the sale of capital assets held more than one year and certain dividends received by individuals (not corporations) received through 2010 are taxed at rates not to exceed 15%. The dividends paid by a Costa Rican *sociedad anomina* or *sociedad de responsibilidad limitada* to its USA controlling owners do not qualify for this lower 15% rate. There are other special tax calculations and rates.

[ii] Effective top marginal income tax rates are not always purely additive. In this circumstance, the USA corporate income taxes are effectively deductible when calculating the total USA income tax on a corporation and its owners. Hence, the effective USA income tax is slightly less than 35% plus 35% or 70%.

[iii] Please remember that USA persons are not limited to USA citizens. Again, USA persons include, among others, USA greencard holders even if they do not physically reside in the USA.

[iv]The definition of control in the USA tax law differs depending on the particular provision in question. Thus, the definition applied in this circumstance may not apply with respect to another issue.

[v] In general, the USA foreign tax credit attempts to implement the policy of requiring the American taxpayer to pay the higher of the USA or non-USA income tax on income subjected to taxation by both the USA and another country. However, it is not necessarily possible to simply compare another country's tax rate schedule to the USA tax rate schedules in order to make this determination. *E.g.,* Costa Rica's current tax rate schedule ramps up much more quickly than the USA schedule. This circumstance could, in theory, result in a higher effective Costa Rican income tax despite the fact that its top tax rate is 30% and the USA's top tax rate is 35% on most income.

[vi] A USA person for USA tax purposes is variously defined in the USA tax law. These definitions include, but are not limited to, USA individual citizens and corporations and other legal entities organized under the laws of the USA.

[vii] The effective rate is not quite additive or 80% because the Costa Rican income and withholding tax is effectively deducted before calculating the USA income tax.

[viii] As used here, a "electing" or "qualified SRL" means one which has timely filed an election with the USA Internal Revenue Service to be taxed as a disregarded entity or partnership. A "nonqualified SRL" is one which has not filed such an election.

[ix] We explicitly refer to "American" or USA English as Canada, the United Kingdom or other English speaking jurisdictions will differ in their view of these same or similar issues.