Council of the European Union

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OUTCOME OF PROCEEDINGS

From:	General Secretariat of the Council
To:	Code of Conduct Group
Subject:	Costa Rica's Manufacturing activities under the amended Free Zones regime (CR002) – Final description and assessment

ROLLBACK REVIEW PROCESS (SEPTEMBER 2019)

Costa Rica, which had committed to amend or abolish the harmful features of its Free Zones regime (CR001-CR002) by end 2018, was granted an extension until end 2019 to adapt its legislation considering that: 1- it had demonstrated tangible progress in initiating these reforms in 2018, 2- this regime covered manufacturing activities, and 3- Costa Rica is a developing country. The ECOFIN Council had indeed agreed in this respect to consider "*the heavier economic impact of these* [manufacturing regime] *reforms on such countries*" (Council conclusions of 12 March 2019, paragraph 7.1[1]).

[1] https://data.consilium.europa.eu/doc/document/ST-7441-2019-INIT/en/pdf

On 24 May 2019, Costa Rica's Legislative Assembly approved the legal reform to remove the cap on local services sales and ensure that they receive a tax treatment equivalent to that granted to services exports under the regime. This reform was published in the official journal La Gaceta four days later (referenced as Law number 9689):

http://www.pgrweb.go.cr/scij/Busqueda/Normativa/Normas/nrm_texto_completo.aspx?param1=NRTC&nValor1=1&nValor2=88862&nValor3=116341&strTipM=TC

On 4 June 2019, Costa Rica furthermore reformed its Bylaws to address the ring-fencing element identified (administrative requirement to report local services sales projections). This reform was published in the official journal La Gaceta on 19 June 2019 (referenced as Executive Decree number 41783-H-COMEX):

http://www.pgrweb.go.cr/scij/Busqueda/Normativa/Normas/nrm_texto_completo.aspx?param1=NRTC&nValor1=1&nValor2=88997&nValor3=116620&strTipM=TC

These amendments were reviewed by the OECD Forum on Harmful Tax Practices (FHTP) at its 19-21 June 2019 meeting, which concluded that they are not harmful. The COCG endorsed the rollback of the harmful features of the CR001 regime at its meeting of 10 July 2019.

Considering that these legislative amendments also addressed the manufacturing activities falling under the free zones regime (CR002), the COCG concluded at its meeting of 13 September 2019 that Costa Rica had also rolled back the harmful features of the CR002 regime. This conclusion was endorsed by the ECOFIN Council on 10 October 2019.

Annex 1: Assessment of the old CR002 regime in 2018 (standstill review)

Annex 2: Assessment of the old CR001 regime in 2017 (standstill review)

Annex 1: assessment of the old CR002 regime in 2018 (standstill)

Gateway criterion - Significantly lower level of taxation:

"*Within the scope specified in paragraph A, tax measures which provide for a significantly lower effective level of taxation, including zero taxation, than those levels which generally apply in the Member State in question are to be regarded as potentially harmful and therefore covered by this code*"

The standard corporate income tax rate is 30%. Companies applying to the regime receive a full tax exemption on CIT. The measure therefore provides for a significantly lower level of taxation and is potentially harmful under the Code.

Assessment:

	1a	**1b**	**2a**	**2b**	**3**	**4**	**5**
Costa Rica– Free Trade Zones	V	?	V	?	X	X	X

V = harmful
X = not harmful

Explanation:

Criterion 1 – Targeting non-residents:

"*whether advantages are accorded only to non-residents or in respect of transactions carried out with non-residents*"

Art. 17 of Law 7210/1990 excludes resident companies from the companies that the beneficiaries of the regime can have transactions with.

Criterion 2 – Ring-fencing:

"*whether advantages are ring-fenced from the domestic market, so they do not affect the national tax base*"

The considerations under criterion 1 can apply by analogy to criterion 2.

Criterion 3 - Substance:

"*whether advantages are granted even without any real economic activity and substantial economic presence within the Member State offering such tax advantages*"

According to the standard practice for the evaluation of a measure against criterion 3, a measure is found harmful under this criterion if there are no specific requirements with regard to real economic activities and notably any requirement with respect to employment obligations.

The measure includes explicit requirements for real economic activity or substantial economic presence, in particular with regard to job creation.

Criterion 4 – Internationally accepted principles:

"*whether the rules for profit determination in respect of activities within a multinational group of companies departs from internationally accepted principles, notably the rules agreed upon within the OECD*"

The measure does not contradict any internationally embraced principle.

Criterion 5 - Transparency:

"*whether the tax measures lack transparency, including where legal provisions are relaxed at administrative level in a non-transparent way*"

All preconditions necessary for the granting of a tax benefit should be clearly laid down in publicly available laws, decrees, regulations etc. before a measure can be considered transparent.

The measure is fully set out and published in the relevant legislation and the practice should not involve any administrative discretion.

Grandfathering

Costa Rica did not avail itself of any grandfathering period.

Overall Assessment

In the light of the assessment made under all Code criteria, the regime should be considered harmful under the Code of Conduct. However, considering that the regime concerned covers mainly non-highly mobile activities such as manufacturing, further aspects could be taken into account.

It was agreed that in certain cases it should be possible to allow further time for a jurisdiction to adapt its legislation. An assessment was to be made on a case-by-case basis using a set of criteria. The analysis was agreed to take into consideration the following elements:

a) the level of cooperation of the jurisdiction, in particular whether the jurisdiction has made genuine efforts throughout 2018 to achieve a reform of its manufacturing regime;

b) in terms of timing, the existence of a clear timetable to stop the harmful elements of the regime.

c) in terms of substance, the evidence provided by the jurisdiction (in 2018) of tangible steps that will be taken to remove the harmful features, such as aligning the rates or removing the ring-fencing aspects. Such steps should for example be part of a public reform program or be announced publicly by the Government in order to be considered as tangible; a new commitment letter as such could hardly be considered as tangible progress.

In the case of Costa Rica it is clear that:

a) There has been extensive exchanges and a cooperative approach. Costa Rica has regularly been in touch with the Commission Services to discuss the reform and provide updates. Part of the reform of the regime is already in force.

b) The Forum for Harmful Tax Practices (FHTP) concluded that Costa Rica's regime is not harmful, subject to the adoption of the legislation. Costa Rica committed to passing the relevant legislation by April 2019.

c) Costa Rica has also shared the details of the legislation that still needs to be adopted. The amendments will bring the regime in line with the Code of Conduct. In particular the ring-fencing features will be addressed removing the maximum threshold imposed on exports in the domestic market, ensuring an equivalent income tax treatment for domestic transactions, and removing the additional administrative burdens in terms of reporting and approvals requirements before local sales can be made. The ring-fencing features will be removed as of the entry into force of the amending legislation and no grandfathering will be provided to existing taxpayers. The draft bill also introduces a new requirement (i.e. the Strategic Eligibility Index for Services Firms (SEISF)) for firms interested in operating in the Free Trade Zone Regime under category c) of Article 17 of the FTZ law. This is designed to ensure the regime attracts business activity that is of strategic value for the Costa Rican economy. The definition and components of this index will be developed and specified in the Regulation to the FTZ law which is in the process of been drafted and will be shared with the FHTP in due course. The new requirement will not be operational until the regulation is issued and it will apply to all new entrants immediately after the regulation is enacted. In the period between the enactment of the Law and the Regulation, there would not be any new firms under category c) of Article 17 of the FTZ law.

Annex 1: assessment of the old CR001 regime in 2017 (standstill)

Category:

Special economic zones

a. Description

The Free Trade Zone Regime (FTZR) is defined in Costa Rica as a set of incentives and benefits granted by the country to companies making new investments and complying with local requirements and obligations. Companies that benefit from this regime establish their operations on Industrial Parks, which are specific areas (FTZ), strictly destined to this kind of industries and companies. An authorization may be obtained for a company to establish its operations or part of such operations outside a Free Trade Zone, but these are exceptional cases.

This regime leads to an exemption from all taxes on profits, as well as any other which taxable base is determined on the basis of the gross or net profits, the dividends paid to shareholders or income or sales. The exemption shall be 100% for a term of 8- 12 years (depending on the location of the company if it is inside the Gran Area Metropolitana Ampliada or not), followed by a 50% exemption for the following 4-6 years.

The FTZ regime is open to manufacturing companies either exporting or not, whereas export requirements still apply to service companies, 50% of services must be exported. This regime is also applicable to significant suppliers who supply 40% of sales to FTZ companies.

Sources: Lang & Asociados, OECD Economic Surveys, Costa Rican Investment Promotion Agency

http://www.therealcostarica.com/costa_rica_business/import_export_costa_rica.html

b. Preferential:

Yes, tax exemption. Whereas the normal CIT-rate is 30%.

c. Possible concern:

Ring-fencing because companies need to export 50% of their services in order to apply for the Free Trade Zone System Regime.

d. Assessment by the FHTP:

Free trade zone regime was assessed by the FHTP in September 2017 meeting as in the process of being amended