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OUTCOME OF PROCEEDINGS

From:	General Secretariat of the Council
To:	Code of Conduct Group (Business Taxation)
Subject:	Costa Rica's Foreign source income (FSIE) regime (CR003) – Final description and assessment

STANDSTILL REVIEW PROCESS (SEPTEMBER 2021)

Costa Rica committed to reform its FSIE regime within a timeline that will permit adoption of the necessary legislation by the end of 2022. Costa Rica also committed not to availing of any grandfathering, as requested by the COCG.

The Code of Conduct Group meeting of 21 September 2021 acknowledged the commitment of Costa Rica. This conclusion was endorsed by the ECOFIN Council on 5 October 2021.

Annex 1: Assessment of the CR003 regime

ANNEX 1

Assessment of the CR003 regime (standstill)

Assessment of FSIE regime

	1a	1b	2a	2b	3	4	5
Costa Rica– FSIE	V	?	V	?	V	V	V

V: Harmful; X not harmful

Gateway criterion – Significantly lower level of taxation:

Costa Rica imposes profit tax at a general rate of 30% on business income[1]. Profit tax is levied on residents' income from Costa Rican sources, i.e. from services provided, goods located or capital used in Costa Rican territory. Income is considered foreign sourced if it is generated under contracts, agreements or negotiations on goods or capital located abroad.[2] Exceptionally, income tax is levied on certain categories of foreign-sourced income and in particular (i) interests and commissions on loans used in Costa Rica, (ii) income from export of goods, (iii) income from international transport and communications.

The ITL provides that profit tax is levied on business income from Costa-Rican sources at a general rate of 30% and conversely no tax is levied on foreign source income.

As the Code of Conduct looks at the effects that tax legislation may have on the location of business activities in general terms, a full tax exemption may be regarded as one of the reasons for a business to establish in one jurisdiction over another. In this sense, the provisions are relevant for the Code.

[1] Income tax is imposed according to Law N° 7092 of 1988 (Income Tax Law and hereinafter "ITL") and Executive Decree N° 18445 (Regulation and hereinafter "ITR").
[2] Unofficial translation provided by the Costa Rican authorities of art. 1 ITL.

The Code of Conduct uses a broad term (‘*tax measures*’) to describe what should be assessed under its criteria. This definition is not limited to specific pieces of legislation nor does it circumscribe the meaning of what should be intended as a ‘tax measure’. In the specific case of the measures of the ITL, it is relevant to take into account the general tax system to understand if the legislation provides for a significantly lower level of taxation. This is the case here, as certain types of income with foreign source are exempted from taxation. The provisions are therefore potentially harmful and should be evaluated under the Code.

Criteria 1 and 2 – Targeting non-residents and Ring-fencing

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

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

The exemption from taxation of foreign source income applies only in respect of transactions carried out with non-residents and it does not affect the national tax base. Such exemption is by its nature targeted to non-residents and ring-fenced. We would therefore propose a tick (“V” – harmful) for criteria 1.a and 2.a.

As regards criteria 1.b and 2.b, Costa Rica informed that as of February 2020 there are 413,669 registered legal entities and around 3,000 thereof may have foreign-sourced income, taking into account their activities (e.g. holding, financial, investment/fund management). The overall non-taxable income of these entities in 2018 was around €11 billion. There is no specific estimate of the foreign sourced income and no data have been communicated on the total income of these entities. We would propose a question mark (“?” – Insufficient information under the criterion) for criteria 1.b and 2.b.

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 criterion 3, a measure is found harmful under this criterion if there are no specific requirements with regard to real economic activities. According to the guidance on FSIE regimes, an evaluation shall focus primarily on passive income and namely if there are conditions or safeguards to prevent ring-fencing and lack of substance. Exemption of passive income without clear conditions (e.g. explicit link to some real activity in the jurisdiction) would be found to contravene the principles of the Code. With regard to active income, the guidance requires to consider if and how it is taxed and in particular if the domestic PE definition is in line with the OECD Model Tax Convention.

<u>*Requirements for passive income*</u>

ITL does not distinguish between active and passive income from the perspective of the application of the FSIE. According to ITL, passive income deemed foreign-sourced is exempt from tax in Costa Rica, with a few exemptions, i.e. interests and commissions on loans used in Costa Rica, export of goods, telecommunications and transport. There are no other conditions in the law in this respect and namely no economic substance requirements are in place for such income.

However, administrative doctrine and jurisprudence have been clarifying the ITL provisions in the sense that passive income linked to an economic structure/producing source in Costa Rica should be considered sourced in Costa Rica and therefore be taxable. In particular, inbound passive income, e.g. interest and royalties, is considered sourced in Costa Rica if the recipient carries out business activity in Costa Rica and the income received from abroad results from such business activity.

The source of passive income is determined by the taxpayer in the annual tax return. Costa Rica informed that there is no specific procedure for the identification of a foreign income source, which is to be identified *a contrario* and by reference to the criteria set by administrative doctrine and jurisprudence. Taxpayers can opt to use a bilateral consultation procedure with the tax authority, which can specify the criteria applicable in the specific case based on the evidence produced by the taxpayer. The type of evidence required or deemed appropriate has not been specified.

Anti-avoidance rules

The Tax Code includes general anti-avoidance provisions to the effect that simulated acts or businesses through which taxpayers reduce or eliminate their tax liability are illegal. Additional general anti-avoidance provisions have been recently introduced[3] by virtue of legislation aiming to strengthen public finances.

Furthermore, there are specific anti-avoidance provisions aiming to prevent a circumvention of the PE status in Costa Rica and thin capitalisation.

<u>Conclusion</u>

According to administrative doctrine and jurisprudence, passive income from foreign source is taxable in Costa Rica to the extent it is linked to business activity in Costa Rica. However, this is not explicit in ITL but arises from its administrative and judicial interpretation. There is no specific procedure to determine the source of the income but taxpayers can seek a consultation with the tax administration on their specific case. There is also no clear indication of the evidence required from the taxpayer in relation to the income source. These circumstances may give rise to a margin of discretion of the authorities, with which lies the final determination. In addition, for the exemption to apply, no specific conditions are required to be met by the taxpayer (e.g. regarding evidence of taxation abroad and/or connection with a real activity in Costa Rica) other than the self-assessment.

While there are general and specific anti-avoidance rules in place in Costa Rica, these are not sufficient to tackle the specific risks of double non- taxation and lack of substantial activities in Costa Rica linked to income exemptions as above. Therefore, we propose a tick ("V" – harmful) for this criterion.

[3] In particular, Law 9635 (Law to Strengthen Public Finances) came into force 1.1.2020 providing that providing that "When acts are performed and individually or as a whole are artificial or improper for obtaining the results achieved, the applicable consequences to the parties that intervened in such acts will be those that correspond to the usual or proper acts for obtaining the results that has been achieved. 2. The preceding provision will only be applicable when the artificial or improper acts do not have relevant economic or legal effects, except for tax savings."

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*"

<u>*Permanent establishment definition*</u>

According to ITL, "permanent establishment" means any fixed business site or place in which is performed, totally or partially, the essential activity of the domiciled person. It includes especially: administrative centres, branches, agencies, offices, factories, workshops, mines, quarries and any other places for extraction of natural resources.

Apart from provisions inspired from the OECD Model, the PE definition also endorses elements of the UN Model, e.g. supplies of services or deliveries of goods can constitute a PE if they reach over a certain threshold.

In addition to the above, the definition contains special provisions (i) to clarify how presence of 183 days should be calculated and (ii) on insurance companies. The detailed definition is provided in Annex.

While the domestic PE definition includes elements from the OECD and UN Models it cannot be considered in line with the international standard. The latter recognises a PE (in a fixed place of business) where the business of an enterprise is wholly or partly carried on. Instead, the domestic definition recognises a PE (in a fixed place of business) where the essential activity of the person is carried on. As a result, the Costa Rican definition sets a higher threshold the qualification of non-resident activities as liable to tax in the jurisdiction.

The measures do not contain other elements that would be relevant from the point of view of internationally accepted principles as referred to in criterion 4 of paragraph B of the Code, while Costa Rica is also in the process of ratifying the MLI.

In conclusion, the domestic PE definition cannot be considered in line with international standards, entailing a risk of double non-taxation with regard to active income from foreign source. We therefore propose a tick ("V" – harmful) for this criterion.

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.

Costa Rica's administrative doctrine and jurisprudence have established an economic rather than geographical interpretation to the ITL to determine source of income. However, the relevant criteria are not reflected in the ITL. As a system of self-assessment applies, without further requirements for income deemed foreign sourced, the determination of the source lies with the taxpayer and ultimately with the tax authority in the context of its audit activity. Because of the discrepancy between ITL and administrative and judicial interpretation and the fact that the determination of the source lies ultimately with the authority, with no specific criteria and processes to rely on, we propose a tick ("V" – harmful) for this criterion.

Overall Assessment

In light of the above, Costa Rica's FSIE regime is considered overall harmful.