

Chapter 2

Reforming the corporate tax system in Costa Rica

This chapter discusses the corporate income tax (CIT) in Costa Rica, focusing on CIT rates and the main CIT base provisions including tax depreciation allowances. Corporate effective tax rate (ETR) calculations show the combined impact of CIT provisions on the effective tax burden on investment in Costa Rica. The chapter discusses the debt-equity bias, the taxation of foreign-source passive income and the country's narrow tax treaty network. The chapter analyses whether the tax system creates a tax-induced incentive for foreign direct investment (FDI) in Costa Rica and analyses the impact on the ETRs of the CIT incentives for companies located in the Free Trade Zones (FTZ); the analysis distinguishes between parent companies which are tax resident in a country with a worldwide or a territorial tax system.

Domestic-source profits are taxed at high standard tax rates but raise relatively little revenue

Costa Rica implements a pure territorial CIT system. Resident and non-resident companies are taxed under the CIT on the income which has its source within the country. Any foreign-source income, earned by either resident or non-resident companies, is not taxed under the CIT in Costa Rica; this exemption applies to active and passive foreign-source income. This turns the Costa Rican CIT system into a pure territorial tax system.

Costa Rica levies a high standard statutory CIT tax. The top statutory CIT rate is 30%, which is higher than the standard CIT rate on average in the Latin-America and the Caribbean (LAC) region (26%) and in the OECD (24.7%) in 2016. On average, smaller countries in the OECD tend to implement lower standard CIT rates; Costa Rica implements lower CIT rates only for small and medium size enterprises (SMEs).

Lower CIT rates apply to SMEs. Costa Rica currently implements two reduced CIT rates. The CIT rate is levied on taxable income at a rate of 10% for firms with annual gross income up to CRC 52.32 million; the rate is 20% for firms with annual gross income between CRC 52.32 million and CRC 105.241 million above which the standard 30% rate applies. About half of the OECD countries levy a reduced CIT rate for SMEs, reducing country's CIT rates on average by about 4 percentage points (OECD, 2015a). Reduced CIT rates for SMEs can also be found in some countries in the LAC region (see Table 2.1).

The Costa Rican reduced CIT rate schedule for SMEs has uncommon design features. The reduced CIT rate schedule has multiple reduced rates. The relevant rate is established according to companies' gross income but the tax liability is determined by applying the rate to taxable income. Empirical analysis (Bachas and Soto, 2016) using Costa Rican tax return data has found that the design of the Costa Rican CIT rate schedule has resulted in clear bunching of firms below each of the turnover thresholds; by underreporting revenues, corporations can benefit from a reduced CIT rate levied on their taxable income. There is clear evidence that firms in Costa Rica not only deflate revenues in order to benefit from a reduced CIT rate but also inflate costs to reduce their taxable income.

In fact, using size-based thresholds is not necessarily an effective tool to support investment and may restrain growth. The creation of tax preferences can introduce additional complexity and distortions into the tax system. For example, thresholds limiting tax preferences to entities under a certain size can create barriers to the growth of SMEs. Size-based tax preferences give businesses incentives to remain below the threshold so as to continue benefiting from such targeted regimes, both in terms of reduced compliance costs as well as tax payable (OECD, 2015a). Growing SMEs or larger companies may be incentivised to split up into different companies to benefit from the preferential tax treatment or to engage in deflating revenues and inflating costs. Such regimes may also provide windfall gains to businesses that, for various reasons, may not be likely to invest and grow. Finally, when reduced rates are based on turnover, they tend to penalise low profit-margin business, which end up being taxed at a higher rate than businesses with a lower turnover but higher profits.

Costa Rica plans to significantly reform its reduced CIT rate schedule for SMEs as part of its tax reform proposal. A double test would apply. First, only firms with turnover below CRC 106 million (about EUR 179 000) would benefit from the reduced CIT rate schedule for SMEs. Second, the reduced CIT rate would no longer vary with turnover but with taxable income. The reduced CIT rate would be 10%, 15%, 20% or 25%; the 25% rate would be levied on taxable income exceeding CRC 10 million (i.e. EUR 16 900).

Table 2.1. Statutory CIT rate, withholding tax rates on dividends and interest paid to non-residents and number of tax treaties for a selection of LAC countries

	Statutory CIT rate	Withholding tax rate on dividends	Withholding tax rate on interest	Number of treaties
Costa Rica	10/20/30 a	15	15	2
Belize	25	15	15	13
El Salvador	25/30 b	5	20	1
Guatemala	25	5	10	0
Honduras	25/30 c	10	10	0
Nicaragua	30	7.5 g	7.5 g	0
Panama	25	10 h	12.5 h	16
Dominican Rep.	27	10	10	2
Ecuador	22	0 i	22	19
Uruguay	25	7	12	18
Argentina	35	10	35	19
Brazil	24/34 d	0 j	15	33
Chile	24 e	35 e	4/35 l	32
Colombia	34/40 f	0 k	15 m	13
Mexico	30	10	35	56
Peru	28	6.8	30	11

Notes: a. CIT rates vary by gross income; starting from CRC 105 241,000 the rate is 30%.

b. The general CIT rate is 30%; it is reduced to 25% only when taxable income does not exceed USD 150 000.

c. The general CIT rate is 25%; companies with taxable income exceeding HNL 1 million (about EUR 41 000) are subject to a 5% surtax.

d. The general CIT rate is 15%; in addition, there is a social contribution tax of 9% and a 10% surtax for companies with taxable income above BRL 240 000.

e. The general CIT rate is 24%; dividends distributed to non-residents receive a tax credit for corporate income taxes paid and are subject to a 35% withholding tax.

f. The general CIT rate is 34% (for year 2017). In addition, companies with taxable income above COP 800 million face an additional surtax of 6% (for year 2017).

g. Withholding tax rates on dividends and interest are 15% on 50% of the gross amount.

h. Withholding tax rates on interest are 25% on 50% of the gross amount. Withholding tax on dividends is 10% if the income distributed is Panamanian-source, 5% if it is foreign-source income, and 20% in case of bearer shares.

i. Withholding tax on dividends is zero if paid out of taxed profits and 22% otherwise.

j. Withholding tax on dividends is zero if paid out of taxed profits and 15% otherwise.

k. Withholding tax on dividends is zero if paid out of taxed profits and 35% otherwise.

l. A reduced rate of 4% withholding tax on interest is available for loans granted by foreign banks, insurance companies or financial institutions.

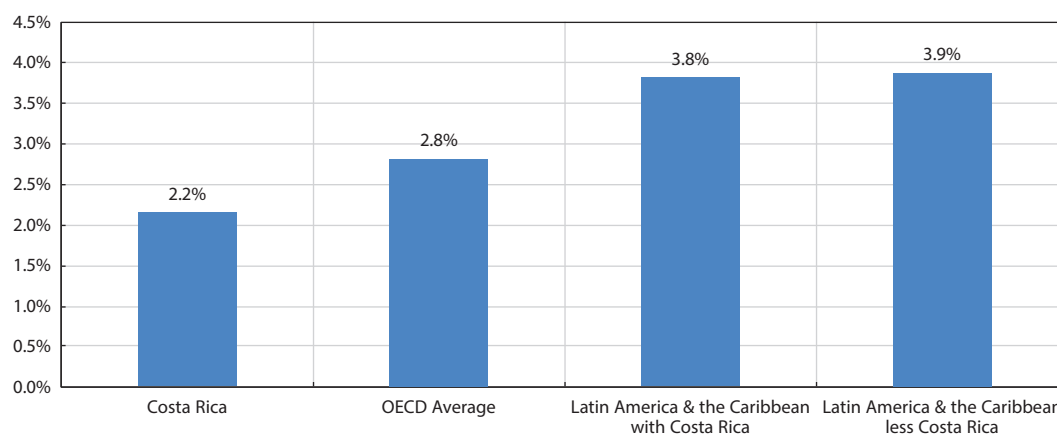
m. Withholding tax rates on interest are taxed at 15%; a reduced rate of 5% is levied on interest payments for loans exceeding a 8-year term for the funding of public infrastructure works under public private partnerships.


Source: Own Research, IBFD.

Costa Rica has very few tax treaties which lower the withholding tax rates on dividends and interest payments to non-residents. In addition to the CIT rate, countries levy withholding tax rates on dividends and interest payments to non-residents; see Table 2.1 for the standard tax rates that apply in a selection of LAC countries. Tax treaties typically apply lower withholding tax rates on dividends and interest payments to non-residents but, as can be seen from Table 2.1, countries differ significantly in the number of tax treaties they have in place. Three countries – Ecuador, Brazil and Colombia – impose withholding tax rates only on dividends paid out of profits which have not been subject to CIT. Among the remaining countries, standard withholding tax rates on dividends vary between 5% and 35%. Withholding tax rates on interest payments are typically higher than those on dividends, ranging between 10% and 35%. Withholding tax rates in Costa Rica are 5% if made by a company listed in Costa Rica and 15% for companies which are not listed in Costa Rica (i.e. the 15% rate applies to dividend payments by a non-listed host company to its parent company located in another jurisdiction). The latter rate is higher than for many neighbouring countries, in particular because the country has only two tax treaties in place (with Spain and Germany).

Despite the high standard CIT rate, CIT revenues in Costa Rica are low. The CIT base in Costa Rica is narrow as a result of high tax evasion, a large informal sector and a wide-range of tax incentives. Recent evidence (Bachas and Soto, 2016) shows that the reduced CIT rates in Costa Rica result in significant tax evasion. In addition, Costa Rica provides a wide-range of tax incentives in particular for companies in Free Trade Zones (FTZ) and for not-for-profit organisations. As a result of the narrow CIT base and the significant tax evasion, CIT revenues in Costa Rica amounted to only 2.2% of GDP in 2014, which is significantly lower than CIT revenues on average in the LAC region and the OECD (see Figure 2.1).

Figure 2.1. Corporate income tax revenues as a % of GDP, 2014



StatLink  <http://dx.doi.org/10.1787/888933544664>

Source: OECD Revenue Statistics database.

The depreciation of assets for tax purposes can be simplified

Costa Rica applies standard tax depreciation methods but the tax depreciation rates vary widely across similar assets. The historical costs of assets can be depreciated either following the straight-line or the sum-of-the-year's-digits method. Other tax depreciation methods can be applied but need to be approved on a case-by-case basis by the tax administration; this follows common OECD practice. However, the tax code foresees over 500 categories of assets. For instance, the tax code distinguishes between 12 categories of machinery and equipment. Machinery and equipment in the rice-growing sector needs to

be depreciated at a rate of 7% while the same assets in the rest of the agricultural sector can be depreciated at a rate of 10%; similar types of assets in the building sector face a 15% tax depreciation rate. The differentiation across industries of similar assets is rarely found in OECD countries. Such sophisticated differentiation makes the tax depreciation system very complex and increases tax compliance and administration costs.

In order to simplify compliance and administration costs related to tax depreciation, Costa Rica could divide assets into broad asset classes. Instead of setting tax depreciation rates on an asset-by-asset basis, Costa Rica could group similar types of assets (such as machinery and equipment, buildings, assets used for transport, intangible assets, etc.) within broad asset classes. The asset classes could be defined such that the assets included in the class would face a relatively similar economic depreciation rate. Such an approach would allow similar types of assets to be depreciated for tax purposes in the same way across different industries. Tax depreciation rates could be set as close as possible to the economic depreciation of the asset (OECD, 2007). Such a reform would contribute to the broadening of the tax base and reduce distortions in capital allocation across assets and industries.

Corporations face an incentive to finance investment with debt rather than equity

Resident corporations face a tax-induced incentive to finance investment with debt. As in most countries, interest payments are deductible from the CIT base but the return on equity is not, which creates a tax-induced incentive to finance investment with debt rather than equity. Dividends paid by a Costa Rican corporation to a domestic corporation are exempt from CIT (at the recipient level), irrespective of whether CIT has effectively been paid. Interest paid to resident companies is taxed as ordinary business income in the hands of the recipient and subject to the corporation's CIT rate. However, an 8% final withholding tax applies over interest on securities registered with a stock exchange in Costa Rica or issued by a registered financial institution in the country.

The debt bias persists when taxes on capital income at the individual level are taken into account. Dividends paid by a publicly traded company in Costa Rica to (resident or non-resident) individuals are subject to a 5% final withholding tax; i.e. no additional tax is levied on distributed dividends at the personal level for domestic shareholders or creditors. Dividends paid by a non-publicly traded corporation to (resident or non-resident) individuals are subject to a 15% final withholding tax. The tax policy rationale for this differential tax treatment is not very clear; in fact, it creates a tax-induced distortion in favour of larger, more international businesses which are more likely listed on the stock market against smaller non-listed domestic businesses. Given a standard CIT rate of 30%, the combined statutory tax burden on dividends equals 33.5% for listed companies and 40.5% for non-listed companies. Interests paid to (resident or non-resident) individuals are subject to a 15% final withholding tax but an 8% withholding tax applies when interests are paid over securities listed on the national bond market. Capital gains are taxed only if they are part of the business's habitual profitable activity, but are not taxed at the individual shareholder level. Despite the absence of a capital gains tax at the individual level, effective tax rate calculations show that debt remains the most preferred source of finance for domestic corporations (see Box 2.1).

The tax code stimulates also intra-group debt financing in case of a non-resident parent company. Dividend distributions to non-resident corporations are taxed in a similar way as the dividends paid to individuals; i.e. a 5% or 15% withholding tax applies for listed and non-listed corporations, respectively. Costa Rican source interest, commission fees and other financial expenses paid to non-residents corporations are subject to a 15% final

withholding tax. The slightly higher withholding tax on interest does not offset the CIT advantage of debt compared to equity-financing. Foreign parent companies may therefore prefer financing their subsidiary in Costa Rica with debt rather than equity.

The corporate debt bias distorts corporate financing and investment decisions. The differential tax treatment of debt and equity provides corporations with a tax-induced incentive to finance investment with debt rather than equity. This may make companies more prone to insolvency and discriminates against small companies and start-ups, which may have reduced access to debt financing or would have to borrow at higher rates (OECD, 2007). It may also imply that highly innovative businesses whose main asset is knowledge capital may face a higher cost of financing than mature companies. Also corporate firms that own firm-specific assets against which it is difficult to borrow suffer a tax-induced competitive disadvantage (Cnossen, 1996).

Costa Rica faces wide ranging ETRs on domestic investment

Corporate ETR calculations show the combined impact of tax provisions on the effective tax burdens on investment in Costa Rica. Box 2.1 presents effective tax rates on domestic investment in Costa Rica; the results capture the impact of the standard and reduced statutory CIT rates, the tax depreciation allowances for different types of assets (i.e. investment in non-residential buildings, machinery and equipment and intangible assets) and the taxes on capital income at the individual level. The analysis presents results for both listed and non-listed companies to capture the effect of different withholding tax rates on dividends.

Corporate ETR calculations for domestic investment confirm the tax financing ranking order: corporations face a tax-induced incentive to finance investment with debt over equity; retained earnings are preferred to newly issued equity as a source of finance (see Box 2.1). Indeed, a clear pattern emerges from the comparison of ETRs across financing sources. First, investments financed by new equity are generally subject to higher ETRs. This result is due to the withholding taxes levied on distributions from publicly traded or non-publicly traded companies. Second, ETRs for investments financed through retained earnings are considerably lower due to the fact that taxation of dividends at the personal level reduces the opportunity cost for this type of financing and because Costa Rica does not levy a capital gains tax at the individual shareholder level. However, interest deductibility implies that debt-financed investments are the most tax-favoured type of investment, especially for firms in the upper tax brackets. Taken together, the tax system thus discourages investments financed by new equity compared to debt finance. For smaller, possibly credit-constrained firms the difference is less significant; however, it becomes substantial for firms in the upper two tax brackets.

Box 2.1. Costa Rica: Effective tax rates on domestic investment

Economic model and assumptions

Forward-looking ETRs are an important tax policy measure capturing information on tax rates and bases as well as other relevant provisions within a comparable framework. A well-established methodology exists to calculate ETRs on the basis of prospective, or hypothetical, investment projects. The modelling approach used to calculate effective tax rates for investments in Costa Rica builds on the standard theoretical framework developed by Devereux and Griffith (1999, 2003) and is described in detail in Hanappi (forthcoming). Building on the economic literature, the OECD model for the calculation of corporate ETRs combines information on

Box 2.1. Costa Rica: Effective tax rates on domestic investment *(continued)*

tax rules (e.g. tax depreciation and incentives) with a set of asset-specific information and other economic assumptions (e.g. rates of return and economic depreciation). Two types of effective tax rates are calculated:

- Effective marginal tax rates (EMTRs) measure the extent to which taxation increases the pre-tax rate of return required by investors to break even. This indicator is used to analyse investment decisions at the intensive margin, that is, to assess how taxes affect the incentive to expand investment given a fixed location.
- Effective average tax rates (EATRs) measure the effect of taxation on investment projects earning economic profits; it is based on a comparison of the net present value of pre-tax and post-tax cash flows. This indicator is used to analyse investment decisions at the extensive margin, that is, location decisions; e.g. when a multinational decides to locate a plant in one of many jurisdictions.

Three sources of finance are considered: retained earnings, new equity and debt. The ETR calculations presented in this analysis focus on domestic investment in Costa Rica by listed and non-listed corporations. Apart from the ETRs, results are also shown for the **cost of capital**, which is defined as the real pre-tax rate of return to generate a zero post-tax economic rent; as such it is linked to the EMTR.

The prospective investment project is described by the pre-tax rate of return and economic depreciation:

- The **pre-tax rate of return** determines income, net of variable costs and depreciation, earned from a given capital stock. The EATRs, which measure tax effects on projects earning economic rents, will be increasing in the pre-tax rate of return. Because the EMTRs measure the tax burden on marginal investments which, by definition, just breaks even, the pre-tax rate of return does not have an impact on the EMTRs. In the context of Costa Rica, an upper middle income country with an average growth rate just below 4% in the last 5 years, the pre-tax rate of return is assumed to be 20%.
- **Economic depreciation** determines the lifetime and, hence, the profitability of the investment project in terms of its Net Present Value (NPV). The calculations presented in this section are based on three stylised assets: (1) non-residential buildings depreciating under the declining balance method at a rate of 3%; (2) machinery and equipment depreciating at 8%; and (3) an intangible asset depreciating at 25%.

Three **tax depreciation schedules** are considered: (1) straight line depreciation at 2% for non-residential buildings; (2) straight line depreciation at 10% for machinery and equipment; and (3) straight line depreciation at 20% for intangible assets. These parameters are based on a recent OECD questionnaire on capital investment modelling in which Costa Rica has taken part in March 2016, capturing tax rules as of July 2015. Comparing tax depreciation rules with the economic depreciation of the corresponding assets shows that tax depreciation is slightly decelerated for non-residential structures, moderately accelerated for machinery and equipment, and decelerated for intangible assets.

The two main economic parameters of relevance are the **real interest rate** and **inflation**. Both parameters interact with each other as well as with tax parameters and financial flows. For the calculations presented in this section both parameters, real interest and inflation, are assumed to be equal to their 5-year average for Costa Rica (2011-15). Correspondingly, the **real interest rate** has been set to 12% and **inflation** to 3.5%.

Empirical results

The results are shown in Tables 2.2 and 2.3. Each table includes EATRs, EMTRs and the cost of capital (CoC) for all nine combinations of tax brackets and asset types given the source of finance. Several results emerge from the analysis:

- Comparing results between different assets shows that both ETRs are higher for assets subject to decelerated depreciation, i.e. non-residential structures and intangibles. Differences in the EATR compared to the second asset, machinery and equipment, can be up to 4 percentage points for firms in the highest tax bracket; difference in the EMTR can be up to 5 percentage points for the retained earnings case and 7 percentage points for debt-financed investments.

Box 2.1. Costa Rica: Effective tax rates on domestic investment *(continued)*

- Comparing the EATRs for a specific asset across tax brackets shows that increases in the statutory CIT rate of 10 percentage points lead to corresponding increases in EATRs of around 8-10 percentage points for equity-financed investments (retained earnings or new equity). However, for debt-financed investments the increase in the EATRs is much lower, around 2-3 percentage points, since interest deductibility implies that higher statutory rates also increase the value of the interest that can be deducted from the corporate tax base.
- Withholding tax rates reduce the opportunity cost of retained earnings in terms of foregone dividends. As a result, EATRs on investments financed by retained earnings are lower than on investments which are financed by new equity. While this difference is more pronounced (around 10 percentage points) in case of non-publicly traded companies, which are subject to a 15% withholding tax rate on dividends, it is also visible for publicly traded companies, which are subject to 5% withholding tax.
- For equity-financed investments the EMTRs are generally quite close to the EATRs; this is due to two factors. On the one hand, tax depreciation schedules largely follow real economic depreciation; only investments in machinery and equipment are subject to acceleration while the other two assets follow slightly decelerated schedules. On the other hand, our assumptions about interest rates and inflation imply that the nominal interest rate and thus the shareholder's discount rate is relatively high; economic rents earned in future periods are thus less valuable in present terms, reducing the difference between the respective average and marginal rates. EMTRs on debt-financed investments are very low, especially for investments in machinery and equipment which are subject to a slightly accelerated tax depreciation schedule.

Table 2.2. ETRs on domestic investment (listed companies)

	Retained earnings								
	CIT 10%			CIT 20%			CIT 30%		
	Buildings	Machinery	Intangibles	Buildings	Machinery	Intangibles	Buildings	Machinery	Intangibles
EATR	5.8	4.5	5.7	16.0	13.4	15.7	26.1	22.3	25.7
EMTR	10.9	8.7	10.7	21.6	17.6	21.2	32.1	26.8	31.6
CoC	12.1	11.8	12.1	13.7	13.1	13.7	15.9	14.7	15.7

	New equity								
	CIT 10%			CIT 20%			CIT 30%		
	Buildings	Machinery	Intangibles	Buildings	Machinery	Intangibles	Buildings	Machinery	Intangibles
EATR	9.4	8.1	9.2	19.5	16.9	19.1	29.7	25.7	29.0
EMTR	16.0	13.9	15.7	25.2	21.5	24.7	34.6	29.7	34.0
CoC	12.8	12.5	12.8	14.4	13.7	14.3	16.5	15.3	16.3

	Debt								
	CIT 10%			CIT 20%			CIT 30%		
	Buildings	Machinery	Intangibles	Buildings	Machinery	Intangibles	Buildings	Machinery	Intangibles
EATR	4.3	3.1	4.2	7.1	4.7	7.2	9.9	6.5	10.4
EMTR	8.7	6.3	8.4	11.0	6.0	10.9	17.7	10.4	17.9
CoC	11.8	11.5	11.8	12.1	11.5	12.1	13.1	12.0	13.1

Note: 5% withholding tax rate applies to dividends; 8% withholding tax rate applies to interest.

Box 2.1. Costa Rica: Effective tax rates on domestic investment (continued)

Table 2.3. ETRs on domestic investment (non-listed companies)

	Retained earnings								
	CIT 10%			CIT 20%			CIT 30%		
	Buildings	Machinery	Intangibles	Buildings	Machinery	Intangibles	Buildings	Machinery	Intangibles
EATR	4.4	3.3	4.3	13.6	11.4	13.4	22.8	19.5	22.5
EMTR	11.0	8.7	10.8	21.8	17.6	21.5	32.4	26.8	31.9
CoC	10.9	10.6	10.9	12.4	11.8	12.3	14.3	13.2	14.2

	New equity								
	CIT 10%			CIT 20%			CIT 30%		
	Buildings	Machinery	Intangibles	Buildings	Machinery	Intangibles	Buildings	Machinery	Intangibles
EATR	14.4	13.3	14.2	23.6	21.2	23.0	32.7	29.2	31.9
EMTR	26.2	24.5	25.9	32.9	29.7	32.3	40.2	35.8	39.5
CoC	13.1	12.8	13.1	14.5	13.8	14.3	16.2	15.1	16.0

	Debt								
	CIT 10%			CIT 20%			CIT 30%		
	Buildings	Machinery	Intangibles	Buildings	Machinery	Intangibles	Buildings	Machinery	Intangibles
EATR	7.8	6.6	7.6	10.3	8.1	10.2	12.8	9.8	13.1
EMTR	16.8	14.7	16.5	17.2	12.6	17.0	22.1	15.0	22.1
CoC	11.6	11.4	11.6	11.7	11.1	11.7	12.4	11.4	12.4

Note: 15% withholding tax rate applies to dividends; 15% withholding tax rate applies to interest.

A broad capital income tax reform could contribute to addressing the debt-equity bias

Costa Rica faces different tax policy options to address the debt-equity bias and to integrate the corporate and personal level taxes on distributed profits. *Dividend deduction systems* provide for a partial or full deduction of dividends from taxable corporate profits. *Split-rate CIT systems* levy a lower CIT rate on distributed profits than on retained profits. *Dividend imputation systems* provide tax relief at the individual level for the CIT paid on distributed dividends. Under a dividend imputation system, dividends are grossed up with (part of) the CIT already paid, after which the grossed-up dividends are taxed at the individual shareholder level. The dividend tax is then reduced with (part of) the CIT with which the net dividends were grossed up in the first place. Finally, dividends can also be taxed at lower effective rates than interest payments under a *schedular tax treatment*, either by including only part of the dividends in taxable personal income or by taxing dividends at lower tax rates than interest payments.

Belgium and Italy have introduced an Allowance for Corporate Equity (ACE) to address the debt-equity bias. An ACE tax system corrects for the differential tax treatment of debt and equity by providing a deductible allowance for corporate equity

in computing the corporation's taxable profits. Similarly to the deductibility of interest payments from the CIT base, the ACE equals the value of the corporation's equity times an appropriate interest rate. The allowance therefore approximates the corporation's "normal" profits; the CIT rate is then confined to economic rents because corporate equity in excess of the ACE remains subject to corporate tax. In order to prevent windfall gains for existing capital owners, and to reduce its cost in the short and medium-run, the ACE could be provided only to new investment (as is the case in Italy) and not to the existing capital stock (as is the case in Belgium) (OECD, 2007).

Costa Rica should not address the debt-equity bias through the introduction of an ACE in the short run. The ACE is costly in terms of tax revenue foregone. Moreover, if not well-designed, the ACE leads to strategic tax planning opportunities which put CIT revenues further under pressure. The introduction of the ACE therefore requires anti-avoidance rules and strict tax enforcement. Because of the corresponding tax administrative challenges and the fact that Costa Rica needs to raise more revenues to balance its budget, the country should not aim at introducing an ACE in the short run.

Over time, Costa Rica could start taxing capital income at the individual level instead of levying final withholding taxes on capital income at the corporate level as currently is the case. An interesting tax policy option for Costa Rica would be the introduction of a Dual Income Tax (DIT) (Brys, et.al, 2016). Under a DIT, capital and labour income are taxed under a separate tax rate schedule. Taxing capital income at the individual level would allow taxing capital income at progressive tax rates and/ or foresee a basic allowance which exempts a minimum amount of capital income from tax – most countries which implement a DIT tax capital income at proportional rates – thereby strengthening the fairness of the tax system. It would allow shifting the capital income tax burden partly from the corporate level towards the individual level, which would allow lowering the standard CIT rate and aligning the rate in Costa Rica with the CIT rates in other LAC and OECD countries. Such a reform would also allow aligning the top tax burden on capital and labour income in order to prevent large tax-induced incentives for employers to incorporate. However, such a reform would come at significant administrative costs and may therefore not be an immediate tax reform priority for the country.

In light of the broader fiscal challenges which Costa Rica is facing, the debt-equity bias could best be addressed, at least in the short run, by taxing interest payments at higher withholding rates. As Costa Rica has to increase the amount of tax revenues it raises in order to balance its budget, reforms that reduce the debt-equity bias should not come at a tax revenue cost. In Costa Rica, interest payments are taxed at a low withholding tax rate of 8% or at a rate of 15% for bonds not listed on the bond market, while dividends of listed and unlisted companies are taxed at 5% and 15%, respectively. In order to reduce the debt-equity bias, Costa Rica could therefore consider increasing the withholding tax on interest payments to, at least, 15% but preferably to a slightly higher tax rate.

Costa Rica does not currently apply any limit to the amount of interest expense that is deductible from the CIT base. In contrast to most LAC and OECD countries, businesses can deduct all interest expense from taxable corporate profits. This makes the CIT in Costa Rica vulnerable to Base Erosion and Profit Shifting (BEPS). Because of the high standard CIT rate, international businesses that are highly leveraged can strip profits easily out of the country and realise a significant tax reduction.

The BEPS Project under its Action 4 has established a common approach to the design of rules to prevent excessive interest deductibility. Even though the common approach does not aim at correcting for the debt-equity bias but at reducing profit shifting,

it does set a limit to the deductibility of interest and, therefore, indirectly reduces the corporate debt bias. The OECD/G20 BEPS project has recommended implementing interest limitation rules that are profit-based (i.e. interest barriers) rather than balanced sheet based. The common approach is based on a fixed ratio rule which limits an entity's net deductions for interest and payments economically equivalent to interest to a percentage of its earnings before interest, taxes, depreciation and amortisation (EBITDA). Interest between 10% and 30% of EBITDA would remain deductible while the excess interest could be carried forward indefinitely (OECD, 2015f). The common approach also includes a group ratio rule alongside the fixed ratio rule, which would allow an entity with net interest expense above a country's fixed ratio rule to deduct interest up to the level of the net interest/ EBITDA ratio of its worldwide group.

Following international best practices, Costa Rica plans to introduce a profit-based interest limitation rule. Costa Rica's current CIT reform proposal plans to introduce a limit to the deductibility of net interests equal to 20% of EBITDA. Any excess interest expense can be carried forward indefinitely. The tax reform proposal does not foresee an additional group ratio rule. The draft tax bill excludes interest paid on loans used to finance public projects as long as the project developer is tax resident in Costa Rica. The limit does not apply to the banking sector either.

Costa Rica should consider including an additional group ratio rule. This would allow an entity with net interest expense above a country's fixed ratio to deduct interest up to the level of the net interest/EBITDA ratio of its worldwide group. A fixed ratio rule provides a country with a level of protection against BEPS, but it is a blunt tool which does not take into account the fact that groups operating in different sectors may require different amounts of leverage, and even within a sector some groups are more highly leveraged for non-tax reasons. If a benchmark fixed ratio is set at a level appropriate to tackle BEPS, it could lead to double taxation for groups which as a whole are leveraged above this level. Therefore, countries are encouraged to combine a robust and effective fixed ratio rule with a group ratio rule which allows an entity to deduct more interest expense in certain circumstances. A group ratio rule may be introduced as a separate provision from the fixed ratio rule, or as an integral part of an overall rule including both fixed ratio and group ratio tests (OECD, 2015f).

Costa Rica could consider taxing capital gains more broadly under the CIT

Costa Rica taxes capital gains under the CIT if they are earned from the business's habitual business activity or from the sale of depreciable assets. The term "habitual" has been defined by the Constitutional Court rather narrowly as the business's predominant activity that is carried out in a public and frequent manner and to which it dedicates most of its time. Any capital gain which does not meet this specification is not taxed under the CIT; this includes the capital gains earned on the transfer of land.

Broadening the capital gains tax base within the CIT would simplify the CIT and reduce tax avoidance opportunities. Taxing capital gains more broadly will also reduce the administration's tax enforcement efforts. The recent tax reform proposals would abolish the differentiation between habitual and non-habitual business activities, which is a welcome reform. However, the reform plans to tax capital gains at a reduced CIT rate of 12%, which continues to provide businesses a tax-induced incentive to transform regular income into capital gains. Instead of taxing capital gains at a reduced CIT rate, Costa Rica should consider taxing them at the corporation's standard CIT rate instead.

Costa Rica could start taxing foreign-source passive income

There are considerable cross-country differences in the taxation of cross-border income. World-wide tax systems, on the one hand, tax corporations on their worldwide income. Territorial tax systems, on the other hand, tax only the income which has its source in the country. In practice, most countries apply a combination of both systems. In 2012, 28 of the 34 OECD member countries had adopted a territorial tax system exempting most active earnings repatriated from subsidiaries resident in (some or all) host countries. OECD member countries commonly require 10% ownership of a foreign affiliate's shares to qualify for the territorial exemption. Most OECD member countries with territorial tax systems exempt active income earned by foreign affiliates as well as gains on the sale of foreign affiliate shares. Some OECD member countries with territorial tax systems limit the exemption to affiliates resident in countries with which they have a tax treaty.

Costa Rica implements a pure territorial CIT system which taxes only the income which has its source within Costa Rica. Any active or passive income which has its source outside Costa Rica is not taxed under the Costa Rican CIT. This means that Costa Rica implements a full participation exemption regime under which dividends received from abroad remain untaxed in Costa Rica, irrespective of the size of the participation.

Costa Rica needs to set clear rules of what constitutes domestic and foreign-source income. Clear definitions of territoriality prevent tax uncertainty and tax disputes on whether income has its source in Costa Rica or abroad. There have been a number of cases where the tax administration has re-characterised foreign source income as Costa Rican source income.¹ Any future changes to Costa Rica's territorial tax system, such as a move towards the taxation of foreign-source passive income, should be put in place through clear tax legislation leaving as little room as possible for misinterpretation by businesses and the tax administration.

Costa Rica should avoid moving from a territorial towards a full worldwide CIT system which taxes all types of foreign-source, i.e. both passive and active business income. The current territorial tax system and the high statutory CIT rate induces Costa Rican businesses to serve foreign markets that levy a low statutory CIT rate from within those markets rather than exporting those goods and services from Costa Rica. However, taxing foreign source active income at a rate as high as 30% would put Costa Rican businesses which compete on foreign markets at a competitive disadvantage. Moreover, Costa Rica is a small open economy and a net importer of capital. It has a relatively low share of tax resident businesses earning income abroad. Under these circumstances, the move towards a full worldwide CIT system would not bring many economic advantages. A move towards a full worldwide tax system would also come at high administrative costs without raising significant tax revenues.

Costa Rica could consider taxing foreign-source passive investment income under the CIT. Because foreign source passive investment income (interest, dividends or royalties) is not taxed in Costa Rica, tax-resident businesses may face tax-induced incentives to invest their profits in financial assets abroad instead of reinvesting them in Costa Rica and finance domestic investment with debt rather than equity, in particular because the CIT rate is relatively high in Costa Rica. By bringing foreign-source passive income within the reach of the CIT, Costa Rica would reduce opportunities for tax avoidance/ evasion as there would no longer be an incentive to re-characterise domestic passive income as foreign-sourced income.

Taxing foreign-source passive investment income at a low rate in Costa Rica will yield low tax revenues. Passive income will be taxed in the host country where the income has its source under that country's CIT and/ or the host country's withholding tax rates when the payments are made to the Costa Rican tax resident corporation. Tax treaties typically reduce the withholding tax rates which apply. However, Costa Rica has only two tax treaties that have entered into force (with Spain and Germany). This implies that for all other countries, standard (i.e. higher) withholding tax rates will be levied. Moreover, in order to prevent double taxation, Costa Rica will have to provide for double tax relief (i.e. to compensate for the fact that the payments already have been taxed at source). As a result, Costa Rica will very likely not raise much revenue from the taxation of foreign-source passive income, in particular if it were to provide double tax relief not only for foreign withholding taxes paid but also for the CIT, although the latter would be rather uncommon with respect to foreign-source passive income.

But taxing foreign-source passive income at a too high rate may be very distortive, in particular because a high tax rate may lower the competitiveness of domestic Costa Rican corporations who invest abroad and it may induce businesses to defer the repatriation of funds back to Costa Rica. It therefore is also important that the new tax rules do not draw active business income earned abroad into the corporate tax base and that only passive income is taxed in order to capture the income which has been shifted abroad for tax avoidance purposes.

The move towards the taxation of foreign passive income should go hand-in-hand with the introduction of relief against double taxation. Currently, Costa Rica's tax system does not provide for any unilateral double tax relief. As pointed out, only two tax treaties are currently in force. In the short run, Costa Rica should consider introducing unilateral tax relief to prevent double taxation of foreign-source passive income. In the medium run, the country could consider the merits of whether it should strategically expand its tax treaty network in order to negotiate lower withholding tax rates and to provide relief against double taxation.

The costs and benefits of double tax treaties should be weighed carefully. Double tax treaties can bring a range of advantages to a country and to those investing in them, but they need to be carefully designed. The negotiation and implementation of double tax treaties can be complex and can absorb valuable administrative resources. As double tax treaties typically lower withholding tax rates, they could provide a windfall gain for foreign investment already in place in Costa Rica and, therefore, could result in a loss of government tax revenues. Whether a capital importing country benefits from signing a double tax treaty will depend largely on whether it realises sufficient gains from increased FDI to offset any tax revenue losses (IMF, 2014). Entering into an increased number of tax treaties would allow Costa Rica also to negotiate lower withholding tax rates levied by other countries on payments made to Costa Rica. This could allow Costa Rica to raise tax revenues from taxing foreign-source passive income and it would provide Costa Rica with the tools to obtain information on the financial activities of its tax residents and their offshore investments. The latter objective can also be achieved through the Convention on Mutual Administrative Assistance in Tax Matters, which Costa Rica has already signed.

The inclusion within tax treaties of provisions that prevent tax treaty abuse is an important instrument to minimise the potential costs and the abuse of tax treaties. The work advanced under Action 6 of the OECD/G20 Base Erosion and Profit Shifting (BEPS) project recognised the importance of preventing the granting of treaty benefits in inappropriate circumstances. A guiding principle is that benefits of a treaty should not

be available where the main purpose was just to secure a more favourable tax position. Different techniques to prevent treaty abuse are available including General Anti-Avoidance Rules based on a Principal Purposes Test and specific anti-avoidance rules such as a Limitation on Benefits rule. As a member of the Inclusive Framework on BEPS (see below), Costa Rica has committed to introduce the minimum standard that prevents tax treaty abuse in all of its double tax agreements.

Taxing foreign-source passive income could go hand in hand with the introduction of Controlled-Foreign-Corporation (CFC) rules. CFC rules enable jurisdictions to tax income earned by subsidiaries located in foreign jurisdictions. CFC rules typically apply to passive income which is retained abroad (i.e. interests, dividends, and royalties). As Costa Rica is a high tax country, its domestic companies may face tax-induced incentives to transfer assets, such as intellectual property, to low-tax jurisdictions such that the corresponding income streams escape taxation in Costa Rica. This income would come within the reach of the tax administration with CFC rules. Over time, Costa Rica might therefore want to consider introducing CFC rules.

Costa Rica should consider introducing additional tax base protection measures. For instance, the current CIT system does not foresee a limit on the amount of expenses incurred to earn foreign-source passive income which are deductible from the Costa Rican CIT base. Government may want to ensure that costs incurred to earn foreign-source passive income are only deductible from the Costa Rican foreign-source passive income tax base.

The current tax reform proposal maintains the country’s territorial tax system but includes foreign-source passive income within the CIT base. Dividends, interest and royalties that arise from the company’s foreign “profitable activities” seem to escape from taxation, however. This would imply that the tax base is not broadened significantly; moreover, it would result in high administrative costs to prevent that income from “non-profitable activities” is re-characterised to escape taxation. Also the tax rate has not been set. The tax reform proposal does introduce unilateral double tax relief; companies would be entitled to a tax credit equal to the minimum of the foreign tax effectively paid or 15% of foreign-source taxable passive income.

High taxes on dividends makes Costa Rica not a very attractive location for FDI

Effective Tax Rates on FDI show the combined impact of the CIT and withholding taxes on foreign direct investment in Costa Rica. Box 2.1 discussed EATR and EMTR for investments in different assets and by different types of domestic firms under various financing arrangements. However, these results only capture effective taxation on domestic investments, corresponding to the assumption that both the investor and the company are residents of Costa Rica. Modelling effective taxation on activities of foreign subsidiaries of MNEs implies that, in addition to standard domestic tax features, taxes on cross-border flows of income as well as interactions between tax systems in source and residence countries have to be accounted for.

ETR calculations have to incorporate the reduced withholding tax rates as set in tax treaties. While countries typically define a set of standard withholding tax rates on international payments of dividends, interest and royalties in their domestic tax codes, bilateral tax treaties are concluded to reduce or eliminate double taxation. To achieve this, treaties often include a reciprocal reduction in withholding tax rates as well as provisions for double tax relief at the level of the recipient (located in the residence country), such

as foreign tax credits or dividend participation exemptions. As a result, outgoing income flows are typically subject to different tax rates depending on the location of the foreign investor. Conversely, incoming income flows may receive different tax treatment in the residence country due to the fact that they originated from different source countries. Effective taxation on in- and out-flows of FDI therefore varies across country pairs, implying that country-level analyses become considerably more complex.

ETRs on FDI vary significantly across investor countries but are high for FDI in Costa Rica compared to the tax burden on investment in similar countries. Box 2.2 presents results for effective tax rates on inbound FDI, comparing ETRs on investments from a fixed group of investor countries (i.e. where the investing parent company is located) across a set of competing host countries (i.e. where the investment takes place). Investor countries include the main Latin American countries including Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela, as well as the main investor countries from other continents (see Tables 2.4 and 2.5, respectively). The group of host countries is more narrowly defined, including all Central American countries except Belize. In addition, three more countries with similar levels of GDP per capita and FDI are included in this group, namely the Dominican Republic, Ecuador and Uruguay. The high withholding tax rates in Costa Rica and the country's very limited tax treaty network results in high ETRs compared to most other countries in the region which have used the general design of their tax system more actively in attracting FDI.

Strengthening the investment climate in Costa Rica requires reforming the CIT system on different tax fronts. Costa Rica has started tightening its CIT base rules in order to prevent tax avoidance and evasion of MNEs. Such reforms are welcomed and follow international best practices. However, these reforms have to go hand in hand with tax policy reforms and, after careful analysis, the potential expansion of the country's tax treaty network. In general, a country's statutory tax provisions start affecting economic outcomes more strongly when it becomes more difficult for MNEs to strip profits out of a country through transfer mispricing or thin capitalisation. In such an environment of tighter legal tax rules and tax enforcement, Costa Rica's high statutory CIT rate, the relatively high withholding tax rates and the absence of international double tax relief become more distortive. The lower tax burdens in other LAC countries could exacerbate these effects.

Different corporate tax reform options exist to strengthen the investment climate. Costa Rica could lower its standard CIT rate, although the fiscal costs of doing so mean that this would most likely need to occur gradually; it could lower its standard withholdings tax rates or lower withholding tax rates for a selection of countries through the strategic expansion of its tax treaty network. These different tax policy options vary in their economic advantages and costs. A broader corporate tax rate reduction and/ or a general reduction in withholding tax rates would more strongly stimulate investment across the board, but would also result in larger windfall gains for current investors and entail larger tax revenue losses; the latter is an important consideration in light of Costa Rica's urgent need to balance its budget deficit.

Locational decisions of foreign investments are determined by a wide variety of factors. Strengthening the investment climate requires an in-depth evaluation of how the domestic and foreign investment climate in Costa Rica could be strengthened. The factors that have contributed to FDI inflows into Costa Rica in the past may not necessarily be sufficient to continue attracting high amounts of FDI in the future. Although Costa Rica is recognised for being an attractive business location because of its skilled labour force, the

country's political stability and its geographical location, the country would nevertheless benefit from a whole-of-government evaluation of its investment climate. Such an analysis would include an evaluation of the corporate tax system including its wide-range system of tax incentives; such an analysis would also take into account the tax system in the investor's country of tax residence, and in particular whether Costa Rica's trading partners and investor countries operate a worldwide or territorial tax system and the type of double tax relief they provide. Such an evaluation could inform an assessment of the impact of specific corporate tax reductions and tax incentives on the overall tax burden faced by foreign investors, and on the incentives to invest in Costa Rica.

Box 2.2. Effective tax rates on foreign direct investment

Economic model and assumptions

The modelling approach used to calculate ETRs on domestic investments has been described in Box 2.1. As noted, the analysis of domestic ETRs accounts for tax depreciation schedules as well as elements of personal income taxation affecting shareholder level decisions. In the international context, however, we adopt a simplified approach in order to focus the analysis on the effects of corporate taxation on multinational FDI decisions. The analysis assumes that tax depreciation completely follows economic depreciation and that investors are exempt from personal income taxation, in line with the observation that, in the context of MNEs, larger shares of investors are either not resident in the country of the parent company or institutional investors which are typically tax exempt on dividend income or capital gains.

As before, we calculate EMTRs, EATR as well as the cost of capital. However, in an international investment context we are most interested in the EATR as it captures the effects of taxation on location decisions; this interpretation is equivalent to the assumption that the MNE expects to earn an economic rent, e.g. by exploiting firm-specific advantages, but will choose to locate production in only one among several possible source countries due to economies of scale. In contrast, the EMTR on international investments captures the incentive faced by MNEs to increase the scale of production in a given source country where production already takes place.

To maintain comparability with the domestic analysis we take the same assumptions as before with regard to the pre-tax rate of return (20%) as well as inflation (3.5%) and real interest rates (12%) in host (i.e. source) countries. These parameters are held constant across host countries in order to isolate the effects of the tax systems on the ETRs. For LAC residence countries we assume the same inflation and real interest rates; however, for residence countries outside the region we assume an inflation rate of only 1.5%, again in line with the 5-year average.

Cross-border income flows are subject to corporate income and withholding taxes in the host country; in the residence country foreign tax relief may be available. However, the tax treatment of foreign source income varies across residence countries and may be altered through treaty provisions. In general, we consider three possible relief methods: exemption, foreign tax credits and deductions. If a residence country has a participation exemption repatriated income is not subject to additional taxation. With foreign tax credits the residence country provides relief for taxes paid in the host country limited to the amount which would be due in case production would have taken place in the country of the parent company. In this case a residence country corporate tax liability may arise only if the corporate tax rate is higher than in the host country. Deductions are the least favourable relief method. In this case recipients in the residence country can deduct foreign taxes paid in the source country from their taxable income, implying that there will in any case be a corporate tax liability.

Box 2.2. Effective tax rates on foreign direct investment *(continued)*

Tax treaties aim at reducing double taxation by reducing withholding taxes and potentially providing more generous foreign tax relief. Changes in relief methods, e.g. from credits or deductions to exemption, can have large impacts on bilateral ETRs. The treaty network is thus a crucial element in determining ETRs on inbound FDI in any given host country. Data on tax treaties and related tax parameters are presented in the next subsection.

In line with the theoretical model developed by Devereux and Griffith (1999), we consider a parent company, located in the residence country, undertaking an investment in the host country through a wholly-owned subsidiary. Compared to domestic companies MNEs have access to a wider range of financing arrangements. The parent company can, for instance, provide funds to the subsidiary through internal debt or equity, raising the required funds through retained earnings, external debt or new equity from its shareholders. Following the discussion in Yoo (2003) we limit the number of relevant financing structures to seven:^a (i) the subsidiary uses retained earnings to finance the investment; the subsidiary raises new equity from the parent and the parent uses (ii) retained earnings, (iii) new equity or (iv) external debt to finance the equity issuance; the subsidiary obtains a loan from the parent uses (v) retained earnings, (vi) new equity or (vii) external debt to finance the equity issuance. However, in the context of international investments we do not offer a separate discussion of the effects of different financing structures on ETRs or possible implications for multinational tax planning.^b Instead, we construct weighted (or composite) ETRs, using equal weights for each financing structure, so as to produce composite ETRs reflecting the impact of the main tax parameters relevant for international investment decisions.

Empirical results

Effective average tax rates (EATR) on international investments are presented in Tables 2.4 and 2.5. Both tables depict the set of host countries in rows and residence countries in columns. Table 2.4 includes the main regional investor countries as discussed above: Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela. In the case of Costa Rica it shows that the weighted EATR on foreign investments from any of these residence countries is equal to 29.5%.^c This result is due to the high statutory corporate and withholding tax rates in Costa Rica combined with the fact that residence countries use only indirect foreign tax credits as a relief for taxes paid in host countries; Costa Rica does not have any tax treaties with regional countries. In addition, this result also shows how debt finance by subsidiaries or parent companies can lead to considerably lower EATRs. As discussed above, our composite EATRs are constructed by placing an equal weight on each of the financing structures; however, EATRs under debt finance are low enough to move the composite EATR just below the statutory rate of 30%, despite taking into account the additional withholding taxes; EATRs under equity finance are close to 40%.

Comparing the 29.5% with EATRs on investments in other host countries shows that Costa Rica has the highest EATR among the set of selected peer countries (excluding the six larger Latin American countries). Apart from Panama most other neighbouring countries in Central America do not have extensive treaty networks; the results are thus driven by statutory corporate and withholding tax rates, implying that Costa Rica ranks comparatively high with regard to EATRs from regional investor countries. The other three peer countries, the Dominican Republic, Ecuador and Uruguay, have developed larger treaty networks, allowing them to improve investment conditions to and from selected regional or non-regional countries. Among them, Ecuador offers the most generous conditions to regional investors, for example, through the use of participation exemptions, a combination of low withholding tax rates and favourable treatment of foreign source income implies that composite EATRs on investments in Ecuador are reduced to 10.9% and 13.9% for investments from Colombia and Peru, respectively.

Box 2.2. Effective tax rates on foreign direct investment (continued)

Table 2.4. Effective average tax rates on investments from Central and Latin American countries

	Latin American and Caribbean investor countries						
	Argentina	Brazil	Chile	Colombia	Mexico	Peru	Venezuela
Costa Rica	29.5	29.5	29.5	29.5	29.5	29.5	29.5
El Salvador	25.7	25.1	24.7	29.2	24.7	24.7	25.1
Guatemala	25.5	24.8	21.2	28.9	22.0	22.0	24.8
Honduras	27.1	27.1	27.1	29.2	27.1	27.1	27.1
Nicaragua	25.9	25.9	25.9	29.2	25.9	25.9	25.9
Panama	25.5	24.8	23.8	28.9	22.0	23.8	24.8
Dominican Rep.	25.6	25.1	25.1	29.0	25.1	25.1	25.1
Ecuador	25.4	16.3	17.7	10.9	21.9	13.9	24.7
Uruguay	25.5	24.8	22.2	28.9	22.0	22.2	24.8
Argentina	-	30.8	30.5	30.5	32.0	32.0	30.8
Brazil	19.3	-	25.3	29.4	25.3	25.3	25.3
Chile	25.4	24.7	-	28.9	22.0	23.1	42.3
Colombia	33.8	33.8	33.8	-	33.8	29.3	33.8
Mexico	27.1	27.1	24.7	29.2	-	27.1	27.4
Peru	25.6	24.9	21.5	21.2	24.2	-	24.9

Source: Authors' calculations based on OECD ETR Model.

The lower part of Table 2.4 shows composite EATRs for investments in larger Latin American economies. Although these countries have developed extensive treaty networks, they also tend to maintain relatively high statutory corporate and withholding tax rates. As a result, EATRs on investments from regional countries are comparatively high, sometimes exceeding the EATR on investments in Costa Rica. However, these economies are larger and more diversified, and provide a better qualified labour force as well as public infrastructure, thus making them a more attractive target for foreign investment than Costa Rica.

Table 2.5 shows the composite EATRs on investments from selected non-regional countries to the same set of source countries. EATRs are generally lower than in Table 2.4. A part of this effect is due to the assumption, in line with observed 5-year averages, that inflation is around 2 percentage points lower in European and North American investor countries. As discussed in the context of domestic investments, corporate tax is levied on nominal returns and lower inflation thus reduces effective taxation. EATRs on investments from non-regional residence countries are thus generally somewhat lower than the rates depicted in Table 2.4.

As before the EATRs on investment into Costa Rica are among the highest in the region, with the exception of Spain and Germany, the two countries with which Costa Rica has signed bilateral tax treaties. In both cases the treaty provides a reduction in withholding tax rates for outbound payments from 15% to 5% as well as a full participation exemption in the country of the recipient. The combined effect of these two provisions is equal to a reduction in the composite EATR of approximately 5 percentage points. Comparing EATRs across host countries confirms the result that, in the absence of bilateral tax treaties, EATRs on investments into Costa Rica are among the highest in the region. However, these results also highlight how other regional countries make use of their treaty networks to selectively reduce EATRs.

Box 2.2. Effective tax rates on foreign direct investment (continued)

Panama, for instance, has treaties with the Netherlands, Spain and the UK which fully eliminate withholding taxes on dividend payments to those countries. Ecuador and Uruguay also provide treaty benefits for several of the regional as well as non-regional investor countries, although in most cases reduced rates remain above zero.

Larger Latin American economies have developed a much denser network of bilateral tax treaties. As depicted in Table 2.1, Mexico currently has 56 treaties while Brazil and Chile both have more than 30. A more active tax treaty policy allows these countries to improve investment conditions with selected investor countries, potentially in line with general economic and trade policy considerations. As a consequence, composite EATRs on investments into these countries, depicted in the lower part of Table 2.5, show much more variation across investor countries. While investments from non-treaty countries into one of these large economies tends to be subject to relatively high EATRs, extensive treaty networks imply that investments from the selected group of non-regional countries are mostly taxed at much lower effective rates. Investments from non-treaty countries into Argentina, for instance, are subject to EATRs of just above 30% (e.g. see Table 2.4); however, investments from low-inflation countries where treaties exist are subject to rates well below 20% (see Table 2.5).

Table 2.5. Effective average tax rates on investments from non-regional countries

	Other investor countries								
	Belgium	Canada	Germany	Italy	Netherlands	Spain	Switzerland	UK	US
Costa Rica	18.8	18.9	13.7	18.9	18.9	13.7	17.3	18.9	18.8
El Salvador	13.7	13.7	13.7	13.7	13.7	11.1	13.4	13.8	17.7
Guatemala	10.2	10.1	10.1	10.2	10.1	10.1	7.2	10.1	17.6
Honduras	16.3	16.3	16.3	16.3	16.3	16.3	13.4	16.3	17.7
Nicaragua	15.0	15.0	15.0	15.0	15.0	15.0	11.5	15.0	17.7
Panama	12.9	12.9	12.8	12.8	7.3	7.3	10.6	7.3	17.6
Dominican Rep.	14.2	14.2	14.2	14.2	14.2	8.8	11.4	14.3	17.6
Ecuador	5.0	8.5	5.3	5.3	7.2	5.0	2.1	5.6	17.5
Uruguay	11.3	11.2	10.1	11.2	11.2	7.3	7.2	11.2	17.6
Argentina	19.7	19.7	19.7	19.7	19.8	19.8	17.4	19.8	19.7
Brazil	14.2	14.2	14.2	14.2	14.2	14.2	12.6	14.2	17.8
Chile	6.9	12.2	33.8	33.5	35.1	9.4	13.4	9.4	32.5
Colombia	23.2	23.2	23.2	23.2	23.2	23.2	20.3	23.2	23.1
Mexico	13.7	13.7	13.7	16.3	11.1	13.7	8.3	11.2	17.7
Peru	13.2	13.2	13.2	13.2	14.5	14.5	11.6	15.9	17.6

Source: Authors' calculations based on OECD ETR Model.

- Notes: a. Note that since we are excluding personal income taxation from this analysis the number of relevant financing structures actually reduces to five: retained earnings finance by the subsidiary as well as debt or equity finance at subsidiary and parent levels.
- b. However, the full set of results is available from the authors on request.
- c. The calculations assume that a Costa Rican non-listed subsidiary makes dividend payments to a parent company in another jurisdiction, which implies that a 15% withholding tax rate applies.

Costa Rica provides a wide range of corporate tax incentives

Costa Rica provides a wide range of corporate tax incentives, including an indirect tax relief for the tourism and agricultural sector, a FTZ regime and tax subsidies for not-for-profit organisations. Some of these tax incentives lack transparency and the requirements that need to be fulfilled to qualify for them are not always straightforward. The system has created opportunities for aggressive tax planning and has put CIT revenues under pressure. As part of its tax reform, government is planning to reassess its current system of corporate tax incentives with the aim of streamlining the incentives and increasing transparency. The OECD welcomes this reform.

Costa Rica has a FTZ regime which offers a wide range of tax incentives.² The regime exempts profits from CIT, provides for import duty exemptions and exemptions from local taxation. In general, the FTZ regime exempts profits from CIT for 8 years and provides a 50% CIT reduction during the following 4 years, but differences exist depending on the types of activities and the location of the FTZ (see Table 2.6). Profits from the sale to the domestic market are taxed under separate tax rules.

Table 2.6. General benefits offered to most companies operating under the FTZ regime

	Within GAMA*	Outside GAMA
Benefits	CIT exemption for 8 years	CIT exemption for 12 years
	Plus, 4 extra years subject to 50% of CIT	Plus, 6 extra years subject to 50% of CIT
	Plus, in total 10 year exemptions from real estate tax, immovable property transfer tax, from the business license fee and all taxes on remittances abroad. VAT exemption on some public services. Right to a bonus equivalent to 10% of the amount paid for salaries in the previous year after deduction SSC	

*GAMA: Gran Area Metropolitana Ampliada.

Free Trade Zone regimes are common in the LAC region. Many countries in the region implement direct and/or indirect tax incentives for FDI; this often includes CIT reductions or exemptions for a significant length of time. In addition to Costa Rica, FTZ regimes can be found in, for instance, Colombia, the Dominican Republic, Nicaragua, Honduras, Mexico, Puerto Rico, Chile, and Paraguay.

The FTZ tax regime does not lower the effective tax burden on investment from regional countries into Costa Rica (see Table 2.7) if the return is paid directly to the foreign parent company in the form of dividends or interest. Although the FTZ regime in Costa Rica does lower the tax burden on investment in Costa Rica, it does imply that the investor's residence country will be able to raise more tax revenues (as it will have to provide lower foreign tax credits) on the return on investment which is paid directly to the parent company in the country of residence (and not to a related entity located in a third country or by engaging in tax strategies that allow benefiting from tax deferral). Overall, the tax burden on FDI into a FTZ is only slightly lower than the tax burden on FDI in the regular economy of Costa Rica. A similar conclusion emerges for the FTZ regimes in other regional countries; they do lower the tax burden in the host country but they allow the residence country to raise higher tax revenues. FTZ tax competition amongst LAC countries is particularly detrimental to the smaller LAC countries and/ or the countries that do not tax foreign sourced income, such as Costa Rica.

The FTZ tax regime does, however, significantly reduce the tax burden on FDI from non-regional countries into Costa Rica as many of the non-regional investor countries provide participation exemptions. EATRs can even become negative as the parent company might be able to benefit from interest deductibility in the home country if it borrows to finance an investment in a FTZ regime in Costa Rica.

While the FTZ regime might have brought economic advantages to the country, it remains important to regularly assess the actual cost and benefits of the FTZ regime. Such ongoing analysis could be supported by an in-depth evaluation of the methodology that is currently applied to weigh the costs and benefits of the FTZ regime to ensure that this approach is consistent with international best practice. Cost-benefit analyses should focus on the additional investment, employment and productivity generated by the FTZ regime. They should also take into account the relatively high tax burden imposed by the regular tax system, which may discourage domestic investment, as well as the tax-induced distortions in market competition between companies within and outside of the FTZs. The evaluation would also take into account the tax incentives offered by other LAC countries. This type of comprehensive analysis would allow the costs and benefits of the FTZ regime to be regularly assessed and changes and/or improvements made to the system as and when appropriate.

In order to comply with WTO rules, certain companies located in an FTZ are allowed to sell goods and services to the domestic economy; certain restrictions to the amount of sales might apply. Profits that are earned on the sales to the domestic market are typically taxed at the standard CIT rate. Trade between the domestic economy and the FTZ regime creates tax evasion opportunities as businesses with a subsidiary in both the regular domestic economy and the FTZ might try to transfer as much profits as possible to their FTZ subsidiary. Transfer pricing rules should be applied and enforced in relation to companies in the FTZs.

Box 2.3. Effective tax rates on FDI in free trade zones

As highlighted in the main text, several regional countries introduced free trade zones in order to stimulate foreign direct investment. In contrast to bilateral tax treaties, free trade zones provide tax incentives for foreign investment irrespective of the location of parent companies or ultimate shareholders. While free trade zones typically offer benefits with regard to several different taxes, the following calculations focus only on corporate tax incentives available through FTZs in Costa Rica, El Salvador, Colombia, Mexico and the Dominican Republic.

As shown in Table 2.7, the free trade zones in Costa Rica, El Salvador and the Dominican Republic offer an initial exemption of 100% of the profits generated within the zones, subject to specific time limits; benefits may be extended for multiple periods or else the share of exempted profits is gradually reduced. While the Dominican Republic continues to tax dividend payments from companies located in the FTZ, Costa Rica and El Salvador exempt these types of payments. In Colombia profits generated within the FTZ are subject to a preferential corporate tax rate of 20% and dividends continue to be taxed at the applicable rates. Mexico, on the other hand, provides no preferential rate, but exempts dividend payments originating in the FTZ from withholding taxes.

Box 2.3. Effective tax rates on FDI in free trade zones (continued)

Table 2.7. EATRs on investments from regional countries into free trade zones

	FTZ: Latin American and Caribbean investor countries						
	Argentina	Brazil	Chile	Colombia	Mexico	Peru	Venezuela
Costa Rica	24.8	24.1	17.0	28.3	21.2	21.2	24.1
El Salvador	24.8	24.1	17.0	28.3	21.2	21.2	24.1
Dominican Rep.	24.8	24.1	17.0	28.3	21.2	21.2	24.1
Colombia	25.3	24.6	20.4	-	21.8	15.8	24.6
Mexico	25.7	25.1	22.3	29.2	-	22.3	25.4

Source: Authors' calculations based on OECD ETR Model.

EATRs on investments within the FTZs of the respective source countries are summarised in Tables 2.7 and 2.8. As expected, the EATRs on investments into Costa Rica, El Salvador and the Dominican Republic do not vary across investor countries because in the absence of participation exemptions effective taxation is determined by CIT rates in the residence countries (Table 2.7). Comparing the results with the EATRs in Table 2.5 shows that the overall reductions in effective taxation due to the FTZs are limited, particularly for investments from countries with relatively high CIT rates such as, for instance, Argentina, Brazil, Colombia and Venezuela. For investments from these countries into Costa Rica the EATRs decrease by only between 1 and 5 percentage points, in line with the fact fewer foreign tax credits can now be claimed in the residence countries (i.e. tax revenues are shifted from source to residence countries). However, the case of Chile shows that FTZs have stronger effects on the EATR when CIT rates are considerably lower in residence countries (12.5 percentage points for Costa Rica). As expected, the effects of the FTZs in Mexico and Colombia are lower; however, the participation exemption for dividend payments from Colombia to Peru now has a more significant effect.

Table 2.8. EATRs on investments from non-regional countries into free trade zones

	FTZ: other investor countries								
	Belgium	Canada	Germany	Italy	Netherlands	Spain	Switzerland	UK	US
Costa Rica	-10.5	8.3	-10.6	-10.6	7.0	-11.7	-13.3	-11.7	17.4
El Salvador	-10.5	8.3	-10.6	-10.6	7.0	-11.7	-12.0	-11.7	17.4
Dominican Rep.	-3.4	8.3	-3.5	-3.4	7.0	-11.7	-7.1	-4.2	17.4
Colombia	9.6	9.4	9.5	9.5	9.4	9.4	6.5	9.5	17.5
Mexico	11.2	11.1	11.1	11.2	11.1	11.1	8.3	11.2	17.7

Source: Authors' calculations based on OECD ETR Model.

A different picture emerges from Table 2.8. Since many of the non-regional investor countries provide participation exemptions, i.e. Belgium, Germany, Italy, Spain, Switzerland and the UK, the effects of the free trade zones are much more pronounced. In these cases EATRs on debt-financed investments turn negative because parent companies benefit from interest deductibility although they do not have a tax liability in their country of residence; for residence countries with participation exemptions this effect is strong enough to yield negative composite EATRs. As before, the EATRs for Costa Rica and El Salvador are the same for investors from a given residence country; however, the EATR for investments into the

Box 2.3. Effective tax rates on FDI in free trade zones *(continued)*

Dominican Republic is now somewhat higher due to the withholding tax on dividends which is still levied. If tax relief is provided in the form of foreign tax credits, the effects of the free trade zones are again stronger for investments originating in countries with lower corporate income tax rates, such as Canada and the Netherlands. Investments from the US, on the other hand, still face approximately the same EATRs due to the comparatively high statutory corporate income tax rate in the country of residence.

Costa Rica needs to make further progress on addressing Base Erosion and Profit Shifting (BEPS)³

Protecting domestic tax bases against international tax avoidance and evasion is a priority. Domestic tax base erosion and profit shifting arises when businesses can exploit gaps and mismatches between different countries' tax systems; BEPS negatively affects tax revenues as well as the efficiency and the ability of tax systems to create a level playing field for all firms. While BEPS is a worldwide concern, it is of particular importance to developing and emerging economies where tax legislation and its administration may struggle with the complexities of modern business. Furthermore, Costa Rica's high CIT rate places it at particular risk of tax avoidance and hence, of revenue losses. In the absence of effective anti-avoidance measures, MNEs investing in Costa Rica may be able to obtain substantial tax advantages by engaging in BEPS strategies to shift profits out of the country. To prevent such tax planning and enable the collection of a fair share of tax on host country profits from such enterprises, Costa Rica should strengthen its tax base protection rules.

Costa Rica has agreed to implement all four minimum standards and recently established a BEPS Commission. Costa Rica has actively participated in the OECD/G20 BEPS project. To ensure a consistent global approach to the implementation of the OECD/G20 BEPS project, OECD and G20 countries have developed the Inclusive Framework on BEPS (IF) which allows interested countries and jurisdictions to work on an equal footing with OECD and G20 members on developing standards on BEPS related issues and reviewing and monitoring the implementation of the whole BEPS package. The first meeting of the inclusive framework took place in June and July 2016, and Costa Rica participated and agreed to the implementation of the four minimum standards. In August 2016, Costa Rican tax authorities established a BEPS Commission to work on a domestic regulatory framework to implement the BEPS Action Plan.

All countries participating in the IF are expected to implement the four minimum standards and implementation will be subject to peer review. The four minimum standards relate to: harmful tax practices (Action 5) (OECD, 2015b); preventing tax treaty abuse (Action 6) (OECD, 2015e); Country-by-Country Reporting (Action 13) (OECD, 2015c); and dispute resolution mechanisms (Action 14) (OECD, 2015d). A robust process for peer review assessment of all countries' implementation of the BEPS minimum standards is being developed by the IF.

Box 2.4. A comprehensive package of measures to address BEPS

The OECD/G20 BEPS project produced a 15-point Action Plan including minimum standards, common approaches, best practices and new guidance in the main policy areas.

- Minimum standards have been agreed upon in the areas of fighting harmful tax practices (Action 5), preventing treaty abuse (Action 6), Country-by-Country Reporting (Action 13) and improving dispute resolution (Action 14). All participating countries are expected to implement these minimum standards and implementation will be subject to peer review.
- A common approach, which will facilitate the convergence of national practices by interested countries, has been outlined to limit base erosion through interest expenses (Action 4) and to neutralise hybrid mismatches (Action 2). Best practices for countries which seek to strengthen their domestic legislation are provided on the building blocks for effective controlled foreign company (CFC) rules (Action 3) and mandatory disclosure by taxpayers of aggressive or abusive transactions, arrangements or structures (Action 12).
- The permanent establishment (PE) definition in the OECD Model Tax Convention has been changed to restrict inappropriate avoidance of tax nexus through commissionaire arrangements or exploitation of specific exceptions (Action 7). Follow-up work is being undertaken in 2016 which will also provide further guidance on the attribution of profits to PEs. In terms of transfer pricing, important clarifications have been made with regard to delineating the actual transaction, and the treatment of risk and intangibles. More guidance has been provided on several other issues to ensure that transfer pricing outcomes are aligned with value creation (Actions 8-10).
- The changes to the PE definition, the clarifications on transfer pricing, and the guidance on CFC rules are expected to substantially address the BEPS risks exacerbated by the digital economy. Several other options, including a new nexus in the form of a significant economic presence, were considered, but not recommended at this stage given the other recommendations plus Value Added Taxes (VAT) will now be levied effectively in the market country facilitating VAT collection (Action 1).
- A multilateral instrument will be implemented to facilitate the modification of bilateral tax treaties (Action 15). The modifications made to existing treaties will address the minimum standards against treaty abuse as well as the updated PE definition.

At the February 2016 G20 Finance Ministers meeting, the inclusive framework for the global implementation of the BEPS project was endorsed, with a reiteration of the commitment to timely implementation of the BEPS project and to continue monitoring and addressing BEPS-related issues for a consistent global approach. Costa Rica is a member of the Inclusive Framework on BEPS.

The tax policy recommendations that can be drawn from this analysis are as follows:

Recommendations

- Simplify the tax depreciation scheme by grouping assets in broad asset classes.
- Address the debt-equity bias, preferably by increasing the withholding tax rates on interest payments to at least the level of dividends, but preferably higher.
- Over time, consider levying taxes on capital income at the individual level and lower the standard CIT rate.
- Introduce a profit-based interest limitation rule, as foreseen in the tax reform proposal.
- Tax all capital gains, both habitual and non-habitual, under the CIT as planned.
- Apply clear and transparent definitions of territoriality.
- Introduce tax relief for the withholding taxes paid on foreign source passive income.
- Ensure that business costs incurred to earn foreign-source passive income can only be deducted from that source of income and not from domestic business income.
- Implement the BEPS OECD/G20 minimum standards.
- Consider the merits of whether to strategically expand Costa Rica’s tax treaty network.
- Perform an in-depth cost-benefit analysis of the corporate tax incentives, including the Free Trade Zone regime.

Notes

1. E.g. DGT-R-032-2014 of August 6, 2014; DGT-755-2008 of November 21, 2008; DGT-066-2008 of January 21, 2016
2. Costa Rica is a member of the Inclusive Framework on BEPS. As part of the Inclusive Framework’s peer review process, Costa Rica’s Free Trade Zone regime is being reviewed by the Forum on Harmful Tax Practices (FHTP) to assess its compliance with the minimum standard developed as part of the work carried out under Action 5 of the BEPS Project. This Tax Policy Review has not involved an assessment of Costa Rica’s compliance with the minimum standard and nothing in this report should be taken to prejudge the FHTP’s assessment.
3. This paper does not carry out a thorough analysis of the extent to which Costa Rica has effectively implemented the minimum standards of the BEPS package. A robust process for peer review assessment of all countries’ implementation of the BEPS minimum standards is being developed by the Inclusive Framework on BEPS, which is the appropriate forum through which such an assessment will be undertaken.

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