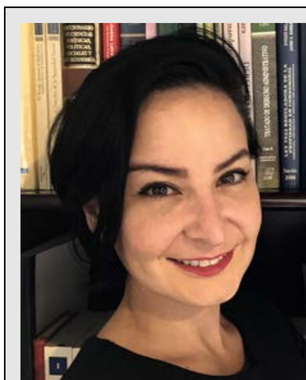
tax notes international®

© 2018 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

Tax Reform and Fiscal Woes in Costa Rica

by Laura Castro-Rauch



Laura Castro-Rauch

Laura Castro-Rauch is a practicing attorney, a notary public, and a founding partner with Techniuris Law Firm in San José, Costa Rica. She is also the founder and board member of the PROSADEH Foundation, which provides legal, human rights, and health assistance to those in need around the world.

In this article, the author discusses Costa Rica's tax reform proposal, which aims to limit state spending, convert the sales tax to a VAT, and restructure income tax and capital gains.

Fiscal problems were front and center during the campaign leading to Costa Rica's recently held presidential and congressional elections. All political parties recognized the need for immediate action to address the problems.

For several years Costa Rica's fiscal deficit has exceeded 5 percent of gross domestic product, reaching 6.2 percent in 2017 (considered the largest fiscal deficit in recent Costa Rican history).

A primary reason behind this situation is the way in which public employees are paid: They are guaranteed real salary growth that in most cases exceeds the real growth of the national economy.

According to the Central Bank of Costa Rica, the growth of government spending for 2017 was 9.1 percent, while tax collection grew only 5.3 percent. The dynamic between expenditure and income has caused pressure groups (including the opposition parties in Congress, trade unions, the National Association of Public and Private Employees, the teachers' union and related unions, and health-sector unions) to call for the containment of spending and the optimization of available resources to prevent more debt.

This is a responsibility that the central government shares with the Legislative Assembly, since in the last decade the legislative branch has approved new expenditures without a proven financing source.

An additional cause of the high fiscal deficit is limited and poorly executed tax collection, which allows taxpayers to evade their tax obligations. The Ministry of Finance has few legal and administrative compliance enforcement tools at its disposal.

Costa Rica's tax laws have not been updated for over 30 years. For example, the 1982 sales tax law does not tax most of the services sector. Also, the 1988 income tax law only taxes profits generated within Costa Rican territory, leaving untaxed any income generated outside the country.

The great challenge facing Costa Rica today is the enactment of tax reform that includes regulated public-sector employment salaries and the increase of state revenue.

Several tax reform bills have been presented to the legislative body in the last decade, but because of political turbulence inside the multiparty Legislative Assembly these bills have been buried or shelved.

In a bid to address the fiscal situation, the outgoing administration of former President Luis Guillermo Solis proposed Ley de Fortalecimiento de las Finanzas Públicas Expediente No. 20.580 (Law 20.580). This bill contains four core reforms, two of which are designed to limit state spending through modifications to the public wage system, with the other two focused on changing the tax laws.

The proposed state spending modifications are:

- To establish a "maximum salary" that regulates public worker benefits and

For more *Tax Notes International* content, please visit www.taxnotes.com.

incentives received in addition to basic salaries, and to encourage public officials to work for the achievement of goals.

- To establish a "fiscal rule law" that limits spending by the central government and autonomous institutions not related to financial services. Under the proposed modifications, expenditures may only increase in response to two variables — central government debt and GDP growth.

Tax reform would include the conversion of the sales tax to a VAT and the restructuring of both income tax and capital gains tax.

VAT

Although the sales tax levies tax on the sale of goods, it does not tax most services. A change to this law is of vital importance because Costa Rica began converting to a service-oriented economy at the end of the 20th century. Today, nearly half the national economy is service-based.

Law 20.580, if approved, would create a 13 percent VAT on both the sale of goods and the provision of services. The bill also includes a reduced rate of between 2 and 4 percent for services including healthcare, private education, air tickets purchased in Costa Rica, agriculture inputs, agro-industry, aquaculture, personal insurance, labor risks, agriculture and livestock, social housing, and residential private security.

The bill would also exempt public transportation, books, loans, housing under approximately $750/month, and low-consumption residential electricity and water services from VAT, among other things. Some sectors, including tourism, architecture, civil engineering, and construction, would have a phased implementation of VAT to reach the 13 percent rate in four years. These sectors would be exempt from the VAT for the first year (one year from approval and execution), and then would pay 4 percent for the second year, 8 percent for the third year, and 13 percent from the fourth year.

Streaming services to customers in Costa Rica, like Netflix and Spotify, would pay a 13 percent VAT, as would internet-based home rentals like Airbnb. Uber services, Google or Facebook advertisements, and paid computer programs like antivirus software would also pay the 13 percent VAT.

The implementation of a VAT should improve tax collection because of the automatic deduction of VAT paid to suppliers in the production chain. This would generate a fiscal footprint that should allow the government through cross-checking to decrease tax avoidance and evasion.

Income Tax Law and Utilities

Law 20.580 is intended to tax wealth, either in cash or in kind, received from assets, rights, or liabilities. The main change from current tax law is the creation of a tax on capital gains income.

Law 20.580 proposes to tax both real estate and capital income, including leases and key rights on real estate. It would also tax income from movable capital like profits obtained from the handling of money or other goods like dividends, cooperative participation, and the distribution of surpluses or other types of benefits similar to dividends. This change would mainly affect companies, trusts, employee financial associations, and credit cooperatives. The tax would be levied at 8 percent.

Law 20.580 also proposes an increase in the tax rate levied on interest earned, calling for it to rise from 8 percent to 15 percent depending on the type of institution holding the wealth. Finally, new regulations concerning capital gains earned in tax havens would no longer allow expenses arising in these jurisdictions to be deducted from income tax.[1] This should help the government improve its fiscal control.

Conclusions

Costa Rican public finances are in a critical phase, with spending outstripping government revenue. This has forced the government into debt and led to the use of government money to pay loan interest instead of funding social programs, infrastructure, and other investments to facilitate national advancement and economic stability.

Most national actors agree that it is necessary to modernize the tax system and reduce tax evasion. However, this will require greater control of executive-branch expenditures.

---

[1]The tax administration qualifies persons, countries, or territories as "tax havens" or "non-cooperating jurisdictions" if they pay less than 40 percent of the tax on Costa Rican profits or do not have agreements with the Costa Rican government to exchange tax and financial information.

For more *Tax Notes International* content, please visit www.taxnotes.com.

© 2018 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

The Ministry of Finance has been implementing several measures to promote the banking sector and to force the use of electronic invoicing as a means of control. However, other specific measures are needed to combat corruption and tax fraud.

Through VAT, Law 20.580 would broaden the tax base by including services and taxing the added value that each producer brings to the good or service they provide. This would formalize the economy and allow tracking of tax evaders. However, it is not enough.

Unions are fiercely opposed to Law 20.580, claiming it would affect the poorest and weaken social care programs. It is therefore expected that legislative discussions will lead to protests and pressure from different sectors.

The previous Legislative Assembly moved the discussion of Law 20.580 to the "fast track." Newly sworn-in President Carlos Alvarado Quesada and his cabinet face an opposition majority in congress and have initiated dialogue with the opposition with the hope of passing the new bill by July 2018.

The majority of opposition deputies agree with the need for reform, but have conditioned support on their own agendas. Opposition lawmakers have also called for a limitation on state spending and the exclusion of staple foods (like rice, beans, and sugar) from new VAT. However, with a general consensus supporting the need for tax reform, the tradition of "kicking the can down the road" has hopefully ended and true reforms can be implemented.

One final caveat: This article was prepared based on proposed Law 20.580 as of May 21, 2018. To date it contains more than 20,000 motions, so many things could change. ■

For more *Tax Notes International* content, please visit www.taxnotes.com.

© 2018 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.