

# Central American Free Zones

## An overview of regulatory frameworks

By Marielos Bogarin

The creation of Free Zones has been a successful initiative by Central American governments to promote trade, attract foreign direct investment, and establish commercial ties and business opportunities.

Free Zones have many positive effects, including contributing to the social and economic development of the respective country or region, diversifying exports, creating employment and strengthening commercial dynamics between the countries. They are also an attractive option for investors as they allow companies to increase competitiveness and profitability by operating under a scheme of incentives and benefits. Companies established within Free Zones receive a number of incentives including tax cuts and exemptions.

The creation of Free Zones in Central America has become an important tool to boost the economies of the countries in the region. Each country has developed its own specific laws to make it easier for foreign companies to get established within their Free Zones.

The fiscal incentives and benefits granted by the legislation of different Central American countries are similar. They include full or partial exemption on: income tax for limited periods; value-added tax; and the taxes, tariff, duties and charges applicable to the import and export of certain products. These tax benefits are generally granted to both the companies established in the Free Zones as well as the companies that administer the free zones (usually local companies that rent space to manufacturers and sell them different services).

The following is a description of the main Free Zone regulations by country.

### Guatemala

The Free Zones Act (Ley de Zonas Francas) of November 1989, Decree number 65-89, establishes the regulations to Free Zones within Guatemala. Free Zones are defined as areas subject to special customs regulations that allow the manufacturing or commercialization of goods for exportation or re-exportation and provide services associated with international trade.

The regulations differentiate between Public Free Zones or those decentralized entities created by law and Private Free Zones, which include companies that are in charge of building and managing the free zones.

The Ministries of Economy and Public Finance are the authorities responsible for authorizing the establishment and operation of Free Zones. As part of the process to obtain

authorization for a Free Zone, the Direction of Industrial Policy (Dirección de Política Industrial) must submit a report to the Ministries.

According to Guatemala's Free Zone Act, companies that produce goods for exportation or re-exportation; companies that commercialize goods to export and re-export them without transforming or modifying the original product; and companies that offer services related to international trade can settle in a Free Zone.



Photograph: Raúl Morán

There are several types of companies that can settle in a Free Zone without prior authorization because they do not benefit from fiscal incentives. These include: travel agencies and airlines; companies of maritime, land or air transportation; companies that are ruled by the banking and financial laws of the country; and companies providing services not related to the exportation activity within the Free Zone.

The law also defines types of companies and activities that cannot be established within a Free Zone. These include: oil and natural gas companies; the fishing and farming of marine

species or fresh-water species; entertainment centers and hotels; sweet cane sugar companies; and companies dealing in explosives and radioactive materials.

Companies that breach the laws of the Free Zone can be fined or have their licenses revoked.

### El Salvador

Free Zones in El Salvador are regulated by the Industrial Free Zones and Commercialization Act (Ley de Zonas Francas y Comercialización) of September 1998, Decree number 405.

This law regulates the benefits granted to Free Zone companies, as well as the responsibilities of Free Zone owners and operators. According to the law, goods within Free Zones are considered outside the custom territory of El Salvador with regards to import and export duties and are subject to special regulations and procedures.

Both national and foreign companies can settle within Free Zones. The establishment, administration and functioning of Free Zones is overseen by the Ministry of Economy, while the fiscal controls are overseen by the Ministry of Treasury.

In order for a company to be eligible for a Free Zone, the business must be in industrial, agricultural or agro-industrial

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trade; its facilities must comply with proper industrial, labor and environmental safety conditions; and the business must have legally approved administrative and financial procedures. Free Zone developers must obtain authorization from the Ministry of Economy before operation in a Free Zone can start.

Companies that do not meet the technical requirements to establish their business within a Free Zone may still receive special customs treatment under the Industrial Free Zones and Commercialization Act if they are importing goods into the country for a limited time only to be re-exported after being processed, manufactured or repaired. This activity falls under the Customs Regime Areas (Depósitos de Perfeccionamiento Activo) or “fiscal enclosures”—regions that operate under special customs treatment.

Excluded from Free Zone benefits are hotels; travel agencies and airlines; maritime, land and air transport companies; banking and financial activities ruled by sector-specific laws; development of oil and natural gas; fishing; and mining extraction.

The law also establishes a series of administrative, fiscal and even criminal penalties for those breaching the obligations related to Free Zones operations.

### Honduras

The Constitutive Act of the Free Zone of Puerto Cortés (Ley Constitutiva de la Zona Libre de Puerto Cortés) of July 1976, Decree number 356, changed its name to the Free Zone Act (Ley de Zonas Libres) Decree number 131-98 in May 1998 and extended the benefits and regulations of the 1976 act

for the Puerto Cortes area to the entire Honduran region.

While Free Zones can be established anywhere in Honduras, they have to be a defined area enclosed by fences or walls. Free Zones or Restricted Areas are under control and fiscal surveillance by customs, do not include a residential population, and have territorial limits established by the executive branch. Local or foreign companies with commercial, industrial or exportation activities can settle in these zones.

The administration of Free Zones is exercised by the Minister of Industry and Commerce, through the General Direction of the Productive Sectors (Dirección General de los Sectores Productivos). Licenses to operate within a Free Zone are granted by the Administrative Institution. The Customs Authority controls, oversees and inspects the performance and operation of companies within these zones. It also authorizes inbound and outbound goods under the special benefits granted by law. The Treasury and Credit Secretary issue the regulations necessary to supervise the entry and exit of goods to the Free Zone. Finally, an ad hoc commission, created by the Free Zone Act, acts as a consultancy for the Industry and Commerce Minister that focuses on sector-specific issues.

Companies that want to benefit from Free Zone incentives must file an application before the Minister of Industry and Commerce. If the application is approved, the next step is to sign an agreement with the office in charge of tax collection, the Revenue Executive Direction (Dirección Ejecutiva de Ingresos), which will include information about the services offered, control mechanisms and inspection of the Restricted Area or Free Zone.

Companies established within Free Zones must register at

Global Park, Costa Rica.

Photograph: Mónica Quesada



least one permanent representative with full powers to act in Honduras with the Minister of Industry and Commerce. In the absence of such a representative, the Minister of Industry and Commerce is entitled to cancel the agreement or license of the company.

Companies that breach the Free Zone regulations are subject to sanction under the Honduran Tax Code.

### Nicaragua

The Law of Industrial and Exportation Free Zones (Ley de Zonas Francas de Exportación) of November 1991, Decree number 46-91 regulates Free Zones in Nicaragua. A Free Zone must be established by various ministries and is defined as an area within the national territory, without residential population, that is under the surveillance of the General Direction of Customs and subject to special customs control.

In Nicaragua there are two types of free zones: ones that are privately owned and managed (called Free Zone Operating Companies) and ones that are owned and managed by the Nicaraguan government (called Free Zone Corporations). Free Zone Operating Companies must be established with the sole purpose of operating in a Free Zone. Foreign firms may operate through their branches or divisions. Free Zone Corporations belong to the government and are in charge of the organization, development and administration of state free zones.

Both the state and private zones receive the same benefits and incentives, such as 100 percent exemption from income tax for a period of 15 years from the start of operations or total exemption from sales taxes and value added taxes. In addition, some companies may be authorized to establish themselves out of the free zone and yet receive all the benefits a company within a free zone receives. These companies are called ZOFAS (Zonas Francas Administradas). They receive this special treatment because of the origin of their raw materials, the nature of their production processes or because of the company's special characteristics.

To settle within a Free Zone, a company must file an application before the National Commission of Free Zones. Only companies involved in the production, storage and exportation of goods or services are eligible to apply.

### Costa Rica

The Free Zone Act (Ley de Zonas Francas) number 7210 of November 1990 sets forth the incentives, benefits and regulations of companies setting up within Free Zones. To be eligible for establishment in a Free Zone, a company must be a "new" investor, which is defined by the Free Zone Act as making an initial investment in fixed assets of at least \$150,000 or its equivalent in local currency. Companies outside a Free Zone may also be eligible for the incentives and benefits of the Free Zone if they make an initial investment in fixed assets of at least \$2 million or its equivalent in local currency. Companies associated with the manufacturing, production, repair and maintenance of goods and services destined for exportation

or re-exportation can establish in a Free Zone.

PROCOMER, the Costa Rican trade promotion agency, is the government body in charge of regulating the Free Zones and recommending the granting of Free Zone licenses to companies by the executive branch. The Ministry of Treasury controls and oversees the fiscal systems of the Free Zones and companies outside these zones that have obtained the benefits and incentives.

When a company receives authorization for a Free Zone license from the executive branch, it must sign an agreement with PROCOMER. Some types of companies are not eligible for Free Zone licenses. These include banking, financial and insurance companies, as well as professional service providers.

The Costa Rican Free Zone Act differs from other Free Zone Acts in the region. For example, in Costa Rica, employees of Free Zone companies may receive special training at the National Institute of Learning (INA) in order to develop the skills and knowledge required by their company. Also, Free Zones or Free Zone companies located in areas of minor development can benefit from the Ministry of Labor and Social Security's national program for employment generation, which provides training and offers jobs to unemployed and low income people in the area.

Finally, similar to other jurisdictions, the law sets forth sanctions for those Free Zone companies that breach their legal and contractual obligations. These vary from fines to the exercise of criminal actions and the suspension of benefits.

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### Summary

Free Zones are an important tool for the development of

Central American countries. They provide incentives and economic benefits that attract foreign and local investment, among them, "extraterritoriality" treatment of goods, which excludes them from taxes, tariffs and duties. Furthermore, companies under this treatment can also obtain other fiscal, legal and logistical incentives that improve their ability to compete on a global level, such as adapted infrastructure for the companies' requirements and technology facilities.

Free Zones enhance free trade and contribute to employment, economic growth and industrialization. They also contribute to the countries' participation in globalization, international trade and attraction of foreign direct investment. In Costa Rica for example, a study by PROCOMER and the Ministry of Trade on the impact of Free Zones between the years 1997-2005, showed that Free Zones constituted 42 percent of foreign direct investment in the country in 2005, and that companies located in Free Zone areas generated 39,000 direct jobs in 2005. The Costa Rican Free Zones Association estimated that those companies contributed to 44,000 direct jobs in 2006.

The Costa Rican figures indicate that Free Zones have made a strong contribution to economic development in Costa Rica and have propagated notable growth in the entire region. The countries in Central America have wagered on this system of Free Zones as the basis for the expansion of their economies. ■



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