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HIGHLIGHTS OF THE TAX AND TRADE FAIRNESS ACT OF 1997

(Ley de Justicia Tributaria y Comercial --Ley Nº 257-- LJTC)

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Highlights of the Tax and Trade Fairness Act of 1997
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Introduction

This is a very comprehensive law that affects almost all the taxes of the central government as well as the system of municipal taxation The law also affects many of the various exemptions and exonerations as well as other conditions authorized by several other laws and decrees This brief note will only highlight those changes that this law introduces that are likely to be of the greatest impact on individuals, business, the fisc, and the nation For detailed information about specific issues, the reader is advised to directly consult the law itself and any related laws

In general terms, the Ley de Justicia Tributaria y Comercial (LJTC) lowers tax rates, eliminates exemptions and exonerations, reduces protection of domestic producers opening them to international competition, and takes away the power of the executive branch and officials to authorize tax breaks that are not explicitly authorized by law At the same time, the law requires that all taxes be paid to the Ministry of Finance or municipal governments This is an attempt to adequately account and budget for all the resources of the Central Government

The LJTC also includes separate chapters for special treatment for investment in hospitals, the treatment of cooperatives, and temporary treatment of the tourism sector Of perhaps little national significance, the LJTC revises the stamp tax that must be paid on a number of official transactions (licenses, passports etc)

Exemptions (the LJTC does not differentiate between exemptions and exonerations)

As an amendment to Common Tax Legislation, the LJTC only authorizes the following exemptions
- Education institutions, as in the Cn Art 125
- Fire fighters and the Red Cross
- Foreign Governments and their diplomatic missions
- Churches
- authorized NGOs
- importation of books and published materials
- importation and transfer of medicines and related materials

The LJTC specifically repeals other exemptions not included in the constitution or not otherwise established by law Specific exemptions are also itemized for each type of tax

An important change is that the LJTC specifically mentions that state enterprises must, in general,[1] pay taxes and that the government itself must pay import duties, although special regulations will be prepared to handle the budgetary and accounting aspects of this change

Income Tax

In general, the income tax law changes take effect July 1, 1997 There are two types of reforms The first are reforms to the basic structure of the income tax and the other is the introduction of the alternative minimum tax based on assets value This alternative minimum tax is to be applied to both corporations and individuals other than salary earners

General reforms The major change in the personal income tax is that the tax rate structure has been adjusted The first taxable income bracket applies a marginal rate of 10% and starts at C$50,001 This compares to the prior floor of C$25,001 at a 7% marginal rate The top marginal rate of 30% is applied to income over C$400,000 The top income bracket, with the 30% marginal rate, had started at C$180,001 What this means is that all taxpayers will now pay less income tax than they had been paying

As of July 1999, the top marginal tax rate is to be lowered to 25% This applies to both individuals (personas naturales) and corporations (personas juridicas)

Under the old law Nicaraguans residing in Nicaragua and working for foreign funded organizations were exempt from the income tax Now they no longer are For instance, Nicaraguan professors at the University of Mobile in San Marcos now are required to pay income tax whereas before they were exempt This is also true for Nicaraguans working on USAID funded projects

One important change is that although cooperatives are exempt from paying income tax on their "surplus generations" (excedentes) any distribution of these surpluses to members will be taxed as ordinary, personal income

Under the new law, financial institutions are now authorized to deduct the increases in their reserves for potential losses This is new for Nicaragua but is consistent with international norms and is considered to be an important step in consolidating other reforms of the financial sector

Interest earnings, capital gains and other earnings from financial instruments are not taxable as personal income

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[1] Certain exemptions will apply, for instance in cases where public enterprises are importing capital goods paid for with donor financing

All businesses that are in the IGV system (agentes retenedores) are required to withhold 5% tax as income tax for all professional services (lawyers, architects, etc) that they pay in fees The fees paid to these professionals are to be reported to the tax authorities (Direccion General de Ingresos) The same is for fees paid to corporate board members (referred to as "dietas") Under the old law only 1% was withheld

Alternative Minimum Tax (pago a cuenta del IR) This is essentially a tax on assets but is creditable to income tax The taxpayer calculates the tax that would be due based on the listed assets and their values and he also calculates the tax that would be due on the income tax and then pays whichever of these is greater The tax is applied to both individuals (except for salary earners) and corporations

The asset base includes fixed, tangible assets, lands, buildings, fixed machinery, vehicles, furniture and office furniture, etc plus inventories Excluded from this base is the taxpayer's principal residence (casa de habitacion) and personal vehicle (only 1 can be excluded)

In the event that the alternative minimum tax exceeds the amount calculated as due under the income tax methods, the surplus can be carried over and applied to subsequent years (up to two years) This gives breathing space to firms generating actual loses while maintaining the concept of the minimum tax payment

The application to agricultural land is not based on value but on area and varies from region to region For instance, in the Pacific Zone, the tax calculation comes to C$30 per manzana, while it is only C$15 per manzana in the Atlantic Regions In the Pacific Region the first 30 manzanas are exempt while in Managua the first 5 manzanas are exempt and in the Atlantic Region the first 100 are exempt The law does not make clear whether a property is afforded this exemption or whether this is assigned to a person If it is the former, it would be possible to create numerous parcels of land belonging to one owner who would not be required to pay any taxes at all

The tax is not applied to steep, forested lands

Value Added Tax (IGV)

The reform of greatest impact is the incorporation of the "fiscal industries" into the IGV system This will be discussed under that section of the paper

The law establishes that the 15% rate is to be applied uniformly except to 6% charged on air transport and 5% on cement clinker Exports are taxed at zero rate, which means that they do not generate a fiscal debit but the exporter can still claim fiscal credits for all paid IGV on purchased inputs

The IGV is not applied to the transfer (enajenacion) of
- live animals and fish
- crude sugar blocks and salt
- fresh, unprocessed sugar blocks ("panela" or "dulce de rapadura")
- fresh, unprocessed fruits and vegetables
- other basic foodstuffs
- used or second hand goods
- financial transactions and certain insurance
- petroleum and derivatives
- property and land transfers and rentals
- rental of agricultural machinery

Fiscal Industries

The reform of the so called fiscal industries is a major breakthrough in increasing competition in the economy and getting a fairer deal for consumers Actually, this reform goes beyond the so called "fiscal industries" to include a broad reform of the Consumption Excise Tax (Impuesto Especifico al Consumo or IEC) This reform is all inclusive except it does not change anything regarding petroleum and derivatives, which remain for the future [2]

The major change is that now the fiscal industry products, which include cigarettes and other tobacco products, rum, whiskeys and other spirits, beer and carbonated soft drinks, will be treated equally regardless of their country of origin, i e , the tax rate applied will be the same for domestic and imported products In addition, these products as well as all other products subject to this tax, will be included in the IGV system, as well

The following are not subject to this tax
- those specified in the constitution
- diplomatic corps and international organizations
- those products that have special customs treatment (free zone and temporary entry)
- baggage and household effects, according to customs regulations
- products paid for with grants authorized through specific international agreements (multi- or bilateral)
- imports of the Fire Fighters and the Red Cross (when related to their activities)
- those of associations or foundations for projects of social benefit subject (subject to authorization by the appropriate government agency)

[2] Dr Robert Weiner, a NEPAI consultant, is in the midst of preparing an analysis of the petroleum and derivatives market and will make recommendations as to increasing efficiency, competition and taxation of this important sector

Commercial Regime:

Two important reforms are included under this heading The first bans the establishment of non-trade barriers on imports (NTBs) except in certain cases, including sanitary or fitosanitary instances, when environmental concerns are raised, or in cases of public security (such as the importation of certain arms) or in cases of "national emergency" Also, in cases such as "safe guards" and in cases of reciprocity (e g , if a country bans Nicaraguan imports, Nicaragua can ban imports from that country) within the rules of the World Trade Organization

The second reform relates contracts between Nicaraguan concessionaires, such as exclusive distributorships, and foreign firms According to the original law that this law repeals, foreign firms were required to pay very steep indemnization to Nicaraguan partners should the former unilaterally decide to either end or not continue with the relationship Now domestic and foreign firms can enter into relationships with the complete freedom of choice rather than subject to restrictions imposed by law It is not clear what effects this change is likely to generate, especially since current contracts are grandfathered, however many observers feel that this change will usher in greater competition Yet, there is nothing explicit in either the original law nor this reform to lead to this optimism

Trade Taxes

This law makes sweeping changes in the system of import taxes, lowering almost all rates and uniting the ITF (Fiscal Stamp Tax on Imports) and the Temporary Protection Tariff (ATP) Although the fiscal industry reforms also represent a change in the taxation of imported vis-a-vis domestic production, it is discussed above and not here

Unification of ITF and ATP The law repeals the ITF while at the same time it expands the ATP to collect 5% tax on all products that had not already been included in the ATP and it raises the tax on those products already subject to the ATP by five percentage points This enters into effect on July 1, 1997 Its net effect in 1997 is zero, since what is taken away by the repeal of the ITF is exactly matched by the expansion of the ATP However, in January of 1998 the ATP drops five percentage points on all products that have traditionally been in the ATP system (Anexo II of the LJTC)

By January of 2000 the ATP drops to a maximum of 15% and all products that in 1997 had been paying 5%, 10% or 15% will then be paying zero For those products which in 2000 will still be paying the ATP, they will decline to zero by mid-2001

For all the products that were paying ITF but not the ATP the tax will turn to zero in 1999, except for those intermediate and capital goods that are not produced in Central America

Regular Import Duties (DAI) By January 1998 the top rate, which will be applied to final consumption goods, drops to 15% and this will drop to 10% by January 2000 For intermediate goods produced in Central America the maximum rate will drop to 10% in January 1998 and decline to 5% in January 2000 For primary goods produced in Central America the rate will drop to 5% in January 1998 and remain there For capital goods produced in Central America the rate drops to % in January 1998 and remains there For all other types of goods the tariff rate will be zero in January 1998

There are a number of exceptions to this restructuring For instance
- beans and white rice, the rate drops from 25% in July 1997 to 10% by July 2000
- white rice, from 30% to 10%
- paddy rice, from 20% to 5%
- yellow corn and sorghum, from 20% to 10%
- chickens, parts and breasts, from 60% to 10%
- chicken legs and thighs, from 200% to 170%, then to 100% by July 2002

The following other products each have their own schedule of reductions
- clinkers
- cement (grey)
- new tires
- powdered and liquid milk
- and sugar from various sorts This is subject to a number of treatments depending on treatment abroad and in international agreements

Municipal Taxation

Municipal taxes are established by the National Assembly The main generator or municipal tax revenues has been a tax on gross revenues (similar to a sales tax) of entities located within municipal jurisdictions This tax had been 2% of total revenues of a firm or its local operation The LJTC lowers this to 1 5% starting January 1998 and then to 1 0% in January 2000 At the same time, a number of exemptions are added, including dairy and meat, exports and a few other products and services An additional reform makes the tax applicable in the municipality where the transfer (enajenacion) takes place rather than where the invoice is drawn up

This reform could lead to severe reductions in municipal revenues, and in some municipalities the reductions may be drastic The LJTC provides a number of years for complete implementation Municipalities need to begin now to ensure their revenues over the coming years

Tax Fraud and Evasion

The LJTC changes a number of aspects of the "delito fiscal" or "fiscal crimes" law, which merit in-depth analysis However, one specific change is likely to weaken the ability of the government to fairly and efficiently impose taxes The LJTC provides that should a tax evader be caught and finally pay the tax obligation and fines that criminal charges will be pardoned Such a provision exists in many countries where tax enforcement is very weak and it is anathema to voluntary compliance, the back bone of every well functioning, modern tax system