International Bar Association Annual Conference 2024

Recent Developments in International Taxation

Ecuador

Juan Francisco Carrasco

Pérez, Bustamante & Ponce, Quito

jcarrasco@pbplaw.com

Introduction

In recent months, the tax system in Ecuador has been modified by two law reforms that are summarised in this report.

Important tax reforms were introduced in the Organic Law on Economic Efficiency and Employment Creation and Organic Law to Confront Internal Armed Conflict, Social and Economic Crisis enacted by the end of 2023 and early 2024, respectively.

The reforms in the Organic Law on Economic Efficiency and Employment Creation focused on promoting employment, simplifying the tax system to increase tax collection, preventing tax evasion and avoidance, and generating sustainable economic growth through investment incentives.

On the other hand, the Organic Law to Confront Internal Armed Conflict, Social and Economic Crisis focused on increasing taxes, and creating temporary taxes to address the fiscal crisis and internal defence against organised crime.

Despite the 2023 presidential candidate Daniel Noboa's campaign promise to reduce taxes, the now-elected President has justified this increase by citing the exacerbation of the country's economic problems following the global Covid-19 pandemic. These problems have led to a significant recession and an increase in security issues proportional to the increase in the unmet basic needs of the population, which has widened the gap between social classes and strengthened the influence of gangs in the country.

The Ecuadorian President also stated that to confront the economic and social situation, resources are needed. According to the Ministry of Economy and Finance, the struggle (to fight gangs) will cost the country approximately $1.2bn, adding all the liabilities that the government currently has, plus delayed payments to social security, suppliers and others of up to $2.9bn, a fiscal deficit of approximately of $5bn, which represents five per cent of gross domestic product, and an external debt of approximately $63bn.

Below is a summary of the main tax reforms included in the two mentioned laws.

Organic Law on Economic Efficiency and Employment Creation

The Organic Law on Economic Efficiency and Employment Creation includes several modifications that, as stated in the draft bill, seek to boost investment and employment, principally among young people. These include the creation of a free trade zone and public private–partnerships due to the impact that such regimes have had on attracting private investment in other countries, as well as other tax measures designed to strengthen the economy and safeguard financial stability.

Free trade zone and public–private investment projects

- A new free trade zone was created for activities related to the industrialisation of goods, services, trade and logistics. It offers special tax benefits, such as a temporary income tax exemption, VAT reimbursement, tax stability and income tax exemption on dividends.

- A new public–private investment regime was created applicable to infrastructure, public services and strategic areas, with special tax benefits, such as a temporary income tax exemption.

Withholding on income tax

- A monthly self-withholding was established for large taxpayers in order to increase tax collection. Pursuant to this law, large taxpayers will not be subject to withholding tax at source, except for transactions made with the Ecuadorian state and its institutions. This self-withholding regime was designed to streamline the process and collect income tax in advance from certain taxpayers who were previously not subject to income tax withholding (eg, exportation companies).

Tax benefits

- New investments focused on the transition towards generating non-conventional renewable energy, and producing, industrialising, transporting, supplying and selling natural gas and green hydrogen will be exempt from income tax for ten years.
- New touristic business investments will be exempt from income tax for seven years. For employers, additional income tax deductibility was implemented related to salaries and wages paid to young employees and people that have been incarcerated.
- A VAT refund was implemented in favour of individuals and companies involved in the construction of real estate projects, except for individuals with more than two projects per year.
- A new tax amnesty regime was implemented for interest, fines and surcharges on outstanding tax obligations before 2023.

New tax residence regime for foreigners

- A new tax residence regime for individuals was created to attract foreigners by offering temporary residence in Ecuador, as long as they invest a minimum set amount and meet other conditions. From a tax perspective, the most attractive aspect of this regime is the tax benefit that allows these tax residents to pay income tax only on Ecuadorian income sources.

Other reforms to prevent tax evasion and avoidance

- Higher fines were implemented for taxpayers who fail to issue invoices, provide information requested by the tax authority or disclose foreign assets.
- Controlled foreign company rules were implemented based on the base erosion and profit shifting action plan.
- The safe harbour provision was eliminated in the transfer pricing regime by which taxpayers who fulfil certain conditions were exempt from the transfer pricing regime. As a result, from this reform on, all taxpayers that have transactions with related parties are subject to the transfer pricing regime.
- A new threshold was established for all transactions up to $500. In such cases, cash payments are not accepted and the financial system must be used in order to benefit from the deductibility of those expenses and tax credit. The threshold is gradually being decreased to reduce tax avoidance (the first threshold was up to $5,000 and prior to this reform, up to $1,000).

Organic Law to Confront Internal Armed Conflict, Social and Economic Crisis

The Bill to Confront Internal Armed Conflict, Social and Economic Crisis, sent by President Noboa to the National Assembly, was limited to increasing the VAT rate. However, after discussions in the National Assembly, the enacted law included temporary taxes and an increase to the capital outflow tax rate. This raised some unconstitutionality claims that are currently being considered by the Constitutional Court.

VAT

The VAT rate was permanently increased from 12 per cent to 13 per cent. At the same time, the President was granted the authority through the law to temporarily increase the VAT rate up to 15 per cent based on public finance and payment balance conditions.

With this new power, President Noboa increased the VAT rate to 15 per cent for 2024. According to the Ministry of Economy and Finance, the VAT increase will generate approximately $1.31bn in revenue for the government in 2024.

Capital outflow tax

The capital outflow tax was increased from 3.5 per cent to five per cent. Concurrently, the President was granted the authority to modify the capital outflow tax rate based on public finance and payment balance conditions.

The report debated in the National Assembly shows that the increase in the capital outflow tax will result in a revenue gain of $241.6m. This is justified by the need for a fastcollections tax that has not yet reached its objective of reducing or deterring the transfer of local funds abroad.

Special contributions

A temporary contribution was created for the following taxpayers:

- companies and permanent establishments that obtained taxable income in 2022 must pay a contribution in 2024 and 2025. The tax rate is 3.25 per cent calculated over the income tax taxable base of 2022; and

- banks and credit unions that generated an income tax taxable base in 2023 must pay a contribution in 2024. The tax rate is progressive, ranging from five per cent to 25 per cent, based on the taxable base amount.

The report debated in the National Assembly indicates that the special contribution for banks and credit unions is intended to tax financial system taxpayers because they have generated the highest profits reported in recent years. This special contribution will amount to $145.9m.

The annual impact of the special contribution for the remaining companies, excluding small and medium-sized enterprises, is estimated at $325.6m.