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Recent Developments in International Taxation

Ecuador

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Introduction: major tax developments in Ecuador

Before reviewing the tax changes in Ecuador, it is necessary to mention some background information about the Ecuadorian economy.

In 2020, tax revenues were lower compared with the last four years. The Ecuadorian public debt reached US$63m, which represents 63 per cent of the Ecuadorian economy.

In 2021, the fiscal deficit was US$7.1m and in order to cover that gap, the government decided to optimise the tax regime through a tax reform that would mainly increase revenues by about US$1.5m in the first two years. In addition, passing the tax reform was a commitment with the International Monetary Fund as part of the agreement for the financial programme with Ecuador.

Taking the above into account, in 2022 Ecuadorian tax developments focused on an important tax reform that had three objectives: (1) to incorporate public finance sustainability measures in order to cover the public deficit cost caused by the Covid-19 pandemic; (2) to restructure inefficient and complex taxes that interfere with investment and sources of employment; and (3) to create evaluation mechanisms and regulations to avoid inefficient tax processes.

The Ecuadorian Government wanted to accomplish these three objectives and passed the Organic Law for Economic Development and Fiscal Sustainability Post-Covid-19 (the 'Post-Covid Law'), which has been in force since 29 December 2021. The main tax reforms are summarised below.

Financial measures

The financial measures mainly targeted the passing of temporary taxes, the increase of existing taxes and the elimination of tax expenditures.

The Post-Covid Law created a temporary tax of 1.5 per cent for individuals who on 1 January 2021 had equity equal to or greater than US$1m, and 0.8 per cent for companies that up to 31 December 2020 had net equity equal to or greater than US$5m. The Post-Covid Law also included a temporary tax to regularise unreported foreign assets to promote transparency, stimulate investment and add resources to the Ecuadorian economy. This special tax is levied on the value of unreported assets of individuals and companies that are Ecuadorian tax residents and have not complied with the payment of income tax or capital outflow tax up to 31 December 2020. The starting rate was 3.5 per cent, which increases up to 5.5 per cent depending on when the voluntary disclosure is made. However, certain taxpayers (eg, public servants and their relatives) are not eligible for this regime. Taxpayers are eligible for
some benefits that include the abolition of fines, sanctions (including criminal sanctions) and any past income liability.

The Post-Covid Law also increased taxable income and its rate for individuals. According to the Ecuadorian Government, this only affects 3.4 per cent of the economically active population (EAP). In addition, the highest tax rate for individuals increased from 35 per cent to 37 per cent.

The Post-Covid Law also eliminated some tax expenditure, such as special deductions (eg, provisions on severance payments are no longer deductible), benefits (eg, income tax exemption applicable for public–private partnerships) and exemptions (eg, the gain derived from the occasional sale of real estate by companies is now subject to tax) in order to increase tax revenues.

The Post-Covid Law also eliminates previous tax benefits that granted income tax exemptions to new investments and replaces them with a reduction of three or five percentage points from the income tax rate (the general rate is 25 per cent). The biggest benefit may be obtained when a taxpayer signs an investment agreement with the Ecuadorian Government.

Domestic rules to avoid double taxation changed from using an exemption method to a tax credit method. Currently, for the calculation of income tax in Ecuador, the income tax paid abroad may be used as a tax credit up to the income tax rate in Ecuador, which is 25 per cent.

**Tax restructuring**

The Post-Covid Law eliminates two income tax regimes that were applicable to small taxpayers and places them in a new tax regime suitable for 'entrepreneurs' and small businesses.

The Post-Covid Law states that legal representatives of companies are not liable for tax debt except under fraud or guilt. Before this reform, legal representatives of companies were jointly responsible for tax debts that a company had, even if there was no fraud or guilt.

Post-Covid Law regulations eliminate the deduction limit applicable to royalties on intellectual property rights, technical services, administrative services and consultancy with related parties.

An excise tax levied on telecommunication services was eliminated in the Post-Covid Law in order to increase connectivity that was essential in the pandemic.
Regulations to avoid inefficient processes

A settlement in tax matters was incorporated as a new option to resolve tax issues and controversies. Before this change, tax controversies could only be resolved through administrative or judicial processes, with the latter taking approximately three to four years to be settled. For this reason, mediation was introduced to resolve controversies and collect taxes in less time, considering that there is approximately US$4.9m in various unresolved appeals.

The Post-Covid Law eliminates the threshold for the automatic application of double taxation agreements. Previously, the possibility to apply a treaty was limited to an amount of approximately US$500k. If the payment exceeded that amount, the Ecuadorian withholding agent was obliged to withhold income tax in application of the Ecuadorian general rules, and the foreign beneficiary had to request the reimbursement of the withheld amount from the Ecuadorian tax authority. Now, taxpayers may apply a double taxation treaty directly and without any limit.