International Bar Association

Taxes Committee Annual Report For 2023

Ecuador

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INTRODUCTION:

Tax reforms in the Organic Law for Economic Development and Fiscal Sustainability Post-COVID-19 (the “Post-Covid Law”) came into force in 2022 to cover the public deficit. The reforms focused on important changes such as an increase in individual income tax, the creation of temporary taxes (e.g., a tax on the net worth of individuals and companies), the creation of new tax regimes, a voluntary and temporary tax regime for the regularization of assets held abroad, and the implementation of a settlement mechanism to resolve tax controversies. This helped to increase tax collection in 2023.

The Ecuadorian Tax Authority collected US$2.742 million in income tax in the first four months of 2023. Although the target of US$2.877 million was not reached, tax revenues increased by 16% which represents US$373 million more than in 2022. Within this group, companies paid 25% more than in 2022 and individuals paid 61% more than in 2022.

This information is worth mentioning since the Constitutional Court analyzed these tax reforms because their constitutionality was questioned, and the Ecuadorian President acknowledged that they made an impact on the economic wellbeing of families. As a result, the Executive Branch is now seeking a new tax reform to alleviate that impact.

Other tax changes were related to several regulatory reforms set forth in Executive Decree 586 which changed previous regulations concerning commercial policies, investments, and fiscal matters to improve economic development. Different tax reforms contained in two separate Law-Decrees issued after the National Assembly was dissolved are pending approval by the Constitutional Court.

Besides the tax legislation changes, the Ecuadorian Tax Authority also focused on control activities to increase tax collection and reduce tax avoidance.

Below is a summary of the mentioned tax reforms and actions taken by the Ecuadorian Tax Authority:

- ***Constitutional Court analysis of tax reforms***

Provisions of the Post-Covid Law that came into force in 2022 were put under review in 2023 by the Constitutional Court due to a lawsuit that sought some provisions to be declared unconstitutional. The Constitutional Court analyzed **(i)** the elimination of the inheritance income tax for offspring, **(ii)** the increase in the income tax rate for individuals, **(iii)** the creation of temporary taxes, **(iv)** the new tax regime for “entrepreneurs” and “small businesses”, and **(v)** the settlement as an alternative to resolve tax controversies; and decided the following:

(i) *The elimination of inheritance income tax for offspring*: It was argued that the exemption from inheritance income tax for offspring and not for other inheritors contravenes the rights of equality and non-discrimination. The Constitutional Court decided that the reform indeed involved an unjustified distinction among the beneficiaries of an inheritance and so it contravenes the rights of equality and non-discrimation. Therefore, the Court ruled that every inheritor will have to pay inheritance income tax.

(ii) *The increase in the income tax rate for individuals:* It was stated that the increase in the income tax rate takes a significant portion of the individual's income, reducing their ability to cover their basic needs and therefore goes against the principle of taxable capacity. The Constitutional Court determined that the tax contemplates a non-taxable allowance and a progressive rate and reasoned that this ensures the fulfillment of taxable capacity, equity and progressiveness principles. The Court decided that this reform is not unconstitutional.

(iii) *The creation of temporary taxes:* The Post-Covid Law included a temporary tax to regularize unreported foreign assets held abroad and to promote transparency. This special tax supposedly contravened the rights of equity, non-discrimination and legal certainty since taxpayers that hid information and avoided paying tax in a given timeframe will not be sanctioned, while the rest of taxpayers will. The Constitutional Court decided that to exempt taxpayers from criminal investigations contravenes the Constitution and hence declared that the criminal provisions were unconstitutional, but not the whole regime.

(iv) *New tax regime for "entrepreneurs" and "small businesses" (this classification was created for smaller tax payers with an income of up to US$300K in the case of "entrepreneurs" and US$20K in the case of "small businesses"):* It was argued that this new regime infringes the principles of taxable capacity and progressiveness. The Constitutional Court decided that the "small businesses" regime that set a fixed tax for taxpayers no matter the income violates the principles of taxable capacity and progressiveness and declared it unconstitutional. However, the Court determined that the "entrepreneurs" regime, which has a progressive tax rate depending on the income, was ruled constitutional.

(v) *A settlement as an alternative to resolve tax controversies:* It was claimed that a settlement infringes the fiscal adequacy principle since it is a disincentive to comply with tax duties. The Constitutional Court decided that for tax transactions, it is crucial to observe the good faith principle which obliges the Tax Authorities to negotiate in good faith in order to protect and accelerate the

tax collection while safeguarding the fiscal adequacy principle. To sum up, the Court ruled that the reform is constitutional.

- ***Other tax reforms***

Executive Decree 586 included income tax reforms such as thresholds on the deductibility of royalties, consultancy, technical and administrative expenses in transactions with related parties, the deductibility of losses on sales of debt portfolios on the stock market, and the recognition of deferred tax. It also included reforms for the regulation of tax stability granted for investment agreements and other minor changes to value-added tax and capital outflow tax.

Overall, Executive Decree 586 encompassed a comprehensive range of reforms targeting income tax provisions, with the intention of bolstering fiscal regulations and ensuring greater clarity and efficiency in taxation matters.

- ***Other tax reforms pending approval***

The Law-Decrees (pending approval by the Constitutional Court to become effective) for the Strengthening of the Family Economy and for the Attraction and Promotion of Investments for Productive Development mainly include tax reforms on individual income tax to increase income tax deductions for personal expenses (aimed to alleviate the 2022 individual income tax increase), the creation of a new regime for tax sports forecast platforms and gamblers, record value-added tax on public events, and the creation of free trade zones.

- ***Increase of control activities***

The Ecuadorian Tax Authority announced the start of control processes after the processing of information received by the Global Forum on Transparency and Exchange of Information for Tax Purposes on more than 70,000 Ecuadorian financial accounts from more than 120 countries. In the first stage of this control process, the main objective was to inform taxpayers of possible unreported information and as a result of this control, more than 270 taxpayers regularized US$812 million of assets by November 2022.

Furthermore, the Ecuadorian Tax Authority checked tax compliance by certain categories of taxpayers who could be failing to fulfill their tax duties, such as:

- *Social media influencers:* The Ecuadorian Tax Authority identified the top 500 influencers in order to control tax compliance mainly with income tax, taking into account that influencers receive income not just in cash but also in kind.

- *Hosts:* The Ecuadorian Tax Authority started a campaign to regulate and check tax compliance by individuals who obtain taxable income from digital platforms such as Airbnb.

- *Sports forecast:* The Ecuadorian Tax Authority identified the 16 main sports forecast companies and lauched a campaign to check tax compliance, since the Authority presumed that these companies had not fulfilled their tax obligations.