

## ECUADOR

### 2007 CORPORATE TAX GUIDE

*Because of the frequent changes to the tax law in Ecuador in recent years, readers should obtain updated information before engaging in transactions. The information contained in this newsletter is current as of January 2007 and is intended to highlight general rules regarding Ecuadorian Corporate Tax Law, and therefore should not be used in lieu of appropriate professional advice relating to your specific circumstances.*

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#### **A. At a Glance**

Corporate Income Tax Rate (%)	25 (a)
Capital Gains Tax Rate (%)	0 (b)
Branch Tax Rate	25 (a)
Withholding Tax (%) ( c )	
Dividends	0
Interest Remitted Abroad	0 (d)
Royalties	25 (c)
Technical Assistance	25 (c)
Services	25 (c)
Branch Remittance Tax	0
Net Operating Losses (Years)	
Carryback	0
Carryforward	5 (e)

- (a) Companies that reinvest their profits in Ecuador are entitled to a reduction of 10% in the corporate income tax rate on the reinvested amount (which means the reinvested profits are taxed at 15%) if they capitalize the reinvested profits until 31 December of the tax year, following the tax year in which the profits are earned. A rate of 44.4% applies to profits derived from oil exploration and exploitation contracts that are not reinvested. (Please see G at the end of the Chapter)
- (b) Capital gains derived from sale of shares are exempt from tax if the sales are “occasional” sales, which are sales that are not made in the ordinary course of business of the company.
- (c) These withholding taxes are imposed on remittances abroad to nondomiciled companies and nonresident individuals. For further details concerning withholding taxes, see Section B
- (d) No withholding tax is imposed on interest remitted abroad if the foreign loan is registered with the Ecuadorian Central Bank and provided the interest rate does not exceed the rates approved by the Central Bank. Otherwise, a 25% withholding tax is imposed on the excess.
- (e) See Section C.

## **B. Taxes on Corporate Income and Gains**

**Corporate Income Tax.** Corporate income tax is levied on companies domiciled in Ecuador. Companies domiciled in Ecuador include those incorporated in Ecuador and companies incorporated in foreign countries that have been approved as branches by the Superintendence of Companies after a legal proceeding. Companies incorporated in Ecuador are subject to tax on their worldwide income. Foreign companies are subject to tax on income derived from activities within Ecuador and from goods and assets located within Ecuador.

**Rate of Corporate Tax.** The standard rate of corporate income tax is 25%. Companies that reinvest their profits in Ecuador are entitled to a reduction of 10% in the corporate income tax rate on the reinvested amount (which means, the reinvested profits are taxed at 15%) if they capitalize the reinvested profits until 31 December of the tax year following the tax year in which the profits are earned. A rate of 44.4% applies to profits derived from oil exploration and exploitation contracts that are not reinvested. (Please see G below)

**Capital Gains.** Capital gains derived from sales of shares are exempt from tax if the sales are “occasional” sales, which are sales that are not made in the ordinary course of business of the company. Losses on sales between related parties are not deductible.

**Administration.** The normal fiscal year runs from 1 January to 31 December. No other closing dates are permitted, regardless of the date a business begins operations. Returns must be filed between 15 April and 30 April.

Companies must make an advance payment of tax equal to 50% of the income tax for the preceding year less withholding tax paid in such year. The amount of the advance payment is calculated in the annual tax return. The advance payment is payable in two installments in July and September.

The penalty for late filing is 3% per month of the income tax due, up to a maximum of 100% of the tax due. Interest at the maximum legal rate, which floats, is levied on all increases in tax assessments from the date the tax was originally due to the date of payment.

**Withholding Taxes.** A 25% withholding tax is generally imposed on the following payments abroad: royalties and payments for technical assistance and services to nondomiciled companies and nonresident individuals; payments to nonresident individuals for services rendered; and payments to nondomiciled companies for professional services rendered abroad or occasional services rendered in Ecuador.

Reimbursement of expenses remitted abroad to third parties on account of costs and expenses incurred outside Ecuador, in connection with the activity carried out in Ecuador, is not subject to any withholding tax, and is locally deductible for tax purposes, provided a Cost Certificate Report issued by an independent audit firm with representation in Ecuador is obtained.

A 5% withholding tax is imposed on local payments of interest by banks and other financial institutions.

Penalties are imposed for failures to comply with the withholding requirements. Delays in depositing withheld taxes with the Ministry of Finance result in a penalty of 100% of the amount withheld, plus interest. A penalty of 5% of the withheld amount is imposed on withholding agents failing to provide the taxpayer with the tax withholding slip. Prison terms of six months to two years are imposed on withholding agents who repeatedly fail to make timely deposits of withheld amounts.

**Dividends.** Gross dividends received from Ecuadorian corporations are exempt from withholding tax and income tax. Dividends received by Ecuadorian corporations from foreign corporations are included in taxable income and subject to corporate income tax at the regular rate of 25%. However, a tax credit is allowed for underlying foreign taxes paid by a foreign corporation on the profits out of which dividends are paid.

**Foreign Tax Relief.** Ecuador does not grant relief for foreign taxes paid to companies domiciled in Ecuador.

### **C. Determination of Trading Income**

**General.** Taxable income is based on accounting profits with appropriate tax adjustments.

In computing taxable income, a company can deduct all costs and expenses deemed necessary and related to the activity, aimed at attaining, maintaining and improving the taxable and not exempt income

Main deductions are listed below:

- Costs and expenses attributable to the income
- Production and manufacturing costs and expenses
- Interest and Financial costs from foreign suppliers
- Interest paid on account of foreign loans, duly registered with the Central Bank
- Devolutions or commercial discounts granted by the Company
- Net cost of merchandizes or services acquired or utilized
- General expenses, being understood as such, administration and sales expenses
- Financial Expenses and costs

- Wages, salaries, fringe benefits, 15% profit-sharing, severances paid to workers and employees
- Taxes, surcharges and Employer's contributions to the Social Security
- Cost of services provided by third parties
- Provisions for uncollectible receivables
- Cost of supplies and materials
- Cost of repairs and maintenance
- Depreciation of fixed assets
- Amortization of investments
- Losses due to destruction, damage, disappearance and other events that affect economically the assets of the Company
- Corporate Losses of previous years. Their amortization shall be effected within the next five tax years following to the year in which the loss occurred, but only up to 25% of the taxable profit of the current year. The non-amortized balance will not be deducted in the following years and will affect the equity directly.
- Employees' travel, lodging and meal expenses
- Promotion and Publicity expenses
- Expenses on account of merges, spin-offs, dissolution and liquidation processes
- Interest on account of debts to local Financial Institutions

**Expenses incurred abroad** are generally deductible, provided appropriate taxes are withheld if the payment constitutes taxable income for the payee. The following payments abroad are deductible within specified limitations:

- Payments for imports, including interest and financing fees, as provided in import licenses;
- Export fees of up to 2% of the export value; and
- Interest with respect to foreign loans registered with the Central Bank of Ecuador.
- Payments on account of international lease of capital goods
- 96% of the Insurance or Reinsurance premiums paid to Foreign Companies that do not have a Permanent Establishment or representation in Ecuador

Nondeductible expenses include the following:

- Interest on foreign loans, to the extent the interest rate exceeds limits established by the Central Bank Board, and interest on foreign loans not registered at the Central Bank of Ecuador; and
- Losses on sales of assets to related parties.

**Inventories.** Inventory is generally stated at cost (calculated using the average, last-in, first-out (LIFO), first-in, first-out (FIFO) or actual methods). Inventory write-offs require specific authorization by the tax authorities.

**Tax Depreciation and Amortization.** Depreciation is generally computed using the straight-line method. The following are some of the straight-line depreciation rates provided in the tax law.

Asset	Rate (%)
Commercial and industrial buildings	5
Office equipment	10
Motor vehicles, trucks and computers	20
Plant and machinery	10

In general, expenditures to acquire property and other assets that produce revenue must be amortized over 5 years, using a straight-line depreciation rate of 20%. Intangibles must be amortized over either the term of the relevant contract or a 20-year period.

The tax authorities may approve other methods and annual rates for depreciation and amortization.

Organizational costs may be amortized over a 10-year period. Research and development expenses are generally written off over five years.

Depreciation of fixed assets in excess of their original cost is permitted if business assets are revalued as a result of inflation or increased replacement costs.

**Relief for Losses.** Net operating losses may be carried forward and offset against profits in the following five years, provided that the amount offset does not exceed 25% of the year's profits. Loss carrybacks are not permitted.

**Groups of Companies.** There are no provisions for filing consolidated returns and relieving losses within a group. However, Consortiums or Association of Enterprises are considered Corporations and therefore subject to file and pay income tax. In all cases, members of a Consortium shall be held jointly responsible for the taxes arising out of the activity for which the Consortium was formed.

#### **D. Value-Added Tax (IVA)**

IVA is levied on the transfer of goods, imports and services provided.

The general rate is 12%, but there are transfers, imports and services levied with "0" rate.

The following transactions are exempt from IVA:

- Contributions in kind to Corporations
- Awards arising from inheritances and liquidation of Companies
- Sale of businesses in which the assets and liabilities are transferred
- Merges, spin-offs and transformation of Corporations
- Donations to public entities and charities
- Transfer of shares, participations and other securities

#### **Transfers levied with "0" rate:**

- a) Food Products of agricultural, aviculture, cattle, apiculture, cuniculture, aquaculture and forest nature; meats and fish in natural estate .
- b) Milks in natural estate, pasteurized, homogenized, powdered. Maternity milks, child protein milks.

- c) Bread, sugar, brown sugar, salt, grease, margarine, oats, cornstarch, noodles, flours for human consumption, canned tuna, mackerel, sardines, trouts, and oils for human consumption, except olive oil.
- d) Certified seeds, bulbs, plants, live roots. Fish flour, balanced foods, fertilizers, insecticides, pesticides, herbicides and veterinarian products.
- e) Tractors with tires up to 200 HP, drill plows, harvest and crop machinery, bombs for irrigation.
- f) Medicines and drugs for human consumption, as well as raw material to produce them. Vases and labels for medicines
- g) Paper and books printed in paper
- h) Goods to be exported
- i) Goods imported to Ecuador by:
  - Foreign Diplomats and Officers of International Organisms, provided they are exempt from custom duties,
  - Passengers entering the country
  - Donations on behalf of Government Entities
  - Goods imported under the Temporary Import Regime, while they are not nationalized
  - Imports of capital goods made by Government Entities, Andean Development Corporation, Interamerican Development Bank and World Bank

**Services levied with “0” rate:**

1. - Fluvial, Maritime and Terrestrial passengers and cargo transportation as well as international aerial cargo transportation.
2. - Health Services
3. - Lease and rent of real estate destined exclusively for housing
4. - Public Services of electricity, potable water, sewer and trash collection
5. - Education Services
6. – Kindergarten, Child Care and Elderly Care Homes services
7. - Religious services
8. - Book printing services
9. - Funeral services
10. - Some administrative services provided by the Government
11. - Public shows and spectacles
12. - Exchange, Stock Market and Financial Services provided by the entities duly authorized by the law and the Government

13. - Transfer of securities
14. - Services for export, including inland tourism
15. - Services provided by Professionals up to an amount of US\$ 800.00 for each case
16. - Toll for the use of roads and highways
17. - Lottery conducted by Junta de Beneficencia and Fe y Algeria (Charity Entities)
18. - Aerial fumigation
19. - Services rendered by artisans
20. - Refrigeration and freezing services for maintenance of food

Services invoiced from abroad for activities performed abroad or occasionally in Ecuador are not subject to IVA .

**IVA Tax Credit:** IVA paid on imports, local purchases of goods, raw materials and services grants tax credit, provided the imports and the purchases are supported by the vouchers and invoices accepted by the Tax Law.

The Tax Credit will be granted on:

- 1.- IVA paid in the local purchase or import of goods that will be part of the fixed assets of purchaser provided the activity of purchaser is to transfer goods or to provide services levied with 12% rate. The tax credit will also apply when the activity of purchaser is to export goods.
2. - IVA paid in the local purchase or import of goods, raw materials and services, provided that goods are transferred or services provided with 12% rate.

### **E. Miscellaneous Matters**

**Foreign-Exchange Controls:** Ecuador does not have exchange controls. All transactions in Ecuador must be conducted in U.S. dollars, which replaced the “Sucre” and is the official currency of Ecuador since January 2002. Exporters may sell their hard currency in the free market. They are no longer required to sell their hard currency to the Central Bank of Ecuador.

**Foreign Investment:** Ecuador does not impose any limitation or pre-requisites to foreign investors. A foreign individual or Corporation can own 100% of a local Corporation. Tax and Legal treatment, in general, is equal for Ecuadorian and foreigners. Repatriation of profits and capital invested has no limitation whatsoever.

### **F. Treaty Withholding Tax Rates**

The Andean Community (CAN) has a new Common Regime to avoid double taxation and prevent fiscal evasion in the Andean Countries, which updates and introduces several

improvements to the current legislation, aimed at promoting the collaboration amongst the Tax Administrations and to attract foreign investment.

The new regime is detailed in Decision No. 576 of the Andean Pact, which was approved by the member countries in the Headquarters of the CAN in Lima, Peru on 4 May, 2004. Former Decision No.40 has been overruled.

The new norm is applicable to Corporations and individuals residents of any of the countries members of the CAN, with respect to income taxes and taxes on patrimony and it is intended to avoid double taxation of the same income or patrimony at the Andean Community level.

### **Tax Jurisdiction**

Independently from the nationality or domicile of the persons, income of any nature received by them, shall only be taxed in the State Member in which said income has its source, unless otherwise stated in the treaty.

### **Royalties**

Shall only be taxed in the State Member where the intangible good is used or owned.

### **Interest**

Interest and other financial yields shall be taxed only in the State Member where their payment or credit into account is effected.

### **Dividends and revenues**

Shall only be taxed in the State Member where the enterprise that distributes them is domiciled. However, the State Member, where the enterprise or individual beneficiary or recipient of the dividends or revenues have their domicile, can not tax the dividends or revenues in the head of the recipient entity or investor, nor in the head of those who, at the same time, are shareholders or partners of the beneficiary or recipient enterprise.

### **Capital gains**

Shall be taxed only by the State Member in whose territory the assets are located at the time of their sale.

### **Providing of personal services**

In general, compensation, fees, wages, salaries, benefits and similar remuneration received as retribution for services rendered by employees, professionals, technicians, or by personal services in general, will only be taxed in the territory in which such services were rendered.

### **Taxes on Patrimony**

Patrimony situated in the territory of a State Member, shall be taxed only by this State.

### Tax Relief Treaties with other countries

The withholding tax rates under Ecuador's bilateral treaties are shown in the table below. The rates reflect the lower of the treaty rate and the rate under domestic tax law.

	Dividends (a)	Interest (b)	Royalties (c)
	%	%	%
Brazil	0	0	15
France	0	0	15
Germany	0	0	15
Italy	0	0	5
Mexico	0	0	10
Romania	0	0	10
Spain	0	0	10
Switzerland	0	0	10
Canada	0	0	15
Chile	0	0	15
Belgium	0	0	10
Non treaty countries	0	0	25

- (a) Dividends are exempt from withholding tax under Ecuadorian domestic law.
- (b) No withholding tax is imposed on interest remitted abroad if the foreign loan is registered with the Ecuadorian Central Bank and if the interest rate does not exceed the rates approved by the Central Bank. Otherwise, a 25% withholding tax is imposed.
- (c) Trademark royalties are taxed at a rate of 25%

### G. Other Related Corporate Issues

- a) **Profit-Sharing:** Ecuador imposes a pre-tax 15% Profit-Sharing to Employers. According to Ecuadorian Labor Law, the 15% Profit-Sharing is distributed in the following manner: 10% among all workers/employees, regardless their salaries or number of dependants and the remaining 5% is distributed among those who have dependants. If we consider this 15% Profit-Sharing as an additional tax, it would turn out that the real Corporate Tax rate is 36.25%, as follows in the example below:

Total Taxable Income	1,000,000
15% Profit-Sharing	150,000
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Taxable Income for Corporate Tax Purposes	850,000
25% Corporate Tax on 850,000 =	212,500
<b>Total Tax Liability: 150.000 + 212,500 =</b>	<b>362,500 (36.25%)</b>

Notwithstanding the above, Employer is obliged to pay this Profit-Sharing only if it has profits in the current year, and provided it maintains employees/workers in the payroll under employment relationship. If it has only one employee/worker, this will be entitled to take the whole 15% Profit-Sharing for himself.

- b) **Transfer Pricing issues:** On 31 December 2004, Ecuador incorporated to its legislation several rules regarding the taxability of transactions between related parties, tax havens and the methods to apply the Arm's Length Principle.

The Methods to apply the "Arms's Length Principle" are briefly described below:

In the transactions celebrated between related parties, the price shall be adjusted through the individual or combined application of any of the below described methods, in such a form that the "*Arm's Length Principle*" is reflected in their result.

1. **Comparable Uncontrolled Price Method.-** It allows to establish the "*Arm's Length Price*" of the goods or services transferred in each one of the transactions between related parties, with the price invoiced for the goods or services transferred in transactions with or between independent parties in comparable transactions.
2. **Resale Price Method. - (Resale Minus).** - It establishes the acquisition price of a good or of a providing of a service, between related parties, multiplying the resale price of the good or the service or of the relevant transaction, to independent parties, by the result of **subtracting**, from the unit, the percentage of gross profit that would have been obtained with or between independent parties in comparable transactions. To these purposes, the percentage of gross profit shall be obtained by dividing the gross profit by net sales.
3. **Cost Plus Method.** - It determines the price of a good or of a providing of a service among related parties, by multiplying the cost of the good, the service or of the relevant transaction, to independent parties, by the result of **adding**, to the unit, the percentage of gross profit that would have been obtained with or between independent parties in comparable transactions. To these purposes, the percentage of gross profit shall be obtained by dividing the gross profit by net sales.
4. **Profit Split Method.-** It establishes the price through the distribution of the "*Global Operational Profit*" obtained in transactions with related parties, in the same proportion that it would have been distributed with or between independent parties in comparable transactions, in accordance with the following rules:
  - a) The "*Global Operational Profit*" of the transactions with related parties shall be determined by adding the operation profit obtained by each one of them; and,
  - b) The so obtained "*Global Operational Profit*" shall be split among each one of the related parties, considering, among others, the individual contribution or each party in assets, costs and expenses incurred in the transactions between said parties.
5. **Residual Analysis Profit Split Method.-** It establishes the price through the distribution of the "*Global Operational Profit*" obtained in the transactions with related parties, in the same proportion that would have been split with or between independent parties, in comparable transactions, in accordance with the following rules:
  - a) The "*Global Operational Profit*" of the transactions with related parties shall be determined by adding the operation profit obtained by each one of them; and,
  - b) Once the "*Global Operational Profit*" has been obtained, both the *Basic Profit* and the *Residual Profit* shall be determined and distributed in accordance with the following rules:
    - (b.1.) The *Basic Profit* shall be obtained for each one of the related parties through the application of any of the other methods, regardless the utilization of intangibles,

(b.2.) The *Residual Profit* will be obtained subtracting the *Basic Profit* from the “*Global Operational Profit*”. This *Residual Profit* shall be split among related parties in the transaction, in the same proportion that would have been split among independent parties in comparable transactions.

- 6. Transactional Profit Method or Transactional Net Margin Method.** - Consists in setting the price, in transactions with related parties, by establishing the operational profit that would have been obtained by independent parties in comparable transactions, based upon profitability factors that take into account variables such as assets, sales, costs, expenses and cash flow.

Companies that perform transactions with related parties abroad in excess of USD 300,000.00 within the same fiscal year must file until April of the following tax year a Transfer Pricing Annex and a Transfer Pricing Integral Report.

**The Transfer Pricing Annex must contain the following information:**

- Taxpayer’s identification
- A nine question questionnaire, to be responded affirmatively or negatively
- Information regarding the related parties abroad
- With respect to transactions performed abroad, the following data must be included:

a) Income operations, received or credited on account of:

Exportation of self manufactured goods, exportation of goods manufactured by third parties, maquila services, administrative services, insurance, reinsurance, commissions, fees, royalties, advertising, technical assistance, technical services, providing of financial services, interest and commissions on loans, leasing,, sale of stock, sale of other obligations and debentures, exportation of fixed assets, other investments, sale of intangibles, profits arising out of transactions with financial derivatives, collaterals and other income.

b) Expenditure operations (costs and deductions) paid or credited into account due to:

Importation of goods for production, importation of goods for merchandizing, maquila services, administrative services, , insurance, reinsurance, commissions, fees, royalties, advertising, technical assistance, technical services, providing of financial services, interest and commissions on loans, leasing,, purchase of stock, purchase of other obligations and debentures, importation of fixed assets, other investments, purchase of intangibles, losses arising out of transactions with financial derivatives, collaterals and other disbursements.

c) Amount of the operation

For income and expenditure operations, other than those of importation and exportation, the US dollar value of the transaction with the related party, must be declared.

d) Methods to apply the arms length principle

For each reported transaction, taxpayer must inform the method utilized, which can be:

- Uncontrolled Comparable Price Method
- Resale Price Method (Resale Minus)
- Cost Plus Method

- Profit Split Method
- Residual Analysis Profit Split Method
- Transactional Profit Method or Transactional Net Margin Method

e) Difference

For each transaction reported, the US dollar value of the difference obtained from the application of the aforementioned methods must be declared, and in the event that no difference results, the US dollar ZERO amount (USD 0,00) must be declared as well.

**The Transfer Pricing Integral Report must contain the following information:**

1. The analysis of the economic environment and of the business, in particular that of the location where the transactions are conducted
2. The activities and functions performed by taxpayer
3. The risks assumed and the assets utilized in carrying out said activities and functions
4. Identification of the related parties domiciled abroad with whom the transactions were effected
5. The detail and the quantification of the operations performed with related parties
6. The elements, facts assessed, circumstances and the documentation for the analysis of the transfer prices
7. The method utilized in the operation, indicating the reasons and foundations for being considered as the method that better reflected the arms length principle
8. The detail of the comparables selected for the application of the method utilized
9. The elements, quantification and methodology used for the implementation of the necessary adjustments to these selected comparables
10. The details of the non selected comparables, mentioning the reasons for discarding them
11. Identification of the information sources from where the comparables were obtained
12. Description of the entrepreneurial activity and characteristics of the businesses of the comparable companies
13. The determination of the median and the arms length range
14. The transcription of the Balance Sheet and Income Statement of the comparable entities corresponding to the fiscal years deemed necessary for the analysis of the comparability, indicating the source of information.
15. The conclusions reached

Additionally taxpayers can also submit an analysis of the related companies abroad and any other type of information which contributes to support their transfer pricing analysis

Information contained in the Transfer Pricing Annex and Integral Report shall be utilized exclusively for tax purposes and can not be disclosed or published.

For additional information contact:

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