

Revenue Policy

The Ecuadorian Experience

Elsa de Mena
March 2005

Politic-economic Environment

- **1998: Economic Situation**
 - **Political instability and social conflict**
 - **Acute economic crisis**
 - **High inflation**
 - **High fiscal deficit**
 - **Petroleum priced at only \$7**

Politico-economic Environment

- **1998: Revenue Situation**
 - Low level of tax collection
 - Negligible fiscal “presence”
 - High levels of evasion
 - High levels of corruption
 - Deficient public spending policy

Politic-economic Environment

- **2000: Dollarization**
 - Made fiscal policy much more important
 - Hence -- *revenue policy too*

The Taxation System

Principal Elements of Tax Policy

1. Legislation
2. Tax Administration
3. Culture of tax compliance in the community

1. Legislation

- Law creating the Internal Revenue Service
- “Ley de Reordenamiento en Materia Económica”
 - Law to reorganize economic affairs
 - Creates the 1% Capital Circulation Tax (ICC)

1. Legislation

- “Public Finance Reform Law”
- Reinststitutes income tax
- Expands the VAT base

1. Legislation

- “Tax Rationalization Law”
- “Tax Reform Law”

Types of Tax

- Income Tax
- Value Added Tax - VAT
- Special Consumption Tax
 - “Impuesto a Los Consumos Especiales” - ICE
- Vehicle ownership tax
- Taxes on inheritance, legacies and donations
- Property taxes
- Public service rates, patent fees and contributions

Capital Circulation Tax

Takes 1% of the value of monetary operations and transactions effected within Ecuador's financial systems.

Income Tax

Applies to legally recorded income of:

- Individual persons
- Corporate persons
 - Ecuadorian or foreign
 - Domiciled in Ecuador or not

Income Tax

Considers recorded income :

- from sources in Ecuador
 - deriving from work or from capital
- from sources outside the country of
 - individual persons
 - corporate persons constituted in Ecuador

Income from Ecuadorian Sources

- Earned by nationals or foreigners from economic activity within the territory of Ecuador.
- Or for activities outside the country by those domiciled within.
- Profits earned on of goods or real estate located within the country.
- Benefits or royalties of any type.
- Dividends and profits distributions from corporate entities constituted, or otherwise established, in the country.

Exemptions

- Profits and dividends calculated *after* income tax has been paid.
- Exonerations stipulated in international treaties, conventions and agreements.
- In reciprocity with foreign states and international organizations
- Of private non-profit organizations.

Exemptions

- Interest earned on demand deposit savings accounts of individual persons.
- Social security benefits from the Instituto Ecuatoriano de Seguridad Social.
- Earnings of institutions of Higher Education
- Non-distributed earnings of legally founded peasant's associations.
- Winnings in the lotteries: “JBG” and “Fe y Alegría”
- Travel ‘per diems’ of civil servants.

Exemptions

- Earnings of the handicapped, and those of sixty-five years of age or more, up to double or triple the basic exemption, respectively.
- Capital gains of investment funds distributed to their beneficiaries after compliance with income tax obligations.
- Insurance indemnities

Taxation Baseline

The taxable baseline comprises:

- the sum of all ordinary and extraordinary income to which the tax applies,
... *less* ...
- the sum of all pay backs, discounts, costs, expenses and deductions attributable to those incomes.

Determinations

Income tax determinations take effect through:

- the declarations of passive subjects (taxpayers)

... or ...

- the acts of active subjects

... or ...

- a mixture of both.

25% Income Tax Bracket

Includes:

- a) Individual persons and undivided heredities
- b) Income of non-resident foreigners.
- c) Organizers of lotteries, raffles, betting and other similar activities.
- d) Beneficiaries of income from inheritances, legacies or donations will pay the single 5% rate over the excess value of the free taxable basis for private individual's income tax.

Income Tax Rate

The 25% rate of taxable income applies to:

- Companies
- Institutions within the national financial system.
- Beneficiaries of other non-dividend or non-profit income sent, paid or credited overseas.

Neither additional obligation nor income tax source retentions apply to:

- Those profits distributed internally, or remitted overseas, *after* payment of income tax
... or ...
- Those with revenue exemptions

Source Retentions

Source retention applies to:

- Payments made by employers to taxpayers working in a relationship of dependency.
- Payments of interest or other financial returns.
- Payments comprising applicable revenues for those receiving them.
- Overseas payments comprising applicable revenues.

Source retention applies *neither* to payments made *nor* to equity used for the exclusive purpose of developing issuance titling under the protection of the Securities Markets Law (“Ley de Mercado de Valores”)

Tax Credits

- Retained tax constitutes a tax credit for the taxpayer that can be used to cancel the full amount of tax indicated in his annual tax declaration.
- In the event that source retention exceeds the indicated tax amount, the taxpayer may, at his option,
 - request reimbursement *or*
 - compensate it against taxes, that were the original object of the retention, indicated in future calculations.

Value Added Tax

Applies to :

- the value of the transfer of ownership at importation time of physical goods and at every following stage of the commercialization chain
... and to ...
- the value of services rendered.

Value Added Tax

Applies to :

- Transfer of ownership of goods, even when the transaction is free of charge
- The sale of goods.
- Purchase-option leasing.
- The use, or personal consumption, on the part of the contributor, of the goods produced or sold by himself.

Exempt of VAT

- Contributions in assets in companies.
- Inheritance judgments
- Partnership dissolution judgments, including matrimonial.
- Sales of enterprises that involve transfer of both assets and liabilities.
- Mergers, splits and transformations of companies.

Exempt of VAT

- Donations to the public sector
- Donations to legally constituted private benevolent, cultural, educational, research, health or sports institutions.
- Stocks, shares and other securities transfers.

Zero rated VAT : Goods

1. Un-processed farmed and fished food products.
2. Nationally produced milk, whether unprocessed, pasteurized, or in powdered form.
3. Local manufactured nursery formulas and baby feeding supplements
4. Basic “family basket” foods.

Zero rated VAT : Goods

5. Agricultural consumables and prepared feeds
6. Fertilizers and insecticides
7. Tractors, agricultural and irrigation equipment
8. Human and veterinarian medications and drugs
9. Bond paper, periodicals, magazines and books
10. Export goods

Zero rated VAT : Goods

10. Brought into the country:
 - a) by diplomats
 - b) by arriving passengers up to the amounts recognized by international convention.
 - c) as foreign donations to state institutions.
 - d) as goods in transit

Zero rated VAT : Services

1. Transport of passengers and cargo
2. Health services
3. Real estate rental for the exclusive purpose of lodgings
4. Public utilities; electricity, water, sewage, garbage collection
5. Education

Zero rated VAT : Services

6. Day care centers and retirement homes
7. Religious and funeral services
8. Printing of books
9. Administrative services of public sector institutions
10. Public events

Zero rated VAT : Services

11. Financial and securities
12. Transfer of securities
13. Exported services including reception of tourists
14. Professional services up to \$400
15. Vehicle traffic tolls

Zero rated VAT : Services

16. The lotteries “JBG”, and “Fe y Alegría”
17. Aerial fumigation
18. Artisan and handicraft
19. Refrigeration and freezing for the purpose of conserving foods

Taxable – Basis

- Is the total value of physical goods transferred or services rendered, that include taxes, service charges and other expenses attributable to the price.
- In the case of barter, personal consumption and donations, the taxable basis shall be relative to going prices.

Defining Event

Transfer of ownership of goods, or rendering of services, attracts VAT at the moment in which it is contracted; obligatorily requiring issuance of the respective invoice, sales note or sales ticket.

Passive taxpayer: perception agent

1. Individual persons and companies that regularly transfer taxable goods.
2. Whoever imports taxable goods for themselves or others
3. Individual persons and companies that regularly render taxable services.

Passive taxpayer: perception agent

1. “Special” taxpayers, through the VAT they must pay over to their suppliers for acquired goods or services.
2. Credit card companies through the VAT charged by their affiliated establishments
3. Insurance and underwriting companies through the payments they make for their own purchases

Tax Credit

A right of passive subjects of VAT, dedicated to:

- commercialization of internal market goods, taxable at 12%
- rendering of services taxable at 12%
- exportation of goods or services

VAT Payment and Settlement

- The total value of taxable operations, with tax credit amounts deducted, must be settled.
- The resulting difference is the value to be paid.
- If the declaration leaves a value in favor, it shall be considered a tax credit, cashable against subsequent months declarations.

VAT – refund

VAT – refunds are allowed to:

- Public sector entities and organizations
- Exporters
- The disabled

Special Consumption Taxes

Apply to sales of :

- Cigarettes
- Beer
- Soft drinks
- Alcohol & alcoholic products
- Nationally produced or imported luxuries

Special Consumption Taxes

The taxable basis shall be determined as 25% presumed commercial margin over and above the customs or factory FOB value.

If margins are greater, then the greater margin applies.

Vehicle Ownership Tax

Placed on owners in accordance with the real valuation of their vehicles, including municipal circulation licenses and any amounts due to other levels of government.

Legislation

- The law must be clear and concise, avoiding the ambiguities that admit tax avoidance interpretations.
- As a matter of basic policy, the law should not admit exonerations.
- The law should specify correspondent non-compliance sanctions.

... Tax Exemptions

- Cause distortion in resource allocation in the economy.
- Complicate administration by breaking lines of control.
- Give rise to a perception of inequality among affected taxpayers.

2. Tax Administration

- Should encourage citizens to voluntary compliance through:
 - simplification of regulations
 - fulfilling taxpayer's information requirements
 - training in and widespread exposure of regulations
- Citizens should come to associate real risk with non-compliance.

Tax Administration

- IRS as an administratively and financially autonomous technical entity
- Personnel regime subject to special statutes that take into account all human resource administration particularities
- Special remunerations regime
- Financial resources:
 - Up to 2% of receipts in 1998
 - 1.5% thereafter

Tax Administration

- Institutional principles and ethics
- Business conceptualization
- Excellent information systems

Information Systems

- Human Resources
- Technology
- Clearly identified processes and procedures

Information Systems

- Single Taxpayer Registry
- Declarations
- Invoicing control

Basic Principles of Tax Administration

1. The administration ensures compliance by remaining open to dialog
2. Compliance is justified, and empowered, when there are no cases of political **mismanagement**
3. Transparent accounting increases confidence in the revenue system and improves compliance.

Basic Principles of Tax Administration

4. Taxation is part of the integrated system of wealth redistribution.
5. Coordination between political government and revenue administration promotes taxpayer compliance.
6. Tax information confidentiality improves taxpayer confidence.

3. Tributary Culture

- Is the civic fiscal behavior of the citizen.
- Implies the recognition that to live within a society carries both rights and obligations.
- Exists in direct relation to the degree of commitment of that society and the legitimacy of the tax administration.
- Presupposes that taxpayers can exact full rendering of accounts.

Tax Evasion

Evasion indicates absence of appropriate levels of tributary culture.

Such behavior constitutes a factor of inequality between taxpayers ...

... which should be eliminated by inculcation of responsible tributary culture.

Revenue Policy

The Ecuadorian Experience

Elsa de Mena
March 2005

*** Fin ***