

DOING BUSINESS IN ECUADOR

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International Tax and Business Guide

Ecuador

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This Guide, which is one of a series dealing with most of the world's trading nations, has been designed for use by clients, professional staff, and business contacts. Copies may be obtained on request from any **MOORES ROWLAND LEADING EDGE** office;

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ECUADOR

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GENERAL INTRODUCTION.-

This Guide was prepared by the professional staff of **MOORES ROWLAND LEADING EDGE,** practice in Ecuador. It is designed to provide potential foreign investors with fundamental information about the Ecuadorian environment, including factors a foreign investor should consider in deciding whether to acquire an existing Ecuadorian company or to start a new operation in the country. These factors include tax planning, employment and labor, financing, importing, exporting, and accounting. The information given is not exhaustive and, unless otherwise indicated, is based on conditions existing at January 2011. Readers are advised to consult with professionals, such as independent accountants, legal counsel, and investment bankers, before taking any formal action.

1. - The Investment Climate

1.01 Introduction to Ecuador;

Straddling the equator on the northwest coast of South America, the Republic of Ecuador is bordered by Colombia to the north, Peru to the south and east, and the Pacific Ocean to the west. Ecuador covers 255,798 square kilometers (98,929 square miles) including 8,010 square kilometers (3,098 square miles) of the **Galapagos Islands**. The Andean Mountains, running from north to south, divide the country into three regions: the coastal plain (*costa*), the central highlands (*sierra*), and the eastern jungle (*oriente*).

Quito, the capital, is located 2,800 meters (9,200 feet) above sea level in the sierra, and **Guayaquil**, the principal port, is located on the river Guayas. Ecuador has tremendous natural resources, including agricultural products, forests, fish, oil, and mining reserves. Spanish is the official and business language. English is spoken extensively, especially in business circles. Ecuador has dollarized its economy and currently uses the United States of America Dollar as legal tender for national and international transactions. Prices, wages, accounting Records are expressed in US Dollars. The dollarization process is an attempt to encourage saving, long-term lending, national and foreign investment, trade, and competitiveness.

With an approximate annual growth rate of 3.45%., at the end of year 2010 the population was estimated at 14.9 million. Population density is 49 inhabitants per square kilometer. The mestizo ethnic group represents 55% of the total population. Foreign investment requirements have been substantially reduced. Furthermore, the government has eliminated all barriers and limitations on the transfer of profits and capital. The same rates of income tax apply to foreign and local investors. Investment incentives are offered to Ecuadorians and foreigners alike.

Foreign investment is especially being encouraged in areas such as forestry, tourism, oil production, mining, and export of nontraditional products. On January 2000, the National

Government “dollarized” the Ecuadorian economy, that is, adopted the United States of America Dollar as the official currency to halt galloping inflation, which threatened to undermine economic stability. International reserves rose to US\$ 5.472,81 million during the year 2010 due to oil price increases on international markets. At January 2011 international reserves remained stable at US\$5.271,62 million. At the end of 2008, inflation was at 8.83 % and for the year 2010 , inflation is projected to be between 4% and 6%.

The Dollarization process has scored some notable achievements such as decreasing interest and inflation rates, and giving rise to economic stability. Projections for year 2011 estimate a growth rate of 2.4%. Imports have registered a notable increase recently. The Imports share in the year 2010 was as it follows: in consumption goods (21%), raw materials (32%), capital assets (26%) and others (21%). The proportion was similar as the one registered in the year 2009.

A decreasing tendency of these exports has been evident during the year 2010. Ecuador is now offsetting its balance of payments deficit through alternative sources such as emigrants’ remittances and the promotion of the country as a tourist destiny. In the financial area, the government has successfully restructured the Banking Supervisory System, based on the Basel Principles.

1.02 Incentives and Financing;

Legal entities incorporated in Ecuador (i.e., limited liability companies, corporations, branches of foreign companies) have full access to all available sources of financing. Incentives take the form of loans at favorable interest rates granted by public and semipublic entities, such as the National Development Bank (*Banco Nacional de Fomento*) and the National Finance Corporation (*Corporación Financiera Nacional*), to approved enterprises and individuals operating in special development areas such as agriculture and industry. Financial entities are being restructured in order to guarantee stability of the financial system.

Tax Stability The Investment Promotion Law guarantees that income tax rates effective on investment registration date be maintained. New investments in established companies not intending to expand or extend production are granted 10 years’ stability, while new investments destined to develop new investment projects or expand production are granted 20 years’ stability. These terms may be extended for a five-year additional term. This benefit is only available for investments exceeding from US\$500,000. Investors availing themselves of such stability may subsequently waive this benefit to take advantage of amended tax rates at a later date, should such be in their interest.

Free Trade Zones. Ecuador has seven free trade zones, located in Esmeraldas, Manta, Riobamba, Machala, Cuenca, Quito and Guayas. The production and commercial use of goods for export and reexport as well as some services such as those linked to international commerce are allowed in these zones. Local manufacturers are not permitted to operate in the zones, but foreign subsidiaries, branches of foreign companies, and foreign individuals can benefit from free trade zone regulations. A foreign investor can also act through a legal representative without setting up a subsidiary or branch. Merchandise entering into a free trade zone is subject to a special customs regime. Imports and exports of merchandise, goods, and machinery to and from the free trade zone are exempt from taxes and duties. Administrative companies located in a zone are exempt from all taxes, including municipal and provincial taxes, for a period of twenty years, which can be extended. Payments for patents, trademarks, and transfers of technology, as well as repatriated earnings, are also tax exempt in the zone. Furthermore, the regime allows personnel to be contracted on a temporary basis, without the

need of a minimum employment term. Investors submit their applications to the company holding the concession to administer the free trade zone. The administrative company prepares and submits a report to the National Council of Free Trade Zones (*Consejo Nacional de Zonas Francas*—CONAZOFRA) for its approval.

In-Bond Assembly Operations Goods entering the country for assembly in Ecuador and reexport are protected by a system of suspended duties and taxes, known as the *Maquila System*. Enterprises authorized under the system to undertake in-bond assembly operations may import raw materials and components on a temporary basis. Temporary admission allows raw materials, molds, dies, machinery, and equipment to be imported free of customs duties under a guarantee for the period until reexport. Such imports are subject to value added tax at the zero rate. Under the *Maquila System*, goods may be imported even if similar national substitutes exist. The MICIP must approve some imports, and a copy of the documentation must be given to the Central Bank of Ecuador (*Banco Central del Ecuador*). Imports authorized by the MINISTERIO DE COMERCIO, do not require permits from the Central Bank. Employment contracts are for a period of less than or equal to the duration of the assembly contract, and some rights (for example, stability) are not covered by labor laws.

Mining Imports of machinery, laboratory equipment, work vehicles, and other supplies necessary for mining activities are subject to import duties at lower than-normal rates. However, the reduced rates do not apply if goods with similar characteristics are produced in Ecuador.

Tourism Tourism companies are generally eligible for an exemption from registration and real estate transfer tax. In addition, certain projects may qualify for total exemption and other tax incentives. This exemption does not affect the 15% employee profit-sharing payment.

Forestry and Agriculture New agricultural companies that are established outside Quito and Guayaquil to process agricultural products pay half of the normal income tax due. The import and commercial use of seeds, animals, and plants to improve the quality of machinery, equipment, and technology are tax exempt. Certain goods, such as food agricultural products, livestock, and fish, are subject to value added tax at the zero rate as long as they are transferred in their natural state.

Exports , are free of all taxes. Preferential customs tariffs or total relief applies to exports transported to specific developed countries, as a consequence of the Generalized Preferential System (GPS). Customs duties paid on foreign raw materials used in the production or manufacture of merchandise destined for export are partially or totally refundable through a drawback mechanism, Value Added Tax paid on acquiring input and raw materials used in the production, manufacture, or treatment of exported products, including agricultural or similar products, is reimbursable. Value added tax reimbursement is also available for products and goods sold within Ecuador, provided that they are ultimately destined for export. The financial sector consists of banks, finance companies, insurance companies, mutual savings and loan associations for housing, storage companies, exchange houses, financial intermediary companies, issuers of credit cards and travelers' checks, and factoring companies.

1.03 Banking and Financing:

Financing is provided to foreign-owned businesses without restrictions, although financial institutions have specific requirements for the granting of credits. Short-term financing is normally provided by commercial banks. Medium-term financing is normally available through financial institutions by leasing or factoring. Long-term credit may be obtained through commercial banks or foreign financial institutions.



2. - Investment, Business Factors and Employment Law

2.01 Foreign Investment rules

Ecuador is a member of the Andean Community, along with Bolivia, Colombia, and Peru. In 1992, the Andean Community decided on a common regime for the treatment of foreign capital and trademarks, patents, licenses, and royalties. These decisions were then incorporated into Ecuadorian legislation. Under this legislation, foreign investment is split into three categories:

1. Direct foreign investment that is not considered sub regional or neutral.
2. Sub regional foreign investment from other Andean Pact countries.
3. Neutral foreign investment by international public financial entities owned by member countries of the Andean Community. Neutral investments are not considered to be either foreign or local investments. Foreign investors are entitled to the free remittance of profits. In principle, Ecuadorian corporations wholly owned by foreigners are free to operate in all economic sectors, without prior authorization, except those reserved for the state (unless The State has delegated the activities to the private sector). The Ecuadorian State may grant to the private sector the performance of the following activities:
 - The production, transportation, storage, and commercial use of hydrocarbons and minerals
 - The generation, distribution, and commercial use of electric power
 - Telecommunications
 - Drinking water & sewer systems

2.02 Participation

The Monetary Regime allows international currency to circulate freely in Ecuador and to be transferred abroad without restrictions. Liabilities may be entered into and paid in foreign currency. Ecuador has “dollarized” its economy, that is, all transactions are executed in Dollars of the United States of America. Ecuador maintains a free exchange market, which is used for imports, exports, inward direct investment, and other private-sector transactions, including transactions in the oil and gas industry.

Inward Direct Investment All foreign investments must be registered with the Central Bank within thirty working days following registration at the Commercial Registry (*Registro Mercantil*) of the articles of association or of any capital increase. A copy of the corporate document and the document supporting the foreign currency exchange must be submitted to the Central Bank at the time of registration.

Foreign Investment Guarantees In sum, enforceable legislation currently provides multiple guarantees to foreign investors such as:

- Reinvestment of non-distributed profits in the same firms in which such profits were generated.
- Remittance abroad (in legal tender) of all proven net profits derived from registered investments, upon payment of local taxes.
- Repatriation of any amounts resulting from the liquidation or sale of an entity in which an investment was made, upon payment of local taxes and deduction of net losses. Transfers of shares to foreign investors are not deemed capital repatriation.
- Unrestricted property ownership and transfers of investments.
- Customs duties preferences granted by the USA and member countries of the Andean Community and the European Union
- Unrestricted access to both national and foreign financial markets. Foreign loans must be registered with Ecuador's central bank in order for interest payments to be tax exempt.
- Income tax stability (10 or 20 years for investments of US\$500,000 or more)
- Foreign investment contracts entered with the State so as to ensure that investment terms and conditions are duly enforced.
- Unrestricted access to promotion and technical assistance mechanism plus incentives in less developed areas and national interest projects.

Repatriation of Funds No control approval is required for the remittance of dividends, interest, or profits abroad. Foreign credits must be registered with the Central Bank of Ecuador. Non-registration of foreign loan shall cause interest payments to be non-deductible. Such interests and financial costs are subject to a 24% income tax withholding when remitted abroad and are deductible for local income tax purposes provided that the amount of the foreign loan does not exceed the 300% of the company's paid capital. The amount exceeding 300% of the paid capital will be not tax deductible. The lending reference interest rate serves as basis to determine the maximum reference interest rates for income tax deduction applicable to foreign loans and funding by foreign suppliers. Such rates are effective on a quarterly basis and calculated in accordance with the lending reference interest rate applicable during the last week of March, June, September and December of each year. The Central Bank of Ecuador registers foreign loans granted to individuals or legal entities organized in Ecuador by foreign financial institutions, head offices, suppliers or vendors and others resident abroad. Overdrafts on current accounts are excluded. For registration purposes, the debtor shall submit within a 45-day term – as of the date the disbursement is made– the corresponding application and enclose the following documents: The document supporting the loan or instrument issued by the foreign creditor that evidences the existence of the foreign liability and financial terms; the document that evidences the entry of currency in to the debtor's local current account; in respect of funding for importation purposes, a copy of the import declaration – and the letter of credit or bill of exchange shall be submitted; and, as regards the payment of services and other liabilities, the invoice or settlement of expenses; amortization schedule if the payment is to be made in installments. Foreign debt substitutions or term extensions shall also be registered with the Central Bank of Ecuador. To this effect, the debtor shall submit the corresponding application and the contract within 45 calendar days following the debt substitution or term extension. In this case, the original foreign loans shall be registered with the Central Bank of Ecuador. The payment of interests, amortizations and other expenses originated from the foreign loans contracted by the private sector – including the financial system– shall be executed in free market currency. The amount of funds remitted for royalties, licenses, or technical fees is not limited, once income tax has been paid. As a general rule, all payments remitted outside of Ecuador is subject to a 25% income tax withholding.

Outward Direct Investment Resident individuals and corporations, whether owned by Ecuadorian residents or foreign residents, may invest in other countries without restriction. They may also borrow abroad for investment in other countries.

Portfolio Investment Foreigners may freely invest in Ecuadorian government bonds, other bonds, or shares. Portfolio investments are treated in the same way as other investments.

2.03 Business and Trade Rules

For tax purposes, every new entity must be registered with the local tax office of the Internal Revenue Service (*Servicio de Rentas Internas*—SRI) and obtain a taxpayer registration number (*Registro Único de Contribuyentes*—RUC). For company law purposes, registration with the Commercial Registry is required in the circumstances outlined in Chapter 6. Every new business must also apply to the municipal authorities to obtain a license to commence business. Trading or manufacturing licenses as such are not required, but specific permits may be necessary for some activities. Registration for social security purposes with the Ecuadorian Social Security Institute (*Instituto Ecuatoriano de Seguridad Social*—IESS) is required. Businesses in Ecuador are required to join a production chamber as per their specific line of business (i.e., chamber of commerce, of industries, of mining, etc.) **Since the tax year 2005, Transfer Pricing legislation is in force in Ecuador.** Such legislation sets forth a regular set of rules, such as those recommended by the OECD. Ecuador is committed to liberalizing commerce. Many commercial restrictions have been eliminated, and import and export procedures have been greatly simplified. Ecuador is a signatory of economic integration agreements implemented to increase commerce under tariff conditions, as well as to promote the economic and social development of the member countries. Apart from the Andean Community, Ecuador is a signatory of the Free Trade American Integration Association (*Asociación de Libre Comercio de las Américas*- ALCA). It is also a member of the Pacific Basin Economic Council (PBEC).

Imports

All companies importing goods into Ecuador must be registered with the Foreign Trade Department (*Departamento de Comercio Exterior*), which is controlled by the Central Bank. The import and export paperwork can be undertaken by private banks. Special imports (agricultural and pharmaceutical products) are subject to additional controls from the Agricultural Ministry and Health Ministry (*Ministerio de Agricultura y Ministerio de Salud*). Most imports require customs returns (including certificates of inspection) prior to shipment, as well as indicators that the goods conform to contractual terms (in amount, quality, and value). The special regimes for imports are as follows:

- *Temporary admission with reexportation in the same state*—suspended regime of customs duties and value added tax if the imports are reexported within the stated term.
- *Temporary admission for active improvement*— suspended regime of customs duties and value added tax if the foreign merchandise is re exported after a transformation or amendment process.
- *Customs transit*—suspended regime of taxes for the local transport of merchandise to another country
- *Customs deposit*—suspended regime of taxes for the storage of merchandise in a commercial or industrial storage house.
- *Temporary export with re import in the same state*— suspended regime of taxes that allows the departure of merchandise.
- *Drawback*—total or partial refund of taxes paid on the import of merchandise to be subsequently exported.
- *Special transformation regime*—Merchandise is subject to a special regime if it undergoes a

transformation process; is incorporated into other merchandise or packaging; is used in the production or transformation process; or is replaced with identical or equivalent merchandise, which is allowed to be imported tax free and is re-exported after a transformation process.

- *Free Trade Zone*—Allows entrance of merchandise free of customs duties to authorized areas.
- *Maquila*—Allows entrance of merchandise into Ecuador for their transformation in order to reexport them. Ecuador has adopted a classification and a merchandise coding system for Andean Pact members (*Nomenclatura Arancelario Común de los Países Miembros del Grupo Andino*—NANDINA). The NANDINA is based on a designation system and a merchandise coding structure of the Customs Cooperation Council.

Most imports are subject to import duties (levied at ad valorem rates varying from 0% to 35%, depending on the importance of the imported product to Ecuador's economic development) and to value added tax (levied at 12%, but some goods are subject to 0%). Additional customs duties must be paid for control service, storage service, and the country's modernization program.

Exports

The Central Bank requires exporters to obtain export licenses. Itemized listings must be presented that clearly show the amount, quality, and unit value of the goods to be exported. Relations between trade agents and their principal offices (which grant foreign trademarks) are subject to the principles of free will and contractual liberty. Trade agents can sign civil representation contracts, trade commission contracts, or any other type of contract permitted under the law. Such contracts must establish conditions, causes for termination, indemnities, and so forth. The Companies' Law (*Ley de Compañías*) prohibits the formation or functioning of companies that monopolize any industry.

Patents and trademarks

Are registered with the MINISTERIO DE INDUSTRIAS. Patents are granted for twenty years from the date of application. Trademarks are granted for five years from the date of application. Copyright protection can be obtained for literary, scientific, technical, musical, and artistic works. Copyrights grant the holder exclusive right to use, exploit, and reproduce the work during the lifetime of the author or creator and for fifty years after his or her death. Ecuador is a member of the Paris Convention for the Protection of Industrial Properties, the Patent Cooperation Treaty, and the Berne and universal copyright conventions. The Consumer Protection Law (*Ley de Defensa del Consumidor*) establishes procedures to protect consumers and defines the rights and obligations of the various parties that must be considered by the authorities.

2.04 Employment Law and Practice

Regulations relating to employment are envisaged in the Employment Code.

Contracts There is a wide variety of employment contracts depending on the nature of the activity performed by the employee and requirements of the employer. An employment subordinated relationship exists when an employee renders his/her services within a specific schedule, at pre-established premises and in exchange of a wage agreed on between employer and employee. Any such contract starts with a trial term lasting three months. Within said trial term, either employer or employee may finalize the employment relationship in accordance with their interests. The minimum employment term is of one year. A fixed term employment contract may not exceed from two years. Following these two years the employment contract will be deemed to have an indefinite term and may only terminate in accordance with the provisions stipulated in the Employment Code, with the corresponding indemnities. The following employment contracts are allowed:

- A- Specific work,
- B- temporary and occasional,
- C- domestic service,

- D- apprenticeship,
- E- craftsmanship,
- F- piecework,
- G- Among others.

Contracts may be signed with individuals or legal entities authorized by the Ministry of Labor and Employment to provide complementary services whose exclusive purpose is the undertaking of activities that include surveillance, security, catering, messenger and cleaning that are not related to the user's own or habitual productive processes. In the contracts referred to in the previous paragraph, the labor relationship is between provider of the complementary activities and the personnel contracted by such service providers, without prejudice to the joint responsibility of the entity or person benefitting from the service

Working Hours, Holidays, and Vacations

Normal working hours are eight hours per day, forty hours per week. However, working time may be increased. Overtime must be paid at a rate of between 150% and 200% of the worker's normal rate. In offices, a five-day, forty-hour week is the norm. Generally, nine paid public holidays are given each year. Employees are entitled to fifteen days of paid vacation per year. An additional day per year is granted after five years of continuous employment with the same employer.

Health and Safety Legislation

Health and safety in the workplace are dealt with in a number of statutes, regulations, and codes of practice. All employers have a general duty to ensure the health, safety, and welfare of their employees and the health and safety of the general public. Health and safety inspectors from the Ministry of Labor and Human Resources (*Ministerio de Trabajo y Recursos Humanos*) can require employers to improve standards and can prohibit specific activities.

Rates of Pay, Bonuses, and Additional Remunerations

Parties may freely stipulate the employee's remuneration. However, salaries lower than the established legal minimums are not allowed. The minimum monthly wage varies depending on the type of work. A worker's salary may not be reduced. The bonuses are as follows:

- *Christmas Bonus.* A worker receives a thirteenth month salary equivalent to one-twelfth of his or her total salary during the twelve months between 1 December and 30 November. The remuneration must be paid by 24 December each year, and the amount payable is not limited. Salaries, remunerations, overtime, and other normal payments are taken into account when the remuneration amount is calculated. The thirteenth month salary is not taken into account when contributions to social security and to reserve and retirement funds, compensation, and vacation are calculated.
- *Educational Bonus.* It is equivalent to one unified minimum monthly wage (US\$200) and payable in September or April depending if employee works in the Sierra or Costa (the school period starts in different seasons in the Sierra and the Costa). It is not taken into account when contributions to social security and to reserve and retirement funds, compensation, and vacations are calculated.

Statutory Employees Profit-Sharing

Employers must annually distribute 15% of pretax profits to employees as profit-sharing participation. Payable before 15 May, the percentage is distributed among all the employees in the following manner:

- Ten percent is distributed on the basis of a calculation that takes into account the time each employee worked during the year.
- Five percent is distributed on the basis of a calculation that takes into account the number of family dependents an employee supports and the time he or she worked during the year.

Dependents are understood to be the spouse, children under age eighteen, and children of any age who have disabilities.

Social Security Contributions

The Ecuadorian Social Security Institute (IESS) is the entity in charge of organizing and applying Ecuador's social security system. The system covers the majority of employees. It provides retirement pensions (up to a certain amount), medical attention, and several other benefits. On November 2001 a new Social Security Law was passed. Social security includes the benefits and loans that an affiliated party (or his or her spouse and family) has a right to receive in circumstances related to illness, maternity, incapacity, retirement, or death.

The law also allows voluntary affiliation for individuals without work contracts. For the purpose of calculating social security contributions, remuneration includes wages or salaries, payments for supplementary and extraordinary work hours, payments for sporadic work, commissions, bonuses, tips, fees, participation in benefits, rights of use or habitation, and any other remuneration that is considered normal. Additional benefits required by law (wages components in process of incorporation, transport allowance; employee profit sharing; reserve fund contributions; travel expenses; or occasional subsidies and social benefits) are not considered part of the remuneration when social security contributions are calculated. An employer must make special contributions to the Ecuadorian Professional Training Service (*Servicio Ecuatoriano de Capacitación Profesional*—SECAP) and the Ecuadorian Institute for Education (*Instituto Ecuatoriano de Crédito Educativo*—IECE) of 0.5% each. Therefore, the overall contribution by the employer is 12.15%. The employer also withholds employee contributions.

Reserve Fund Contributions.

In addition to contributing to the social security system, employers must pay one month's wage each year to a reserve fund managed by the social security system for each person who has completed a full year of employment by 30 June. This payment is due when the employee completes his or her second year of employment. *One month's wage* means one twelfth of earnings between 1 July and 30 June, excluding bonuses and compulsory profit sharing. These funds are not part of the social security program, even though they are paid to the IESS.

The employee may withdraw amounts from the fund, which is maintained by the IESS. If an employee dies, his or her beneficiaries may access the fund.

Pensions

Employers must provide employees with pensions after twenty-five years of service. The amount varies according to the employee's age and length of service and is calculated as 5% of average annual remuneration for the last five years multiplied by the number of years of service and divided by a coefficient corresponding to the employee's age. The amount may not be greater than the annual wage received by the worker in the last year of service. The pension may not be less than the if the retired worker has no other pension, nor may it be less than half the minimum monthly wage if the retired worker receives another pension.

An employee who is dismissed after twenty years' service is entitled to receive a proportion of the retirement benefits. Companies may provide for pension liabilities on the basis of actuarial calculations. There is no obligation to fund pension liabilities.

2.05 Work Contracts

May be terminated when the time period specified in the contract is completed, when a specific job is finished, by mutual agreement, by decision of one of the parties, or for reasons beyond the control of either party. The party terminating the contract must give thirty days' notice. In most cases, if an employer wants to dismiss a worker, and if legal reasons support such a dismissal, the employer must first obtain authorization from the Ministry of Labor and Human Resources. Should the employer fail to obtain the authorization or should the employer not have any legal justification for the dismissal, indemnities, based on years of service, are payable to the employee. Three months' remuneration is payable for service lasting for up to three

years. For service of three or more years, one month's remuneration for each year, up to twenty-five months' remuneration, is payable. A fraction of a year is considered a complete year. A bonus equivalent to 25% of the last month's salary is payable for each year of service.

The law stipulates a worker's right to associate in defense of his or her interests and to form various types of entities for different purposes. A minimum of thirty workers is needed to form an association. A company may not dismiss any worker while a labor organization is being formed (that is, until the organization's bylaws are registered and its first board of directors is appointed). A special type of association, a *comité de empresa*, formed by more than 50% of a company's workers, has supremacy over other labor organizations within the same company. The bylaws of the *comité de empresa* must be approved by and registered with the Ministry of Labor and Human Resources. Collective contracts are signed between the employer and a legally constituted labor organization to establish general conditions and bases for successive individual contracts. Collective contracts may be totally or partially revised upon termination of the period indicated in the contract. If no period is indicated, collective contracts are revised every two years. In the case of confrontations between employers and workers, both parties must present their statements of petition before the labor inspector or assistant inspector. An employer may choose to accept the workers' petition, in which case the dispute immediately ceases. If the employer does not accept the petition, the dispute passes to the Department or Subdepartment of Labor Mediation (*Departamento o Subdepartamento de Mediación Laboral*), which is part of the Ministry of Labor and Human Resources. If mediation does not result in reconciliation, an arbitration court will hear the case and pronounce judgment.

This court consists of five members: the labor inspector, two representatives nominated by the employer, and two representatives nominated by the workers. Labor may use a strike to pressure management to resolve a conflict. The law acknowledges the right to strike, provided that the strike is declared and carried out in accordance with the law. The formation of councils or similar bodies in individual workplaces is not required. Employees have no right to appoint officers or members of a company's management or supervisory boards, nor can they object to candidates for such boards proposed by other interested parties.

2.06 A non-Ecuadorian Citizen

A non-Ecuadorian Citizen intending to work and reside within Ecuador must apply for a visa from the Ecuadorian consulate in his or her country before arriving in Ecuador. Issuance of the work visa is dependent upon authorization from the Ministry of Labor and Human Resources. Non-Ecuadorian citizens who arrive as visitors and subsequently apply for visas to stay and work may experience difficulties and, in any event, will be required to return to their points of origin to obtain visas. Businesses, other than Andean multinational companies, are restricted in the number of foreigners they can employ. The number of foreign employees may not exceed 20% of the total number of employees, or the remuneration paid to foreign employees may not exceed 20% of the total remuneration.

2.07 Choice of Business Entity

The principal forms of business organization in Ecuador are corporations, the limited liability companies and branch of a foreign company. Partnerships and other types of entities may also be formed. Registration of corporations, limited liability companies, and branches with the Commercial Registry is governed by the Companies' Law. Each business must have a legal representative domiciled in Ecuador. Corporations are the most flexible form of entity, allowing a mixture of foreign and local capital. Limited liability companies are useful as closed companies, but they have disadvantages with respect to the sale and transfer of capital and are usually not advantageous for foreign investors. Most foreigners choose to use corporations or branches to set up business in Ecuador. The corporation offers the same major advantages to investors as the corporate form does in other countries. It provides limited liability for its shareholders and the possibility of unrestricted transfer of shares without affecting the corporation's existence.

Incorporation The Incorporation formalities are usually entrusted to lawyers and public accounting firms in Ecuador. For formation purposes, a corporation needs at least two Founder shareholders or incorporators, although the number of share-holders can be reduced to one at any time following incorporation. The founder shareholders may be Ecuadorian nationals or foreigners, individuals, or legal entities. The entity that supervises and controls corporations is the Superintendence of Companies (*Superintendencia de Compañías*); banks and financial entities, however, are supervised and controlled by the Superintendence of Banks (*Superintendencia de Bancos*). The proposed name of the corporation must be approved by the Superintendence of Companies. The Commercial Registry gives permission for the use of the proposed name so as to avoid confusion with any other name already registered.

The deed of incorporation, which includes the articles of association or bylaws must be submitted to and signed by the founder-shareholders in the presence of a notary in Ecuador. However, the founder-shareholders may be represented at this incorporation meeting by authorized persons, so that foreign founders do not need to travel to Ecuador to form the corporation. The articles of association contain, among other things, the corporation's name and objectives, the address of its legal seat (registered office), a description of its share capital, and details of the management body and its powers. Once the deed of incorporation has been signed in the presence of a notary, it becomes a public deed and must be submitted to the Superintendence of Companies. After the Superintendence of Companies approves the deed of incorporation, the corporation must be registered at the Commercial Registry.

Founder-shareholders and any others involved in actions taken and contracts entered into in the corporation's name before it comes into legal existence will be individually liable for any resulting losses, except in the case of indispensable acts such as incurring the expenses of incorporation. If the corporation is to be formed by public subscription, an abstract of the deed of incorporation must be published in a newspaper. The abstract must include the number and date of the Superintendence of Companies' resolution that approved the public offer and the inscription with the Stock Exchange Registry (*Registro del Mercado de Valores*). The cost of forming a corporation can vary, depending on the size of the share capital stated in the deed of incorporation. Costs include professional fees for the drafting of the documents, notary fees, and fees for registration with the Commercial Registry. Other professional fees may arise from necessary investigations and legal consultations.

Capital. A corporation's share capital may not be less than US\$800. All shares must have a par or face value and must be in nominative (registered) form. Bearer shares may be freely transferred at any time. The initial share capital with which the corporation proposes to be incorporated (its authorized capital) must be stated in the deed of incorporation and recorded at the Commercial Registry. The deed of incorporation and the entry at the registry must be amended when the share capital is modified. A corporation cannot be set up unless its share capital is fully subscribed and at least 25% of the face value of each share is paid in. The balance must be paid in within two years. The form of paying the balance will be determined by the articles of association or by the shareholders at the general meeting. Cash contributions must generally be made in US\$. Cash contributions must be evidenced by bank deposit receipts delivered to the notary when the deed of incorporation is executed. Contributions other than cash contributions must be stated in the deed of incorporation, which must identify the goods to be contributed and their value and state the transfer of ownership to the corporation. The goods must be appraised by the founders or by expert appraisers. If the founders make the appraisal, they are liable for the assigned value. A corporation may acquire its own fully paid-in shares by decision of the shareholders at the general meeting. In such cases, the corporation can use only profits accruing from amortization or resale to buy the shares.

Legal Reserve and Dividends

At least 10% of a corporation's after-tax profits for each financial year must be

transferred to a legal reserve until this reserve reaches 50% of the authorized share capital. A legal reserve may be used to meet future losses and, when so used, must be rebuilt out of subsequent profits. It may be capitalized but may not be distributed to shareholders except on the dissolution of the corporation. Dividends may be distributed from retained earnings. At least 50% of annual profits must be distributed unless the shareholders unanimously decide otherwise. Nevertheless, in the case of companies whose shares were sold on public offer, at least 30% of the profits must be distributed; this kind of company can also give quarterly or semiannual advances, with prior authorization of the shareholders at the general meeting.

Meetings and Votes

During the creation of the corporation, once the capital has been subscribed, the promoters must call a constitutional shareholders' meeting. This meeting must be called no later than fifteen days after the meeting at which the subscribed capital became due, and notice of at least eight days must be given. Resolutions from the first shareholders' meeting for the constitution of a company must be approved by at least one-quarter of the subscribers that attend the meeting, representing at least one-quarter of subscribed capital. Shareholders' meetings are classified as ordinary and extraordinary. The former must take place once a year within the first quarter of the year. The subjects to be dealt with must include the reading and approval of financial statements; approval of the distribution of profits; and presentation of the reports of the legal representative, directors, and corporate comptroller. A shareholder's right to vote depends on the number of shares the shareholder owns. Shareholders holding at least 25% of common shares may file claims against illegitimate resolutions. For a general meeting to take place at the first notification, shareholders representing no less than 50% of paid-in capital must attend the meeting. Otherwise, a second notification must be made, and the general meeting can be held if shareholders representing at least one-third of paid-in capital are present. If this quorum is not assembled, a third announcement must be made, and the general meeting can be legally constituted with those shareholders present. In general, resolutions at general meetings must be adopted by a majority. Abstentions and rejected votes are added to the majority.

Publication of Information

In addition to the deed of incorporation, which is filed with the Commercial Registry at the time of formation, a corporation must also file other information, including:

- Changes in name, activities, share capital, or legal
 - Amendments to its articles of association
 - Changes in the composition of its governing body
- Companies must file with the Superintendence of Companies an annual return containing the financial statements and other relevant information, as well as reports of the legal representative, the corporate comptroller, and the external auditors if applicable. Companies controlled by the Superintendence of Banks are obliged to publish their June and December financial statements in a local newspaper within thirty days of the close of the period. Public companies also must publish their financial statements. Establishing a branch of a foreign company in Ecuador requires the following documentation: proof that the company has been legally established in its country of origin; proof that, according to the laws of its country of origin, the company can establish branches and is authorized to negotiate abroad; and the name of a permanent legal representative in Ecuador. The branch must have assigned capital of no less than US\$ 2,000. The documentation must be presented to the Superintendence of Companies, along with a certificate issued by the Ecuadorian consul nearest to the foreign company's head office certifying the establishment and legality of the company in its country of origin and authorizing it to do business abroad. Also, the company's legal representative must present a certified bank deposit of the capital paid. If the legal representative is a foreign citizen, he or she must obtain a resident visa.

The formation procedures applying to corporations must also be followed. A branch is easier than a corporation to set up, but this factor should not be the overriding consideration in deciding which type of entity to use. A branch cannot be reorganized as a subsidiary. The license granted to a branch to operate in Ecuador must be canceled before a new company can be formed. Instead of forming a branch, a company that simply requires representation in Ecuador may prefer to open a representative office. Limited liability companies closely resemble limited partnerships in other countries and are suitable for similar types of operations. They must have at least three members and not more than fifteen. Members have limited liability for corporate obligations up to the amount of their individual contributions. Capital cannot be less than US\$ 400. At least half of the capital must be paid in at the time of formation, and the remainder within one year. A legal reserve must be set up by transfer of 5% of annual after-tax profits until the reserve equals 20% of capital. Foreign corporations are excluded from membership. A partnership may be organized in two different forms: as a company with a collective name in which all partners are jointly and severally liable for all actions taken by any partner in the firm's name or as a silent partnership, which has general partners and limited partners. Silent partners are not part of the firm's name and do not participate in management.

The bylaws of a partnership must state the name, nationality, and domicile of the partners; number of payments made and future payments; form of payments made and future payments; time period for which the company will function; manner in which the administration will be organized; and fiscal control established, if any. A draft copy of the bylaws is presented before a civil judge, who will order the extract to be published in a newspaper. Later, the judge will order the inscription of the bylaws in the Commercial Registry and, if there are property taxes, in the Property Registry (*Registro de la Propiedad*).

Joint ventures are customarily formed by two corporations. The rights of the partners are limited to obtaining an accounting of funds that have been paid in and an accounting of losses or earnings obtained by the end of the contract. Other types of companies include the mixed economy company. In such a company, both private and public capital is used. The public sector funds may come from the state, municipal, or provincial governments or from judicial representatives of either the public or semipublic sector. The dispositions imposed on corporations generally apply to mixed economy companies as well. When the public sector investment exceeds half of the capital in a company, a director from this sector acts as president of the board of directors. Private shareholders may later acquire the public-sector investment. When this happens, the company may continue to function in the form of a corporation. Any modification of the bylaws or other action or transaction necessary to achieve this transformation is free of any municipal or special tax. Another type of company is the holding company. A holding company buys shares from other companies, with the purpose of gaining control through shareholder relationships, performance, administration, credit responsibility, or results, and then forms a business group.

Companies formed with this objective are obliged to make and maintain individual financial statements for control purposes, for profit distribution among employees, and for the corresponding tax payment. Also, the companies must fulfill their liabilities with the public treasury and the pertaining comptroller bodies on the basis of their financial statements.

Transformation A corporation can be transformed into a limited liability company or another corporate form and vice-versa.

Mergers are regulated by the Companies' Law and, unlike acquisitions, require prior authorization from the Superintendence of Companies. A merger can be effected by the absorption of one corporation by another through an exchange of shares. The absorbed corporation is then dissolved. Alternatively, it is possible to effect a merger through the amalgamation of existing corporations into a new one. In this latter case, the assets and liabilities of the merging corporations are transferred to the new one in exchange for its shares, and the merged corporations then cease to exist. Various formalities must be complied with

when corporations are merged. For example, cross-holdings of shares by the merging corporations must be canceled, independent experts must examine the merger proposals and evaluate the net contribution by each corporation, and due publicity must be given to the merger proposals.

Split ups The shareholders, at a general meeting, can decide on the split up (*escisión*) of a corporation into one or more companies. A company deciding on the split up will maintain its nature. Therefore, companies formed as a result of a split up can be different from the original. If a company that is going to be divided does not have enough share capital to form the new companies (that is, if the share capital, when divided between the new companies, would be less than the required minimum), the company must increase its share capital to an adequate amount before the split up takes place.

Liquidations A corporation may be liquidated and dissolved by special resolution if its members so decide or on the expiration of its life as stated in its articles of association. A corporation must be liquidated if its accumulated losses amount to 50% or more of its share capital and 100% of its reserves, unless that capital is reduced or further capital is subscribed, and if its capital is reduced below the legal minimum.

3. - Accounting and Audit

3.01 Financial Statements

The Superintendence of Companies (*Superintendencia de Compañías*) issues in December, 2008 the resolution 08.GDSC.010, on the application of IFRS (Normas Internacionales de Informacion Financiera), for all the Companies in Ecuador.

The Superintendence of Companies is the body that controls entities in Ecuador (with the exception of finance and banking organizations). The accounting policies used in the preparation of financial statements must be disclosed. This disclosure is usually made in the first explanatory note forming part of the financial statements. In addition, a change in accounting principles must be disclosed in the financial statements.

Ecuadorian regulations require that accounting records be maintained in Dollars of the United States of America and in Spanish. In year 2000, as a result of the implementation of the “dollarization” regime, the Economic Transformation Law determined that all legal entities and individuals obliged to keep accounting records convert their records from Sucres to Dollar of the United States of America, in accordance with NEC 17 (Ecuadorian Accounting Standard). The transition date for the conversion of financial statements was March 31, 2000. Since May 1st, 2000 accounting records are kept in Dollars of the United States of America.

Depreciation Although maximum depreciation rates have been set for tax purposes, depreciation rates estimated in accordance with the useful lives of assets should be applied for accounting purposes. The favored method for calculating accounting depreciation is the straight-line method, on the basis of the average restated value of fixed assets.

Goodwill , Is the difference between the price paid for an acquired enterprise and the equity value of its underlying net assets. Any difference between the two must be identified, and the value of assets acquired (mainly fixed assets) must be restated at appraisal values. If a difference still exists after this exercise, it is disclosed as the goodwill figure in the financial statements. Goodwill is amortized by charges to income over a reasonable period. Negative goodwill is presented as part of shareholders’ equity and is not amortized.

Treatment of Dividends Approved dividend distributions are included in the statement of variations in shareholders' equity and in the notes to the financial statements. They are accounted for by decreasing retained earnings and including them in current liabilities or deductions from cash.

Merger Accounting Assets and liabilities of the merged company are incorporated at book value.

Leased Asset. There is no accounting standard for leased assets, but the normal practice is to record the expense directly in the income statement as a rental payment.

Research and Development Expenditure Research and development costs are capitalized and amortized in accordance with the straight-line method over five years. Depending on their relative importance, such costs are disclosed in the financial statements or related notes.

Capitalization of Interest Accrued interest on assets used in construction or installation must be capitalized as part of their cost.

Inventory Valuation Manufacturing costs (that is, all costs directly and indirectly incurred) are usually included in the

Consolidation Practice. Is necessary the Consolidated financial statements that will be prepared by requirement of IFRS

3.02 Audit

Businesses with total assets in excess of US\$1,000,000 are required to submit audited financial statements to the Superintendence of Companies along with their annual tax returns. For this purpose, the total assets are those reported to the Superintendence of Companies for the prior year.

4. - Tax System and Income Taxes

4.01 An Overview

Taxes are levied in Ecuador both at the national level by the central government and at the local level by municipal authorities. The principal national taxes are corporate income tax, personal income tax, overseas payments tax, value added tax - VAT, and excise tax (ICE). Other taxes include business fees, inheritance and gift tax, municipal tax on total assets, and municipal property taxes. The Tax Code (*Código Tributario*) is the general law that prevails over other laws with respect to taxation. The Internal Tax Regime Law (*Ley Orgánica de Régimen Tributario Interno*) covers income tax, overseas payments tax, value added tax, and excise tax. This law came into effect on 1 January 1990, and since then several regulations and reforms have been added. Special tax provisions are included in other laws such as the Tax Equity Law (*Ley de Equidad Tributaria*), Hydrocarbons Law (*Ley de Hidrocarburos*), Mining Law (*Ley de Minería*), Tourism Law (*Ley de Fomento Turístico*), Free Trade Zone Law (*Ley de Zonas Francas*), Maquila Law (*Ley de Maquila*), Stock Market Law (*Ley de Mercado de Valores*), Agrarian Development Law (*Ley de Desarrollo Agrario*), and Telecommunications Law (*Ley de Telecomunicaciones*). Municipal taxes are generally governed by the Municipal Tax Law (*Ley de Régimen Municipal*). This book covers reforms incorporated into Ecuadorian legislation until January 2009.

4.02 Relief under Double Tax Treaties

Ecuador has ratified agreements with the countries of the Andean Community, Belgium, Brazil, Canada, Chile, France, Germany, Italy, Mexico, Romania, Spain and Switzerland to prevent double taxation of income. These treaties cover most types of income. The treaties are based on the Model Treaty of the Organization for Economic Cooperation and Development (OECD) and observe the principle of the source of income. In general terms, income from real estate may be taxed in the country in which the property is located. Companies' profits are taxed in the country in which operations are carried out, unless the company is operating in another country through a permanent establishment. In that case, such profits are taxed in the other country up to the amount attributable to such an establishment. Ecuador is party to the multilateral treaty concluded by the Community Andean countries. Ecuador has also signed some bilateral tax treaties dealing with international shipping and air transport.

Unilateral Relief Ecuadorian residents may obtain an ordinary tax credit against their Ecuadorian income tax liabilities for income taxes paid abroad on income from foreign sources. The credit, determined on a country-by country basis, is limited to the lesser of the foreign tax paid on income from the country in question or the amount of income tax attributable to such income in Ecuador. In the case of foreign-source dividends, credit relief is granted for foreign corporate income tax levied on the profits out of which the dividends are paid ("indirect tax credit"), as well as for foreign withholding tax, provided that the rate of the foreign corporate income tax is similar to that of Ecuador's corporate income tax.

4.03 Corporate Income Tax

Ecuadorian and foreign corporate entities are liable for corporate income tax on their income and capital gains. In some cases, these entities are also liable for various other taxes. For tax purposes, a *company* is defined as a legal entity, a de facto entity, a joint venture, or any other form of association different from its members. Whether the taxpayer is a business entity incorporated in Ecuador or a branch of a foreign entity, its Ecuadorian source income is subject to corporate income tax. Revenues received from abroad by resident companies are also subject to Ecuadorian income tax. Resident companies are those incorporated under the laws of Ecuador. Nonresident companies are entities that are incorporated under the laws of a foreign country and that have their principal seats of administration outside Ecuador. Such a company may have a branch in Ecuador. In general, the taxable income of a business is the aggregate of its ordinary and extraordinary revenues subject to tax, less the cost of sales, expenses, discounts, and other deductions necessary for producing taxable revenue or pertaining to taxable revenue. Companies must record revenues and costs on the accrual basis, except for construction companies, which are allowed to choose between the completed contract or percentage-of-completion method of accounting. Once one of these methods is chosen, it cannot be changed without permission from the Internal Revenue Service. Taxable income is computed in accordance with special rules in the case of some industries. For petroleum companies that have entered into exploration and exploitation service contracts, taxable income is based on Payments made by PETROECUADOR (the state oil company) for services rendered when commercially exploitable oil is found. Reimbursements by PETROECUADOR for investments, costs, expenses, and interest on non-amortized investments are not considered part of the contractors' gross income subject to income tax or to any other tax, and related costs are not deductible. For companies that have entered into participation contracts for the exploration and exploitation of hydrocarbons, gross income is the participation percentage, calculated at the sales price of the oil, which will not be less than the *reference price* (an average price based on the volume of foreign sales made by PETROECUADOR during the last month), less costs and related expenses. In the case of international transport companies, taxable income is computed at 2% of annual revenue. There are some special rules with punitive character for computing taxable income for companies that, in violation of their legal obligations, do not maintain

accounting records: In the case of construction companies without (proper) accounting records, taxable income is computed at 12% on fixed-price contracts or at 15% if the contract contains a financing agreement clause. In the case of companies deriving their income from urban development, real estate dealings and similar activities without (proper) accounting records, taxable income is computed at 30% of the fiscal year's sales.

4.04 Exempt Income.

The following items are exempt from corporate income tax:

- All dividends distributed by resident companies to other resident companies and to national or foreign individuals residing or not in Ecuador, except those dividends distributed to tax heavens companies (24% withholding tax applies)
- Certain capital gains
- Certain Interest income
- Income exempt through international agreements.
- Income from non-monetary investments made by companies that have entered in to hydrocarbon exploration and exploitation service contracts with the Ecuadorian government. These contracts must be arranged through related companies for services rendered at cost and registered with the Central Bank as non-monetary investments subject to reimbursements.
- Earnings from capital, profits, benefits, or yields distributed by investment funds and investment trust funds to their beneficiaries.

4.05 Foreign-Source Income

Foreign-source income is considered income tax exempt in Ecuador provided that such income paid income tax in the foreign jurisdiction.

4.06 Capital Gains

A company's gains from occasional sales of urban and rural real estate are exempt from corporate income tax unless the company is a real estate dealer; however, such gains from sales of urban property are subject to a municipal capital gains tax.

4.07 Inventory Valuation

Tax authorities accept any of the generally accepted accounting methods of inventory valuation. In general, expenses are deductible if they are necessarily incurred for the purpose of generating taxable income. Expenses not supported by adequate documentary evidence are not deductible. Deductions for certain types of expenses between related parties, especially interest payments, are restricted.

4.08 Depreciation

All tangible fixed assets subject to decrease in value through wear and tear, natural causes, or normal obsolescence are depreciable for tax purposes. The straight-line method on the cost of the asset, is usually allowed for tax purposes. When assets are subject to rapid obsolescence, a company may file a request with the Internal Revenue Service to depreciate those assets over shorter useful lives. Depreciation must be recorded in the income statement regardless of profitability. If depreciation is not charged in a loss-making year, the depreciation forgone may not be carried over to subsequent profitable years. Companies dealing in the leasing business must depreciate assets held for lease under the straight-line method or over the term of the related contract.

4.09 Investment Amortization

The investment amortization shown will be tax deductible, in the following:

Straight-Line Depreciation Rates

Type of Asset Rate (%)

Real estate (except land) 5 ; Machinery and equipment 10; Furniture and fixtures 10; Vehicles 20; Computers 33; Preoperation, organization and incorporation, investigation, and experimental expenses; start-up operations and enlargements of industrial plants; exploration and development of mines; and planting and cultivation of seeds 5 years in equal annual percentages or in less time without using more than 24% of the earnings

4.10 Interest foreign loans

Interests and commissions on business-related loans are subject to a 24% withholding tax and tax deductible to the extent that the loans amounts do not exceed the 300% of the company's paid capital. Any excess over said limit is not tax deductible. Interests on foreign loans are tax deductible providing that the related loans are registered with the Central Bank.

4.11 Bad and Doubtful Debt

Uncollectable accounts arising from business transactions that have been recorded for at least five years are deductible. Alternatively, an annual provision for bad debts at the rate of 1% on credit sales to clients outstanding at year-end is deductible. The provision cannot exceed 10% of total debts. However with IFRS is necessary the total provision of bad and doubtful debts. The difference is not deductible for income tax. Certain provisions are deductible, including provisions made by insurance companies for contingencies, and provisions for labor pensions of retirement based on actuarial studies, provided they correspond to personnel employed for at least 10 years by the same employer.

4.12 Special Deductions

Tax deductions related to salaries and social benefits for the net increase of employees can be deducted with an additional 100% during the fiscal year in which the new employees are hired. Payments for International Leasing made abroad are not deductible if the transaction is performed on goods that belonged to the lessee, to related parties, nor when the contract is for a lesser period than the useful life of the good. A number of special deductions to promote new investments; exports; investments in specified sectors, such as mining, tourism, forestry, and agriculture; and financial investments, were eliminated since 1999.

4.13 Payments remitted abroad

Payments remitted abroad for direct expenses incurred either abroad or in Ecuador, other than expenses such as fees and royalties, are deductible. In order for these expenses to be tax deductible the paying company has to perform a 24% withholding tax on such payments. However, in the absence of a tax treaty provision to the contrary, a branch can deduct an allocation of head office general administrative expenses up to 5% of company's total expenses. Corporate income tax is levied at a 24% rate on the Ecuadorian-source taxable income of both resident and nonresident companies. However since the year 2001 the companies that reinvest their profits will pay a 15% rate on profit reinvested in the same company by increasing its capital and acquiring new machinery and equipment. The rate is 44.4% in the case of petroleum companies or branches that have entered into hydrocarbon exploration and exploitation risk contracts. Moreover, Petroleum companies that have entered into exploration and exploitation contracts pay a 1% nondeductible and non reimbursable research and development tax. Ecuador's tax law contains provisions forbidding a

consolidated tax return to be filed for a group of companies. In addition, the law does not permit transfers of losses between companies in a group. Companies in the process of liquidation must pay income tax for all pending periods. Legal representatives must notify the Internal Revenue Service of the decision to begin the liquidation process. Notification must be accompanied by documents related to compliance with tax liabilities for the last three years. Otherwise, the representative may become responsible for any unpaid taxes and be personally liable for any penalties. In a merger, the surviving company or the newly formed company becomes responsible for all prior tax obligations of both merged companies. In a sale of total assets and liabilities, merger, or transformation, no value added tax is charged. The Companies' Law states that companies may purchase their own shares and keep them as treasury stock without having to change their capital structure.

4.14 Transfer Pricing

Since the tax year 2005, Transfer Pricing legislation is in force in Ecuador. Such legislation sets forth a regular set of rules, as recommended by the OECD, but with the following unusual rules:

- Transfer Pricing rules are applicable not only to transactions with foreign related entities, but also with local related entities.
- Transfer Pricing rules can be considered applicable by the tax authorities to transactions with non-related entities if such are domiciled in tax havens.
- Entities that have done transactions with related entities must present Transfer Pricing attachment to their tax returns, and present a full Transfer Pricing report justifying income and expenses from transactions with related entities.

In April 1999, Congress introduced article 91 to the Ecuadorian Tax Code whereby the tax collector (Internal Revenue Service – SRI) may, as part of its attributes, establish the necessary standards to regulate transfer pricing on goods and services for tax purposes. Standards effective up to December 2004 limited the application of transfer pricing in Ecuador since the onus of proof was the responsibility of the tax authorities and transfer pricing regulation applied to sales performed at cost or below cost and for exports or imports performed at amounts below or above international market prices. On December 31, 2004, the SRI through the President of the Republic, issued a reform to the Regulation for Application of the Tax Law (RALRTI) whereby standards were introduced to govern transfer pricing for tax purposes. One aspect peculiar to Ecuador is that, for tax purposes, related parties include individuals domiciled or otherwise in Ecuador. Although such has no material effect on the regulation of transfer pricing between related parties, since the income of one party constitutes an expense for the other, the tax administration is interested in regulating transfer pricing between Ecuadorian related parties in a second stage (after a further three or four years) and basically in the case of amortization of losses. The acceptable methodology for transfer pricing considers methods established by the OECD, that is: Comparable Uncontrolled Price, Resale Price, Cost Plus, Profit Split, Residual Profits Split and Transactional Operating Profit Margins. No one method prevails over another for use. Rather, such must be applied either individually or combined so that the end result reflects application of the Arm's Length principle. All taxpayers undertaking transactions with related parties must file an appendix for the corresponding transaction and an integral transfer pricing report in April and October of the following tax year, respectively. We understand that the SRI will shortly be issuing resolutions indicating the form and content of these procedures. Current standards do not deal with Future Price Agreements.

Scope.- taxpayers subject to income tax and that have undertaken operations with related parties domiciled overseas, within the same fiscal period for an amount exceeding US\$5'000,000 must file an appendix and an integral transfer pricing report within the periods determined by the Regulation for the Application of the Tax Law which must be submitted to tax authorities

4.15 Personal Income Tax

Ecuadorians and foreign individuals resident in Ecuador are liable for income tax at progressive rates on their worldwide income, excluding exempt income. Income obtained abroad by the referred individuals is considered tax exempt in Ecuador providing that such income paid taxes in the foreign jurisdiction. Regardless of whether foreigners are resident or non resident, such individuals are only subject to tax with their Ecuadorian-source income at either a flat rate or progressive rates, depending on the circumstances. Ecuadorian-source income includes income derived from economic activities performed in Ecuador and, if the income is paid by an individual or company resident in Ecuador, or income derived from activities performed abroad. Foreign individuals are generally considered resident in Ecuador if they hold permanent visas or if they hold temporary visas and have been present in Ecuador for more than six months. Each spouse is taxed separately on his or her own employment income. Income from investments is taxed in the hands of the spouse who owns the asset producing the income. Investment income arising from assets that are jointly owned and income from a business that a husband and wife undertake together may be split equally. A child's income is taxed separately and is not added to the taxable income of either parent. Taxable income is an individual's earnings in the form of cash, goods, or services derived from work, capital, or a combination of both.

Employment Income Taxable employment income includes wages, salaries, benefits in kind, and other remuneration from employment. Indemnities paid according to the labor law for termination of employment are not subject to income tax.

Foreign-Source Income Ecuadorian residents domiciled in Ecuador should not include their foreign-source income in their taxable income.

Capital Gain Gains from occasional disposals of urban real estate are exempt from income tax and are subject instead to a municipal capital gains tax

Exempt Income. Exempt income includes income from pension funds, income from short-term savings deposits, dividends received, income from occasional sales of real estate, and occasional earnings on the sale of shares. Individuals are allowed to deduct their children's education and health costs. Employees may deduct their social security contributions in computing taxable income. An individual who carries on a business may deduct expenses entirely and exclusively incurred in the production of business income. Taxpayers with businesses may carry forward their business losses for setoff against future business income in accordance with the rules described for companies. Such losses may not be set off against employment income. Progressive rates of personal income tax applicable to Ecuadorian individuals domiciled in Ecuador and foreigners resident in Ecuador. These rates also apply to income, other than employment income, from permanent services (services lasting more than six months) rendered in Ecuador by nonresident individuals. Nonresidents are subject to a final withholding tax on payments for occasional services (lasting no more than six months) rendered in Ecuador other than in the capacity of an employee. The rates are 24% if the payment is made in Ecuador and 24% of the payment if it is remitted abroad.

4.16 Withholding Taxes

Virtually all payments made by legal entities, as well as payments made by individuals obliged to maintain accounting records, are subject to income withholding tax. The tax withheld is usually an advance payment of a resident recipient's income tax and may be used to offset the total annual tax due. However, the withholding tax is final for non-residents. The payer is responsible for withholding the appropriate amount, providing tax withholding certificates to the recipient of the payment, filing returns, and paying over the amounts withheld within the following month. Withholding returns must be filed and the tax paid between the tenth and twenty-eighth of the month following the withholding. If withholdings are not made (or if made

partially or if not paid over), the withholding agent is charged with a penalty of 100% of the amount that was not withheld (or paid over), plus monthly interest. A penalty for late filing of withholding returns is levied at 3% per month of the amount withheld. Late payment is subject to monthly interest until payment is made. Withholding agents that do not hand over a tax withholding certificate are subject to a penalty of 5% of the amount withheld. Withholding agents more than three months in arrears in presenting and paying their withholdings may be penalized with the closure of their business, following prior notification. Ecuadorian-source dividends are exempt from income tax and withholding tax in the recipient's hands. The corporate income tax on the profits out of which the dividends were paid is considered to be on account of the recipient's tax liability. No withholding tax is imposed on the remittance of branch profits or dividends unless they are distributed to tax heavens companies. Foreign-source dividends paid to residents have to be included in the taxpayer's total income and are subject to progressive tax rates. An ordinary tax credit is granted for source-tax paid abroad.

Employers must withhold income tax on wages, salaries, and other personal income derived from employment. To this effect, all income to be obtained during the fiscal year must be included in the calculation. Then progressive rates are applied proportionally to monthly income. The according amount must be withheld from the gross salary.

- Payments on imports
- Commissions on exports of up to 2% of the export value
- Commissions for the promotion of inbound tourism up to 2% of the export value.
- Payments for expenses incurred abroad by airlines and maritime transport companies.
- Payments to hotels and tourism paid by travel agencies
- Eight five percent of payments to movie and television companies for film rental and payments to international press agencies.
- Ninety-six percent of premiums paid to foreign reinsurance companies.
- Payments for international leasing of capital goods if the interest rate is not higher than the one provided by the Ecuadorian Central Bank.
- Ninety percent of payments for the charter of airplanes and vessels by international transportation companies.

5. - Other Taxes

5.01 Value Added Tax

A value added tax (*impuesto al valor agregado*), referred to here as VAT, is levied on imports and on the supply of most goods and services by individuals and companies. Businesses are responsible for collecting the tax from their customers and paying it over to the government. Businesses are placed in a neutral position since they are entitled to an input tax credit for any VAT costs incurred on goods or services acquired in the course of producing taxable supplies or services. VAT is therefore a tax on consumption, since the ultimate consumer bears the cost. Nonresidents cannot recover VAT incurred. A record of all transfers of goods and provisions of services must be kept. The law stipulates that a corresponding sales invoice must be issued, regardless of the contracts into which a company enters. In general, monthly returns must be filed between the fifteenth and nineteenth of the month following the date of the transaction. The exact date depends on the entity's taxpayer registration number. A delay of more than three months in filing and paying VAT can result in the closure of the taxpayer's business until the payment is made. Suppliers of goods and services may take tax credits for

VAT levied on fixed assets, as long as the acquired asset is subject to VAT, and on raw materials for the production or commercial use of taxable or exported goods or services. Tax credits must be offset against VAT charged on sales in the monthly VAT return. If it appears that the tax credit will not be recovered within the next six months, a claim for a refund may be filed. VAT is imposed at a rate of 12%. Many supplies are subject to a 0% rate. Such items include basic food products, medicines, paper, books, agricultural products, and exports. A business that sells zero-rated goods and services does not have to charge VAT to its customers, but it is not entitled to recover VAT charged to it on its purchases. The following transactions are outside the application scope of VAT: capital in-kind contributions to companies; sales of businesses in which assets and liabilities are transferred; transfers of assets upon inheritance or the liquidation of a company; transfers as a result of mergers, split ups, or transformations; donations to non-profit making organizations; and transfers of shares. Special taxpayers, as defined by the Internal Revenue Service, must act as withholding agent on the purchase of goods (30% of VAT at 12%), services provided by companies (70% of VAT at 12%) and professional services provided by individuals (100% of VAT at 12%) and file the VAT returns in the following month in which the VAT withholdings were performed. The difference not withheld by special taxpayer must be changed and declare to the tax authorities by the supplier. The supplier only charges and pays over the remaining part of the withholding tax. In the case of transactions between two special taxpayers, these withholding rules do not apply.

5.02 Additional Taxes

Excise tax is imposed on tobacco; alcoholic beverages and soft drinks; and land, sea, and air transport vehicles. Companies governed by the Superintendence of Companies must pay an annual fee of up to 0.1% of their total assets as of 31 December, to the Superintendence of Companies. Companies governed by the Superintendence of Banks must pay each semester a fee based on their average monthly assets to the Superintendence of Banks. In addition, a municipal license tax and certain mandatory contributions are imposed for the financing of controlling agencies, chambers of commerce, chambers of industries, and so forth. Various taxes are also payable upon incorporation of a company. A progressive tax rate from 5% to 35% is applied to inheritances, gifts, and bequests in excess of US\$50,000. Tax on total assets (*impuesto sobre activos totales*) is levied annually by municipalities on the total business assets less current liabilities and contingencies of business enterprises. The rate is 0.15%. If an enterprise carries on activities in more than one municipality, the tax is allocated among the municipalities on the basis of the contribution to gross income of the activities conducted in each.

Both urban and rural properties are subject to annual municipal property taxes assessed at relatively low rates (*impuestos a los predios urbanos y rurales*). If a taxpayer owns several urban or rural properties, the assessed values of these properties are grouped by municipality, and a rate is applied to each group total. Urban properties are taxed at a percentage that goes from 0.25 per 1,000 and a maximum of 5 per 1,000 less deductions for certain types of loans directly related to the property's acquisition or the operations on the property. Profits on occasional sales of urban property (*impuesto a las utilidades en la compraventa de predios urbanos y plusvalía de los mismos*) are taxed by the municipality in which the property is located. Profits are subject to a basic tax at progressive rates. The amount on which tax is levied is obtained by deducting from the selling price the historical cost; improvements made to the property; the amount corresponding to currency devaluation; and 10% of the profit subject to tax for each year of ownership, starting from the year following the year of acquisition (consequently, no tax is payable if the property has been owned for at least twenty years). The tax is deductible for income tax purposes by businesses other than those dealing in real estate. Companies dealing in real estate can take this tax as a tax credit against income tax due. Tax is assessed by municipalities on transfers of real property and vessels (ships,

airplanes, and so forth) at scaled rates on the greater of the contract price or the appraised value of the property.

