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THE TAX  
DISPUTES AND  
LITIGATION  
REVIEW

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SECOND EDITION

EDITOR  
SIMON WHITEHEAD

LAW BUSINESS RESEARCH

# THE TAX DISPUTES AND LITIGATION REVIEW

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For further information please email  
[nick.barette@lbresearch.com](mailto:nick.barette@lbresearch.com)

THE TAX  
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REVIEW

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Second Edition

Editor  
SIMON WHITEHEAD

LAW BUSINESS RESEARCH LTD

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# EDITOR'S PREFACE

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The objective of this book is to provide tax professionals involved in disputes with revenue authorities in multiple jurisdictions with an outline of the principal issues arising in those jurisdictions. In this, the second edition, we have continued to concentrate on the key jurisdictions where disputes are likely to occur for multinational businesses.

Each chapter provides an overview of the procedural rules that govern tax appeals and highlights the pitfalls of which taxpayers need to be most aware. Aspects that are particularly relevant to multinationals, such as transfer pricing, are also considered. In particular, we have asked the authors to address an area where we have always found worrying and subtle variations in approach between courts in different jurisdictions, namely the differing ways in which double tax conventions can be interpreted and applied.

Perhaps it is merely a perception from a jurisdiction whose prime minister has publicly vilified a multinational for complying with the national tax laws, but tax avoidance seems to have become the new international evil. As such, this book provides an overview of each jurisdiction's anti-avoidance rules and any alternative mechanisms for resolving tax disputes, such as mediation, arbitration or restitution claims.

We have attempted to give readers a flavour of the tax litigation landscape in each jurisdiction. The authors have looked to the future and have summarised the policies and approaches of the revenue authorities regarding contentious matters, addressing important questions such as how long cases take and situations in which some form of settlement might be available.

We have been lucky to obtain contributions from the leading tax litigation practitioners in their jurisdictions. Many of the authors are members of the EU Tax Group, a collection of independent law firms, of which we are members, involved particularly in challenges to the compatibility of national tax laws with EU and EEA rights. We hope that you will find this book informative and useful.

Finally, I would like to acknowledge the hard work of my colleague Federico Cincotta in the editing and compilation of this book.

**Simon Whitehead**

Joseph Hage Aaronson LLP

London

February 2014

## Chapter 6

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# ECUADOR

*Juan Gabriel Reyes-Varea and Alejandro Páez-Vallejo<sup>1</sup>*

### I INTRODUCTION

In Ecuador, the administration of justice in tax and customs matters is in the charge of the Tax Disputes Court (TDF), a jurisdictional entity with sectional competence and the Special Tax Litigation Chamber of the National Court of Justice (CNJ) as the appellate body with national jurisdiction, based in Quito.

Tax dispute jurisdiction consists of the public authority to consider and resolve disputes arising between tax administrations and taxpayers or those responsible for acts that determine tax obligations or establish responsibilities, or for the consequences of legal relations arising from the application of laws, regulations or resolutions related to tax matters.

Litigation in tax and customs matters has been gradually increasing, with the main defendant in this area being the Internal Revenue Service (SRI), the institution responsible for the collection of the principal taxes, such as income tax and value added tax. This institution has modified the tax culture in Ecuador by turning tax collection into the main income for the state.

In 1998 a deep restructuring process of the aforementioned tax authority in Ecuador was initiated, as well as a modernisation of auditing and tax control systems, which resulted in an increase in tax assessment acts and accordingly an increase in the lawsuits brought by taxpayers against these acts.

Because of the backlog of court cases in taxation, litigation in tax matters (i.e., the procedure of challenging an administrative act for determining a tax liability in the courts,) can last between four and seven years and the cost of this process can be significant.

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<sup>1</sup> Juan Gabriel Reyes-Varea is a partner and Alejandro Páez-Vallejo is a junior associate at Pérez Bustamante & Ponce, Abogados.

One of the factors that increases the cost of litigation in tax matters is the condition that must be met by any person who intends to bring an action against an act in which a tax liability is determined: a bond or security equivalent to 10 per cent of the contested obligation must be paid. If this bond is not paid (which may be satisfied through a cash payment, a bank or insurance guarantee, or similar), the claim must be set aside by the judges hearing it. In the event of a judgment in favour of the taxpayer, the amount lodged as a guarantee must be returned to the taxpayer and, in the case of an unfavourable decision, the amount is charged to the total demanded by the tax administration.

In the event of an appeal, heard before the CNJ's Special Tax Litigation Chamber, and to suspend the effect of the trial court judgment, the law requires the taxpayer to pay a second bond, which rather than a specific fee is usually set between 5 per cent and 10 per cent of the contested amount.

In addition to the costs of bringing of lawsuits or appeals in tax matters, should the judgment go against the taxpayer, the Tax Code (COT) requires the payment of interest at a rate equivalent to 1.5 times the current reference lending rate determined by the Central Bank of Ecuador (i.e., approximately 13 per cent per annum; interest accrues notwithstanding the duration of the contestation process).

Furthermore, in addition to the costs of contesting tax determination acts through court proceedings, the tax administration has the legal obligation to impose a 20 per cent sanction or surcharge on any tax liability that is determined. The taxpayer has no option to reduce or avoid this surcharge; if the tax liability is confirmed by a judge, this confirmation necessarily brings with it the obligation of paying the 20 per cent surcharge.

To summarise, and as will subsequently be explained, non-payment of taxes in Ecuador and the initiation of legal proceedings before the courts can be a costly business for taxpayers.

## **II COMMENCING DISPUTES**

Legal actions on tax matters can only be initiated by the taxpayer, and the TDF has jurisdiction to hear challenges to legislative acts on tax matters and against acts that determine taxes, penalties or other charges that are exclusively related to tax matters. The TDF also has jurisdiction over direct actions that seek the recovery of that which was unduly paid.

Once the tax required by a particular tax administration has been determined, taxpayers have two alternatives: (1) file a complaint with the tax administration responsible for the act (a claim that must be resolved within 180 days), or (2) bring a suit before the TDF. As a rule, the taxpayer has 20 business days from the day following the notification of the contested act to choose either of these alternatives. After said term, the obligation determined takes force and therefore is enforceable through a compulsory collection proceeding.

In exceptional cases, and only for issues restrictively identified in the COT, the taxpayer or the tax authority has three years counted from the notification of an administrative act, to present an appeal for review to the highest administrative authority. This appeal does not have an answer term and does not suspend the effects of

the contested measure. If the appeal decision goes against the taxpayer, the taxpayer may challenge it before the TDF, within the same 20 working days specified above.

The entitlement of the tax administration to determine a tax liability expires in: (1) six years, counted from the date that the return filing deadline lapsed, when not declared in whole or in part, (2) three years counted from the date of the tax return for which the law requires determination by the taxpayer, or (3) one year in the case of verification of a determination act undertaken by the taxing agency or in a mixed manner, counted from the notification date of such acts.

The term of the tax administration's entitlement to determine a tax liability is interrupted with the notification of the 'order of determination' to the taxpayer (i.e., the tax authority's decision to initiate a formal examination process that concludes with the determination of a tax liability).

#### **i Determination process before the SRI**

Since the most representative tax administration in Ecuador is the SRI, the following is a summary of an audit process that culminates with the notification of a tax assessment certificate.

Generally, the SRI has three years to start a process of determining a tax liability that has been previously settled by the taxpayer. Therefore, the SRI can notify the taxpayer with an order of determination at any time within these three years, and after giving notification of said order, it usually has one year (this period may be longer, depending on the circumstances) to issue the corresponding tax determination certificate.

After the verification process (cross-checking information), the SRI must issue a draft determination certificate, which although it has no legal effect as it is a preparatory measure, has the object of informing the taxpayer of the audit results and the differences that have been found regarding the audited tax.

The taxpayer then has 20 working days to exercise its right to object, and to file its objections and justifications against this draft determination certificate, presenting all the necessary documentation to justify the differences found by the authority. In this instance both legal issues and documentary support and accounting matters are discussed.

After these 20 days, the SRI verifies and analyses the documents and arguments submitted by the taxpayer then gives it notice of a tax determination certificate, which is a purely administrative act.

Once given notice of the tax determination certificate, the taxpayer has 20 working days to contest it either in court or in administrative proceedings.

### **III THE COURTS AND TRIBUNALS**

The TDF is the competent entity to resolve conflicts in tax and customs matters, and above this entity is the CNJ's Special Tax Litigation Chamber, the highest jurisdictional body.

There is reiterated case law according to which an appeal heard by the CNJ does not act as a second instance; rather it only analyses defects committed by the TDF in the first instance process or in the judgment issued (legal violations or omissions). That is, it is an extraordinary remedy that does not allow the assessment of evidence, nor is it a dispute process (there is no lawsuit, nor answer to the suit or litigation); also by

being extraordinary, its invocation is extremely formal and is appropriate only in cases exhaustively specified by law.

Notwithstanding the aforementioned, the Constitution in force in Ecuador since 2008 established an extraordinary action in constitutional matters for the protection of constitutional rights and due process in court decisions, final orders and resolutions with the force of judgments where rights recognised in the Constitution have been violated by action or omission.

This action, therefore, may be lodged against judgments handed down by the highest court in tax dispute matters (CNJ), even when its scope is very limited.

#### **i Internal review**

We have already stated that the tax authorities have the power to initiate a review of their own actions through an extraordinary review procedure and they may also, if still within the established time limits for determining tax liability, verify their acts of determination within the year these were issued. In an interesting judgment, the CNJ determined that this latter power – of verifying determination acts – is appropriate only to the extent that the original act of determination has not been contested by the taxpayer before the TDF. If there has been an objection lodged against the original act of determination, the tax authorities will not have jurisdiction to verify that act, as the enforceability of the act is suspended until the relevant judgment.

With regard to a case in which the tax authority initiated a verification process for an act of determination that had been appropriately challenged before the TDF, the CNJ ruled as follows in the judgment of appeal of cassation No. 282-2010:

*6.1.4. The initial effects of the legal challenge of the first certificates of determination, as stated above, do not suspend the exercise of the administration's determinative capacity, as it is not the issue that is in question when there is a judicial challenge, but it does create a suspensive effect on the enforceability of the certificate, which is why the tax authorities must consequently wait for the pronouncement of the judge to act [...]. 6.1.6. This action of the tax administration obstructs the administration of justice on contested acts, goes against the principles governing the judicial process, as the system or means of the administration of justice, that of the effective judicial protection of rights, that of the obligation to administer justice, and that of the contestability of administrative acts in this court.*

#### **ii Establishment of courts and appellate levels**

In Ecuador there are five TDFs, each with its respective chambers and each comprising three judges and a secretary. Their jurisdiction is limited territorially.

The judges of the different TDFs are independent and act as judicial officers. However, it is common that TDF or CNJ judges are former tax administration officials, mainly from the SRI.

It is always the taxpayer who initiates the legal process before the TDF. Nevertheless, an appeal of cassation to the CNJ may be brought by either the taxpayer or the tax administration; however, as a formal appeal, this can be rejected through a writ of prohibition. If a partial judgment is issued by the TDF (partly in favour of the taxpayer

and in part for the tax authorities), it may be the case that two appeals are made against the same judgment, each with different arguments.

This appeal of cassation must be filed with the TDF chamber that issued the judgment. This chamber must consider whether the appeal meets all the formal requirements laid down by law and, through a decree, if applicable, must deliver the process to the CNJ for the latter to rule on the admissibility of the action or alternatively to reject it.

## **IV PENALTIES AND REMEDIES**

### **i What to expect from a tax dispute**

If the respondent tax authority is the SRI, we can expect a neat and well-structured defence (the tax authority has a legal obligation to defend itself in a contestation process, with no option to acquiesce to the lawsuit or compromise in any circumstances).

We can also expect the issue to be dealt with by judges who are just starting their work as administrators of justice (since more than half of the judges of the TDF have less than five years' experience as judges) and we must expect a long and costly process.

Recently two out of three judges of the CNJ's Special Tax Litigation Chamber were temporarily suspended from their duties following allegations by the SRI's director general that one of their decisions – favourable to the taxpayer – was damaging to the interests of the state. We believe that this could motivate TDF and CNJ judges to be more cautious regarding the economic impact of their decisions on the state.

### **ii Criminal penalties**

With regard to criminal sanctions, the COT contains an entire chapter on tax illegality. Most penalties are pecuniary and the only offence that constitutes a criminal offence is fraud, understood as any intentional act of simulation, concealment, omission, misrepresentation or deception leading to an error in the determination of the tax liability, or acts that result in a failure to pay all or part of the taxes actually due, for the taxpayer's own benefit or that of a third party, as well as any fraudulent conduct that contravenes or impedes the work of control, determination and sanction exerted by the tax administration.

In cases of fraud, the following are the most frequent: (1) providing false or adulterated information or declarations on goods, figures, facts, circumstances or backgrounds that influence the determination of tax liability, (false, incomplete or disguised data); (2) the wilful omission of income, the inclusion of costs, deductions, rebates or withholdings that are non-existent or in excess of that legally due; (3) the wilful alteration of computerised accounting records or books of accounts, notes, entries or operations related to the economic activity as well as false accounting records of accounts, names, quantities or data; (4) deliberately undertaking double accounting; (5) simulating one or more acts or contracts to obtain or grant a benefit of a subsidy, reduction, exemption or fiscal stimulus; (6) undue and wilful recognition or appropriation of a refund of taxes, interest or penalties, so established by a firm or enforceable act of the tax administration or competent court.

Depending on the type of fraud that is committed, prison sentences can range from one to five years.

With regard to financial penalties, these are divided into regulatory violations and offences. Violations are punishable for lack of compliance with the tax laws and are sanctioned monetarily with fines from US\$30 to US\$1,500, while regulatory offences are punishable for lack of compliance with tax regulations and are sanctioned monetarily with fines from US\$30 to US\$1,000.

Additionally, legislation provides for penalties such as closure of the establishment or business, suspension of activities, confiscation, definitive seizure, suspension or cancellation of entries in public registers, suspension or cancellation of patents and licences, and suspension or removal from public positions. However, the most common penalty used is the suspension of activities and closure of the establishment.

## **V TAX CLAIMS**

### **i Recovering overpaid tax**

Cases where for some reason (error in the tax return, accumulated tax credits, etc.) taxpayers have overpaid the amount of due tax or, alternatively, have paid taxes that were not due (overpayment) are frequent.

Therefore, if a taxpayer has paid taxes in excess of that required by law, it has the right to request the return of the overpaid or wrongly paid amounts. This taxpayer action (claim) lapses in three years counted from when the payment is made and must be answered by the tax authorities through a resolution within a period not to exceed 180 working days.

If the decision is negative for the taxpayer, it may challenge said decision before the TDF in what is called a contestation action for undue payment or overpayment.

Notwithstanding the aforementioned, there may be a case where a taxpayer has initiated proceedings before the TDF regarding an administrative act that requires the payment of a tax but during the course of the judicial process, and to avoid the accrual of interest and reduce any relevant risks, decides to pay the said tax liability. In such a specific case, two alternatives are open to the taxpayer: (1) to discontinue the trial, and be liable for an order for court costs; or (2) pursue the contestation action as a challenge for improper payment or overpayment.

The latter is increasingly used by taxpayers and in cases of a favourable decision for the taxpayer the tax administration must return the amount paid by the taxpayer with the corresponding legal interest. The tax administration must pay the same interest that would arise if the taxpayer were the debtor, (i.e., about 13 per cent annually).

### **ii Challenging administrative decisions**

If the tax administration issues an administrative act with general legal effects (regulations) that violates any of the rights and principles enshrined in the Constitution, it may be the subject of a public action challenging its constitutionality; such an action aims to declare the resolution unconstitutional and thus remove it from the legal system generally. This action must be brought before the Constitutional Court.

On the other hand, if the tax administration issues an administrative act with general legal effects that violates any of the provisions of the Internal Tax Law (LORTI) or COT (statutory rules), it may be challenged through a contestation action before the TDF. This action seeks to declare the illegality of the administrative act and, therefore, remove it from the legal system.

If the tax administration issues an administrative act with individual legal effects (a tax assessment certificate) that violates any of the rights and principles enshrined in the Constitution, it can be challenged through a protective action, which aims to suspend the effects of the administrative act.

Finally, if the tax administration issues an administrative act with individual legal effects that violates any provisions of the LORTI or COT, it can be challenged through a contestation lawsuit before the TDF. This lawsuit is the one typically used by taxpayers against tax assessment acts.

### **iii Claimants**

In Ecuador, any taxpayer may make requests or complaints to the tax administration. Faced with an unfavourable resolution of the complaint, the taxpayer, as we have seen, may file a complaint with the tax administration itself or initiate legal proceedings before the TDF (subject to the penalty of court costs).

In the event that there is shared involvement by several taxpayers or if the same administrative decision generates legal effects for several taxpayers, even though current tax legislation does not provide for joint actions, procedurally, under the principle of judicial economy and speed, we see that there is no conflict in this.

Ecuadorian tax legislation (COT) explicitly prohibits the recipients of tax exemptions from taking over the duties, established by law, of a taxable person; as well as extending, in whole or in part, the benefit of exemption in any way to non-exempt taxpayers. It is not feasible, therefore, for the right to claim an overpayment to be transferred from one taxpayer to another. Notwithstanding this, it is possible, in the trial stage, for a taxpayer to transfer to another taxpayer its litigation rights over the judicial process it has begun.

## **VI COSTS**

In Ecuador, the court costs regime is regulated by tax legislation, especially when the taxpayer drops the court case or it is declared abandoned due to lack of momentum.

Before the CNJ's Special Tax Litigation Chamber, the court costs will be paid by the claimant whenever the appeal has been declared void or it is manifestly apparent it was brought without legal basis or for the purpose of delaying the execution of the judgment. In these cases a fine of up to the equivalent of 15 minimum wages may also be imposed depending on the importance of the case.

## **VII ALTERNATIVE DISPUTE RESOLUTION**

Conflicts in tax matters are not susceptible to being resolved through an alternative dispute resolution method therefore there can be no compromises or negotiations over them.

Notwithstanding this, the only way to reach some sort of agreement with the tax authority on a tax liability is in respect of the payment facilities, (i.e., a term given to the taxpayer for the payment of the obligation, during which the interest referred to previously accrues).

## VIII ANTI-AVOIDANCE

Since 2008, Ecuador has pursued a strict tax policy aimed at preventing tax evasion, mostly limiting unjustified enrichment and the use of tax havens or lower tax regimes.

Thus, as of said fiscal year, legislation was implemented that would restrict the deductibility of a series of costs paid abroad, and the application of transfer pricing for any kinds of transaction with related parties

In the same vein, together with the implementation of rules that limit transactions and expense deductions, forms of coercion to enforce compliance and the payment of tax obligations required by the tax administration have also been strengthened, especially the use of precautionary measures as well as increased penalties (currently the new Comprehensive Penal Code is being debated in the National Assembly, which will strengthen penalties regarding tax offences).

Precautionary measures are frequently used by tax administrations, especially the SRI. The most controversial case during fiscal year 2013 was the seizure and auction of goods from one of the country's largest banana companies due to a tax liability of US\$45 million, which, when interest was added, exceeded US\$90 million.

## IX DOUBLE TAXATION TREATIES

Ecuador currently has double taxation treaties (DTTs) with the following 15 countries: Mexico, Brazil, Argentina, Italy, Spain, Korea, Chile, Germany, Canada, France, Romania, Belgium, Switzerland, Uruguay and China; and one subregional agreement to prevent tax evasion with the Andean Community (Peru and Colombia).

In practice these treaties are not frequently used by taxpayers, despite the fact that in public international law they have a supra-constitutional hierarchy; in Ecuador the applicability of these treaties is restricted by procedural requirements contained in the Regulations for the Implementation of the Internal Tax Regime Law (RLRTI).

Therefore, the RLRTI has set the following requirements or conditions for the use of DTTs: (1) a certificate of tax residence of the foreign taxpayer and beneficiary of payments made from Ecuador, and (2) an independent auditors' report on the taxation of said income abroad. These two requirements added by the RLRTI have greatly limited the use of said agreements.

## X AREAS OF FOCUS

One of the more recent cases that has been the subject of discussion and controversy within the tax field relates to the decision issued by the CNJ regarding appeal of cassation No. 282-2010 (see Section III, *supra*) on the deductibility of expenditure on interest payments for external credits to related companies abroad.

According to the tax authorities' criteria, external credits granted to taxpayers in Ecuador by related parties abroad do not constitute actual loans but are equity contributions or provision of funds.

To put this in context, in Ecuador before fiscal year 2008, interest payments abroad paid on foreign loans were not subject to withholding and were therefore deductible, provided this was registered with the Central Bank of Ecuador and the interest rate did not exceed that set by that institution. Nevertheless, due to high utilisation of said tax benefit, the SRI began to challenge the deductibility of these payments on the basis that, in essence, this relationship was not a true external credit but an equity contribution or provision of funds from abroad (i.e., the taxpayer was using a legal instrument – foreign loans – to send money abroad without paying the accompanying tax by using a tax benefit – payment of interest without withholding at source).

This criterion was accepted by the CNJ's Special Tax Litigation Chamber in five different judgments; except in the judgment for appeal No. 282-2010, wherein it accepted the deductibility of expenditure for the payment of interest for external credits to related parties.

In said ruling, it was indicated that the case of the taxpayer (an Ecuadorean company that had several foreign companies as shareholders and creditors) was different from the cases already considered by the CNJ, as in that specific case the foreign credit was real by virtue of having provided much of the capital and also because said credit was provided for in a contract signed by that company and the Ecuadorean state.

Finally, another tax system being frequently used by the SRI is that related to the transfer pricing regime.

## **XI OUTLOOK AND CONCLUSIONS**

Currently, the Ecuadorean system for administration of justice is the object of constant and radical changes. Among them, in tax dispute matters, to expedite the clearance process and prevent a backlog of cases, new chambers have been created within the TDF. Where formerly there were only three chambers of the TDF in Quito, this changed to five and then to the current nine chambers; that is a total of 29 judges. This is evidence of the proliferation of conflicts in tax matters.

Nevertheless, to maintain impartiality, in fiscal year 2014 it is planned to eliminate the chambers and establish interaction among judges, among whom cases will be randomly drawn. This system, while pursuing the reasonable goal of fairness, will in practice create complications, primarily regarding organisation for legal proceedings or investigations, the dismantling of shared criteria and the hiring of new judges who have no expertise in the matter.

We hope that these modifications have the rights of taxpayers as their ultimate goal, primarily the right to defence and to effective judicial protection.

## Appendix 1

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# ABOUT THE AUTHORS

### **JUAN GABRIEL REYES-VAREA**

*Pérez Bustamante & Ponce, Abogados*

Juan Gabriel Reyes-Varea graduated as an attorney from the Pontifical Catholic University of Ecuador in 2002 and from the Academy of American and International Law, Dallas in 2007. He was a candidate for a master's degree in administrative law from Universidad San Francisco de Quito. He was a specialist in tax studies and international taxation at the Internal Revenue Service of Ecuador from 2001 to 2003 and president of the Law School Students' Association at the Pontifical Catholic University of Ecuador from 2000 to 2002. Juan Gabriel Reyes-Varea was general coordinator for 'Libros Jurídicos Ruptura' Nos. 43 and 44 and professor of tax law at the Universidad de las Américas from 2007 to 2011. Since 2011 he has been a professor of tax law at the International University of Ecuador and, since 2012, a professor in the Tax Management Program at Universidad San Francisco de Quito. Mr Reyes-Varea has also been a member of the board of directors and of the executive committee of the Chamber of Industry and Production since 2012. His publications include: 'Precios de transferencia en Ecuador', 'Libro Jurídico Ruptura' No. 47; and 'El Ecuador ante los problemas de doble tributación', 'Libro Jurídico Ruptura' No. 44. Mr Reyes-Varea's areas of practice are tax and commercial law.

### **ALEJANDRO PÁEZ-VALLEJO**

*Pérez Bustamante & Ponce, Abogados*

Alejandro Páez-Vallejo graduated as an attorney from Universidad San Francisco de Quito and from the American University, Washington College of Law, Legal English Institute in 2013. His practice areas are tax, customs, civil law and contracts.

**PÉREZ BUSTAMANTE & PONCE, ABOGADOS**

Av. República de El Salvador 1082 y Naciones Unidas

Edificio Mansión Blanca, Quito

Ecuador

Tel: +593 2 382 7640 to 649

Fax: +593 2 224 4462

[jreyes@pbplaw.com](mailto:jreyes@pbplaw.com)

[apaez@pbplaw.com](mailto:apaez@pbplaw.com)

[www.pbplaw.com](http://www.pbplaw.com)