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Introduction

Ecuadorian transfer pricing rules apply to taxpayers undertaking cross-border operations from fiscal year 2005 onwards. The regulations expressly recognise the guidelines established by the Organisation for Economic Co-operations and Development (OECD) as technical reference in transfer pricing matters.

Statutory rules

Ecuadorian taxpayers should be able to demonstrate that their transactions with foreign-related parties are conducted in accordance with the arm's-length standard. Transfer pricing rules are applicable to all types of transactions (covering, among others, transfers of tangible and intangible property, services, financial transactions, reimbursement of expenses and licensing of intangible property). Transfer pricing rules apply to cross-border transactions with foreign-related parties in the following manner:

- Taxpayers with cross-border transactions with foreign-related parties for cumulative amounts between 1 million United States dollars (USD) and USD 3 million must file a transfer pricing annex within two months after the filing date of the tax return when the sum of the transactions is more than 50% of the total taxable income of a company.
- Taxpayers with cross-border operations with foreign-related parties for cumulative amount greater than USD 3 million during any given fiscal year must file a transfer pricing annex within two months after the filing of the income tax return (which normally occurs in April of the following year).
- Taxpayers with cross-border operations with foreign-related parties for cumulative amounts greater than USD 5 million must file, in addition to the transfer pricing annex, a comprehensive transfer pricing report within two months after the filing date of the tax return.

Any adjustments arising from the application of transfer pricing regulations must be included in the tax return and affect taxable income.

Related parties

Related parties are defined as individuals or entities in which one directly or indirectly participates in the direction, control or capital of the other, or in which a third party, individual or entity participates in the direction, control or capital of the others.

In order to establish any relationship among entities, the tax administration will consider, in general terms, the participation in the companies' shares or capital (more than 25%), the holders of the capital, the entity's administration, the distribution of dividends, the proportion of transactions carried out between entities (more than 50%

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of total sales, or purchases, among others) and the pricing mechanisms used in such operations. Specifically, the regulations list the following situations as related parties:

- Head offices and their subsidiaries, affiliates and permanent establishments.
- Subsidiaries, affiliates and permanent establishments among themselves.
- The parties that share the same individual or entity directly or indirectly in the direction, administration, control or capital of such parties.
- The parties that maintain common directive bodies with a majority of the same members.
- The parties with the same group of shareholders participating directly or indirectly in the direction, administration, control or capital of such parties.
- The members of the directive bodies of the entity with respect to the entity, as long as the relationships between them are different to those inherent to their positions.
- The administrator and statutory auditors of the entity with respect to the entity, as long as the relationships among them are different to those inherent to their positions.
- The entity with respect to the spouses and relatives (fourth degree of consanguinity and second degree of affinity) of the directing shareholders, administrators and statutory auditors.
- The entity or individual with respect to the trusts in which it has rights.

The Ecuadorian law also deems transactions as being carried out by related parties when such transactions are not carried out at arm's length or when they take place with individuals or entities located in tax-haven countries or jurisdictions.

Comparability

Operations are deemed comparable if no differences exist between their relevant economic characteristics that significantly affect the price or value of the goods and services or the arm's-length margin; or, in instances where these differences exist, they can be eliminated through reasonable technical adjustments.

In order to verify whether the operations are comparable or if there are significant differences between them, the following factors should be considered when assessing the comparability of a transaction:

- The specific characteristics of the goods or services.
- The functions that each taxpayer performs, including the assets used and the risks undertaken.
- The terms and conditions (contractual or not) that exist between related and nonrelated parties.
- The economic circumstances of different markets, such as geographical location, market size, wholesale or retail, level of competition, among others.
- Business strategies, including those related to market penetration, permanence and expansion.

Methods

According to transfer pricing regulations, the following methods should be used when assessing the arm's-length principle in transactions with related parties:

- Comparable uncontrolled price (CUP) method.
- Resale price method (RPM).
- Cost-plus (CP) method.

- Profit split method (PSM).
- Residual profit split method (RPSM).
- Transactional net margin method (TNMM).

Ecuador's transfer pricing regulations contain a best method rule. They also indicate that the methods must be applied hierarchically beginning from the CUP method through the TNMM, along with an explanation of why each method has been discarded. Transfer pricing regulations state that the application of the methods should be interpreted based on the OECD Guidelines, as long as they are not contrary to local legislation.

Transfer pricing regulations include the use of the interquartile range and the adjustment to the median if the taxpayer's result falls outside the range.

Transfer pricing annex

As previously stated, taxpayers exceeding the materiality threshold on cross-border operations with foreign-related parties during the fiscal year must present a transfer pricing annex. The annex must include:

- Identification of the taxpayer, including taxpayer identification number and fiscal year.
- Identification of foreign-related parties, including name, address, fiscal residence, taxpayer identification number in the country of fiscal residence.
- Operations with foreign-related parties, including type of operation, amount of operation, and method used to determine arm's-length compliance.
- The margin obtained by the taxpayer on each type of operation.
- Transfer pricing adjustment, if applicable.

Transfer pricing report

The transfer pricing report should include the following information:

- The background and functions performed by the group the taxpayer belongs to.
- The background, functions performed, risks borne and assets used by the taxpayer on its business.
- An explanation of the elements, documentation, circumstances and facts valued for the transfer pricing analysis or study.
- Details and amounts of the inter-company transactions, subject to analysis.
- Details of the related entities abroad with which the company carried out the transactions subject to analysis.
- A global and local analysis of the industry in which the taxpayer operates.
- Method used to support the transfer pricing, stating the reasons and fundamentals which led to considering it as the best method for the transaction under analysis.
- The identification of every selected comparable to justify transfer pricing.
- The identification of the information sources used to obtain the comparables.
- Description of the activities and characteristics of the business of the comparable companies.
- Listing of selected comparables that were rejected, stating the reasons for such consideration.
- Listing quantification and methodology used to practice adjustments necessary on selected comparable.
- Median and the interquartile range.

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- Profit and loss statement of the comparable entities corresponding to the commercial years considered for the economic analysis, indicating the source of information.
- Conclusions.

Other regulations

The *Servicio de Rentas Internas* (SRI) enacted resolutions establishing the contents of the transfer pricing annex and the integral transfer pricing report, as described previously.

Legal cases

Transfer pricing rules were introduced as part of the Income Tax Law in January 2008. Currently, there are transfer pricing cases at the tax court level.

Burden of proof

In practice, the burden of proof lies with the taxpayer for filing the transfer pricing annex and the transfer pricing report.

Tax audit procedures

There are no specific tax audit procedures established for transfer pricing purposes. Transfer pricing obligations are audited as part of regular tax audits conducted by the SRI.

Tax audit-related inspections are carried out first as desk reviews based on detailed information provided by the taxpayers and, subsequently, at the taxpayer's office. Taxpayers must make available all basic accounting records, auxiliary records, as well as all sources of information supporting the financial statements, the tax returns and the transfer pricing annex and report.

Once the tax audit has been completed, inspectors prepare an assessment that either confirms the declared taxable income and the tax paid or requests payment of additional taxes arising from the objections resulting from the audit. Among these objections, the administration could challenge the adequacy of the transfer pricing study and establish different transfer pricing adjustments for income-tax purposes.

Revised assessments and the appeals procedure

Taxpayers have the right to file objections with the SRI against additional tax assessments established because of tax audits within 20 days of receipt of the notification of assessment. The SRI must issue its resolution within 120 days of the appeal. The lack of response of the SRI within 120 days is considered a tacit acceptance of the claim presented by the taxpayer.

If the appeal to the SRI is unsuccessful, the taxpayer can appeal before the Fiscal Court, which is organised into several chambers of three judges each. Each chamber processes claims and issues judgments independently from the others. In the event that taxpayers do not agree with the judgment made by a particular chamber of the court, they have the right to appeal before the entire court (i.e. all three chambers). Only legal issues are discussed before the full court.

Additional tax and penalties

Failure to file the transfer pricing annex or the comprehensive transfer pricing report on the established dates can result in a fine up to USD 15,000. The same fine may apply to cases where the information presented in the annex and the report is incorrect or differs from the information provided in the income-tax return.

Finally, the delayed presentation of the transfer pricing report or annex give rise to a fine up to USD 333.

Resources available to the tax authorities

There is a unit within the SRI that deals specifically with transfer pricing issues.

Use and availability of comparable information

Comparable information is required in order to determine arm's-length prices and should be included in the taxpayer's transfer pricing documentation. Ecuadorian companies are required to make their annual accounts publicly available by filing a copy with the local authority (e.g. the superintendence of companies). However, these accounts do not necessarily provide enough or sufficient information on potentially comparable transactions since they do not contain much detailed or segmented financial information. Therefore, reliance is often placed on foreign comparables. This practice would be acceptable under Ecuadorian transfer pricing regulations.

Tax legislation allows the SRI to use secret comparables.

Limitation of double taxation and competent authority proceedings

The domestic legislation is supplemented by the provisions of the double taxation treaties that Ecuador has signed with several countries (Brazil, Belgium, Chile, France, Germany, Italy, Romania, Spain, Canada, Mexico, Switzerland, Uruguay and the nations of the Andean Community: Colombia, Peru and Bolivia). These agreements generally include provisions on mutual agreement procedures, related parties and business profits.

Advance pricing agreements (APAs)

Ecuadorian legislation does establish the possibility of advance pricing agreements (APAs).

Anticipated developments in law and practice

Law

According to changes in tax legislation in force since 1 January 2010, taxpayers are excluded from applying transfer pricing rules if they comply with the following:

- Income tax due is higher than 3% of taxable income.
- There are no transactions with tax-havens or low tax jurisdictions.
- There is no contract in place with the government for the exploitation of non-renewable resources.

These taxpayers must file with the SRI until one month after the due date established for the filing of the income tax return, the relevant information of its operations with foreign related companies.

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Practice

It is expected that tax authorities will become more skilled and aggressive in handling transfer pricing issues. Transfer pricing knowledge of tax inspectors is expected to increase significantly, as training improves and they gain experience in transfer pricing audits.

Liaison with customs authorities

Tax authorities and customs authorities may exchange information. Experience suggests, however, that the authorities do not deal very closely with each other where transfer prices are concerned.

OECD issues

Ecuador is not part of the OECD, but according to transfer pricing rules the OECD's transfer pricing guidelines for multinational enterprises and tax administrations are used as a technical reference for transfer pricing purposes.

Joint investigations

Transfer pricing regulations do not establish specific procedures for joint investigations.

Thin capitalisation

As of 1 January 2008, thin capitalisation provisions must be considered by taxpayers. In effect, if the amount of a foreign loan exceeds three times the amount of the paid capital, the interest expense will not be considered as a deductible expense for income-tax purposes.

Management services

In instances where the amount of a management charge has been calculated on an arm's-length basis, the management fee would normally be tax-deductible.