

INTER-AMERICAN CENTER OF TAX ADMINISTRATIONS- CIAT

TECHNICAL CONFERENCE

**“AN INTEGRAL APPROACH IN PREVENTING
AND COMBATING TAX EVASION”**

Topic 1.2

“CURRENT CHALLENGES IN CONTROLLING COMPLIANCE”

Internal Revenue Service - SRI

(Ecuador)

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Case study

TOPIC 1.2 CURRENT CHALLENGES IN CONTROLLING COMPLIANCE – THE ECUADORIAN EXPERIENCE

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CONTENTS: 1. Background.- 2. The National Tax Administration Context.- 3. SRI Efforts to Improve Tax Obligations' Compliance.- 3.1 Tax services.- 3.2 Tax control.- 4. Tax Control Actions: Outcomes.- 5. Challenges Facing the Tax Administration.- 6. Conclusions.

OVERVIEW

The globalization of economies is a phenomenon that fosters the movement of economic players the boundaries of States, impacting the tax sphere. In this sense, the notions of permanent establishment, agreements to avoid double taxation, tax havens, harmful tax competition and tax harmonization, among others, call for new and updated definitions, tax entities and management models, which pose new and genuine challenges for Tax Administrations.

On the other hand, the increasingly larger informal economies in Latin America constitute a challenge for massive tax control by regulatory agencies. Taxpayers' reluctance towards paying taxes, their social and cultural level and the complexity of economic transactions require defining appropriate strategies to apply formal fiscal policies and improve the equity and generality of the tax system.

Also relevant in countries like Ecuador, with a significant agricultural sector that produces raw material for export, are the difficulties in controlling tax compliance, given the unsophisticated production processes or the poor tax culture of the economic players. Additionally, behind small and medium sized farms, there are large trading organizations that benefit from such informal sectors and supply goods in the illegal market.

Under the current economic and fiscal scenario in Ecuador, in which the availability of greater oil resources contributes to finance the General State Budget to the detriment of tax revenues, a number of the issues described have not been approached by society with the focus they require. To the contrary, in the last few years, tax policy has been

geared at creating new tax exemptions, generating greater inequity in Ecuador's tax system and more limitations for the Tax Administration's control capacity.

Therefore, Ecuador's Internal Revenue Service is faced with numerous challenges vis-à-vis such issues: a large informal sector, a limited tax culture, a legal and institutional framework that facilitates tax avoidance and a disputable system of justice with low quality government expenditure, which is a disincentive for taxpayers' voluntary compliance. In spite of these issues, citizens perceive that the Tax Administration is on the right track, implementing control programs aimed at bridging evasion gaps with actions that are strictly compliant with the principles of legality and generality.

For such purpose, the SRI has consolidated an information platform that stores the taxpayer identification information (Single Taxpayers' Register) and their economic transactions (Invoicing System). Currently underway are database information sharing programs, with different sources of information from public and private entities in the country. Progress has been made as to the enforcement of intensive audits.

Consequently, the SRI control actions have impacted society in Ecuador, since a large number of economic players became compliant and understood the significance of tax compliance for the country's sustainable development. Notwithstanding, more efforts are required to control informal sectors and evasion and avoidance by multinational corporations or exporting companies. In this regard, the SRI is aware that there are a number of pending challenges ahead, such as defining a simplified system for an adequate approach to informality, incorporating regulations on e-commerce and implementing international tax policy programs.

1. BACKGROUND

Taxation in Ecuador has undergone a relevant change in recent years. Tax pressure from non-oil revenues of the Non-Financial Public Sector grew from 15% in 1998 to 19% in 2005. To attain such an outcome, a number of tax reforms have been implemented in Ecuador in line with a phased-in modernization process, especially for institutions that manage taxes on a national as well as local basis.

National Tax Administrations are made up by the *Servicio de Rentas Internas* (SRI, as per the Spanish acronym) and the *Corporación Aduanera Ecuatoriana* (Ecuadorian Customs Corporation, CAE, as per the Spanish acronym).

- The SRI is the agency in charge of the administration of Income Tax, Value Added Tax, Special Tax on the Consumption and the Motor Vehicle Tax. This entity's tax pressure went from 6.2% in 1998 to 10.8% in 2005.

- The CAE is the agency in charge of the administration of duties, with relevance against the GDP that went from 1.9% in 1998 to 1.2% in 2005.

The complex economic and tax situation and the bankruptcy of private banks in the country in 1999, entailed the examination and approval by Congress of a set of tax reforms that broadened the tax base and strengthened control powers, especially for the National Tax Administration.¹

Since its creation by Act N° 41 in 1997, the Internal Revenue Service has geared its strategic planning at the basic purpose of maximizing taxpayers' voluntary compliance. In the context of poor tax culture and staff, infrastructure and IT systems that hurdled the performance of the former General Revenue Agency, the SRI based its management model on the renewal of human resources, investment in new infrastructure and comprehensive use of leading edge technologies in institutional processes. During the first years, this approach focused largely on taxpayers' services and the enforcement of massive tax controls, instead of the implementation of intensive controls.

Currently, SRI revenue collection accounts for over 50% of the General State Budget and has become one of the main sources of support for the sustainability of government finances in Ecuador.

2. THE NATIONAL TAX ADMINISTRATION CONTEXT

For an easier understanding of the economic, social and institutional scenario in Ecuador, a description follows on a number of variables measured in 2005, which bear an incidence on the National Tax Administrations' management capacity in the country:

- 1 Social investment: Ecuador features one of the lowest social investment rates, pursuant to ECLAC,² which points out an average US\$ 79 per inhabitant and poverty levels reaching 52%.³
- 2 Income distribution: the income structure in Ecuador is one of the most unequal in the region, the wealthiest 10% of the population concentrates approximately 40% of national income.⁴ The Gini ratio is 42.0;⁵
- 3 Informality level: the activity of the informal sectors of economy in Ecuador accounts for 30% of the GDP and underemployment, as a measure of the number of working age people that work less than 40 hours weekly, accounts for 49%;⁶

¹ The 1999 Tax Reform, one of the most relevant in Ecuador in the last few decades, considered the elimination of a number of Income Tax shields and shifted from a short list to a long list of goods and services levied with VAT.

² Source: *Panorama Social de América Latina* 2005.

³ Source: 2006 CIA World Factbook.

⁴ Source: *ENIGHU* 2002 – 2003 (National Survey of Urban Household Income and Expenditure).

⁵ Source: 2006 CIA World Factbook.

⁶ Source: Central Bank of Ecuador.

- 4 Income from oil resources: in the last few years, the General State Budget has been financed with significant unforeseen income from oil resources, to the detriment of tax revenues as a relevant source of income and the Tax Administration's work in consequence.
- 5 Political instability: the Executive and Judicial branches have undergone conflicts, which have affected the Government's image and weakened the institutional quality of State regulatory agencies; and,
- 6 System of justice: the administration of justice in the country is an aspect that bears a negative impact on the control actions implemented by Tax Administrations, whether on the basis of response times or the outcomes of the litigation processes.

Such aspects affect the efficacy of the Tax Administration's actions in different manners, and therefore, restrict its capacity to counter tax evasion and tax fraud.

The tax evasion level in Ecuador prior to 1999 was directly tied to the lack of trust regarding the quality of government expenditures, the poor tax culture and a deteriorated image of the previous Tax Administration. Although the issues regarding accountability and government investment in the social sector have not been overcome yet, the new administration in the Internal Revenue Service has gradually achieved greater confidence and respect from citizens regarding compliance with their tax obligations. The figures on the following table allow us to assess the evolution of the tax evasion gaps in taxes under the IRS umbrella, between 2001 and 2005:

Tax Compliance Gaps in Ecuador

Figures in thousands

Item	2001	2005
Taxpayers pending registration in ⁽¹⁾ the RUC	1,689	2,353
Taxpayers registered in the RUC	1,030	1,620
Registration gap	39%	31%
Taxpayers who must file VAT ⁽²⁾	648.5	1,020
Taxpayers who file VAT	290.4	551.9
Filing gap	55%	46%
Vehicles levied by tax	675.9	910
Invoicing noncompliance (transactions)	92%	24%
Noncompliance with waybills (documentation supporting the goods)	88%	25%
Individual Income Tax Evasion ⁽³⁾	63%	- n/a -
Corporate Tax Evasion ⁽³⁾	43%	- n/a -
VAT evasion ⁽³⁾	28%	- n/a -

Preliminary information subject to review.

Source: SRI Database

Note (1) Economically Active Population, less unemployed, less employees less domestic employees plus corporations.

Note (2) Taxpayers with an economic activity as determined by the Tax Administration or by an SRI process in the last two years.

Note (3) "Proyecto Salto" Survey - USAID

The gaps stated on the foregoing table enable to define the dimension of the issues and challenges facing the Internal Revenue Service. Registration in the RUC and filing taxes pose a clear challenge for control areas and reflect the levels of informality and poor culture of citizens vis-à-vis compliance with tax filing requirements. Notwithstanding, the agency has developed new mechanisms to incorporate taxpayers, by implementing systematized screening programs for the taxpayers' register and simplified tax payment programs.

3. SRI EFFORTS TO IMPROVE TAX OBLIGATIONS' COMPLIANCE

3.1 Tax Services.

In order to describe the improvement process in the level of taxpayers' compliance with tax obligations in Ecuador, we must firstly refer to the broad technology and physical infrastructure investment program to render better tax services to citizens.

Nevertheless, society in Ecuador still features a poor tax culture as to tax compliance, mainly given their ignorance vis-à-vis regulations, the still limited coverage of the tax services rendered by the SRI and the complexity of procedures, and lastly, given the fact that they deliberately breach regulations.

- With reference to the fact that taxpayers ignore the regulations in place, the SRI has developed a number of training and education programs, which range from communication via mass media and tax education meetings and seminars, to the agreement with the Ministry of Education and Culture to educate children and adolescents on tax issues in schools throughout the country.
- The SRI has also invested significant resources to improve and simplify taxpayer assistance services, by appointing officials with a vocation to serve the citizen and upon opening offices in the main cities across the country and using technology-based processes that include Internet services. It is worth clarifying that citizens' Internet access is limited.
- In the light of deliberate noncompliance with tax regulations, the Tax Administration of Ecuador faces a number of issues, which especially relate to the high degree of informality and openness of the Ecuadorian economy. This hurdles tax control since we lack regulations and adequately specialized officials. On the other hand, the existence of non-tax government revenues from the exploitation of oil has generated a lack of support by society of certain attempts at updating tax regulations, as proposed by the National Tax Administration.

Consequently, in the first phase of SRI actions, the improvement of tax services significantly facilitated taxpayers' voluntary compliance, increasing tax collection,

consolidating the institutional image and improving relations among the Tax Administration and society. Such institutional advancements went hand in hand with the enforcement of new control systems, leveraging the experiences of other Tax Administrations, as described hereunder.

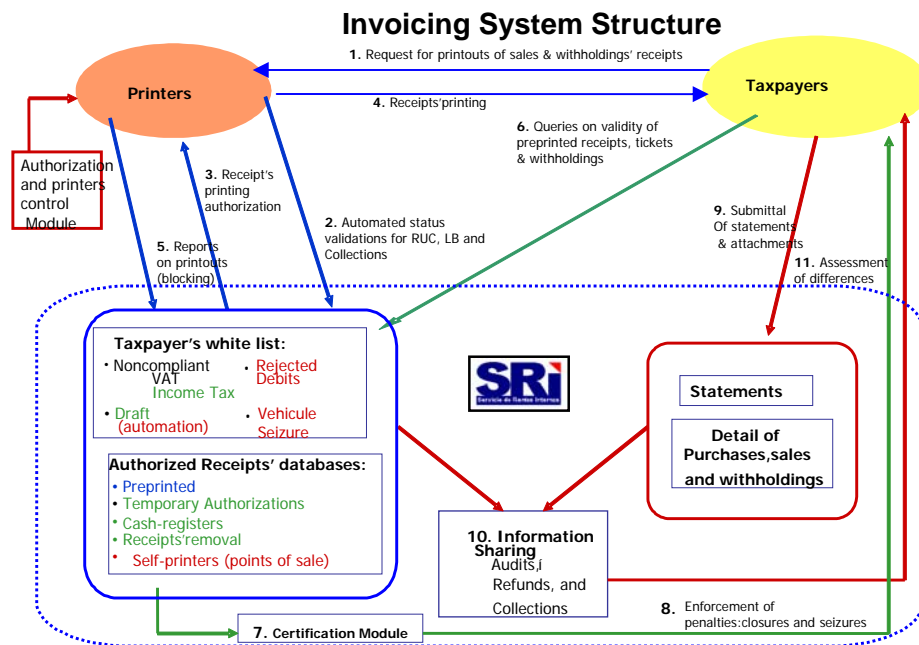
3.2 Tax Control.

In the SRI, the tax control programs were initiated upon the consolidation of the information platform to identify taxpayers and their economic transactions, a process enhanced by the implementation of an invoicing control system. This project included the development of IT systems and field programs, aimed at verifying the tax identification, issuance of sales receipts and compliance with other formal duties, according to three fundamental pillars:

- The Integrated Invoicing system, which is an Internet-based system and enables printers to issue sales receipts for taxpayers registered in the Single Taxpayers' Register (RUC, as per the Spanish acronym), for a given period, depending on whether they are listed on the White List or not.
- The White List system, which daily processes the information from the databases and produces a detail of taxpayers that have complied with the register's formal update duties, tax filing, payment of outstanding debts, among others.
- The Tax Certification program, which is based on field controls, enforces sanctions for noncompliance with tax obligations, whether by closure for failure to register or deliver sales receipts or seizures for not carrying the waybill to support the legal origin of goods in transit.

These components enabled the agency to rely on an appropriate mechanism to regularize compliance with taxpayers' reporting obligations, by means of automated systems that reduce the cost of control actions. Likewise, they have provided an information platform integrated into an institutional data warehouse with information of diverse type to enforce the subsequent tax control phases.

The following chart describes the Integrated Invoicing System, implemented in Ecuador in 2000:



As to massive tax controls, the SRI has made significant progress with the intensive use of technology, by applying database information exchange methods, geared at bridging the tax filing gap and reaching the first level of certainty. Control processes are comprehensive and automated. They exclude discretionary decisions and minimize contact between officials and taxpayers. For such purpose, the Tax Administration relies on the following sources of information:

- Tax statements: forms with detailed information on taxpayers' financial statements for the payment of Income Tax, Value Added Tax, Special Tax on the Consumption and Motor Vehicle Tax;
- Transactions' Modules: monthly detail of the transactions of registered taxpayers. It includes customer information as to local sales, exports, suppliers in local purchases and imports, beneficiaries of financial income, among others;
- Credit cards: information rendered by credit card companies detailing credit card transactions;
- Foreign trade: information from the Foreign Trade Integrated System, with a detail of the single forms for exports and imports, description of the goods traded, customs system, weight, country of origin or destination, value of the goods, among others;
- Financial income: information from the National Financial System regarding the income and applicable Income Tax withholdings on the beneficiary;

- Credit transactions: detailed information of the credits granted by the National Financial System and the withholdings on the beneficiary;
- Risk Assessment Center: consolidated information on the credit rating issued by the Superintendence of Banks regarding National Financial System debtors;
- Donations: detailed information on the amounts allocated to different public or public entities, as an Income Tax donation item;
- Vehicle registration: detailed information on the features of motor vehicles owned by taxpayers subject to the Motor Vehicle Tax;
- Social Security: detailed information on the contributions of corporations and individuals to the Ecuadorian Social Security Institute. It enables to validate corporations' payroll expenses;
- Civil Registry Office: information on the citizens' register. It enables to update the Single Taxpayers' Register record;
- Migrations: information from the citizens' register on individuals who have left the country. It enables to update the Single Taxpayers' Register record;
- Foreign credits registered with the Central Bank of Ecuador: detailed information of the credit transactions between foreign banks or corporations and local public or private corporations;
- Superintendence of Corporations and Banks: detailed information on the registry of corporations under the control of such entities; and,
- Other Tax Administration processes: invoicing system information, white list, claims, refunds, among others.

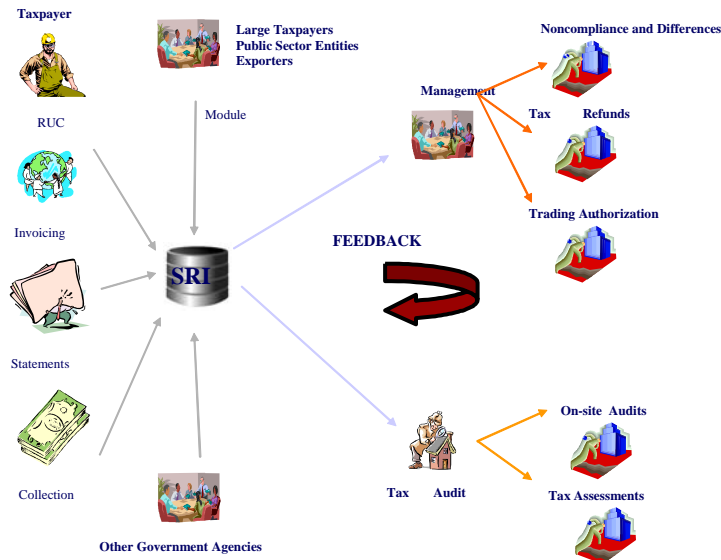
The following massive control programs have been defined on the basis of such databases, which involve taxpayers notification and the applicable process to regulate the breaches detected:

- Unregistered taxpayers: identification of individuals or corporations with economic activities reported by third-parties, who are not registered in the RUC;
- Noncompliant taxpayers with economic activity reported by third-parties: individuals or corporations whose economic activity has been reported by third parties but have failed to file VAT or Income Tax;
- Inconsistencies: identification of statements with a mathematical or legal inconsistency. For example, allowances that exceed the regulatory threshold or show inconsistencies with other tax statements from the same taxpayer;
- Differences: identification of statements with economic transaction information inconsistent with the figures reported by private companies or government agencies; and,
- Tax refunds: examination of the tax registration status and compliance with formal duties by public sector suppliers, senior citizens, international covenants and disabled persons, in the VAT refund process.

The following chart explains the structure according to which the SRI uses information for massive controls:

Use of Auditing and Control

Information



As regards intensive audits, especially for large corporations, economic holdings, international tax policy and complex tax notions, such as e-commerce and compliance with covenants to avoid international double taxation, the Ecuadorian Tax Administration is faced with the greatest challenges. Nevertheless, a certain degree of progress has been made in recent years.

The SRI relies on a risk profile matrix for the selection of taxpayers that shall be audited, which avoids discretionary decisions and considers the following:

- Taxpayer tax and financial information;
- Taxpayer record with the SRI;
- Compliance with formal duties;
- Results from the information sharing processes from massive tax control programs;
- Information on claims and appeals for review;
- Compliance reports from auditing firms; and,
- Investigation processes and claims from regulatory agencies.

Based on the economic relevance and the data from the risk center of the Superintendence of Banks of Ecuador, an analysis of the taxpayer's credit record is undertaken, analyzing the taxpaying capacity and assigning priorities to cases accordingly. The following screen shows a report from the risk profile matrix used by the SRI Tax Audit units:

Matriz de Perfil de Riesgo

SECTOR: <Todos> RUCS: RIESGO: Todos Por Rango Desde: Hasta: TIPO: <Todos> PERSONA: <Todos> AÑO: 2003

RUC	Razón Social	Histori	Cumplim	Propie	Cruces	Financiero	Análisis	Auditorías	Total	Nivel de	Possibilidad
					Tercero		Eco - Trh	Externa	%	Importancia	Recaudación
1791779703001	CORPORACION AEROPUERTO ZONA FRAN	0.00	6.67	9.64	19.00	7.78	1.76	0.00	43.85	5	5
0990967946001	JUNTA DE BENEFICENCIA DE GUAYAZUL	8.21	1.67	9.96	14.88	8.06	0.16	0.00	42.94	5	3
1790105601001	PONTIFICIA UNIVERSIDAD CATOLICA DEL	5.71	1.11	9.84	15.76	7.36	2.78	0.00	42.64	5	5
1390074323001	COOPERATIVA DE PRODUCCION AVICOLA	7.14	1.11	7.23	14.48	7.59	3.41	0.00	40.87	5	3
1791736956001	HOSPITAL VOZANDES DE QUITO	0.00	3.89	10.12	16.56	8.31	1.76	0.00	40.64	5	5
1390079172301	COOPERATIVA DE PRODUCCION AGROPEC	2.86	1.67	8.96	15.46	7.25	4.37	0.00	40.57	4	4
0991236780001	UNIVERSIDAD DE ESPECIALIDADES ESPIR	7.57	1.11	7.96	14.72	6.96	2.07	0.00	40.42	5	2
1790919363001	CAJA NACIONAL DE CESANTIA DE LOS SER	2.86	1.11	10.11	16.05	8.73	1.12	0.00	39.98	5	4
0991392423001	FUNDACION MALECON 2000	5.71	1.67	8.25	12.87	7.64	3.73	0.00	39.87	5	5
1790890279001	FUNDACION ECUATORIANA PARA LA PROT	7.14	2.22	8.28	13.98	5.25	2.78	0.00	39.75	5	4
1790349578001	AUTOMOVIL CLUB DEL ECUADOR ANETA	7.14	1.67	8.00	13.99	6.10	2.71	0.00	39.61	5	4
1790164210001	FONDO ECUATORIANO POPULORUM PROG	5.00	1.67	9.00	12.17	9.10	2.46	0.00	39.39	5	5
1390141544001	JUNTA CANTONAL DE LA CRUZ ROJA DEM	2.14	2.22	8.27	12.84	9.04	4.89	0.00	39.21	5	5
1790262480001	SINDICATO CANTONAL DE CHOFERES PRO	2.14	2.22	8.33	16.56	7.58	2.39	0.00	39.04	5	5
0991033904001	SOCIEDAD PROTECTORA DE LA INFANCIA	0.00	2.22	9.33	14.76	8.47	4.05	0.00	38.83	5	5
1791809146001	UNIVERSIDAD TECNOLOGICA EQUINOCCIA	2.86	3.33	9.01	14.16	7.19	2.07	0.00	38.63	5	5
0990150723001	COLEGIO SAN VICENTE DE PAUL	5.71	1.11	7.79	14.08	6.24	3.67	0.00	38.60	5	5
1791745623001	CORPORACION CUERPOS DE CONSERVAC	2.14	1.11	9.02	15.84	7.38	3.03	0.00	38.63	5	5
1791377516001	COLEGIO SAN GABRIEL DE QUITO	0.00	1.67	9.42	15.84	6.80	4.69	0.00	38.42	5	5
0290014328001	SINDICATO GENERAL DE CHOFERES PROF	7.14	2.22	7.98	10.80	7.19	3.03	0.00	38.36	4	5

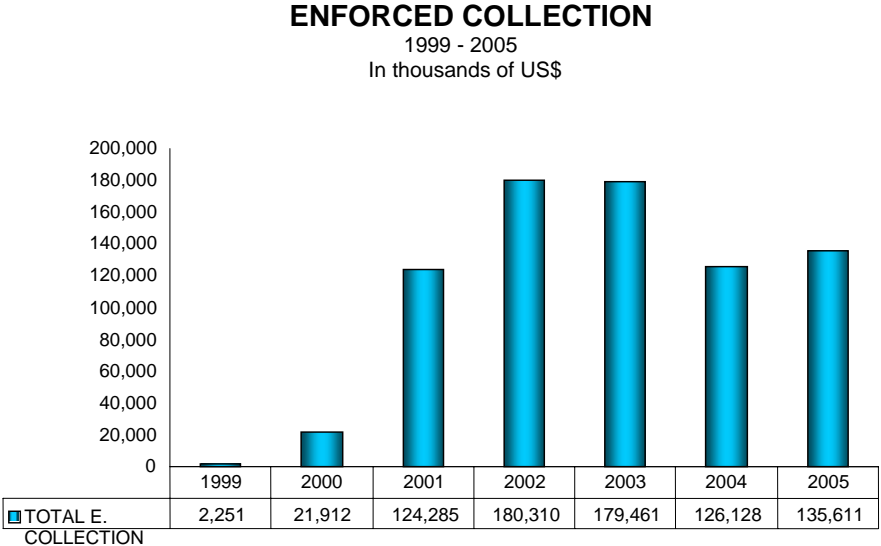
As to the auditing method, as mentioned above, in 1999 the Internal Revenue Service almost fully replaced the staff from the former General Revenue Office. Thus, the experience of such officials was lost, and they were replaced with resources that met the technical requirements and, moreover, the principles and values necessary to enhance the technical and objective purpose of the Tax Administration of Ecuador. This staff is still undergoing a professional development and training process, with the purpose of gaining a similar experience to that of auditors and lawyers hired by private companies in the country, especially in specialized industries such as metallurgy, telecommunications' services, banking, insurance, oil industry, among others. We must highlight that the Agency has undertaken significant efforts to train officials on issues in key areas of the Ecuadorian economy, such as the oil industry, banana plantations, flower industry, fishing, liquor production, among others.

One of the priority areas in the Administration's efforts is the control of foreign trade corporations. In this regard, discussions have been held in Ecuador on several occasions as to the possibility of merging the Internal Tax Administration and the Customs Office with the purpose of having a single tax control authority that integrates control actions, regardless of the origin of transactions. Currently, the Director of the Internal Revenue Service is the Chairman of the Ecuadorian Customs Agency (CAE), but his field of action is limited and the political interference on customs management still impacts customs operations. Thus, smuggling and tax fraud continue to pose a problem.

In spite of the limitations to redress the abovementioned situation, a number of coordinated control actions have been recently implemented by the SRI and the CAE on the basis of IT systems. We may mention, for example, the obligation to register with the RUC for importers and exporters in order to conduct their transactions in the customs system and the IT restriction on authorizations of imports to shell companies, that is to say, those the SRI reported as unidentified businesses.

4. TAX CONTROL ACTIONS: OUTCOMES

Massive and intensive control programs undertaken by the SRI in the last few years directly contribute with enforced collection revenues of approximately 3% of the overall revenue. Therefore, on planning and assessing the outcomes of this process, priority is attached to objectives such as reduction of tax evasion in certain segments and indirect revenue collection results, stemming from the risk generated for taxpayers by the SRI capacity to identify tax evasion or tax fraud thereby. The following chart states the outcomes of collection efforts directly generated by the SRI tax control units in recent years:



Intensive controls in Ecuador involve the assessment of approximately two hundred taxpayers annually and the generation of debt for an estimated US\$ 172.9 million, out of which 80% are subject to litigation in tax courts in the country. The following table presents the indirect incidence on collection, deriving from intensive SRI audits in the period 2001 - 2004:

Descriptive assessment of the Incidence of Audits on Corporate Income Tax Statements

Increase

Fiscal Years 2001 - 2004

ratio	Tax-Income Ratio Filed		Audits Conducted	Income of Audited Businesses (in million US\$)	Overall Income (in million US\$)	Audits' Coverage	
	2001	2004	2001 - 2004	2004	2004	2004	
ECONOMIC SECTOR							
	OIL AND MINING	2.4%	9.3%	61	2,755	2,909	94.7%
	BANKING AND INSURANCE	1.2%	1.6%	70	1,329	3,080	43.2%
	POWER, GAS AND WATER	0.6%	1.6%	30	1,190	1,770	67.2%
	CONSTRUCTION	1.1%	1.2%	40	46	970	4.7%
	COMMUNITY AND PERSONAL SERVICES	0.5%	0.6%	15	18	732	2.5%
	FISHING	0.3%	0.4%	46	67	384	17.5%
	Subtotal Increase	1.2%	4.0%	262	5,406	9,846	54.9%
INDUSTRY No Change							
	INDUSTRY	1.4%	1.4%	152	2,217	9,061	24.5%
	TRADE	0.6%	0.6%	249	5,636	18,136	31.1%
	REAL ESTATE, BUSINESS AND RENTAL	1.2%	1.2%	81	177	2,487	7.1%
	AGRICULTURE	0.4%	0.4%	46	265	2,068	12.8%
	Subtotal No Change	0.9%	0.9%	528	8,296	31,751	26.1%
Reduce							
	TRANSPORTATION AND COMMUNICATIONS	1.6%	1.4%	51	1,289	3,809	33.8%
	SOCIAL AND HEALTH SERVICES	0.8%	0.5%	19	47	740	6.3%
	HOTELS AND RESTAURANTS	0.9%	0.8%	14	107	366	29.2%
	EDUCATION	0.8%	0.2%	7	29	697	4.1%
	Subtotal Reduce	1.4%	1.1%	91	1,472	5,611	26.2%
	Total	0.9%	1.4%	881	15,174	47,208	32.1%

Preliminary information subject to review.
Source: SRI Databases, Tax Audit Information
Developed by: Collection Planning and Control

Cutoff date: July 2006

The table highlights the relevant effect of the tax/income ratio from SRI audits between 2001 and 2005, in the oil sector, which in spite of the fluctuation of the international price of crude, has been subjected to significant tax adjustments based on Tax Administration reviews of the statements filed prior to 2004. Other sectors in which the incidence of tax statements' audits has been favorable are the banking and insurance sectors, power, construction, community and personal services and fishing. It is worth underscoring that such sectors, on average, recorded the largest audit coverage on the income filed.

On the other hand, we observe sectors like trade, industry, real estate and agricultural businesses with a relevant number of taxpayers, in which the coverage of SRI actions relating the income of audited businesses with the overall income for such sectors is still limited, and consequently, the tax incidence is null.

In the last segment, communication services provided by utilities, the sectors with lower tax culture such as transportation, and the exemptions in effect for numerous non-profit organizations in the social services' sector and taxpayers in the areas of health, hotels, restaurants and education, account for the shrinkage of the tax contribution per every income dollar filed.

5. CHALLENGES FACING THE TAX ADMINISTRATION

Pursuant to the foregoing issues and given the evolution of the economy in the international scenario, we may infer that the Tax Administration of Ecuador is facing numerous challenges as to the new tax evasion and tax avoidance practices, such as the creation of shell companies, creation of false tax expenditures or claims, over or undervaluation in international transactions and the lack of regulations relative to e-commerce tax policy.

Such challenges are complex for the Ecuadorian Tax Administration, to the extent the actual economic and tax scenario in Ecuador and the availability of greater oil resources that facilitate funding of the General State Budget are detrimental to tax revenues. Therefore, society has failed to consider several reforms with the relevance they deserve and, to the contrary, in recent years, tax policy has been geared at the creation of new tax exemptions, generating inequity in the Ecuadorian tax system and restrictions upon the Tax Administration's control capacity.

On the other hand, pursuant to specialized studies, in the micro-enterprise sector, which includes approximately 160 thousand business owners, craftspersons or transportation companies with annual sales amounting to US\$ 1.6 billion, 70% of participants in the survey lack the RUC and fail to comply with the invoicing system because 90% of their sales are for end consumers. In order to address the challenge of the informal economy, which generates a significant degree of tax noncompliance and unfair competition against the formal sectors of the economy, the Tax Administration determined the need to submit to the consideration of Parliament the approval of a Simplified Tax Return System for micro-enterprises, self-employed individuals, craftspersons and transportation companies. Such project provides for a monthly payment in the form of a single tax to replace the system that requires filing an Income Tax and VAT statement. The project includes the obligation that taxpayers demand invoices from their suppliers, which would facilitate the identification of large tax evaders for the SRI, corporations that avail themselves of informal practices to distribute goods of an illegal origin.

Additionally, with the purpose of reducing tax evasion gaps, the SRI tax control units are perfecting an automated system to monitor the massive control of the formal cycle, the inconsistencies and differences. This system shall facilitate SRI actions, since it allows:

- The automatic detection of breaches;
- Automatic addition of taxpayers to be subject to control;
- Automatic allocation of processes to analysts;
- Generation of the appropriate documentation, such as Preventive Notifications, Reporting Requirements, Notices of Differences, Penalty Decisions, Closure Stay Decisions, Reversal of Business Closure Orders;
- Individual and massive entry of notifications' status;
- Automated notifications' receipt, if applicable; and
- An interface with the institutional Workflow, to verify the related procedures.

The Administration has also focused its actions towards international tax policy. The first steps were taken in 2005, upon the approval of the Transfer Pricing Rules, based on the OECD models and methods. It foresees that in 2006 taxpayers shall file the transfer pricing attachment and the report on international transactions with related parties. Thereafter, in June, 2006, the Transfer Pricing Unit was created, with the purpose of defining the procedures to undertake tax controls on international transactions, within the context of economic globalization, such as:

- designing programs to control transfer pricing,
- designing specific and automated processes to exchange information with other Tax Administrations,
- coordinating mutual assistance and cooperation among Tax Administrations,
- verifying appropriate compliance with agreements to avoid double taxation,
- defining control plans for non-residents, according to the income produced in the country and worldwide income controls, according to the residence principle.

6. CONCLUSIONS

The Internal Revenue Service, since its creation and under the scenario described herein, has achieved relevant progress vis-à-vis tax administration in Ecuador. Tax collection, lower evasion rates, the image and respect earned as a technical agency and the gradual change process observed in Ecuadorian tax culture, reflect that the administration model adopted by the agency has been fruitful in the middle term.

The grater difficulties and challenges vis-à-vis tax compliance are largely based on the high levels of informality in the country's economy, a situation that hinders the National Tax Administrations' task. The reluctance to pay taxes, the social and cultural level of taxpayers and the complexity of economic transactions at this level call for defining appropriate strategies to implement tax policies and enhance the equity and generality of the Ecuadorian tax system. In this sense, the creation of a Simplified Tax Return System embodies a vital project to counter tax evasion and tax fraud in these sectors.

There are still pending challenges in the SRI's intensive control efforts. Globalization and specifically the increasingly easier movement of international capital flows and the lack of adequately updated tax regulations regarding permanent establishments and the treatment of businesses that operate with tax havens or preferential tax regime jurisdictions, which empower tax harmonization, restricts the SRI's capacity to react in the light of tax avoidance practices.

Notwithstanding, the recently created regulations on transfer pricing treatment, set forth a new scenario for the SRI's international tax policy in future years. According to this scenario, the relatively short experience of SRI officials in conducting audits on multinationals and large economic holdings is an aspect that the organization is

improving on a yearly basis with more investment in training and education in tax matters.

Finally, it is worth highlighting that in spite of such factors, the massive control processes and certain intensive auditing programs undertaken by the SRI have enabled to sustain the tax presence and generate a risk in the light of tax noncompliance, significantly contributing to voluntary compliance with tax obligations and a greater equity and generality in the payment of taxes in Ecuador.