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Team (NESST)



The Legal and Regulatory Framework for CSO Self-financing in Ecuador

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This guide examines the legal and regulatory framework governing the self-financing activities of civil society organizations (CSOs) in Peru and provides an assessment of the relevant laws and their practical effects in order to identify areas where the law might be created, overruled or reformed. Chapter 1 explains the concepts used and defines CSO self-financing, explains the regulatory environment as it relates to self-financing, and details the methodology NESST used in researching and assessing the current legal framework in Ecuador. Chapter 2 describes the typology first developed by the International Center for Not-for-Profit Law (ICNL) to examine the legal treatment of CSO economic and commercial activities in different countries around the world. Chapter 3 describes the current regulatory framework in detail and its application in Ecuador. It also shows that, although the use of CSO self-financing is not expressly prohibited in Ecuador, the tax structure can vary; that is to say, that CSOs can have or lose exemption from income tax depending on whether or not they are fulfilling the social mission of the institution. This chapter also explains the procedures for CSOs to follow. Finally, Chapter 4 discusses the Ecuadorian legal framework for CSOs carrying out commercial activities, including an analysis of two case studies and makes recommendations for its updating and/or improvement.

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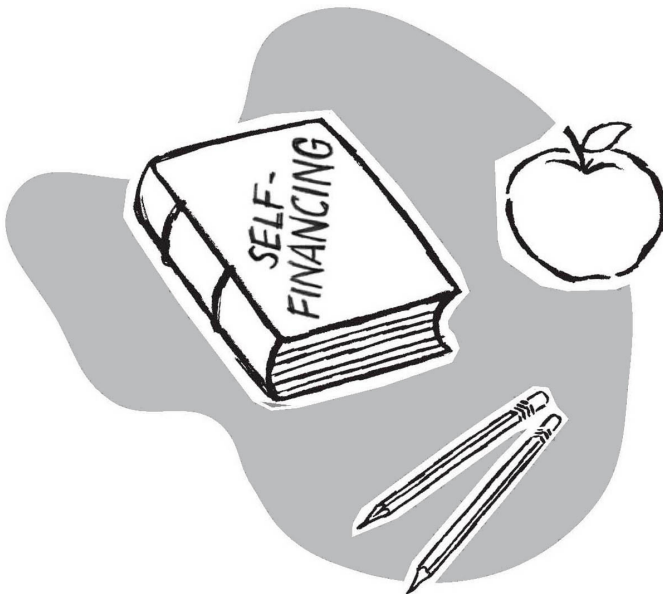


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Setting the Stage: Purpose and Methodology



The term *civil society organization* (OSC)¹ encompasses nonprofit, non-state organizations as well as community-based associations and groups that fall outside the realm of the government and business sectors. Given limited philanthropic and government assistance, many CSOs undertake self-financing activities² to generate revenues in support of their mission and programs.

NESST has documented over 100 cases of CSOs in Latin America and Central Europe which engage in these types of activities, and has analyzed the impact of these strategies on the organizations' performance and sustainability. An important factor that emerged from this research is the need for a clear and supportive legal and regulatory framework to provide a basis and support for encouraging the adoption of self-financing strategies among CSOs.

1. NESST uses the term *civil society organization* (CSO) to refer to a wide range of formally registered nonprofit, non-state organizations or community-based associations and groups that fall outside the realm of the government and business sectors. In Ecuador, this definition includes the legal classifications of corporation, foundation and international NGO.

2. NESST uses the term *self-financing* to refer to diverse strategies used by civil society organizations to generate their own revenues, including service fees, sale of products, use of hard and soft assets, membership dues, and investment dividends. NESST uses the term *social enterprise* to refer to self-financing activities that are designed by a CSO to significantly strengthen its financial sustainability and further its mission.



This framework defines whether or not CSOs may engage in self-financing activities and influences the way in which they do so. The tax structure, the level of bureaucracy, and the clarity of existing laws are also factors that have a direct bearing on the development of self-financing activities. Many organizations are not aware of these rules and believe that they cannot engage in self-financing activities or income-generating business activities; others believe that if they do, their reputation or relationship with donors will be adversely affected.

Even when CSOs are aware of the respective legislation, they often do not understand what taxes they need to pay, what forms to file, or which administrative procedures to follow.

The purpose of this guide is to clarify the legal framework for CSOs in Ecuador and to assess the degree to which this framework provides an enabling environment for them to pursue self-financing strategies. Since Ecuador's Asamblea Constituyente (Constituent Assembly) was established, a series of mandates, laws and recently a new constitution have been passed. The constitution makes it obligatory to reform Ecuador's entire legal and regulatory framework.³

Draft legislation specific to CSOs is currently being drawn up, which will be the first of its kind designed specifically to regulate the third sector.

1.1 What Is self-financing and why is it important?

Self-financing or self-financing strategies are used by CSOs to generate revenue in support of their missions. The use of these strategies is a response to the current funding paradigm in which CSOs compete for a limited pie of existing government and philanthropic funding from both national and international sources. This reality makes many CSOs heavily dependent on short-term, project-based funding and prevents them from

focusing their attention on long-term, strategic development. Through self-financing, CSOs may be able to increase their ability to act and their independence by generating their own resources to supplement support from public and private donors.

Self-financing does not necessarily lead to the commercialization of CSOs. Rather, it can provide these organizations with a greater level of independence and sustainability without compromising their mission purpose or values. Income from self-financing can be one alternative for CSOs to support work that is often more difficult to finance through traditional sources of funding, such as core operating expenses, administrative costs, new programs, promotional work and others.

NESsT does not believe that self-financing should entirely replace traditional sources of financing, but instead proposes that self-financing can provide a powerful complement to government and philanthropic support. Through self-financing, many CSOs are not only financially strengthened, but also institutionally empowered by their own ability to generate new revenues and to determine the course of their work with fewer constraints from donors.

Furthermore, when pursued in a socially and environmentally responsible manner, the enterprise activities of CSOs can help create an alternative economy that is more responsive to the needs of local communities, small producers, and low-income people. By purchasing products and services sold by CSOs, consumers are simultaneously promoting their missions and contributing to a more equitable and sustainable world.

Types of self-financing activities include the following:

- **Membership dues:**⁴ raising income through dues from members or constituents in exchange for some kind of product, service, or

³ This guide makes reference to various laws. In some cases the most recent version of these laws are not found on the Internet.

⁴ The Ecuadorian regulatory framework does not recognize membership dues as commercial activities; however, it does regard them as a means for CSOs to generate funds.



other benefit (for example: a newsletter or magazine for its members or discounts on products or services). If the fee is not paid in exchange for a product or service, it is considered a donation.

- **Fees for services:** capitalizing on some existing skill or expertise of the organization by contracting work to paying clients in the public or private sector (for example, a CSO may provide consulting services to businesses or local government agencies).
- **Product sales:** selling, rather than giving away, the products of projects (for example, books or other publications); or reselling products (for example, in-kind donations) with a mark-up,⁵ although this depends on the type of donation, since there are certain prohibitions in the law; or producing and selling new products (for example, T-shirts or mugs).
- **Use of *hard assets*:**⁶ renting out real estate, space/facilities, equipment and other assets, when they are not being used for mission-related activities.
- **Use of *soft assets*:** generating income from patent licenses or other intellectual property, such as manuals or methodologies, or by endorsing products with the CSO's name or reputation.
- **Investment dividends:** passive investments such as share accounts, savings accounts and mutual funds, or other more active and sophisticated financial transactions: active trading on the stock market or engaging in debt swaps, etc.

As previously mentioned, CSOs engage in self-financing activities with the overriding aim of strengthening their financial resources or advancing their social purpose. Some of these may be solely interested in generating profits that they can use to fund core mission programs. In these instances, the organization is not concerned

with advancing its social mission directly through self-financing, but rather indirectly by applying the profits earned through this activity to further its social mission. An example of this is a health education organization that starts a printing business and uses the revenue to fund research projects. This activity could ultimately be considered non-mission-related.

Other CSOs may be primarily interested in using a self-financing strategy to advance their social mission. For example, a CSO whose social mission is to offer carpentry training and job placement to recovering substance abusers sells the furniture that the trainees produce in order to pay for the costs of the materials and the salaries of the trainees. This activity would be considered mission-related.

These two examples are not mutually exclusive, and neither are the financial and social goals that motivate CSOs engaging in self-financing activities. Many times, CSOs aim to achieve financial and social goals simultaneously through self-financing. A health organization may be better positioned to disseminate the findings from its research by publishing its own materials, and the job training organization may be able to apply surplus from its furniture sales to fund other programs of the organization or its core operating expenses. In each of these scenarios, the objectives of CSO self-financing activities and the relationship between these activities and the organization's primary mission are fundamental in determining the legal treatment of these activities, as this guide will illustrate.

1.2 Purpose and contents of this guide

In an attempt to diversify their funding base, many Ecuadorian CSOs have initiated self-financing strategies. For the most part, however, most of these have done so with little expertise and with insufficient capital or other forms of support. Research by NESST on the use of self-financing among CSOs in Latin America in general, and in Ecuador in

5 In Ecuador, foreign social organizations are restricted from selling assets received as in-kind donation; this is detailed in the cooperation agreement which they sign with the government of Ecuador. Ecuadorian organizations, however, are not expressly

restricted in this manner.

6 They are not allowed to use assets for purposes other than the organization's mission or social objective.



particular, demonstrates that many do not have sufficient internal capacity (skills, human resources, adequate financial systems, stakeholder support, business plans) or the external support (financing, consulting support, favorable legal and regulatory environment) to engage in self-financing activities. When such organizations attempt to pursue self-financing strategies, a great deal of stress is put on their staff and indirectly on their other programs and the underlying mission. When a CSO decides to pursue self-financing activities, it is important that it do so with the appropriate levels of technical and financial support and with an external framework that make such activities possible.

The pressures and demands faced by CSOs engaging in self-financing activities in Ecuador highlight the need to understand the legal framework affecting them.

In this context, the purpose of this guide is to address the following areas:

1. Summarize the key laws, regulations, and procedures governing the use of self-financing by CSOs in Ecuador. Chapter 3 explains what Ecuadorian law, specifically the Civil Code and tax law, says about the use of self-financing or *commercial activities* (the most frequently used term in Ecuador). It provides an analysis of the administrative registries and procedures and tax regulations that apply to CSOs that engage in commercial activities. Chapter 3 also offers a general overview of these laws and regulations, so that Ecuadorian CSOs have a clear idea of where they fit within the legal system and the tax implications of the commercial or social enterprise activities they operate for self-financing.

2. Assess the relevant laws governing CSO self-financing activities in Ecuador, evaluate their practical effects, and identify areas where the law might be improved. The guide identi-

fies the strengths and weaknesses of Ecuadorian laws — whether they are a help or a hindrance to self-financing, whether they allow for transparent use of self-financing, and whether they foster the development of the CSO sector as a whole. The legislation is analyzed within a tax treatment typology that makes it easy to understand and assess.

This typology was first developed by the International Center for Not-for-Profit Law (ICNL) to examine the legal treatment of CSO economic and commercial activities in Central and Eastern European countries.⁷ It has now become a widely accepted typology for understanding and assessing the tax treatments of such activities.

The ICNL typology is presented in Chapter 2; Ecuadorian legislation is analyzed in the context of this typology in Chapter 3; and the criteria presented are used as a basis for the assessments and recommendations offered in Chapter 4.

1.3 Background and methodology

Since 1997, NESST has conducted applied research on CSO self-financing in order to identify common challenges and needs. The objectives of the applied research were as follows:

- Assess the current use of self-financing activities among CSOs. NESST has developed national assessments of CSO self-financing in nine countries to determine their needs and to prepare the capacity-building tools and support for organizations seeking to implement or expand their self-financing activities.
- Document success stories and obstacles in self-financing activities among CSOs. NESST has documented over 100 case studies of self-financing activities to gain insights into their development.

⁷ ICNL is an international organization whose mission is to facilitate and support the development of civil society and the freedom of association on a global basis. ICNL, in cooperation with other international, national, and local organizations, provides technical assistance for the creation and improvement of laws and regulatory systems that permit, encourage, and regulate the not-

for-profit, non-governmental sector in several countries around the world. ICNL maintains a documentation center for laws, regulations, self-regulatory materials, and other relevant documents; provides training and education; and conducts research relevant to strengthening and improving laws affecting the NGO sector. For more information on ICNL, see: www.icnl.org.



- Examine the legal environment for CSO self-financing in 12 countries,⁸ including the regulatory and tax framework in place at local and national levels that affects these activities.
- Disseminate lessons from the research at conferences, seminars, and workshops to stakeholders from all sectors in an effort to develop strategies for assisting CSOs in the use of self-financing.

The research methodology for this guide was developed by NESST to assess the legal framework for CSO self-financing activities in a given country. This methodology strives to help answer the following core questions:

1. *What the law states.* What is the current legal treatment of CSO self-financing activities, including current legislation, legal provisions, history of the law, revisions of the law, regulatory approach, tax rates, reporting requirements, other laws or regulations, legal cases, and organizations or lawyers providing advice or assistance?
2. *How is the law understood?* Are the regulations of CSO self-financing activities understood by CSOs?
3. *Effects of the law.* What is the effect of current regulations on CSO self-financing activities?
4. *Recommendations for the law.* What are the most important recommendations for addressing current regulatory problems?

NESST researched CSO self-financing activities in Ecuador and interviewed organizations that operate self-financing activities, donor organizations, CSO support organizations, academics, and other experts in the area. The study also took into account research and papers which have been developed on the issue, including *The Regulatory Framework for Civil Society Organizations in South America (Marco Regulatorio de las Organizaciones de la Sociedad Civil en Sudamérica)* compiled and edited by ICNL in 1997.

Furthermore, to illustrate the legal framework developed in Chapter 3, two case studies were developed to provide an in-depth understanding of the experience of CSOs in this area. The organizations selected for the case studies are: **Fundación Mariana de Jesús** and **CAMARI**, the commercial arm of Grupo Social FEPP.

⁸ The countries in Latin America and Central Europe where NESST has analyzed the legal and regulatory framework for CSOs are: Argentina, Chile, Colombia, Croatia, Czech Republic, Ecuador, Hungary, Peru, Romania, Slovakia, Slovenia, and the Ukraine.





A Typology for Assessing the Legal and Regulatory Framework



This chapter presents a typology for analyzing the regulations that govern CSO self-financing activities. The typology was developed by ICNL;⁹ NESST has expanded and modified the typology to be more applicable to the Ecuadorian legal system. This section presents four key areas of analysis that are vital for understanding the legal structure for CSO self-financing before assessing the specifics of Ecuador: 1) the legal characteristics of CSOs; 2) the legal definition of self-financing; 3) the criteria for permitting self-financing; and 4) the taxation of self-financing activities.

In its texts, ICNL uses the term *nonprofit organizations (NPOs)* or *non-governmental organizations (NGOs)* to refer to a subgroup of the broader classification of *CSOs*, the term used by NESST. This guide uses the term *CSO*, except in parts that specifically draw upon the ICNL typology, where it maintains the original ICNL terminology. The broad scope of organizations encompassed by the term *CSO* is consistent with existing Ecuadorian law, as laid down in the Civil Code where it relates to nonprofit legal entities: corporations (in their various forms) and foundations.

⁹ The overall typology presented in this chapter was adapted, with permission, from the paper *Regulating Economic Activities of Not-for-Profit Organizations* that was first prepared by ICNL for the "Regulating Civil Society" Conference in Budapest, Hungary, in

May 1996 (copyright ICNL, 1997) and from the *Handbook on Good Practices Relating to Non-Governmental Organizations*, Appendix I: Economic Activities and Taxation (copyright ICNL, 2000).



2.1 Legal characteristics of nonprofit organizations

The characteristics listed below illustrate the key differences between nonprofit and for-profit organizations and provide a context for understanding how nonprofit organizations (NPOs) engage in self-financing activities. The discussion that evolves in this chapter and the rest of the guide addresses a subgroup of all NPOs: those whose philanthropic purposes are intended to promote public benefit. There is no agreed-upon definition of what constitutes public benefit, which is why Chapters 3 and 4 address this issue in terms of Ecuadorian law.

There are some NPOs, such as parents' associations for educational establishments, or members of sports clubs, which do not pursue these goals but nonetheless may be legally recognized as NPOs. The same regulations apply, even when their objectives are related only to the well-being of their own members. However, this guide will only make reference to those NPOs whose mission is the public benefit.

ICNL makes the same distinction between NPOs. With specific reference to the public benefit, its typology identifies two basic legal assumptions that distinguish NPOs from for-profit entities:

1. **Non-distribution constraint.** Although NPOs are not prohibited from generating income, this income may not be distributed to private parties who might be in a position to control them for personal gain: founders, members, officers, directors, agents, employees, or any related party.
2. **Public benefit as objective.** By definition, this class of NPO is organized and operated primarily to provide a public benefit.

These characteristics are not dependent on the particular legal form of the NPO. Accordingly, this discussion specifically addresses NPOs with various legal forms as long as they provide a public benefit and uphold the principle of non-distribution (nonprofit purpose).

As will be shown in Chapter 3, in Ecuador some nonprofit organizations have a specific social aim, while

others do not. In some cases, it is debatable whether they provide a public benefit service. Comunas, or districts, are an example of this. These are territorial jurisdictions in rural areas, with a maximum population of fifty people, and their official organization is the *cabildo* (local administrative unit). These have a certain purpose and are ruled by specific legislation; when there is no specific social aim, they are governed by Ecuador's Civil Code, which includes the following definition: "a legal entity is a fictitious person, able to exercise rights and undertake civil obligations and to be represented on legal and other matters". Furthermore, it divides legal entities into two types: **corporations** and **foundations for public benefit**; the definitions for these are provided in the next chapter.

Organizations are considered NPOs as long as their objective is to provide a public benefit and uphold the principle of non-distribution.

2.2. Legal definition of self-financing

From a legal and financial standpoint, there are many terms and definitions that are currently in use to describe activities that generate revenues for CSOs (e.g., commercial activity, economic activity, philanthropic enterprise, social enterprise, social-purpose business, earned income, income-generating activity). ICNL uses the term *economic activity* to refer to self-financing activities. ICNL defines economic activities as *regularly pursued trade or business activities*, with the exception of those that have traditionally been excluded (such as ticket sales for cultural events, tuition fees at educational institutions, and patient fees at nonprofit hospitals). NESST, on the other hand, uses the term *self-financing* to refer to activities that generate revenues for CSOs, including the six types of activities described in the previous chapter.

In general, Ecuadorian legislation does not differentiate between "commercial activities" and other types of income-generating activities for CSOs.



In fact, neither the Civil Code nor the general tax framework – including the Tax Code, the Internal Income Tax Law (Ley de Régimen Tributario Interno, or LRTI), and the LRTI Regulations - expressly differentiates between “commercial activities” and other types of income-generating activities for CSOs.

Note: This guide uses the terms *self-financing*, *economic activities*, and *commercial activities* interchangeably when presenting the ICNL typology, although *commercial activities* is more generally used in Ecuador to refer to activities or operations that CSOs adopt to generate revenue, whether these are directly related to their social purpose or simply contribute to their sustainability.

2.3 Criteria for allowing self-financing

According to ICNL, a threshold issue is the extent to which NPOs should be permitted to engage in economic or commercial activities without losing their philanthropic status. From this standpoint, the question is not whether such activities would be tax-exempt, but under what circumstances they could be permitted at all.

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There is a global debate about whether or not an NPO that engages in commercial activities retains its essential characteristics. The answer is simple: provided the activity is not interpreted as or related to the generation of profit, and this difference remains clearly established, we can assert that NPOs that carry out commercial activities do not lose their quality as NPOs.

To this effect, two types of tests have been developed to determine if economic activities are *for-profit* or *nonprofit*:

1. Principal purpose test. This test provides a legal model for regulating NPO self-financing. It does not prohibit the use of self-financing activities, but rather emphasizes that the NPO is established and operated primarily for nonprofit purposes and not for private gain. This test implies that self-financing would be for mission-related purposes and would not be the principal activity of the organization. Examples of this treatment can be found in the regulatory framework of many countries, which determine that economic activities are not the principal purpose (i.e., the principal activity) of the NPO; that economic activities are complementary (or additional) to the NPO's programs; or that economic activities are related to institutional objectives.

2. Destination-of-income test. This treatment ignores the economic or commercial nature of the activity in question and focuses exclusively on the purposes for which profits from the activity are used. Under this test, an organization must devote all of its income to its nonprofit purposes in order to qualify as an NPO. Thus, an organization that devotes 99% of its time to commercial activities and only 1% to public benefit activities, but which dedicates all of its profits to public benefit activities, may qualify as a NPO. In this case, the example of a destination-of-income test is when the profits from economic activities are used to support the organization's mission and definitely not distributed as earnings.

Under either test, an NPO is permitted to engage in economic activities that further the mission (nonprofit purposes) for which it is established. More frequently, some countries combine the NPO characteristic under the principal-purpose test and destination-of-income test to determine whether or not the economic activities of an NPO are permitted. For example, a country's legislation may authorize only those commercial activities that are related to the mission of an NPO (principal-purpose test) and require that the revenues from these be used exclusively for mission-related activities (destination-of-income test).



But what justification is there for a country's laws to permit NPOs to conduct self-financing activities?

There are two good reasons related to public policy which permit NPOs to develop these activities:

1. Self-financing applies non-public resources to the public benefit. Income from economic activities is a primary source of funds for NPOs (particularly in countries in transition, where there is a lack of private capital and philanthropic tradition) and enables them to do their public-benefit work with less dependence on governmental support and charitable donations.

2. Self-financing meets public benefit objectives. Certain economic and commercial activities directly accomplish public-benefit purposes. For example, even though the sale of a book on teaching techniques by an educational organization is an economic activity, the distribution of the book directly serves the public-benefit purpose of promoting education. Preventing NPOs from using such commercial and economic means to attain their goals could directly impair their ability to serve public-benefit purposes.

2.4 Taxation of self-financing activities

Although the legal treatment of CSO self-financing varies on a practical level from country to country, most have avoided going to extremes (i.e., a complete prohibition on economic activities or, conversely, allowing economic activities to be the principal activity of the organization). The important issue is the tax treatment of such activities. Governments have typically employed four approaches, alone or in combination, to determine the tax treatment for CSO self-financing activities.

1. Blanket tax. A *blanket tax* policy is applied to income from all economic activities, regardless of the source or destination of the income. Under this approach, the organization is not limited by the

level or type of activity, but is taxed on all revenues generated by these activities regardless of how the revenues are used.

2. Destination-of-income tax. A *destination-of-income tax* policy exempts income derived from economic activities that is used for public-benefit purposes. Under this approach, the organization is not limited by the level or type of economic activity, but is taxed on all income that is not used to further its public-benefit purposes.¹⁰

3. Source-of-income tax. A *source-of-income tax* policy focuses on the source of the income, granting a tax exemption only when the income is generated by activities that are related to the public-benefit purposes of the organization. Under this approach, the organization is taxed for all income generated from non-mission-related activity even if the income is used to support mission-related programs.

4. Mechanical tax. A *mechanical tax* applies criteria *automatically* to determine the difference between economic activities that are taxed and those that are not; or it may establish an exemption ceiling (a maximum profit level). Income levels below the ceiling are tax-exempt and those above it are taxable.

Governments have typically employed four approaches, alone or in combination, to determine the tax treatment for CSO self-financing activities.

Some governments have created hybrid tax policies that are based on one, two, or more of these approaches. For example, it would be possible to allow net income from economic activity to be tax-exempt below a specified, pre-established threshold and to apply a mission-relatedness mechanical test to determine whether net income above that threshold should be taxed.

¹⁰ The destination-of-income tax should not be confused with the destination-of-income test. The test is used to establish that CSOs may conduct economic activities without compromising their

nonprofit legal status as long as any revenues are destined to the organization's mission. The destination-of-income tax, on the other hand, focuses purely on the tax treatment of CSOs.



The following chapter analyzes the legal framework in Ecuador and the criteria that it applies to the *destination-of-income tax*. These criteria indicate that in order to qualify as such, CSOs must dedicate all their profits to nonprofit purposes. In terms of income tax, a *destination-of-income tax* is applied, which exempts from tax all profits from economic activities that are for public-benefit purposes. In effect, until now, the Internal Income Tax Law has not focused on the origin or source of income (specifically for income originating from commercial activities), but rather generally establishes the tax exemption for CSOs and those working for the public benefit whose profits have been destined towards specific and exclusive purposes in the country and have been contemplated taxation-wise in the law and regulation, provided that this income or revenue is not distributed among partners (nonprofit purpose).

There is no consensus on which of these tax approaches is best, since each entails certain benefits and costs and defines a different public policy objective.

NESST applies four of ICNL's criteria to shed light on the practical implications of each approach:

1. Simplicity or complexity of administration.

Blanket taxation of all economic activity is the simplest approach to administer. Once economic activities are defined, NPOs are treated the same way as for-profit organizations. The *destination-of-income* rule is slightly more complex to administer. The main difficulty is establishing and enforcing criteria for what constitutes expenditure to support public-benefit purposes. This requires monitoring of the CSOs and how they use their income. This political function can be difficult to administer. Moreover, this approach creates a greater potential for abuse by unscrupulous individuals seeking to use NPOs as vehicles for tax evasion.

A *mission-relatedness* test is the most complicated to apply because it is difficult to specify the necessary connection between the economic activity and the public-benefit purpose. However, this test works best when developed over time through administrative practice. This *mission-relatedness* approach is also the most likely to keep NPOs focused on economic activities that also provide public benefit.

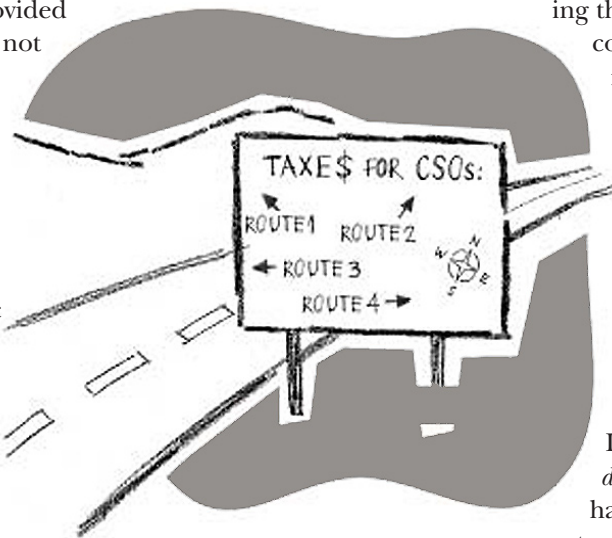
2. Effects on revenue collection. When the tax rates under the various treatments are equal, the greatest tax revenue is generated under the blanket taxation approach, since it subjects the largest number of NPO self-financing activities to taxation. However, it is difficult to estimate the level of tax which would be collected, as by applying the same tax rate to all

commercial activities, it is likely that the level of commercial activity carried out by NPOs would decrease. In other words, blanket taxation is not an incentive for NPOs to decide whether to undertake commercial activities.

In its purest form, the *destination-of-income* rule has the lowest potential to produce tax revenue

because all income, regardless of the source, is free

from taxation if it is applied toward public-benefit purposes. In practice, many countries impose limits on the amount of income that is exempt under the *destination-of-income* rule, thereby limiting potential losses to the state's revenue base. The *mission-relatedness* test also potentially reduces the size of the tax base, but probably less so than the *destination-of-income* test, because it only provides tax benefits for mission-related activities. However, the *mission-relatedness* test has an additional benefit: it channels NPO economic activity into specific areas that produce public benefit.





3. Effects on the commercial sector. The *blanket taxation* approach to NPO income from economic activities is most favorable for the commercial sector, since there is no possibility of *unfair competition*, as NPOs do not receive preferential tax treatment when compared to for-profit entities. The *destination-of-income* rule does not create any mechanism to prevent complaints about unfair competition. The use that NPOs make of their income could give them an advantage over their for-profit competitors. However, a limit on this benefit reduces the comparative advantage for NPOs. The *mission-relatedness* test minimizes unfair competition by encouraging NPOs to focus on activities that generate a public benefit and by applying the standard tax treatment used for for-profit enterprises when NPO activities are conducted purely for profit. The difficulty in implementing this *mission-relatedness* rule lies in establishing which economic activities advance the public benefit and which do not (or which do not advance it enough).

socially beneficial directions than the *destination-of-income* test, which encourages NPOs to engage in economic activities that can earn the greatest potential financial return but not necessarily the greatest social return.

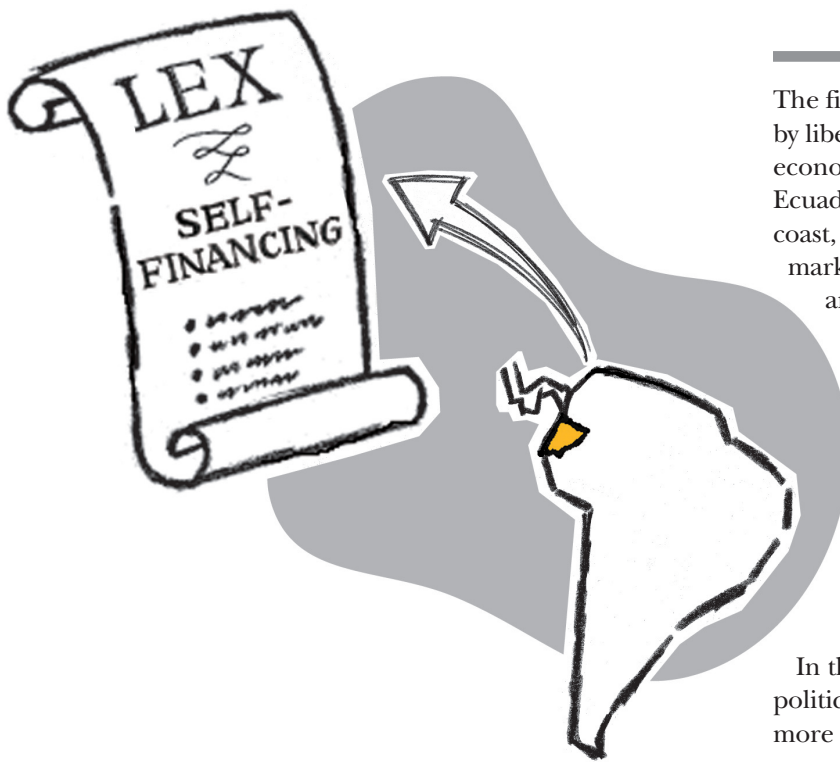
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4. Effects on the development of the NPO sector. The *blanket taxation* approach reduces resources for the nonprofit sector, essentially transferring money from NPOs to the public sector. It is generally accepted that NPOs devoted to public-benefit purposes should at the very least not be required to transfer resources to the state (i.e., pay taxes) if they are not eligible for state subsidies. Blanket taxation of all NPO income from economic activities eliminates the incentive to engage in income-generating, public-benefit activities and is the least favorable to the nonprofit sector. NPO proponents claim that such taxes should be at a lower, more preferential rate than taxes for for-profit enterprises.

The *destination-of-income* rule provides the greatest potential revenue to NPOs, since virtually any income can be made tax-exempt if channeled into public-benefit activities. The *mission-relatedness* test is less favorable to NPOs because activities that are undertaken purely to obtain revenue enjoy no tax exemption. However, the *mission-relatedness* test still provides significant tax benefits for NPOs, particularly when they focus on activities associated with public-benefit purposes. Moreover, this approach channels NPO economic activities into more



The Legal and Regulatory Framework of Ecuador



The first half of the 20th century was characterized by liberalism's influence on social, political and economic matters. The two most powerful groups in Ecuador were that of the export sector based on the coast, and the productive sector serving the internal market in the mountains. Later, another key actor arose: the financial sector. Other important sectors besides these economic groups include the unions, the Church, and political parties.

In the second half of the 20th century, there was an eventual increase both in the number of private nonprofit entities and civic participation of sectors that had not traditionally held power.

In the last 20 years the issue of representation and political parties has reemerged through a stronger, more participatory movement that encompasses groups that previously had been marginalized or easily swayed by the demagogical pattern of *political patronage*, particularly indigenous communities, women, youth, and low-income groups.

The most recent World Bank publication¹¹ on social development indicates that CSOs in Ecuador are

¹¹ World Bank, Social Development Document. Participation and Civil Society, document N° 105, September 2007.



gaining influence in the areas of governability, democracy, and transparency. The social mobilizations of the last decade have resulted in the deposition of three presidents, thus clearly manifesting the antagonistic relationship that exists between the government and civil society. The most common strategies used by CSOs to participate in and influence these issues are the forging of alliances with other organizations and the communications media, in addition to demonstrations and formal cooperation agreements signed with the government.

The research concludes that in Ecuador, unfortunately, the relationship between civil society and the state is more efficient when it involves personal contacts rather than inter-institutional relationships. The role played by civil society organizations is becoming more important, but their work still largely occurs within an informal arena.

Civil society organizations in the third sector¹² gained prominence in Europe when it became an axis of support for governments in matters of social well-being, although not in obvious areas such as health and education, but in addressing new social problems. These organizations fulfilled a fundamental role in identifying problems and their causes and in seeking alternative solutions. Their basic function has been to create awareness of concrete issues, influencing opinion and participating in the development of public policies. Certainly, in Ecuador, although various organizations work in that way, there are still a large number of CSOs which carry out projects that should fall to the state, such as those related to health and education issues, among others.

For CSOs to fulfill their role as a voice for marginalized communities and to contribute to resolving the country's most pressing problems, it is important that they be strengthened and self-sustaining over time. A sustainability strategy consists of find-

ing mechanisms for an organization to generate its own resources through self-financing activities, lessening their dependence on donations, while at the same time strengthening their social mission.

Below is a guide to the formal process these organizations must follow to carry out self-financing activities.

3.1 General regulatory framework governing CSOs

In Ecuador, the hierarchy of laws is made up of: the Political Constitution of the Republic, International Treaties and Accords,¹³ Organic Laws, Special Laws, Ordinary Laws, Regulations, Decrees,¹⁴ Agreements, and Resolutions.

From 1830, when Ecuador was established as a republic, through 2007, the country had 20 constitutional charters¹⁵ and each one has been a manifestation of global trends and the government in power. However, with respect to CSOs, the most significant one was undoubtedly that of 1906, which resulted from the Liberal Revolution at that time, ushering in new freedoms and profound reforms in the political life of the state.

Among the most important points in the 1906 Charter:

- a) A secular government was proposed, with separation of Church and State;
- b) The supremacy of the Constitution was established; that is, no other law may contradict it;
- c) In education, it established the predominance of secularism in the national educational system and educational freedom;
- d) Capital punishment was abolished; and

12 This makes reference to civil society organizations (private, non-profit, and charitable organizations). The government is known as the first sector and the business sector is referred to as the second sector.

13 Recognized in Article 163 of the Constitution.

14 The executive decree has the same weight as a regulation.

15 As this legal guide went to press (August 2008), the referendum process to approve Constitutional Charter N° 21 was pending.



- e) The guarantees established by the 1897 Charter were maintained, but with greater protection for civil and political rights, such as respect for all religious beliefs and their manifestations, indicating at the same time that these guarantees do not impede the exercise of those rights.

For that era, the Constitution was a progressive expression of individual guarantees and policies. This generated a propitious environment for the development of civil society organizations as an alternative for collective joint participation and expression of interests and freedoms.

By popular vote, there is currently a Constituent Assembly made up of 130 Assembly members. This Assembly has been charged with two specific functions: to reform the institutional framework of the State and prepare a Draft Constitution, which shall be approved or rejected via a referendum. Nevertheless, this Assembly has gone beyond the attributions granted to it: it has created and approved, via *constitutional mandates*, new laws and has reformed others, thus changing the legal framework that is in force.

With regard to civil society organizations, both the Constitution and the Draft Constitution¹⁶ guarantee the right to free assembly for peaceful purposes.¹⁷ Despite this, there are no organic or special laws in the Ecuadorian judicial system that refer to civil society; to regulate it, rules have been enacted using Executive Decrees. These rules have clarified the operations, order, and oversight of these organizations.

The Civil Code recognizes three types of legal entities:

- Corporations and *public-benefit* foundations
- Industrial legal entities

- Public law entities

The last two are governed by special laws and regulations. The *industrial legal entities* are governed by the Commerce Code and the Law of Companies; while *public law legal entities* are governed by all current public laws and regulations.

Regarding corporations and foundations, these are *nonprofit organizations* which are governed by the Civil Code and regulations. According to Article 565 of the Civil Code, for foundations or corporations to become legal entities, they must be created through the passage of a law or be approved by the President of the Republic, who delegated this authority to each Minister of State¹⁸ depending on the relevant area.

At the time, this decision led to the establishment of differential treatment and diverse regulations by each of the ministries, until finally, through Executive Decree 3054,¹⁹ they were unified in the *Regulation for the approval, oversight and dissolution of nonprofit private legal entities with a social purpose* under the protection of the provisions of Title XXIX –now called Title XXX– of Book 1 of the Civil Code. Since 2002, two Executive Decrees have been enacted, which redefine or complement what the provisions of the Regulation indicate.

In addition to corporations and foundations, the regulation recognizes the existence of international non-governmental organizations (NGOs). Thus, in relation to the country's legislation, the term ONG (the Spanish acronym for NGO) is not a synonym with the three types of legal entities described earlier, although the term is used colloquially to refer to organizations formed outside the realm of the government. In Ecuador, the regulation refers specifically to foreign nonprofit organizations.

Generally speaking, the development of civil society organizations has not resulted from a defined

16 Sixth Chapter, the Right to Liberty. The free and voluntary right to association, assembly and demonstration.

17 Article 23, number 19, of the 1998 constitution. Also guarantees freedom of the press, freedom to work and to hire and freedom

to participate in community life, provided no law is violated.

18 Through Executive Decree 339, of November 28, 1998.

19 RO 660: 11-09-2002.



public policy or a strategy pushed through by this sector, and "de facto" organizations are indeed recognized for tax purposes, but outside the field of philanthropy.

Historical events and the political context have affected the formation of CSOs that represent specific interest groups and are founded for a specific purpose: political parties, labor unions, chambers, professional associations, districts, and cooperatives, among others. These organizations have been legally recognized through the approval of special laws. The mere mention of the legal figure assumed by these entities is enough to identify their purpose. For example, in the case of the *Sindicato de Choferes de Pichincha (Pichincha Driver's Union)*, it can be inferred from the name that this refers to a group of workers whose goal is to ensure respect for their obligations and rights.

In the case of foundations and corporations, the specific purpose can be broad and diverse, since their objectives relate to the public benefit and they may work in a variety of areas: environment, overcoming poverty, health, education, gender and human rights, among others. They may have diverse target groups: children, youth, senior citizens, people with disabilities, and women, among others. As mentioned, they are governed solely by regulations; there is no organic or special law that regulates them. The names of corporations or foundations do not necessarily provide evidence of their purpose; for example, *Fundación Esquel*, *Fundación Arco Iris* or *Corporación Grupo Randi Randi*.

The purpose of the analysis in this legal guide is based precisely on the second group of organizations - foundations and corporations - with broad and diverse social purposes. The challenges that they face in terms of promoting the public benefit require collaboration with the state and the business sector, as well as coming to terms with their sustainability. The recent reform provides a clearer legal framework in relation to this group. The last

Executive Decree, 982 (the regulation that modifies Decree 610 and Decree 3054), introduced the term *organizaciones de la sociedad civil (OSC)*, which is the Spanish equivalent for civil society organization (CSO), although it fails to provide a definition of the term.

3.1.1 Differences between corporations and foundations

As mentioned previously, corporations and foundations are generally regulated by the Civil Code,²⁰ and more specifically by the regulations enacted in the Executive Decree.

The basic conceptual difference between the two kinds of organizations lies in the type of beneficiaries that each kind has and in their initial assets. Corporations promote the public benefit of their members or associates or of a certain community; they require capital -which does not necessarily come from a donation- in order to start their activities. On the other hand, foundations are created with *donated* assets that are used to promote public benefit within a group other than that of its founding members. Thus, it is important that they define the issue and the beneficiary group.

There are other components that differentiate these two types of entities; such differences are described in the next subheading. Among corporations, there are some characteristics that differentiate one from another. There is a classification which takes into account the type of members (individuals or legal entities) and the geographic scope of the organization (local, provincial, national):

- First-tier corporations, which are groups of individuals.
- Second-tier corporations, which are groups of first-tier corporations or legal entities such as federations or chambers.

20 Articles 564-579 of the Civil Code refer to corporations; Articles 580-582 of the Civil Code refer to foundations, although Article 581 indicates that articles 568-579 also apply to foundations.



- Third-tier corporations, which are groups of second-tier corporations, such as confederations, national trade unions, or similar organizations.

Associations, clubs, committees, and centers are some of the various types of corporations.

3.1.2 Requirements and legalization of civil society organizations

With the constitutional guarantee of free association, there is a variety of purposes for which corporations and foundations are created.

However, some activities are not permitted, such as:

- Holding shares private financial institutions (not applicable to mutual benefit societies).
- Raising money from the public.
- Participating in the insurance and re-insurance businesses, with the exception of an insurance cooperative.
- Carrying out consultancies (in the case of international NGOs, and with various limitations for Ecuadorian corporations and foundations).
- Violating the public order, laws, or good conduct.

With these considerations, *the creation, legal existence* and even the *dissolution* of CSOs are subject to regulations that vary in complexity for each of the stages mentioned.

Creation of a foundation or corporation

With the passage of Executive Decree 339,²¹ the President of the Republic delegates the approval of foundations and corporations to ministers of state. This decision created a problem, since the ministers enacted a variety of regulations without applying the same criteria to all organizations. This resulted in the formation of a Judicial Purging

Commission to unify the procedures, since potential organizations opted to seek approval from the ministry²² requiring the least amount of administrative procedures.

Since this unification, regulations have been enacted²³ with increasingly detailed procedures. The goal is to facilitate the process of creating an organization with the ministry of that area, although the majority of CSOs are founded through the Ministerio de Inclusión Social (Ministry of Social Inclusion), which is best suited to such organizations with a wide variety of purposes.

According to Executive Decrees 3054 and 982, the prior requirements are:

- The Founding Charter, in which the desire of the members to create an organization is declared.
- The organizational bylaws, revised and discussed in at least two assembly meetings.
- Assets that vary, depending on the type of organization, between US\$ 400 and US\$ 4,000, the existence of which is certified by a combined capital account held in any bank in the country.

For the purposes of this guide, *Appendix 1* contains details of the requirements.

The bylaws must contain at least the following: address, name and nature; mission and purposes; number of members; assets; information about the CSO's property and assets; representatives and decision-making processes; and conflict resolution mechanisms, which must always be an alternative conflict resolution method (mediation and arbitration).

The bylaws of a corporation or foundation must be followed.²⁴ That is, its members are required to respect them and will receive the corresponding

21 RO 77: 30-11-1998.

22 There are currently 20 ministries and another six ministries for inter-ministry coordination. For more information, visit: www.presidencia.gov.ec/modulos.asp?id=16.

23 Latest regulation enacted through Executive Decree 982 (RO 311, April 8, 2008).

24 Article 572 of the Civil Code.



warnings if they do not follow them, regardless of what is indicated in common law.

The processing time varies in each institution, and after the submittal of all documents, the respective authorities have a maximum of 15 days to review these and issue a decision. After that time period has passed, the organization may file a complaint regarding any delay in receiving a response from the public institution.²⁵ In practice, this right is not generally exercised and the periods for approval of an organization can take as long as 30 to 90 days.

The most important recent changes have been made in the following points:

Purpose and mission

The bylaws must clearly define the purpose of the organization,²⁶ and based on this, the registration will be made with the corresponding ministry. If the organization's mission addresses diverse issues, it is important to establish a main purpose (for example: to contribute to the development of at-risk communities) and then detail the specific objectives (for example: improve health conditions, environment, training). It is important to indicate specifically why and for what purpose the organization is formed.

Executive Decree 982 defines foundations as entities seeking or promoting the public benefit of society as a whole, including activities to promote, develop, and provide incentives for the general benefit through social, cultural and educational

aspects, as well as activities related to philanthropy and public charity.²⁷

In practice, one of the most common difficulties is the lack of interaction between members of the organization and the lawyers they have retained. Many organizations are formed using *model bylaws* which do not always meet their real needs, leading to situations in which the organization is founded on a mistaken conception, which does not reflect its actual mission, purpose, objectives, and policies. It is important that the organization's members discuss the content of the bylaws in at least two sessions in order to ensure consensus among them.

Number of members

Foundations are created by one or more founders who contribute assets that must be used toward activities for the public benefit. There is no required minimum number of founders, but the board of directors must have at least three members. The founder may or may not serve on the board.²⁸ If the founder dies, the organization continues working with the board of directors.

A corporation, on the other hand, may only be founded with at least five members, who must also be members of the board of directors. The corporation does not necessarily need to have received donated assets in order to operate. The bylaws must include a method for maintaining the minimum number of members in the case that one member passes away.²⁹

25 According to the Ley de Modernización del Estado (Government Modernization Law), "all complaints, claims, or requests to a public authority must be resolved within a period of no more than 15 days, starting from the date of presentation, unless there is a law that expressly indicates a different period of time". No administrative agency is permitted to suspend the processing or deny the issuance of a decision regarding petitions or complaints presented by those subject to their administration. In all cases, once the respective deadline has passed, if the *administrator does not respond*, the application or request will be understood to have been approved or the complaint resolved in favor of the claimant. In the event that an administrative authority refuses to accept a petition, suspends an administrative procedure, or does not issue a resolution within the deadline established, this situation may be reported to judges with criminal jurisdiction as an act that violates the right to petition guaranteed by the Constitution, in accordance with Article 213 of the Criminal Code, regardless of the exercise of other actions conferred to it by law".

26 The objective must include the organization's mission, the issue it addresses and the target group it seeks to reach.

27 Article 1 of Executive Decree 982.

28 Article 580 of the Civil Code defines that charity foundations, which must be administered by a group of individuals, will be governed by the statutes that the founder has laid out; if the founder has not expressly stated or has not completely expressed, this aspect will be governed by the president of the Republic.

29 Article 578 of the Civil Code mentions that if the number of members of a corporation is reduced because of death or other accidents, and as a result its ability to comply is affected, or if all members are not present, the corporation shall proceed to constitute it or renew it, in accordance with the provisions of the bylaws, and if the bylaws do not contain an explicit definition, the procedure shall be that set out by the authority that legalized its formation.



Assets

The organization must identify what its assets are comprised of (property or money). The law requires second-tier and third-tier corporations and foundations to have US\$ 4,000 (in cash) in assets, while first-tier corporations must have at least US\$ 400.

To verify the assets, the organization must present a bank certificate that indicates the minimum value required by law or a sworn statement, if the assets are made up of property. This value is not directly related to the amount needed to carry out the organization's programs and projects; in most cases, the budget for the organization tends to be much higher.

Regarding CSO property

Regarding a corporation's property,³⁰ none of it belongs to the individuals who are members of the corporation; the same occurs with debt, unless it has been expressly stipulated that there is a common responsibility of the members in this regard. According to the Civil Code, this regulation is also applicable to foundations.

Once a corporation or foundation is dissolved, its property shall be distributed in accordance with the bylaws;³¹ if there is nothing explicit in the bylaws regarding this, the property will pass to the state, which will be required to use it for purposes similar to those of the institution. Congress is responsible for determining these purposes.

Representatives and the decision-making process

Once the mechanisms for election, duration, and rotation of members of the board of directors are defined, the organization must name its representatives and provide the corresponding ministry with a list of board members within a maximum period of 15 days. The chief executive officer or director is designated as the legal representative of the organization.

The personal obligations of the corporation or foundation representative are briefly described in Article 571 of the Civil Code, which indicates that, to the extent that the representative's actions do not exceed the limits established by law, they are considered actions of the institution itself. If they do exceed the limits, this only affects the legal representative, who also has obligations to the organization in labor, tax, and social security issues.

Regarding the decision-making process, Article 569 of the Civil Code indicates that if the majority of a corporation's voting members are present at a meeting, it is considered a legal meeting of the corporation as a whole, unless expressly specified otherwise in the bylaws. In the latter case, the bylaws must determine a voting procedure for decision-making and who will have voting rights.

Legal existence/operation of a corporation or foundation

The regulations for the existence and operation of a corporation or foundation are generally complex and are related to laws from different fields, principally those linked to taxation and employment.

Legal existence does provide access to benefits, such as the waiver of income tax that applies to NPOs, although it also requires that such organizations comply with other tax obligations. In the labor area, for example, an entity may hire personnel and deduct these costs, as long as it makes social security contributions for its employees.

By being legally constituted, an organization can become a legal entity and therefore carry out activities in the name of a group, make payments and receive payments, and execute any kind of act or contract authorized by the law and the organization's own bylaws.

If a corporation is not legally established, it can still act as a de facto organization. In this case, the weight of responsibilities falls not on the legal representative but on each and every member.³²

30 Articles 568, 575, 576 of the Civil Code.

31 Article 579 of the Civil Code.

32 Article 565 of the Civil Code.



This happens frequently in Ecuador. The main reasons behind this are due to a lack of awareness of the laws among these organizations, as well as the costs required to develop skills and capacity in the areas of accounting, finance, taxation and overall management.

In some cases, organizations are not interested in raising their visibility, since this implies becoming subject to tax, employment, and enforcement inspections by different authorities.

There are some grassroots organizations and other informal organizations that do not have legal status, but the law grants them certain qualities (recognition by the Servicio de Renta Interna, or Internal Revenue Service, known as SRI in Ecuador) or capacities (to hire personnel). They can do this only as individuals, particularly for taxation purposes, prior to obtaining a Registro Único de Contribuyentes (taxpayer registration number, or RUC).

22

The following elements are required for operating a foundation or corporation:

- **Civil society organization registry number:** This implies that, regardless of the registries maintained by each ministry, information must be submitted to the Secretaría de Pueblos, Movimientos Sociales y Participación Ciudadana (Secretariat of Indigenous Peoples, Social Movements and Public Participation), the entity that organizes, maintains and distributes the registry. This registry will consolidate the information from the ministries and the organization itself.³³
- **Taxpayer registration number (RUC):** This is required in order for organizations to be recognized by the Servicio de Renta Interna (SRI), once the formation of the organization is approved by the respective ministry or organism. This is the organization's nonprofit

registry number and is also used to identify the organization in the fulfillment of its tax obligations.

- **Accreditation:** Foundations and corporations that receive public funding shall begin the process for accreditation; this accreditation is granted for a period of up to four years. This process was recently included (Decree 982) and the specific requirements that CSOs must meet for each public entity have not yet been determined. To start the process, NPOs should have the following information as a minimum: information about the population served, geographic coverage, costs of its activities, sources of financing, professional profiles of members of its board of directors, indicators of its efficiency, efficacy, and quality, and the person designated to carry out audits.³⁴
- **Maintenance of accounting records and submission of reports to inspection authorities :** CSOs are required to operate in a similar fashion to the business sector, with the only difference that the income tax declared would be zero, if the organization meets all of the requirements. This issue will be addressed in greater detail under subhead 3.5.2 of this guide.
- **Compliance with labor and social security requirements:** This is related to the hiring of personnel who provide professional volunteer services, and in some cases, interns. It is necessary to obtain an *employer registration number* which is the number that enables payment of contributions to the Instituto Ecuatoriano de Seguridad Social (Ecuadorian Social Security Institute, known as IESS) which all employers are required to make for the workers they employ. The latest labor reforms approved in Constituent Mandate N° 8 eliminate and prohibit using third parties and outsourcing and hiring by the hour. As a result, organizations that in the past have hired

33 As of April 8, 2008, foundations and corporations were granted a period of 180 days to update their information, bylaws and the amount of their endowment.

34 At the time this legal guide was being written, no regulation had been passed regarding obtaining accreditation. Thus, this procedure is still not operative.



staff on a fee-for-services basis rather than as employees, will have to adjust their budgets to meet these requirements.³⁵ The purpose of the Mandate is to ensure that labor relationships are not misrepresented and contracts are transparent.

Outsourcing is possible only for carrying out what are now called *complementary activities*, which may only be related to: surveillance services, security, meals, courier services and cleaning, tasks other than those that the organization carries out or that are habitual as part of the productive process of the organization that contracts for such services. The organization and those companies providing complementary services may not be affiliates, subsidiaries, or be related to one another.

On the other hand, at no time may a salary be paid that is less than minimum wage. When professional fees are paid, the organization must make contributions for income tax and VAT. Regarding the organization's employees, these must be registered with Social Security and the additional payments must be made. Any agreement that violates these rights is prohibited; if such an agreement is signed, a surcharge of triple the payment may apply.

Current law does not address volunteerism, but in order to ensure transparency in the relationship, an agreement may be signed by both parties, or the contribution of volunteers may be assigned a value and accounted for as a donation. Interns, according to the Internship Law, may only serve in the for-profit, productive sector for commercial purposes. The nonprofit sector is not productive; however, there are exceptions for internships in cases where an organization carries out some sort of self-financing activity.

- ***Establishment of annual income with a minimum donation amount:*** after one year, at least one source of income for foundations and corporations must be from donations. The percentage, which varies between 5% and 15% depending on the annual budget, must come from contributions or bequests in cash or in kind, such as property and volunteer work by members, founders or others, such as non-reimbursable aid and compensation for services. This issue will be addressed in greater detail under subhead 3.2.1 of this guide.

Liquidation or dissolution of a corporation or foundation

Dissolution of a foundation or corporation, according to Article 577, requires the approval of the authority that granted the entity legal status when it was founded. There are four causes for dissolution, regardless of the will of its members:

1. When state security or interests are threatened, or provisions from ministries or oversight/regulation organisms are repeatedly violated.
2. When the actions of a CSO are not in line with the purpose of the institution.
3. In the case of a foundation, when the property or assets that sustain the organization are lost or depleted.
4. When the number of members of a corporation falls below the established minimum.

The procedure for liquidation of an organization must be carried out in accordance with what has been established in the bylaws regarding these matters and the will of its members to liquidate it must be expressed through an act that determines the future use of the foundation's assets. This document is submitted to the ministry that approved the organization's legal status, and the organization's RUC will then be canceled.

³⁵ The difference between permanent employment and professional fees lies with the fact that the first is governed by the Labor Code and the second is governed by the Civil

Code, and thus does not result in social responsibilities or the worker's right to labor benefits.



3.1.3 Oversight authorities

Nonprofit organizations must report to several authorities, as explained below:

- *The authority that creates them and dissolves them.*³⁶ These are the relevant ministries, the same that are responsible for verifying the organization's compliance with its objectives and purposes, registration of members of board of directors and the list of members. In practice, oversight is difficult, since the registries of these organizations are not automated or digitalized.
- *The authority that oversees tax obligations and fulfillment of mission for taxation purposes:* This authority falls to the Servicio de Rentas Internas (SRI). In November 2007, the SRI created an office exclusively dedicated to management of nonprofit institutions that are exempt from paying income tax. This office verifies that organizations that should be set up as for-profit companies are not using the nonprofit legal status. Currently, the office is determining and reviewing how many organizations are registered with a taxpayer registration number (RUC) and how many are complying with tax obligations.
- *New oversight organism (introduced by the most recent legal reforms):* The Contraloría General del Estado (General Comptroller of the State) has been created to oversee the use of public resources by CSOs and determine if an organization may remain exempt from paying income tax. This verification will occur before a CSO obtains its registration number. This is a very significant change, since it implies state control over private organizations.
- *The authority that regulates labor relations:* Inspectors from the Ministerio de Trabajo (Ministry of Labor) and from the Instituto Ecuatoriano de Seguridad Social (IESS).

In addition, according to Decree 982, the most recent in force, the Secretariat of Indigenous Peoples, Social Movements and Public Participation, affiliated with the Presidency of the Republic, shall register all NPOs. It will not have the authority of a *regulator* but will maintain a mandatory registry (for statistical purposes and to ensure transparency). Until now, each ministry has managed its own information, but there is no statistical system, nor are there automated systems that would provide information about the number of corporations and foundations in Ecuador.

The Sistema Ecuatoriano de Cooperación Internacional (Ecuadorian System for International Cooperation)³⁷ was created to oversee foreign NGOs and administer international cooperation resources. It is led by the Consejo Directivo de la Cooperación Internacional (International Cooperation Advisory Board), which is made up of: the President of the Republic, who serves as chairperson; the Ministro de Relaciones Exteriores (Minister of Foreign Relations); the Ministro Coordinador de la Producción (Minister Coordinator of Production); the Ministro Coordinador de Desarrollo Social (Minister Coordinator of Social Development); the Ministro de Patrimonio Natural (Minister of Natural Heritage); the Ministro de Seguridad Interna (Minister of Domestic Security); the Secretaría Nacional de Planificación y Desarrollo (National Secretariat for Planning and Development, known as SENPLADES); and a representative of the Asociación de Municipalidades del Ecuador (Ecuadorian Association of Municipalities) and the Consejos Provinciales (Provincial Councils). The Agencia Ecuatoriana de Cooperación Internacional (Ecuadorian Agency for International Cooperation, known as AGECI) is in charge of registering foreign NGOs.

The government has proposed redirecting international cooperation resources toward projects that are considered national priorities. The purpose of

36 In other words, the benefits provided by the legal entity.

37 Executive Decree N° 699, of October 30, 2007, published in the Official Record Supplement N° 206, of November 7, 2007.



the Advisory Board would be to plan cooperation activities and prioritize geographic locations and needs. Its first step is to map out the management steps, organizations, programs, and projects.

However, the Advisory Board has had little success with implementation, since it is primarily composed of ministers' delegates. One of the functions of the director of the AGECI, who also serves as the board secretary, is to negotiate and sign international cooperation grant agreements on behalf of the Ecuadorian State. But this also falls to the Ministerio de Relaciones Exteriores, and thus there is an overlapping of functions among the AGECI, the Ministerio de Relaciones Exteriores and SENPLADES.

3.1.4 Foreign non-governmental organizations³⁸

Decree 982 contains a chapter specifically for foreign non-governmental organizations interested in carrying out activities in Ecuador.

The requirement for establishing a legal entity consists of a written application to the Ministerio de Relaciones Exteriores, indicating the purposes and work that the organization seeks to carry out in Ecuador. This application must be accompanied by the legalized documentation demonstrating its formation abroad and the bylaws in Spanish.

Subsequently, the ministry, through its embassies and consulates abroad, obtains information regarding the legal status, solvency, and reliability of the NGO seeking recognition. This is done both in the country where the organization was formed as well as in other countries where it engages in similar activities.

After this is completed, the foreign NGO signs a Basic Operations Agreement with the Ministerio de Relaciones Exteriores, allowing it to maintain a registry for inspecting and monitoring the work of the NGO, to ensure that it is consistent with its organizational purpose.

The Ministerio de Relaciones Exteriores shall not only legalize the international NGO, but will also oversee the organization's plans and projects to ensure that they have the information necessary to clearly identify the objectives, goals, specific tasks and resources, both internal as well as external, which are required for each stage of project execution.

Foreign NGOs may not engage in consultancies, for-profit work, or sell the assets used in the country. Nor are they permitted to carry out activities in violation of public peace and security. Foreign employees of these organizations are only authorized to carry out the work described in the signed agreement. Neither they nor their family members are permitted to engage in for-profit work and/or campaign work other than that described in the agreement. If the spouses of such personnel want to work in Ecuador, they must change their visa to the 12-VI migration category and meet the legal and regulatory requirements required for this activity.

If the foreign NGO does not comply with these provisions or what is established in the Basic Operations Agreement, the Ministerio de Relaciones Exteriores, after studying the case and issuing a resolution, will prohibit the organization from carrying out activities in Ecuador.

Previously, this procedure was the responsibility of the Instituto Ecuatoriano de Cooperación Internacional (Ecuadorian Institute for International Cooperation, or INECI), which was part of the Ministerio de Relaciones Exteriores. Today it is carried out by the Agencia Ecuatoriana de Cooperación Internacional (AGECI), which is part of the Secretaría Nacional de Planificación y Desarrollo, or SENPLADES.

There are still legal gaps that need to be clarified, since the approval process varies among these three organisms. However, without the existence of an intermediary with responsibility for this procedure, filling these gaps implies costs and time.

³⁸ Articles 17-24 of the Regulation of nonprofit legal entities. Executive Decree 3054, Official Record 660 of September 11, 2002.



3.2 Regulations that apply to CSOs with regard to commercial activities

Ecuadorian law addresses commercial activity but only with regard to the for-profit business sector, not in relation to organizations working for the public benefit. Article 6 of the Code of Commerce indicates that any person with the ability to enter into contracts in accordance with the provisions of the Civil Code may also engage in business.

The Draft Constitution³⁹ generally establishes the *right to carry out economic activities* either individually or collectively, in accordance with the principles of solidarity and social and environmental responsibility.

While NPOs are not explicitly prohibited from engaging in commercial activities, there are no clear regulations, nor is there debate or discussion on the subject. There is an ever-increasing need to establish a formal recognition that commercial activities may be carried out by NPOs and that such activities are a legitimate alternative for CSO sustainability.

Recognition of this right is still implicit. For example, the Tax Regulation⁴⁰ mentions that an entity of this nature must obtain between 5% and 15% of its annual budget from donations, which implies that the majority of income could feasibly come from self-financing activities generated by the organization itself.

In other words, these entities may –as occurs in practice– provide services or sell goods as a self-financing strategy that enables them to obtain resources. In the case that a surplus is generated, the law establishes that this amount must be invested toward fulfilling the organization's mission within one year; if this does not happen, the organization could lose income tax exemption, or even be subject to a cause for dissolution.

Certainly, due to the fact that there is no explicit prohibition, and given current regu-

lations, the focus applied in Ecuador is the *destination-of-income test*, which requires that any surplus be invested in the institution's social objective. This prevents misuse of the nonprofit legal status.

At a more operational level, organizations, regardless of whether they carry out business activities, have formal and complex obligations with respect to the tax authority. Such obligations are almost identical to those of any other type of company. The main difference is that they are exempt from income tax.

To follow is a description of the relationship between existing regulations and the various sources of financing, with a special emphasis on CSO self-financing activities.

3.2.1 Regulations that affect non-commercial sources of financing

For many years, CSOs have sought diverse non-commercial ways to finance their public benefit programs and projects. Among these sources of financing, the four main ones are: *donations, public tenders and consulting projects, loans and emergency funds*. Initially, when international aid promoted assistance programs, *donations* made up the primary source of income. Today, donations continue to be an option for funding disadvantaged groups, particularly in the areas of health, education, human rights and others.

As the number of CSOs grew and donor funding became more diverse, the latter began to distribute funding through the use of open *tenders and consulting bids*. The state also adopted these mechanisms as a way to distribute funding.

While the procedures and mechanisms used have not produced the expected results in terms of meeting the needs of beneficiaries and strengthening the long term impact of these organizations, these two financing alternatives continue to be very important for many organiza-

39 On September 28, 2008, Constitutional Charter N° 21 was approved in Ecuador through a referendum.

40 Recently approved in May 2008.



tions. The need to generate other sources that can help cover CSO administrative expenses, however, has slowly become more apparent.

As a result, *loans* have become one alternative, but they are largely circumstantial and short-term, and are used primarily for the purchase of hard assets. *Emergency funds*, meanwhile, are also not an ongoing financing mechanism, but they do help to meet some needs during periods of short-term crisis.

Donations

Donations may be made in money or in-kind and may come from individuals or entities, both from within Ecuador and from abroad.

During the 1970s and 1980s, the business sector, particularly large companies, created corporations and foundations to which they transferred financial resources as donations which could be deducted from the donor's income tax. One of the aims was to direct resources toward other activities that did not necessarily fulfill a social purpose. The tax authority, in an effort to increase efficiency and control, chose to limit the deductibility of these contributions, applying a progressive elimination of tax shields (caused by legal gaps) to avoid a drastic reduction in tax collection.

The percentage of tax deductions varied for the next few years until they were completely eliminated in 1996, leaving only the possibility of deducting donations made to universities. This was later changed with the Ley de Equidad Tributaria (Tax Equity Law) enacted on December 28, 2007.

Currently, donations may not be deducted from the donor's income tax, but they are exempt from paying VAT when donated to public sector entities and private institutions and associations that are legally constituted and dedicated to charity, culture, education, research, health, or sports.⁴¹

When donations come from abroad, the procedure is similar to an importation procedure, with

additional requirements such as the legalization of documents in the Ecuadorian consulate located in the country from which the goods are sent.

In addition, the entity that receives the donation must find out if it is subject to tariff exemptions, which will depend on the item that is being imported. It is the organization itself that must find out which procedures and actions it must take with the Corporación Aduanera Ecuatoriana (Ecuadorian Customs Corporation, known as CAE) in order to be eligible for an exemption.

The Ley Orgánica de Aduanas (Organic Customs Law) provides for exemption from tariffs for donations from foreign countries, but this is applicable only to state institutions or the nonprofit sector in the following fields: environmental health, nutrition, technical assistance, charity, medical assistance, education, scientific and cultural research services, as long as they have signed cooperation contracts with state institutions.⁴²

The entities that are eligible for these benefits must present a tax waiver application to the general manager or regional deputy manager of the Corporación Aduanera Ecuatoriana (CAE) along with several documents (a list that has been certified by the Ecuadorian Consulate, the country of origin of the goods to be donated, shipping authorization, the cooperation agreement that has been signed with a state institution) and submit the goods to a mandatory valuation by customs agents.

Vehicle donations are not exempt from taxes, except special-purpose vehicles such as ambulances, clinical or radiology vehicles, mobile libraries, and fire trucks, as long as their function is compatible with the activities of the charitable institution. Organizations must keep accounting records of the monetary value of donations, which are normally backed by a contract. Depending on the contract conditions, the donation must be evaluated to determine whether it constitutes a contribution to the organization's assets or endowment or if it is considered income.

41 Internal Tax Regime Law, Article 54, number 5.

42 Organic Customs Law, Article 27, letter e.



In practice, this is mandatory, since starting in May 2008, all CSOs are required to obtain annual donations,⁴³ either in the form of contributions or bequests in money or in-kind, property, or volunteer work, and such donations may come from different stakeholders: organization members, founders, national or international aid (non-reimbursable funds), service fees, etc. The value of donations has been set as a percentage related to the institution's total income (see Table 1).

Table 1: Donations as a percentage of total income

Annual income in US dollars	% of income from donations and contributions
From 0 to 50,000	5%
From 50,001 to 500,000	10%
500,001 and higher	15%

Tenders and consulting projects

As mentioned previously, many organizations use this form of financing as almost their only source of income. For example, environmental organizations depend heavily on this activity, because they carry out environmental projects involving highly specialized training.

There is generally no law or regulation governing competitions organized by international and national organisms. Competition terms and conditions and participation requirements are defined by the national or international organisms themselves.

In Ecuador, international aid has slowly been withdrawing; however, there are teneerthat have remained active with the support of the European Commission, USAID, the Inter-American Development Bank (IDB) and its Multilateral Investment Fund (MIF) as well as UN agencies.

There are also other alternatives, such as debt swap, for example, with the Agencia Española de Cooperación Internacional para el Desarrollo (Spanish Agency of International Cooperation for Development, known as AECID) and with the Italian government's aid agency. There are also bilateral organisms and international and Ecuadorian second-tier organizations⁴⁴ that occasionally launch tenders.

For consultancies provided to the government, the Reglamento de Consultoría (Consultancy Regulation) authorizes CSOs to provide such services; however, both the Consultancy Law and its Regulation have been superseded by the Ley Orgánica del Sistema Nacional de Compras Públicas (Organic Law of the National Public Purchasing System).⁴⁵

Loans

As indicated previously, the use of this source of financing is restrictive for CSOs because it requires real guarantees, but it is applicable for the purchase of hard assets or for specific situations when there is a lack of liquidity. A CSO must consider any restrictions on indebtedness that are included in the bylaws or, alternatively, in a board of directors assembly or meeting.

With respect to the formal financial system, CSOs cannot easily access credit because they do not show regular income, or because they operate at a loss. In some cases, they are considered risky entities in terms of granting credit. Often, the organization's legal representative takes on the risk of debt, even mortgaging or providing a credit guarantee with his or her own property.

Credit operations are taxed at a 1% annual rate; this is flat if the credit is for more than one year, or proportional if it is granted for a period of less than one year. The amount collected from this tax is given to the Sociedad de Lucha contra el Cáncer (Society to Fight Cancer, known as SOLCA).

43 Article 19 of the Regulation of the Internal Tax Regime Law.

44 These function as centers for depositing or collecting funds to be distributed among organizations, also known in other countries as support organizations.

45 A more profound analysis of this law is not included in this legal guide, because the law was developed after this study was finished.



Formation of emergency funds (asset or capital accounts)

Due to the nature of CSOs, *non-distributed profit* is not an alternative for generating resources. However, the creation of emergency funds through *capitalization* of a generated surplus is possible.

While surpluses are not common, in the case that one does exist, it may not be distributed among the organization's members, nor may it be accumulated during more than one fiscal period. This eliminates the possibility of maintaining a reserve to be used in a crisis or when there is a lack of liquidity. If a reserve is held, the organization must pay taxes.

The new tax regulations in Ecuador indicate literally that any surplus generated at the end of a fiscal period must be reinvested in the social mission before the close of the following fiscal period. If this provision cannot be met, the Servicio de Rentas Internas (SRI) must be notified and a justification for the situation must be provided.

3.2.2 Regulations that affect commercial sources of financing: self-financing activities

CSOs carry out self-financing activities, generally offering a product or service at a price lower than the normal market price. In addition, they use differential pricing when serving populations other than the target group.

Generally, organizations are exempt from income and value-added tax.⁴⁶ Only when there are explicit exemptions are they permitted to charge for services without VAT. In most cases, even when there are special laws that establish that the VAT should not be paid, organizations encounter difficulties exercising this right, given the lack of understanding among the authorities.

According to NESST's definition, self-financing activities include:

- **Membership fees⁴⁷:** numerous organizations charge a membership fee in exchange for a service or publication. In Ecuador, income tax is applicable when the fee is higher than US\$ 1,500 annually per member and the same rule is applied for the application of VAT. If the fee is lower than that amount, VAT is invoiced at a rate of 0%.
- **Use of soft assets:** royalties for intellectual property and the registration of trademarks are instruments that are still not widely used. For example, few organizations register training methodologies and product trademarks.

If a CSO offers a product or service with a unique characteristic that enables it to raise its visibility among consumers, the organization should protect this characteristic or element that makes their product unique, through registration and use of intellectual property or an industrial patent.

Intellectual property includes copyright over creations, computer programs, and brands. An industrial patent, meanwhile, protects methods, models, diagrams, formulas, innovative combinations, or transformation.⁴⁸

Regarding the marketing of products whose value is derived from knowledge passed down through time, no one is permitted to convert such products into their own assets. The Instituto Ecuatoriano de Propiedad Intelectual (Ecuadorian Intellectual Property Institute, known as IEPI) is the administrative organism with responsibility for regulating this area.

The purpose of the Ley de Propiedad Intelectual (Intellectual Property Law)⁴⁹ is to promote free competition with adequate protection for intellectual property rights over goods and services that include soft assets, both in the Ecuadorian market and the international market.

⁴⁶ Due to ignorance or nonapplication of the law.

⁴⁷ The Ecuadorian regulatory framework does not recognize membership dues as commercial activities; however, it does regard them as a means for CSOs to generate funds.

⁴⁸ The expenses to be paid in the case of intellectual property and industrial patents are determined in Resolution N° 82 of the Executive Council of the IEPI. RO 389 of August 14, 2001.

⁴⁹ Intellectual Property Law, Law N° 83. RO/320 of May 19, 1998.



In addition, an aspect of competition depends increasingly on the ability to incorporate technological advances into the production and marketing of goods and services whose intellectual property rights must meet the ethical principles of universality and international standardization, regulated by this law.

- **Use of hard assets:** in general, foundations are set up with donated property, the sale of which is restricted. In most cases, this consists of property that is used for the institution's services. Rental of such assets is not very common. The Tax Equity Law establishes that the SRI has the authority to verify "...that its property, income, and surpluses...are used solely to fulfill its specific purposes". In this sense, it is important to determine whether the rental of a fixed asset to generate income is or is not considered part of the specific purpose.⁵⁰
- **Sale of Products:** this may or may not be related to the organization's mission. In some cases, organizations are set up as commercial enterprises with a social purpose. Normally sales are subject to VAT, unless the goods being sold are included on the list of exemptions.
- **Fees for services:** these are most often trainings and special events such as forums and private consulting services. The services are usually related to the organizational mission.
- **Investment dividends:** investment dividends are generated by investments in the financial system (fixed-term deposits); stock market investments (securities) and dividends, when a CSO owns shares in a company.

All financial gains are subject to the respective *source withholding*⁵¹ of 2%. However, CSOs are not subject to any withholding, since this is simply an early payment of income tax, and as previously mentioned, these organizations are exempt from paying such tax.

Dividends from fixed-term deposits *of one year or longer*, paid by Ecuadorian financial institutions, are also exempt from income tax withholding; this also applies to dividends from fixed-income securities with a term *of one year or longer*, and which are traded on securities exchanges in Ecuador.⁵²

This exemption does not apply when *the investor* has a loan from the institution where the deposit or investment is made, or from any of its affiliated companies.

According to the Law of Companies, CSOs may own shares in a commercial company. Profit generated by the company is subject to income tax prior to being distributed and utilized by the civil society organization that owns the shares, and from that moment forth it becomes exempt income.⁵³

Currently, some organizations have sought alternatives through setting up a trust account to manage funds with specific purposes; however, under Ecuadorian legislation, trust accounts are subject to taxes and, thus, if they generate a profit they are subject to income tax.

3.2.3 Changes in the social mission of organizations that engage in self-financing activities

The public sector is focused on what the law stipulates; the business sector, on the other hand, has greater flexibility to develop activities that are not explicitly prohibited by law. In that sense, it would seem that if a CSO includes the possibility of self-financing activities in its bylaws and its mission, it may also carry out such activities. The challenge is that there is still no unified criterion among the ministries with respect to CSO self-financing.

In response to an inquiry, the legal director of the Ministerio de Inclusión Social y Económica specified that self-financing activities are the purpose of a company and not of a CSO, and if

50 If the organization can prove that the income generated from the rental is used for the organization's programs (objective and purposes), the exemption would apply.

51 This is an advance method of collecting income tax, which requires those who make payments to pay the Treasury a percent-

age that is established by the Internal Tax Regime Law and by the SRI.

52 Internal Tax Regime Law, Article 9, number 5.

53 Internal Tax Regime Law, Article 9, number 1.



an organization wants to engage in self-financing activities, its legal status must be changed to meet the requirements of the Law of Companies. Nevertheless, organizations that work on fair trade issues are recognized and do not encounter legal problems; it is accepted that they generate a surplus that serves to improve the living conditions of the country's poorest and most vulnerable groups.

In general, fair trade and economies that recognize special needs of the poor have been addressed and accepted by some public institutions that are focused on social development. In fact, there is a Subsecretaría de Economía Solidaria (Subsecretariat of Solidarity Economics), which is being transferred from the Ministerio de Economía (Ministry of Economy) to the Ministerio de Inclusión Social.

In addition, the Ministerio de Industrias y Competitividad (Ministry of Industries and Competitiveness) has approved the creation of productive organizations and others related to improving productivity and competitiveness, which do carry out self-financing activities; the same is true with the Ministerio de Agricultura, Ganadería, Acuacultura y Pesca (Ministry of Agriculture, Livestock, Aquaculture and Fishing).

Certainly, there is no unified criterion for treatment, redefinition and approval of self-financing activities when such activities are explicitly permitted by an organization's bylaws.

3.2.4 Pending changes in the regulations

Law specifically for CSOs

There is interest on the part of the authorities in passing a law for NPOs with a specific regulation for public law organizations.

This is a trend not only among government officials, but among the organizations themselves, who see the need for a law that recognizes their contribution and social impact. In addition, the government has an interest in clarifying the legal framework and the system of statistics to establish

where and on which issues public benefit work is actually being carried out. With this information, the state would be better able to develop public policies and specific actions jointly with civil society.

Reform of AGECI's functions (for foreign NGOs)

Whether ACEGI should be part of the Secretaría Nacional de Planificación y Desarrollo (SENPLADES) or the Ministerio de Relaciones Exteriores is still under discussion.

The problem lies in the fact that the decree that created the AGECI is incomplete. It does not define all of the functions needed and in public law, if a concept is not explicitly indicated there is no authority to carry it out. To address this, a reform of the decree has been proposed, which would include the appropriate and adequate functions.

Development of commercial activities

The Ley de Competitividad y Defensa del Consumidor (Competition and Consumer Defense Law) defines unfair competition as all actions or practices that directly or indirectly impede, falsify, restrict or distort competition in such a way that, whether it produces an economic benefit or not, tends to eliminate competitors. All intellectual property rights will be applied using this same criterion to prevent unfair competition.

The Competition and Consumer Defense Law will govern all business entities that develop commercial activities within the country and those responsible for the actions and decisions of those entities.

Although there has never been a case reported of unfair competition between the nonprofit and for-profit sectors, it is nevertheless necessary to address the issue, since there are several organizations engaged in economic and production activities and thus, they could come to represent competition for the business sector. Concern about whether there is unfair competition, however, should take into



consideration whether their activities are being carried out on behalf of disadvantaged groups that are generally not a target market of for-profit companies. It is important that the definitions included in the law take these aspects into consideration.

Prices offered by corporations and foundations are subsidized because they serve these groups. The hope is that the authorities who develop these laws will not view this fact as unfair competition and recognize that these *social investments* deserve special tax advantages.

Oversight authority

A mechanism to verify what organizations are doing with their income tax exemptions is currently being defined by the Contraloría. Although most organizations match their costs to income and don't owe taxes, the law will give the government the authority to verify that the information provided by the organization is correct.

If an irregularity is detected, it can even lead to an accusation of fraud based on misuse of public funds. The punishment for such a crime may even include a prison sentence.

3.3 Tax laws and taxes

The purpose of this section is to highlight general aspects of the tax laws, briefly summarize their content, and describe the relevant taxes applicable to CSOs that engage in self-financing activities, as well as the consequences of not complying with or following these laws.

As mentioned in the previous section, CSO self-financing or commercial activities are not regulated in a single body of law; as a result, it is necessary to examine the content of several laws. When business activities are carried out, organizations must meet a series of requirements and pay various taxes at both the national and local level.

In addition, there are exemptions or taxes that may positively or negatively affect them, depending on the product or service they provide.

3.3.1 General aspects of tax law and taxes

According to the Tax Code, individuals or legal entities are exempt from paying taxes only if the law explicitly states that such an exemption exists.⁵⁴ There are other situations where payment of a tax does not apply to a certain individual or entity because it is not included in the law; in that case, the individual or legal entity is not subject to the tax.

Taxes may only be established, modified, or eliminated through a legislative act.⁵⁵ Regulations may not be used to change or alter the meaning of the law or create tax obligations or exemptions that are not included in the law.⁵⁶

The President of the Republic has the exclusive authority to enact tax regulations. The general director of the Servicio de Rentas Internas or the general director of the Corporación Aduanera Ecuatoriana may issue circulars or general provisions for the application of the respective laws.⁵⁷

In other cases, municipalities and provincial councils may also issue regulations through *ordinances* when these are contemplated in the respective law,⁵⁸ but the supremacy of the Tax Code must be taken into account with respect to other general laws (regarding national, provincial, municipal, or local laws).

The President of the Republic directs the central tax administration, while district tax administration is overseen by the prefect or mayor.⁵⁹

In Ecuador, the Constituent Assembly has generated several legal reforms. In relation to the tax law framework, the Tax Equity Reform Law, approved in December of 2007, incorporated changes to the Tax Code and the Internal Tax Regime Law. As a result of these changes, in May of 2007, a new Tax Regulation was approved, which was adjusted to the established requirements.

54 See Articles 32 and 35 of the Labor Code.

55 See Article 3 of the Tax Code.

56 See Article 7 of the Tax Code.

57 See Article 7 of the Tax Code.

58 See Article 8 of the Tax Code.

59 See Article 64 and Article 65 of the Tax Code.



3.3.2 Brief description of the tax laws

In general, organizations face three taxation levels, with different authorities responsible for tax administration:

1. National taxes. The content of these laws is found in the Tax Code,⁶⁰ the Internal Tax Regime Law, and the Tax Regulation. Observance of these laws is mandatory, regardless of whether an organization engages in self-financing activities. Oversight authority falls to the Servicio de Rentas Internas (SRI).

2. Local taxes. The content of these laws can be found in the Ley Orgánica de Régimen Municipal (Organic Law on the Municipal System) and applies to certain kinds of business activities. Thus, it only governs those organizations that engage in these types of activities. The oversight authority is the council of the canton where the organization is located. These taxes do not preclude payment of the taxes in numbers 1 and 3 of this list.

3. Foreign trade taxes (tariffs). The content of these taxes can be found in the Organic Customs Law and is applicable if the organization's self-financing activity is related to the import and/or export of goods and services. The oversight authority is the Corporación Aduanera Ecuatoriana (CAE). These taxes do not preclude payment of the taxes described above.

Depending on the activity that a CSO carries out to generate income, the regulations of the second and third group do not always apply, but those in the first group are obligatory.

Following is a description of the three types of taxes mentioned above and the legal framework on which they are based:

National taxes

For NPOs to be eligible for the *income-tax exemption*, they must meet the conditions stipulated in the

Tax Code, the Internal Tax Regime Law, and the Regulation of the Internal Tax Regime Law. If these conditions are not met, the organization must pay taxes, and if the SRI notices anything abnormal, this could be viewed as a cause for the organization's dissolution.

Table 2 on the following page summarizes the primary laws and several procedures to be followed by organizations.

a. The Tax Equity Reform Law in Ecuador⁶¹

The Tax Equity Reform Law has 180 articles, 99% of which are designed for companies. In addition, the Reform requires that NPOs have a RUC and meet all tax obligations, which results in foundations and corporations being subject to the same formal responsibilities as commercial companies.

This law reforms the Tax Code, the Internal Tax Regime Law and Special Laws. It also creates new taxes: a tax on transfers of currency abroad, rural properties, and extraordinary oil income. It created a simplified system that implemented certain changes, such as a tax on inheritance, bequests, and donations. Several of the articles that it reforms and expands have been included in this study.

This law was designed to provide resources to the state for better wealth distribution, in an effort to reduce social inequalities. To do this, it established a progressive increase in direct taxes for individuals (up to 35%) but not in indirect taxes, which do not consider the income level of the taxpayer.

This law provides expanded mechanisms to prevent and control tax evasion and tax loopholes (i.e., taking advantage of an administrative error) and institutionalizes a tax crime system that establishes sanctions that are effective and proportional to the damage caused.

The Tax Equity Reform Law includes everything that was previously treated as exemptions in the Tax Code for private, nonprofit organizations.

⁶⁰ The Tax Equity Reform Law, approved in December of 2007, incorporated changes to the Tax Code and the Internal Tax Regime Law.

⁶¹ Ecuadorian Tax Equity Reform Law, R.O. 242 of December 29, 2007.



Table 2: Laws, procedures and formal obligations

Body of Law	Exempt Organizations	Condition / Requirement	Formal obligations
Tax Code Exemption: Article 35, number 4. Formal obligations Article 96, number 1.	Among the limits established by law and regardless of the provisions of organic or special laws, in general, private charitable or educational associations (...) are exclusively exempted from paying taxes, but not from paying tariffs or special contributions.	<ul style="list-style-type: none"> - They must be legally constituted. - Their property and income must be used toward their mission and purpose, only to the extent that such property or income is directly invested in them. 	<ul style="list-style-type: none"> - Be registered. - Request prior permits. - Maintain an accounting system. - Present declarations. - Comply with the obligations established by the Law.
Internal Tax Regime Law Article 9, number 5.	The organizations defined in the Regulation shall be exempt.	<ul style="list-style-type: none"> - The SRI shall verify that they are exclusively nonprofit. - They are dedicated to the purposes set out in the bylaws. - That their property and income are used in their entirety for the organization's specific purposes. - Any surpluses that are generated at the end of the fiscal period must be invested in the organization's specific purposes, until the closure of the next fiscal period. - If they do not meet these requirements, they must pay taxes and shall not be exonerated. 	<ul style="list-style-type: none"> - They must be registered and have a Taxpayer Registration Number (RUC). - They must keep accounts. - They must comply with all of formal obligations included in the Tax Code, this law, and other laws of the Republic.
Regulation of the Internal Tax Regime Law Articles 19 and 20	<ul style="list-style-type: none"> - Religious groups - Charity - Support and development of women. - Children and families - Culture - Art - Education - Research - Health - Sports - Professional - Guilds - Unions - Political parties - Municipal - Indigenous peoples - Cooperatives - Alliances - Federations and confederations of cooperatives - Peasant and small farmer associations 	<ul style="list-style-type: none"> - They must be legally recognized. - Their property and income must be used toward their mission and purpose, only to the extent that such property or income is directly invested in them. - They must be nonprofit CSOs. - They must be dedicated to the purposes set out in their bylaws. - If this provision cannot be met, the Servicio de Rentas Internas (SRI) must be notified with justifications for the particular case. - They must comply with all formal obligations (see next column). - A portion of their annual income must come from donations (between 5% and 15%, depending on the CSO's budget). 	<ul style="list-style-type: none"> - They must be registered with the Taxpayers' Registry. - Maintain an accounting system. - Submit an annual income tax declaration (which shows no tax owed, if they meet all requirements). - Present the VAT declaration as a receiving agent, if applicable. - Withhold income at the source for income tax and value added tax and present the corresponding declarations and payment of amounts withheld. - Provide the information required by the tax administration.



b. Tax Code⁶²

This body of law regulates the relationship between the state (active subject) -through the tax authority- and the taxpayer (passive subject), indicating the features and forms of payment for taxes, tariffs, and contributions.

The Tax Code has four books:

Taxation fundamentals. Includes three chapters addressing: (a) basic provisions, (b) tax obligations and (c) the tax administration.

Taxation procedures. Includes two chapters addressing (a) tax administration procedures and (b) complaints, inquiries and administrative resources.

Litigious procedures. Includes two chapters addressing: (a) tax-litigation jurisdiction and (b) presenting evidence before the district tax court.

Tax crimes. Includes three chapters addressing: (a) basic provisions (b) tax infractions in particular and (c) tax crime procedures.

c. Internal Tax Regime Law⁶³

Since 1990, the Internal Tax Regime Law has undergone more than 40 reforms, and as a result it is difficult to determine exactly when each of the current taxes went into force.

The law provides a detailed description of three taxes: Income tax, value-added tax, and tax on special consumption. The law explains how each tax developed, who is subject to the taxes and the tariffs that are applied, as well as certain accounting aspects, exemptions, deductions (of income tax), and declarations.

d. Regulation for the Application of the Internal Tax Regime Law⁶⁴

The Regulation enacts the provisions of the Law and Code, without representing a reform of either.

With respect to NPOs, Article 19 creates a requisite that is not contemplated in the Law, and which refers to a minimum amount of annual donations or contributions that NPOs are required to receive, as detailed in point 3.2.1.

A donation is defined as any kind of money or in-kind contribution, such as goods and volunteer work, provided by founding members and others, such as non-reimbursable cooperation funds and provision of services.

Local taxes

Organic Law on the Municipal System⁶⁵

This law defines the sphere of action of a municipality, the coordination of its work with other government institutions, the attributes and duties of those who work in municipal government, and the areas that must be addressed by municipal administration.

Municipalities have the authority to collect several types of taxes, basically those related to property, vehicles, purchase and sale of property, and public events. Other sources of municipal income include tariffs and contributions.

CSOs should contact their local municipalities regarding permits for operating industrial, commercial, and professional facilities.

In addition, municipalities should take into account possible ways to coordinate activities with CSOs, since the municipality undertakes activities that could be incorporated into the work of the CSOs:

- Plans, coordinates, and executes prevention and social assistance plans and programs.
- Promotes and supports cultural, artistic, athletic, and recreational development.
- Coordinates environmental pollution prevention and oversight actions in this area.

63 Internal Tax Regime Law, Codification 2004-026, Official Record N° 463 of November 17, 2004.

64 Regulation for the Application of the Internal Tax Regime Law,

R.O. 337, May 15, 2008.

65 Organic Law on the Municipal System, Codification 16, Official Record 159 of December 5, 2005.



- Contributes to the development of productive activity and commercialization (handicrafts, micro-enterprises, and small-scale industrial producers, among others).
- It oversees sales, in public spaces and roadways, of all artistic, literary, musical, or scientific works, in any format, whether produced, reproduced, or distributed, which are protected by the Intellectual Property Law.

Foreign trade taxes (tariffs)

Organic Customs Law⁶⁶

This law regulates the legal relationships between the state and individuals or legal entities that operate in the international trade of goods within the customs jurisdiction. It includes guidelines regarding tariff rights, taxes, and fees for customs services.

The tariffs applied to imports fluctuate between 5% and 20%,⁶⁷ with certain exceptions (tariff structure under Decision 570 of the Comunidad Andina, or Andean Community). The exemptions are mentioned in Article 27 of the Organic Customs Law.

Civil society organizations working in the following areas⁶⁸ are exempt from paying tariffs:

- Emergency relief after natural catastrophes or disasters to public sector entities or private charitable or emergency aid organizations.
- Donations from abroad for state institutions or the nonprofit sector, which are meant to fund services in environmental health, nutrition, technical assistance, charity, medical assistance, education, and scientific and cultural research, as long as they have signed cooperation contracts with state institutions. Vehicle donations are not tax-exempt, with the exception of special-purpose vehicles such as ambulances, clinical or radiology vehicles, mobile library

ies, and fire trucks, provided their function is compatible with the activities of the charitable institution.

- Orthopedic vehicles, medical apparatus, technical aids, special tools, raw materials for orthoses and prostheses used by people with disabilities or legal entities responsible for assisting them.

3.3.3 Taxes

When engaging in business activities, for-profit companies and CSOs must meet a series of requirements and, depending on the situation, pay local or national taxes.

Articles 87 through 93 of the Tax Code explain how taxes are determined, through references to the procedures that must be completed in order to establish the taxable basis and the tax amount.

Income Tax

According to Article 2 of the Internal Tax Regime Law, both Ecuadorian sources of income and those obtained from abroad are considered *income*. Income tax is applicable to individuals or companies; the earnings may come as a donation, from work or from capital, and may be received in cash, goods, or services.

The tax rate that applies to companies is 25% and the rate for individuals is 35%; NPOs are exempt from paying income tax, as long as they meet all of the requirements applicable in the regulations explained in section 3.3.2 of this guide and comply with the following:

- They must submit a tax declaration, maintain an accounting system, and demonstrate that the income-generating activity is related to their mission; if it is not related to their mission, they must pay taxes and are also subject to other penalties.

66 Organic Customs Law, Official Record 219, November 26, 2003.

67 For more information on the national integrated tariff, see:

<http://sice1.aduana.gov.ec/ied/arancel/index.jsp>

68 Organic Customs Law, Article 27, letters "c", "e", "i".



- If they conduct a related economic or business activity, they have deductible costs and expenses that must be clearly recorded.
- Advance payment of the tax does not apply because they are exempt; however, if the SRI determines that they are generating a surplus that is not reinvested in the mission, they must pay the taxes without the option of deducting costs and expenses, and are subject to the applicable fines and sanctions.
- Donations received by a CSO are normally considered a contribution to its assets, although depending on the contract with the donor, they may be part of the fixed assets if it is a good, or working capital, if it is a donation of money. Some CSOs record donations as income, although the changes made in the Tax Regulation, requiring CSOs to obtain 5% and 15% of total income from donations, will influence how such donations are accounted for.

Although CSOs do not pay this tax, it is important to properly calculate the profit or income, especially if there is income from self-financing activities. CSOs must calculate all income received and deduct all related costs and expenses. Not all expenses may be deducted from income.

Two related taxes are considered: the Investment Tax and the Inheritance Tax. The first was already

addressed in section 3.2. Regarding inheritance, there are two contradictory observations. According to the Tax Code, an exoneration must be explicit, in which case it would only apply to an individual, including minors and people with disabilities (with a disability of at least 40%, verified by CONADIS), as described in the provision contained in Article 36 of the Internal Tax Regime Law.

But the other interpretation is that an inheritance is part of income, and thus would be among the areas taken into account in the calculation of income tax (although it has a different tax rate table). According to this concept, NPOs would be exempt. Foundations that create an endowment from bequests they have received would not need to pay taxes on this inheritance. This issue should be subject to an SRI ruling and should be managed carefully by the authority, as shown in Table 3 below.

According to the latest legal reforms, the amount that the state no longer receives as a result of this exoneration from paying taxes constitutes a public subsidy as per the provisions in the Organic Law of the Contraloría General del Estado and other laws of the Republic. Organizations are subject to oversight by the Contraloría, despite being private entities, and if the Contraloría detects a diversion of funds for which an exemption is applied, the CSO could be accused of defrauding the Servicio de Rentas Internas, which is considered a tax crime.

Table 3: Tax on inheritance, bequests and donations - 2008

Basic fraction	Excess up to	Basic fraction tax	% fraction tax exempt
-	50,000	-	0%
50,000	100,000	-	5%
100,000	200,000	2,500	10%
200,000	300,000	12,500	15%
300,000	400,000	27,500	20%
400,000	500,000	47,500	25%
500,000	600,000	72,500	30%
600,000	and up	102,500	35%



Value Added Tax (VAT)

This tax is imposed on the value of transfer of ownership⁶⁹ (whether a purchase, donation, or self-supply) or on the import of physical goods, in all stages of trade, as well as on the value of services provided, in the forms and conditions envisioned by this law.

The rate of this tax is 12% and there are no exemptions for NPOs. If some of the self-financing activities carried out by these organizations are related to exempt services or products that do not pay VAT, as defined in articles 55 and 56 of this law, then they also enjoy this benefit.

At the same time, organizations that sell their products abroad, such as those that are involved in the area of fair trade, should also be aware of the procedures for applying for a tax credit and the refund of VAT (Articles 57, 66 and 72).

Finally, NPOs that carry out international projects must observe the definitions of Article 73:

Article 73. VAT paid by public sector organisms and entities. This will be refunded without interest within a period no longer than 30 days by the SRI; the organism must present a formal declaration made by the legal representative, accompanied by copies of the invoices detailing the VAT payment.

Those eligible for this refund include specialized international agencies; non-governmental organizations; private legal entities designated as executors of international treaties or that receive funding from government-to-government credits, or from multilateral organisms such as the World Bank, the Corporación Andina de Fomento (Andean Development Corporation), and the Inter-American Development Bank.

They are eligible as long as the local import or acquisition of goods or services are made using the funds from such treaties or credits, to meet

the purposes expressed in these instruments, and that they have been registered in advance with the Servicio de Rentas Internas. In addition, they must provide the necessary administrative support documentation (invoices from acquisitions, local purchases, imports, payments, and others).

The value added tax is also refunded for local purchases or imports of goods which are subsequently exported.⁷⁰

A foreign NGO that initiates activities in the country and has signed an agreement with the Ecuadorian state, through the Ministerio de Relaciones Exteriores, is permitted to import one vehicle duty- and tax-free for use by the organization.

Municipal taxes that affect self-financing activities

According to Article 307 of the Organic Law on the Municipal System, the following are considered municipal taxes: tax on urban property; tax on rural property; real estate transfer tax; registration and license tax; tax on profits from the purchase and sale of property and capital gains from the same; vehicle tax; tax on public events; and gaming tax.

Of these, taxes related to property and the operation of business activities are described below.

a. Real estate (or property) tax

An annual tax on urban real estate must be paid to the municipality where the property is located. The tax base is the property's value, as established by each municipality.

Civil society organizations do not pay real estate tax in urban areas, as long as they meet certain requirements.⁷¹ In urban areas, the exemption mentions private charitable, social assistance, or educational institutions, which must be legally constituted and the buildings and income must be used solely for those functions. However, if the

69 See Article 52 of the Internal Tax Regime Law.

70 See Internal Tax Regime Law, Article 72.

71 See the Organic Law on the Municipal System, Article 326, letter d.



surplus and the property are not wholly used for charitable purposes, the part that is not used for those purposes will be subject to the tax.

b. Rural real estate (or property) tax

As in the case of urban property, rural properties belonging to social assistance or private educational institutions are exempt –in this case the law omits the word *charitable*– as long as they are legally established and the income they receive from use or rental of their properties is used for social purposes and does not benefit private enterprises with no connection to such purposes.⁷²

Ecuador's Tax Equity Reform Law did however create the tax on rural lands⁷³ for properties with an area equal to or greater than 25 hectares, within a radius of 40 kilometers from watersheds or sources of water.

The value to be paid is equivalent to one one-thousandth of the basic non-taxed fraction of income tax (which was US\$ 7,850 in 2008) for each hectare or fraction of a hectare over the limit, that is, US\$ 7.85 per hectare. If the lands are productive, there is a deductible amount that corresponds to the same fraction multiplied by 4, that is, US\$ 31.40 per hectare in 2008, as long as the total amount is not greater than the income taxed for that activity.⁷⁴

Exemptions are related to location:

- Property located more than 3,500 meters above sea level.
- Property located in ecological protection areas or reserves, whether public or private, and registered with the corresponding public organism.
- Property belonging to communal land holdings, indigenous peoples, cooperatives, unions, federations and confederations of coopera-

tives, and other legally recognized associations of peasants and small farmers.

- Wetlands and natural forests duly qualified as such by the environmental authorities.
- Property owned by the state and other public sector entities.
- The portion of property that belongs to universities or higher education institutions recognized by the Consejo Nacional de Educación Superior (National Council for Higher Education, known as CONESUP), except for private, self-financed institutions, that goes toward agricultural research or education.
- Properties that fulfill an ecological function, whose lands include areas of voluntary conservation of forests and priority ecosystems.
- Lands categorized as belonging to the Patrimonio de Áreas Naturales Protegidas del Ecuador (Protected Natural Heritage Areas, or PANE); areas protected at the provincial or canton level, private forests, and communal lands.⁷⁵

c. Real estate transfer tax

This tax is applied to the transfer of ownership of real estate (property) and boats. The rate is 1% of the contract value; this value may not be for an amount less than the assessed value of the property.⁷⁶ There are certain exemptions to this tax, such as donations made to the state, donations to private entities with a social or public purpose, and donations to private societies or institutions dedicated to social assistance, education and other similar functions, as long as their bylaws are approved by the executive branch.

d. Municipal license

This is an annual payment for a municipal permit to carry out business activities within a municipality.

72 See the Organic Law on the Municipal System, Article 336, letter c.

73 See articles 173 and 174 of the Tax Equity Reform Law.

74 See articles 178 and 179 of the Tax Equity Reform Law.

75 See Article 180 of the Tax Equity Reform Law.

76 See Article 344, Article 349, Article 351, Article 352, Article of the Organic Law on the Municipal System.



All business and industry owners operating within a canton, as well as those who perform any kind of economic activity, are required to obtain a license.⁷⁷ In the Law on the Municipal System, there is no exemption; however, this tax would not apply to CSOs as these organizations are not included in the law. This tax is applicable to economic activities directed at commercial or industrial companies. However, a municipality could eventually claim that an NPO should be required to pay for licenses because it carries out self-financing activities.

Artisans who are qualified as such by the Junta Nacional del Artesano (National Artisan Council) are exempt from this tax. Municipalities require a license for buying and selling a good; in these cases, the non-profit organization must be registered and obtain a certificate even though it does not pay the tax.

e. Tax on profits from purchase and sale of urban property (capital gains)

This tax is 10% of the difference between the property purchase value and the sale value. It functions with some additional deductions that reduce the tax basis and thus the final amount of tax to be paid.

3.3.4 Penalties

Penalties are applied in accordance with the infraction committed; this requires a determination of regulatory violations, breaches, or fraud.

Article 323 establishes the penalties applicable to the infractions, including: fines, closure of the establishment or business, suspension of activities, confiscation, permanent seizure, suspension or cancellation of registration in public registries, suspension or cancellation of licenses and permits, suspension or dismissal from public office, and even prison sentences. These penalties shall be applied alongside the corresponding taxes and delinquent interest, starting on the date the violations occurred.

Failure to observe tax procedures implies:

- Self-declaration fines (when the corrections are made by the organization itself).
- Penalty fines and delinquency interests (when the SRI applies its determination authority).

Organizations are permitted to make corrections up to one year later, when the amounts declared are less than the transaction executed and imply a greater tax, advance payment, or withholding value, as long as the SRI has not already initiated an inspection process or determination process (this enables determination of what is deductible, the way in which the tax must be calculated and the amount of tax).

If the organization does not correct the problem and the SRI uses its determination authority to confirm that tax declarations have not been presented or there are changes, the CSO is subject to all of the procedures established by the authority, as granted by the Tax Code, with the administrative and penal consequences this implies.

Civil society organizations often make mistakes because they do not understand how the laws and regulations are applied, basically in their tax declarations. Table 4 on the next page summarizes these errors and their respective penalties.

3.4 Other relevant laws

In this Legal Guide, we have described the effects of certain important laws, including the Consultancy Law, the Law on the Municipal System, the Organic Customs Law, and the Intellectual Property Law, all addressed under sub-headings 3.2 and 3.3. In addition, there are three other laws related to CSO self-financing activities. These are:

77 See Article 364 of the Organic Law on the Municipal System.



Commerce Code⁷⁸

This law has not been modified since 1960, and as a result does not fit the current reality. However, it has two articles that are worth pointing out: Article 6, related to the right to hire, and Article 7, which describes restrictions on who may not carry out business activities.

Company Law

This is applicable when a CSO seeks to become a shareholder or form a commercial company. The important articles are: Article 1, which includes the legal definition, and Article 114, which refers to the company contract and inspection of the shareholder or company packet.

Table 4: Common errors made by CSOs and applicable penalties

Error made	Form	Fine / penalty ⁷⁹
Did not have any transactions and did not declare.	VAT: Form 104.	US\$ 1.00 for each month if it is a nonprofit organization; US\$ 17.00 if it is a company.
Did not have any transactions and did not declare.	Income tax withholding: Form 103.	US\$ 1.00 for each month if it is a nonprofit organization; US\$ 15.00 if it is a company.
Did not have any transactions and did not declare.	Income Tax: Form 101.	US\$ 10.00 for each declaration omitted (annual).
Had transactions, income and expenses with VAT. Must calculate the tax incurred (offsetting VAT in purchases and sales for the net calculation, while taking into account the respective tax credit).	VAT: Form 104.	The fine is calculated as 3% of the tax incurred, to a maximum of 100% of this tax per month or fraction of a month, for each month.
Had transactions, but no surplus.	Income Tax: Form 101.	0.1% of gross income received by the organization during the period cited in the declaration (per month or fraction of a month), without exceeding 5% of this income.
Non-declaration in any case in which there are transactions and the SRI has begun the determination process.	- VAT: Form 104. - Income tax withholding: Form 103. - Income tax: Form 101.	SRI will charge fines of 20%. ⁸⁰
Noncompliance with formal obligations, contemplated in the Regulation of the Internal Tax Regime Law.		Includes amounts between \$30 and \$1,500. ⁸¹

78 Commerce Code, RO/ Sup 1202 of August 20, 1960.

79 Article 100, of the Internal Tax Regime Law and Resolution 117, issued by the director general of the Servicio de Rentas Internas, has already undergone several changes.

80 Corresponds to the modification of Article 90, of the Tax Code, "...a surcharge of 20% of the principal..."

81 Corresponds to the modification of Article 103 of the Tax Code,

which indicates: "in case of recurrence, they will be punished with dismissal from their position by the maximum authority of the respective tax administration, regardless of the ensuing criminal sentence. The administrative sanction may be appealed in accordance with the *Organic Law of the Civil Service and Administrative Careers and of the Unification and Standardization of Remuneration in the Public Sector.*"



*Law on Cooperatives*⁸²

Cooperatives, which are quite common in Ecuador, are NPOs recognized through the Law on Cooperatives. Their specific characteristics are different from corporations and foundations. They are private companies, formed by individuals or legal entities that, without seeking profit, pursue activities with a social or collective benefit, through a company managed by its members and formed from their economic, intellectual and moral contributions.⁸³

The economic benefits obtained by a cooperative are called *surpluses* and are not considered profits for the purposes indicated in tax and business laws.

Cooperatives are required to distribute their surpluses among their members after balancing their books at the end of the corresponding fiscal year. This distribution is allocated in proportion to the operations or the work done by each member of the cooperative and with the deductions established in the Reglamento General (General Regulation).⁸⁴

The Ministerio de Inclusión Económica y Social (MIES) keeps a registry of the various types of cooperatives. There are about 18 categories, and including the sub-categories, there are about 40 different kinds of cooperatives. This produces a situation in which regulation of cooperatives varies and is interrelated with other laws, depending on the sector where the cooperative operates. This working model has been used for centuries in European countries and demonstrates that collective business activities are a real option for development.⁸⁵

3.5 Process for the declaration of taxes and other legal reports

The tax declaration process is, in general, complex and even more so for CSOs engaging in self-financing activities. All transactions must be registered so as to ensure that funds have not been diverted and the CSO is fulfilling its social mission.

The problem lies in the way in which accounting is done, which may be by project or program, with details about products or services offered, and/or for the products that are subject to VAT and those that aren't. The current situation requires greater professionalism and the use of management, financial, and accounting tools.

CSOs often have at least one person dedicated full-time to accounting, under the supervision of another professional who specializes in financial and tax management for the required payments and tax withholding.

This operational burden is often exacerbated by the need to provide non-accounting information requested by the SRI. Even when an organization has the technology to generate a file with all of the information required by the tax authority, an employee of the organization must re-enter all of the information into the SRI forms.

As explained earlier, CSOs are exempt from paying income tax, as long as they meet all of the formal requirements, including declarations and third-party withholding. Even when there have been no business transactions or the organization is still not operating, it must make the respective declaration.

Although the SRI is the public institution best equipped and prepared to carry out inspections, it does not conduct general inspections in the non-profit sector, limiting its actions to examining large companies and formal institutions. The assumption is that in 2009, the SRI will begin inspections of public benefit organizations with large endowments and organizations that mobilize a significant amount of financial resources.

If a violation is detected, the procedure to be followed, according to the Tax Code, is to verify, amend, or add to the taxpayer's declaration. In doing this, the provisions of the regulation must also be followed. The end purpose is to establish the taxable base and the tax amount.

82 Law N° 2001 - 52. R.O. 400, August 29, 2001.

83 Law of Cooperatives, Article 1.

84 Law of Cooperatives, Article 61.

85 Law of Cooperatives, Article 60.



Chapter VII of the Internal Tax Regime Law refers to the *tax calculation* for income tax payment. There are three options for making the declaration: the taxpayer can do it; the tax authority can do it; or a combination of the two (taxpayer and tax authority).

Now, more than ever, the tax authority has an increased capacity to determine taxes owed. If a taxpayer seems suspicious, the SRI verifies the financial statements, particularly in those cases where companies declare losses but continue to operate in the market and even appear to prosper. It is easier to apply such oversight to foundations and corporations if they do not maintain proper accounts or have misused their legal status.

3.5.1 Tax declaration and other legal reports

Prior to 1996, accounting software systematization was difficult, but due to the SRI's modernization process over the last 10 years, organizations have been forced to make more complex declarations and to endure greater supervision.

Article 96 of the Tax Code identifies the formal duties of taxpayers, including the duty to present information in response to tax administration requests.

The SRI requires entry of monthly transaction records into its Internet information program (DIMM),⁸⁶ per invoice, in addition to the respective tax withholdings forms.⁸⁷ There are now two kinds of transactional appendices: a lengthier one called Anexo Transaccional Simplificado (Simplified Transaccional Appendix, or *ATS*) and a simplified one called *Anexo de Retenciones en*

Compras (Purchase Withholding Appendix, or REOC); CSOs must submit the simplified form.⁸⁸

The corresponding payments must be made to the authorized entities. Generally, these entities are banks, payment services, and some SRI agencies –but only for certain taxpayers with a special agreement.

The monthly deadlines for declaring taxes, withholding, and transactions are determined by the ninth digit of an organization's RUC, which corresponds to the day of the month all year, as indicated in Table 5 below.

Income tax is declared once a year. For legal entities, this was between the 10th and 28th of April last calendar year.⁸⁹

For tax withholding formulas, percentages must be applied in accordance with the determination made by the Servicio de Rentas Internas, in force since May 2008.⁹⁰ This percentage is either 1%, 2%, or 8%.

In general, organizations are constituted as withholding agents. This concept is defined in the Internal Tax Regime Law and its respective regulation.

3.5.2 CSO Accounting

A crucial aspect of the formal obligations of a CSO is its accounting, particularly if the CSO engages in a self-financing activity. To keep accounting records, organizations must follow current accounting rules, keeping in mind that as NPOs they may not generate any profit to be distributed

Table 5: Tax declarations by date, according to the RUC

RUC	1	2	3	4	5	6	7	8	9	0
Date	10	12	14	16	18	20	22	24	26	28

86 A detailed list of local purchases, imports, local sales, export.

87 Form 103 for income tax withholding and Form 104 for declaring VAT.

88 SRI Resolution 1319, RO 244, January 3, 2008.

89 Form 101 for income tax declaration.

90 Resolution N° NACDGER2008-0512, published in the Official Record 25 N° 325 of April 28, 2008.



among members. If there is a surplus, this must be reinvested in the social mission.

Apart from that, however, there is no difference in terms of accounting between for-profit and non-profit organizations. In fact, an organization with several kinds of self-financing activities will have accounting procedures that are just as complex as those for-profit companies.

According to the Internal Tax Regime Law, organizations must do double-entry bookkeeping, in Spanish and in US dollars, following the Normas Ecuatorianas de Contabilidad (Ecuadorian Accounting Standards, known as NEC), and International Accounting Standards for areas not included in Ecuadorian standards.

If an organization manages its programs and projects with private donor funds or funds from multilateral or bilateral organisms, accounting must be per project, to provide donors with the maximum transparency, and also to reflect the impact on and number of beneficiaries, with social indicators for each initiative.

In accounting, there is a discussion regarding *what* should be recorded as a asset and *what* should be recorded as income. The list of assets must contain accounting records for contributions from members of the organization, although membership fees are counted as income; the same occurs with donations, the balance of which remains in assets (cash) if it is liquid; and in real estate and other property, if they are hard assets. Normally, the donation agreement establishes how such property will be accounted for and what treatment it will receive at the end of its useful life or the end of the project, stipulating if it may or may not be sold by the organization.

Occasionally, donations are received in the form of medicine, food, and other kinds of products which are immediately delivered to the organization's beneficiaries. In these cases, the organization should maintain a record of memorandum accounts (temporary accounts). If these donations are large and

the organization will administer them, they must be directly accounted for as assets.

Organizations that maintain an emergency or reserve fund must record this value as part of assets. Depending on the nature of the fund, it may have to be reinvested during the year following its creation. For example, if this fund was created from extraordinary donations, it may remain within assets, without having to reinvest it. However, if it was created from the organization's self-financing income, it must be reinvested within one year; failing that, the organization must pay income tax on any accumulated interest. A good tax reform measure would be the possibility of NPOs maintaining a certain percentage of reserve funds without having to pay taxes.

Nonprofit organizations, as taxpayers exempt from paying income tax, must meet all formal requirements, be subject to SRI oversight, make proper declarations, and inform the SRI on a monthly basis regarding executed transactions.

If an organization has a self-financing activity that is a separate legal entity, this entity is subject to the Law of Companies and must pay all relevant taxes, applying income tax deductions found in Article 10 of the Internal Tax Regime Law, discounting also any losses, depreciation, and payments made abroad.⁹¹

There are specific products and services that are not subject to VAT or are taxed at a rate of 0%; these may be domestic or imported products.⁹²

If because of its self-financing activity, an organization must use some of these products or services, or transform them or sell them, it must also maintain separate accounting for purchases subject to a 12% VAT rate and those subject to a 0% rate; the same must be done with sales invoiced at the 12% rate and those invoiced at the 0% rate. VAT offsetting purchases and sales generates a tax credit; the same occurs with exports,⁹³ which makes it easier to make declarations and tax payments.⁹⁴

91 Articles 11, 12 and 13 of the Internal Tax Regime Law.

92 Articles 54, 55 and 56 of the Internal Tax Regime Law.

93 Internal Tax Regime Law, Article 57 tax credit for export of goods.

94 Internal Tax Regime Law, Article 63 taxpayers of VAT, Article 64 tax invoicing, Article 66 tax credit, Article 67 tax declaration.



3.6 Knowledge required to undertake self-financing activities

Civil society organizations interested in engaging in self-financing activities need to understand the Internal Tax Regime Law and its regulation. They must also understand how to carry out specialized accounting for these activities. In general, few organizations have an expert in financial and tax strategy on staff; normally, organizations lack adequate and timely information about the requirements they must meet.

Civil society organizations need to have in-house capacity or external support to guide them in these decisions. For example, some accountants register donations as income, when depending on who the donor is, these could be resources that contribute to the organization's endowment or assets. This means that, in accounting terms, the transactions may have been recorded but not with a strategic criterion in mind.

Outside the tax realm, when organizations sell branded products or services, they are often unaware of the advantages or disadvantages of intellectual property. If they use trademarked brands or products, they may be subject to penalties, including prison.

One way to determine how to complete unfamiliar procedures is to network with organizations that fulfill similar functions. Until now, those most knowledgeable on SRI tax declaration issues are domestic and international NGOs, as they operate a variety of programs and some provide assistance to national or local CSOs. These NGOs can share their experience and advice. The Fideicomiso Ecuatoriano de Cooperación para el Desarrollo (Ecuadorian Cooperation Trust for Development, known as FECD),⁹⁵ for example, has expressed its desire to assist the organizations it works with in this area.

The same is true of NESST (www.nesst.org), a CSO that works to promote the sustainability of civil society organizations, specifically in issues of self-financing and social enterprise. NESST has been working in Ecuador since 2008.

In regard to legal counsel, there are practically no lawyers in Ecuador who specialize in CSOs. This is because there is no specific legislation for CSOs that addresses the complex reality of self-financing.

The lawyers consulted for this guide mentioned the following consultants with some degree of specialization in this area:

- *Dret Consultores*. Its Law for Development unit consults with CSOs and institutions that work in the area of microfinance (www.dret.com.ec).
- *Pérez Bustamante and Ponce Abogados*. This law firm specializes in corporate and tax issues (www.pbplaw.com).
- *Alberto Wray*. Specialist in issues of arbitration, labor, and nonprofit organizations.
- *Dr. Fabián Corral*. Dean of the Faculty of Law at Universidad San Francisco, with experience in business, corporate, and tax issues (www.frsfco.utn.edu.ar).

In Ecuador, unlike other countries, the concept of pro bono services is still not widely used. There are some law firms that have provided pro bono services for specific cases, but these services do not translate into potential tax deductions. Partnerships are also an alternative for sharing the cost of consulting services provided by accountants, financial advisors, lawyers, customs agents, as well as consultants providing business performance, income-generation, and market study services.

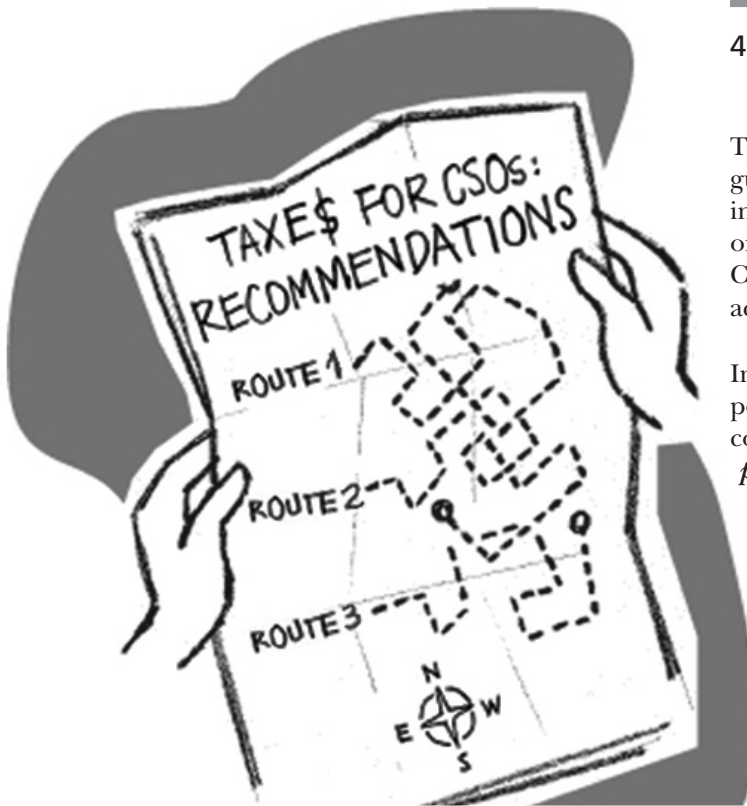
⁹⁵ The FECD is focused on a sustainable way of improving the living conditions of vulnerable groups in Ecuador through integrated development proposals based on building local capacities, understood as what the people have, know, want, and are capable

of doing, to strengthen local development projects. This implies direct public participation in assuming the management and decision-making of their own development proposals. Another option it provides is legal and tax advising. www.fecd.org.ec.





Interpretation of and Recommendations for the Ecuadorian Legal Framework



4.1 Interpreting the legal framework in accordance with ICNL

The observations contained in Chapter 3 of this guide, which analyzes the legal and tax regulations in Ecuador, lead to interesting conclusions based on ICNL concepts, which are useful to Ecuadorian CSOs in the development of self-financing activities.

In terms of the criteria that make self-financing possible, Ecuador has a hybrid model that combines the *destination-of-income* and the *principal-purpose* test.

The focus that has been applied in the country is that of *destination-of-income*. This focus indicates that CSOs that engage in business activities, to qualify as nonprofit organizations, must put all of their earnings toward fulfilling their nonprofit purposes. In this sense, the legislation ignores the economic or commercial nature of the activity in question and concentrates solely on the purposes that determine the use of the income generated by the activity.

Thus, in the case of Ecuador, according to the legislation, foundations and corporation may engage in commercial activities provided that the profits are put towards the organizational mission and objectives.



On the other hand, this is not a sufficient condition. When organizations seek registration with oversight organisms, their bylaws must clarify their objectives. It is in this stage that Ecuador is restrictive in accordance with the *principal-purpose* test, since the bylaws must clearly state that self-financing will be destined to mission fulfillment and is not the main activity of the organization. This test provides a legal model for regulating NPO self-financing. It does not prohibit the use of self-financing activities, but rather emphasizes that the NPO is established and operated primarily for nonprofit purposes and not for private gain.

Although in Ecuador there is currently no policy or specific law to regulate a CSO's business activities or self-financing activities, the tax regulation authority –the SRI– evaluates if CSOs are actually putting their goods and income toward their specific purposes, and if they are doing so with all of their resources or only with a percentage of them.

According to the ICNL legal framework, Ecuador uses the destination-of-income tax test, which exempts CSOs from paying all the profits obtained from business activities, provided they are invested in the public benefit. Until now, the Tax Regime Law has not focused on the origin or source of income (specifically for income originating from commercial activities), but rather generally establishes the tax exemption for NPOs and those organizations dedicated to the public benefit, whose profits have been destined towards specific and exclusive purposes in the country, provided that this income or revenue is not distributed among members for for-profit purposes.

In Ecuador, whether an organization may engage in some type of self-financing activity is determined at the ministerial level. In some cases, ministries do not permit certain non-mission related activities. Thus, these CSOs may be subject to a source-of-income tax policy, where the tax exemption is applied only when income is the product of activities related to the public-benefit purposes of the organization.

Under this approach, the organization is taxed for all income generated from non-mission-related

activity even if the income is used to support mission-related programs.

The relationship of the Ecuadorian legal framework with the ICNL criteria lies in how these criteria have been applied in the law and not directly to the definition of the criteria. There are exceptions to tax treatment for certain cases. These cases are analyzed individually by the oversight organisms.

4.1.1 Design of the current regulatory framework

Because there is no organic or special law for CSOs, there is a heavy dependence on regulations and a CSO's own bylaws. Although this gives organizations a relative degree of freedom, it also allows the authorities to act with a certain level of discretion; as a result, it is essential that there be discussion and clarification of some concepts that need to be incorporated into the legal framework, such as:

1. Clarify meanings and terms: Currently, all of the following terms are used as synonyms: nonprofit organizations, public-benefit organizations, non-governmental organizations (used nowadays to refer only to foreign organizations), third sector, and the most recent term incorporated in Decree 982, civil society organizations. Assessed at a more operational level, it is not so clear that these terms mean the same thing. Table 6 on the next page includes the classification used in the abovementioned decree and other special laws.

Although Decree 982 clearly divides corporations into first-tier, second-tier, and third-tier organizations, once such definitions have been clarified, the abovementioned organizations can be more clearly defined and categorized.

2. Address the explicit recognition that *non-profit and public-benefit* organizations have the right to carry out commercial activities as a self-financing mechanism to fulfill their social mission and cover administrative and operating costs and, if the case may be, to generate a surplus that may be reinvested into the social purpose of the organization.



3. Debate and clarify the concepts and issues related to commercial or economic activities among civil society organizations and clarify the regulatory framework in relation to these issues.

Currently, the Regulation of the Internal Tax Regime Law establishes the requirement that between 5% and 15% of a CSO's resources must come from donations. The impact of this measure will depend on the size of the organization's

Table 6: Classification of organizations, according to Decree 982

Type of organizations	Nonprofit	Public benefit	
		To its members	To society in general
Foundations	x		x
Corporations	x	x	
Associations (F.T.) ⁹⁶	x	x	
Clubs (F.T.)	x		
Committees (F.T.)	x	x	
Professional associations (created under special laws) (F.T.)	x	x	
Centers (F.T.)	x	x	x
Federations (S.T.) ⁹⁷	x	x	
Chambers (production, commerce, etc.) (S.T.)	x	x	
Confederations (T.T.) ⁹⁸	x	x	
National alliances (T.T.)	x	x	
Other organizations (Special Laws)	x		
Rural communities	x	x	
Unions and employer organizations	x	x	
Cooperatives	x	x	
Mutual associations	x	x	
Securities exchanges	x		
Credit-guaranty corporations	x		
Political parties	x		

96 (F.T.) = First tier. Group of individuals.

97 (S.T.) = Second tier. A group of first-tier organizations.

98 (T.T.) = Third tier; a group of second-tier organizations.



budget. The higher the level of income, the higher the amount of donations that will be required. The law implicitly recognizes that these organizations may make use of other financing mechanisms, including self-financing.

With respect to the payment of taxes, the only generalized exemption that applies to these types of organizations is the exemption from paying income tax. While the Tax Code makes reference to "...private institutions and associations, charitable or for education...", there is greater detail in the Regulation: "...private, nonprofit, legally constituted (...) either religious, charitable, for support and development of women, children and families, cultural, art, educational, research, health, sports, professional, guilds, classist (refers to labor and artisan unions), political parties, municipal, indigenous peoples, cooperatives, federations and confederations of cooperatives and other peasant and small farmer associations, legally recognized, provided their goods and income are used for their specific purposes and meet the formal obligations contained in the Tax Code".

The situation for cooperatives is specified and restricted in the following way: "...the only cooperatives, federations and confederations of cooperatives, and other associations whose income is exempt are those made up exclusively of peasants and small farmers, these being understood as those whose income is below the levels established for individuals required to keep accounting records. Thus, other types of cooperatives, such as savings and loan cooperatives or housing cooperatives, are subject to income tax".

Irrespective of the type of the work that CSOs engage in, to be exempt from taxes, these organizations must be formed as legal entities and guarantee the *destination-of-income*, that is, that the goods and income are used for specific purposes.

The initial conclusion is that:

- The Ecuadorian legal system has not explicitly considered civil society. This sector has evolved in response to actions taken by the business and government sectors and international cooperation agencies, without defining mecha-

nisms or actions that would empower its work in the social arena.

- Although enacting a special or organic law for these organizations would not solve all of the problems faced by CSOs, at least it would regulate with greater clarity and autonomy the large universe of entities that are *public benefit* and *nonprofit*. In addition, such a law could explicitly permit the use of self-financing mechanisms.

There is ambiguity and a highly discretionary interpretation of the law with respect to economic or self-financing activities carried out by CSOs, because the concept has not been legally defined.

As a result, they are left to the interpretation of a government authority and his or her opinion regarding self-financing activities among CSOs and whether s/he regards them as an efficient and self-managed alternative for sustaining organizations over time, without confusing this concept with commercialization or the generation of profit for its own sake.

In response to this ambiguity, some foundations have formed a company or corporation where the founders are shareholders, in order to enable the *business arm* of the organization to function autonomously and independently from the organizational structure of the foundation. In other cases, the self-financing activity has been created as part of the same CSO.

4.1.2 How other sectors view Ecuador's CSOs

In Ecuador there are almost 33,000 CSOs, of which around 11,500 present financial reports to the SRI and approximately 7,000 are registered with the Ministerio de Inclusión Social y Económica.

To understand why there has been an increase in the growth of CSOs, we highlight some of the causes that have motivated their creation over the past 50 years:

- The need to organize and strengthen civil society. Many people have worked hard to



promote legal reforms and inclusion processes for women, children, people with disabilities, and indigenous peoples and nations. In the 1990s, the indigenous movement was able to gain representation in various institutions and in the political arena.

The recent oversight role⁹⁹ of civil society with respect to the public sector, which responds to popular participation processes that demand transparency in government.

- The response to international cooperation requirements regarding the participation of CSOs as counterparts or local executors in carrying out social projects.
- The diversion of resources from the business sector to the nonprofit sector in order to reduce their tax payments. This implied that some companies created foundations in order to transfer their resources as donations and avoid paying income tax. Companies were able to deduct the donation and there was no follow up process to verify if the surplus was actually reinvested in charitable activities or in the social purpose; either way, they were eligible for income tax exemption.
- Some civil society organizations have assumed consulting projects as a way to generate revenues.

This has sometimes led to organizations being founded with multiple social objectives in order to expand the possibility of participating in projects promoted by a variety of stakeholders, and not necessarily with the goal of seeking and proposing solutions to the country's most serious social problems.

Perceptions of CSOs are quite varied. There is a growing trend among grassroots groups that organized in order to improve their living conditions through activities that strengthen local capacities, as well as to better understand the market and the need to respond to existing demand. These groups are well-received.

In some cases, the beneficiary group is made up of the founding members themselves. In other cases, the organization works for the public benefit in response to specific consulting opportunities. Some organizations are set up to serve a specific niche with certain products and services. Others have expanded and diversified their target group and the products and services offered, in order to increase their chances of sustainability.

There are also unions or associations that have political representation or influence and are needed to organize diverse groups and sectors. However, within this group there are some organizations that are not always considered to be working for the public benefit, although they engage in activities that do not have a for-profit purpose.

Finally, there are public corporations and foundations, formed with the participation of local governments or other state entities. These have come under criticism from the central government, which has accused them of being simply a mechanism used to avoid application of the Ley de Contratación Pública y de Licitación (Public Contracting and Tender Law).

This diversity of forms and activities has had a negative affect on the authorities' perception of the work carried out by CSOs, which has led to tougher regulations, such as increased oversight and application of sanctions and penalties for those organizations that do not comply with the laws.

Certainly, there are no legal or regulatory prohibitions that would impede the work of CSOs; nor, however, is there effective oversight by the authorities that would enable an evaluation of the real impact created by these organizations. Changes are occurring that could be considered opportunities and should be leveraged.

Civil society organizations can no longer delay the need to work and interact in a systematic way, especially because of the new government policy related to international cooperation, which will directly affect CSOs.

99 Equivalent to a civil society inspection process.



Only recently are mechanisms being defined to coordinate the work of the central government, local governments and international cooperation. A proposal has been made that international cooperation should support priority social goals, as defined by the government, through the Secretaría Nacional de Planificación y Desarrollo (SENPLADES). There are eight strategies, 12 objectives, 118 policies, 600 government strategies and 94 government goals in the Plan Nacional de Desarrollo (National Development Plan) for 2007-2010. This system is related to the millennium goals.

Within objective 5, Policy 5.6 mentions the need to "...adapt international cooperation as a complement to social, productive, and environmental investment". This means that international cooperation can complement, but not replace, government action and that the resources must be used in projects that are a priority for the country. For this, the government has developed an Agenda Nacional de Cooperación (National Cooperation Agenda) which also includes the Plan de Desarrollo Productivo, Social y Ambiental (National Productive, Social, and Environmental Development Plan).

However, the oversight mechanisms and tools to demonstrate transparency and guarantee the investment of resources in public benefit areas have yet to be developed. It is important that NPOs begin to truly specialize and that they form networks that will enable them to act and interact with the state in the implementation of this national plan.

4.2 Implications of the regulatory framework in public administration

There is no policy or law that regulates a CSO's commercial or self-financing activities.

Due to the *destination-of-income tax* approach, the tax authority – Servicio de Rentas Internas (SRI)— will begin a much more exhaustive oversight system, and will have to develop a human resources unit that has the capacity to verify if CSOs are or are not effectively eligible for the income-tax exemption, by evaluating whether their property and all of their income goes toward their specific pur-

poses, or only a percentage of them. This requires that CSOs pay more attention to the requirements of the authorities and the development of internal oversight mechanisms and systems; for the SRI, this prepares it to provide CSOs with the support they need to clarify any doubts that may arise regarding these requisites.

To do the above, the SRI also needs to hire and train new personnel to address the challenges brought about as a result of recently approved regulations. This is essential to promote transparency and mutual trust.

However, it will be some time before the oversight authorities have the personnel and information required to focus their efforts on these areas.

4.2.1 Simplicity or complexity of administration

The level of complexity for the tax authority is moderate, but for CSOs it implies a high degree of complexity and difficulty in reporting.

The current registration and reporting system for nonprofit and for-profit organizations are identical and are geared exclusively toward tax collection. The information required by the SRI must be presented in digital format or be entered directly into the software provided by the oversight entity online.

As aforementioned, the legislation makes no reference to CSO commercial activities, only to the oversight of the institution's objectives and the reinvestment of any surplus into such objectives, which implies a greater degree of verification.

On the other hand, the new regulations should standardize the information collected by the SRI, making it more transparent and facilitating an increased awareness of CSO activities.

The problem that remains unresolved is that ministries require the submittal of various types of reports, such as balances, work plans, projects; but they do not all require the same information, nor in the same format. This is exacerbated by the lack of systematization and automation of these entities, which hinders inspection and monitoring, as well as constructive feedback to the CSOs.



4.2.2 Effects on tax collection

It is hard to draw any conclusions about the SRI's collection of taxes from the third sector, because this is a recent issue in Ecuador. Until now, the topic has only been analyzed superficially. The SRI is planning to develop and improve regulations for overseeing CSO operations.

Given that CSOs do not pay income tax, if biased rulings on the part of the tax authorities can be avoided, the expectation is that tax collection from commercial activities would be low.

4.2.3 Effects on the commercial sector

It is important to assess whether existing tax laws and regulations currently give civil society an advantage over the commercial sector, creating a tax benefit for CSOs that could be the basis of unfair competition.

In general, the law that regulates commercial activities –the Commerce Code– has not been updated. The last change was made in 1960, and the basis of the original text dates from the beginning of the 20th century. It stipulates that any person –individual or legal entity– with the right to enter into contracts is free to engage in commercial activities, according to the Civil Code. Cases where this has been prohibited are rare and explicitly indicated in the law.

Based on these regulations, the tax laws are really what differentiate the treatment of the commercial sector versus the nonprofit sector. Although the principle of tax neutrality should prevail,¹⁰⁰ under the destination-of-income, it is unlikely that an organization that fulfills its social mission will be required to pay income tax.

Thus, CSOs that engage in self-financing activities could benefit from unfair competition. In practice, however, this does not occur, since the target group of CSOs are the poorest and most vulnerable sectors of the population, which in most cases are not a target niche for commercial companies.

The tax benefits or exemption from taxes do not include exemption from paying tariffs or contributions, and when organizations create separate companies with a social purpose, these are subject to the regulations of the commercial sector. As a result, there are really very few areas where a situation of unfair competition between the for profit sector and civil society organizations practicing self-financing could actually exist.

4.2.4 Effects on the development of civil society

In general, the Ecuadorian economy is characterized by a bipolarity between the government and the private sector. When the government has tried to regulate the for-profit sector more efficiently, the third sector is usually affected negatively. The elimination of deductibility of donations, for example, was intended to control the diversion of resources from the business sector, but in fact it affected the organizations that were recipients of these resources and managed them responsibly.

This brings up the need to strengthen the visibility and transparency of CSOs with a law that promotes better organization of these organizations, with clear guidelines about internal structure and governance, and guarantees that organizations pursue their mission in an ethical and responsible manner.

It would be helpful to allow CSOs to generate surpluses, without losing their *nonprofit* status, since they achieve this classification by creating and providing for the public benefit, and use these surpluses to further carry this out.

Currently, there are three entities or authorities that have influence over the regulation of self-financing activities:

1. The pertinent ministry, which approves and grants legal status.
2. The SRI, for oversight of compliance with tax obligations.

100 In other words, that don't seek to affect positively or negatively any specific sector or stakeholder, since the objective is to maintain impartiality in economic activity, without giving an

advantage or disadvantage to anyone, while also generating income for the state.



3. The Contraloría General del Ecuador, to oversee the use of public resources. This organism is included here as an oversight entity but has yet to exercise any functions related to CSOs.

In the first case, the ministry must verify the organization's documents; the fulfillment and description of its objective and mission, related to the public benefit; the registry of the board of directors; and the list of members. In the second case, the SRI has the authority to check the fulfillment of the objectives of CSOs and when a CSO has a surplus, it must verify that this income is reinvested in the purposes for which the organization was created.

It is here that conflict arises, because the SRI verifies what each ministry approves. This means that if an organization wants to engage in self-financing activities, such activities must be described along with the organization's mission. Moreover, according to the opinions of some officials who were interviewed, the mission itself should state that the organization will engage in self-financing activities.

In applying the law, three types of situations could occur, depending on the interpretation of the law by ministerial officials and depending on the way in which they believe the social mission and bylaws should be approved:

1. Include that for the fulfillment of the mission, the organization shall engage in self-financing activities, the results of which will be used to reinvest in the organization's objectives and guarantee its sustainability – thus, the *destination-of-income tax* policy would apply in terms of taxation.
2. State that self-financing activities are permitted as long as they are associated with the concept of public benefit (mission-related).
3. Prohibit them.

Table 7 on the following page includes a more detailed analysis of the regulation of self-financing activities and the strategies that can be applied.

In the second case, without the tax authority having proposed it, the principal-purpose approach would be incorporated.

In terms of prohibiting and/or restricting CSO self-financing activities, NESsT considers that this is not a good regulatory practice, because it limits the sustainability of the sector.

Although there are CSOs that have taken advantage of certain applications of the law and/or do not fulfill their social mission, it is important that the law be general and impartial, and that organizations that do indeed make good use of self-financing and fulfill a social purpose are not punished to the point that their survival is jeopardized.

It is likely that the draft CSO law will include a toughening of restrictions on CSOs, because the government is generally suspicious of their non-profit status. This has resulted in greater oversight of CSO activities. In this context, NESsT considers that in the case of non-mission-related commercial activities, there could be a combination of the *destination-of-income tax* with limits on earnings, a threshold above which an organization would pay taxes. This would enhance trust on the part of government authorities and further strengthen the use of mission-related activities.

Increased use of formal procedures to verify which and how many organizations are really working in areas related to the public benefit should serve as an incentive for the sector. On the other hand, certain regulations have been implemented that could be considered *entry barriers* for its participation, as the asset requirement was increased from US\$ 400 to US\$ 4,000 for second- and third-tier organizations.



Table 7: Applying the law in the regulation of self-financing activities

	Ministry	SRI	Self-financing activity	Possible strategies	Recommendation
1	Allow self-financing activities as an option for generating resources that will be invested in the organization and its objectives. These may or may not be mission-related.	The destination-of-income approach would apply in order to determine if the organization would pay income tax.	Products and services that may or may not be related to the mission of the organization could be sold.	<p>The first option would be to sell products and services to beneficiaries (the CSO's target group) at affordable prices.</p> <p>In addition, other strategies may be included, such as:</p> <ul style="list-style-type: none"> - Diversification of market niches: clients that pay for the service may have different payment capacities. In this case, a sliding scale can be used. - Diversification of activities: selling non-mission related products or services to various groups. 	A limit on income from self-financing activities that are not mission-related could be recommended.
2	This permits self-financing activities, but only those related to the mission and objectives of the organization.	The destination-of-income approach and the principal-purpose approach would apply.	Only mission-related products and services may be sold.	<p>The first option would be to sell products and services to beneficiaries (the CSO's target group) at affordable prices.</p> <p>Other income-generation strategies would be:</p> <ul style="list-style-type: none"> - Diverse market niches: clients that pay for the service may have different payment capacities. A sliding scale may be used. - Diversification of products and/or services: selling directly mission-related products or services to various groups. 	Formulate the organization's mission with a broad focus in relation to the specific objectives of the CSO.
3	Inclusion of self-financing activity in the bylaws and social mission of the organization is not allowed.	The destination-of-income approach would apply in order to maintain the income-tax exemption.	Form an independent legal entity, but with a social approach, with normal payment of all taxes.	<p>Within the CSO, the only self-financing alternatives would be training and consulting in mission-related areas.</p> <p>If an independent legal entity with a social focus is formed, the self-financing activity could be broader, either mission-related or not and any surpluses could be recorded as a donation to the CSO.</p>	Create incentives for donations. The government has a limited capacity to cover the specialized areas of CSOs and the disadvantaged groups they serve. Therefore, the impact of these organizations should not be underestimated. Some type of incentive should be created to promote assistance between the private sector and civil society.



4.3 Limitations of the legal and regulatory framework

4.3.1 Limitations of the general regulatory framework that governs CSOs

As has been explained, the legal framework lacks clarity, there is no defined law for CSOs, nor is there an explicit regulation on self-financing or the development of economic or commercial activities in the third sector. Although the law neither prohibits nor provides incentives for carrying out self-financing activities, until now this term has not been used, nor has there been explicit recognition of this in CSO bylaws.

In compliance with recent reforms, organizations will be required to modify their bylaws and describe the activities they engage in.¹⁰¹ Whether or not an organization carries out self-financing activities, this change in bylaws is not a simple process, since the lack of computerized records in the ministries produces delays and bureaucratic processes that require the presentation of several documents¹⁰² that have already been submitted for the initial approval. In addition, the organizations will be dependent on the discretionary interpretation of the authorities.

There are no flexible options in terms of sources of income.¹⁰³ For example, donations are not deductible for donors; however, private, nonprofit organizations (foundations and corporations, in their many forms) are required to obtain donations that comprise between 5% and 15% of their annual budget, depending on the size of each organization's budget. Organizations that work in several regions in the country, or in several provinces, will clearly encounter greater difficulties because their budgetary requirements will be higher.

In the case of in-kind donations from abroad (which represent a decreasing percentage of CSO income sources in Ecuador), the bureau-

cratic process for importing these without paying tariffs takes approximately two months. From the moment in which foundations and corporations develop public-benefit activities, the current time restriction on using donated products, which may be used in an emergency or simply for daily activities in assisting vulnerable groups of people, has consequences that have not yet been efficiently addressed by the state.

If a CSO generates income from consulting projects, it must provide significant financial guarantees. This, coupled with waiting periods for payments from the state, may generate liquidity problems that cannot be easily covered by credit or by member contributions.

Loans may constitute a source of emergency financing, however, financial institutions require a permanent source of income or cash flow when assessing CSO creditworthiness, which is difficult for these organizations to demonstrate. In addition, the debt limit of up to 300% of assets must be taken into account.

The alternative of creating funds to be used in times of crisis or lack of liquidity is limited by the legal framework itself, which indicates that *property and income* must be used for the *specific purposes* of the organization within a maximum period of one year after being generated. In other words, organizations have little freedom to consider financial strategies that would help them through difficult periods. Some organizations have proposed the option of forming a trust account to cover administrative costs. However, the difficulty lies in the fact that the trust would need to be part of the organization's purpose, which is unlikely.

The Ministerio de Inclusión Social y Económica has formed a special unit to address fair trade, which is an alternative for self-sustainability for grassroots or nonprofit organizations. The hope is that this opportunity will open the possibility of a law that addresses CSO self-financing in its various forms.

101 Decree 982 and Regulation of the Internal Tax Regime Law.

102 The assembly act in which the bylaw reform is approved, a copy of the codified bylaws with the incorporation of the reforms

and all documentation required by the Regulation.

103 Decree 982 asks that the sources of income be included along with the specific objectives and purposes of the organization.



The last legal limitation was included in Mandate 8, approved by the Constituent Assembly. All persons who work on a professional fee basis or consulting basis within an organization, but who can be verified to be working permanently, month after month, must be hired as permanent employees, with all of the benefits provided by the law. There is no hourly hiring option; the only alternative is to hire on a part-time (half-day) basis. Although the mandate is meant to protect workers and ensure that they receive benefits, it also increases costs and difficulties for organizations, especially those that carry out consulting projects using personnel paid on a fee basis.

4.3.2 Limitations in the regulations that apply to CSOs with respect to commercial activities

As mentioned earlier, in Ecuador the legal framework does not explicitly state that the nonprofit sector can carry out self-financing activities. Nonprofit organizations are protected under the very general definition contained in the Commerce Code: organizations that have the capacity to enter into contracts, according to the Civil Code, also have the right to engage in commerce.

Also, because the Regulation of the Tax Equity Law specifies that between 5% and 15% of NPO income must come from donations, it implicitly allows self-financing as an option.

The ministries should explicitly allow the establishment of self-sustainability strategies, such as the development of self-financing activities and not require that these necessarily be included in the organization's purpose. Recovery of program costs should be considered a direct investment in an organization's purpose and mission as it is in many cases the only way to further its projects. Non-mission related activities should be allowed, but limitations in the level of revenues that are tax exempt should be considered.

Products or services can also be trademarked with the Intellectual Property Institute, wherein each

time the *brand* is used it generates royalty income. However, this alternative would eventually generate a tax burden.¹⁰⁴

If an organization has physical space to rent out, for training courses or other activities, the tax law and regulation specify that the income tax exemption applies if the property and income are used toward specific mission-related purposes and only to the extent that they are directly invested toward such purposes. For example, if the organization has not specified training events among its objectives, it would not be able to make use of this option.

Among the income-generating options, one financial strategy is investment dividends, but the limitation here is that organizations seeking to create a fund for times of crisis must justify the fund to the SRI. However, in general terms, the formation of an emergency fund, or of an investment fund that provides income for the organization (through a trust or other option), is not permitted. This limitation is unfortunate. Such an investment fund would be a beneficial alternative for partially covering expenses, particularly administrative expenses, which neither donors nor public or private stakeholders working in partnership with the third sector are willing to support.

Membership fees, unlike before, are now subject to VAT and are also not exempt from income tax if the annual fees are US\$ 1,500 per member or higher. In addition to VAT, fees for exclusive social clubs such as golf, tennis, equestrian or similar clubs are also subject to the tax on special consumption (ICE).

Of all the initiatives mentioned, the sale of products and services has the fewest limitations.

4.3.3 Limitations to the regulations that apply to CSOs with respect to taxes

In order to be exempt from income tax, organizations must use their property and income for specific purposes. If any part is invested in

104 Withholding at the source is done by those who act as withholding agents, but such withholding is nothing more than an "advance payment of income tax".



something outside the organization's specific purposes, income tax applies to that amount. The difficulty here is in identifying what is and isn't covered under such purposes.

Among the possible legally formed organizations, the regulation identifies *charities*. Environmental and human rights organizations could fall within this group, although they are not explicitly described.

Organizations that engage in self-financing activities do not have to pay for municipal permits, nor the tax of US\$ 1.50 for each thousand dollars of their total assets, which applies to all for-profit companies.

There are no general VAT exemptions for CSOs, but there are certain products that are exempt or subject to a 0% rate and therefore produce a benefit for individuals or legal entities that purchase or sell these, regardless of whether such individuals or entities are part of civil society.

There are certain legal gaps that prevent or hinder the proper implementation of existing regulations. For example, organizations that assist people with disabilities and sell related products must charge VAT on those products, and subsequently, the beneficiaries must request a VAT refund from the SRI, regardless of the provision stating that people with disabilities do not have to pay tax on certain products.

The same is true when organizations import tariff-exempt products, which is quite common in the fields of health and agriculture. Despite the existence of the explicit legal provision, there are no categories of specialized (health) products included in the description of product codes for import tariffs, and consequently the explicit legal condition is lost and taxes must be paid, increasing the cost of a product aimed at vulnerable, low-income groups.

The regulatory framework should incorporate the conditions needed to make the few benefits that exist more effective. In practice, government entities –Customs, the SRI– have not found a

mechanism that keeps costs down and doesn't produce a negative impact on the groups mentioned.

4.3.4 Limitations of other laws

The overall ambiguity of the regulation becomes more evident in relation to international non-governmental organizations, whose authorization and recognition falls to the Ministerio de Relaciones Exteriores, while they are overseen and monitored by the Agencia de Cooperación Internacional (AGECI), as guiding body of the Sistema de Cooperación Internacional, an entity created to replace the Instituto Ecuatoriano de Cooperación Internacional (INECI) and which is part of the Secretaría de Planificación para el Desarrollo (SENPLADES).

4.3.5 Limitations in the tax declaration process and other reports

As CSOs diversify their activities and increase their focus on self-financing, accounting and tax procedures will become more complex. Not only will it become increasingly necessary for CSOs to provide clear and transparent information, but also to have personnel with experience in business management.

If the Tax Administration determines that organizations are not complying with the requirements described by law, for any reason, they must pay taxes and lose all exemptions. They may only recover their income tax-exempt status in the fiscal period in which they meet all requirements established by law.

4.3.6 Limitations in the knowledge required to engage in commercial activities

Civil society organizations still have limitations, both legal and in terms of access to assistance in several areas: tax, financial, business and marketing, among others.

Organizations often have very specific and specialized knowledge in the area in which they work but do not have the complementary administrative tools they need.



4.4 Case studies on important issues in the regulatory framework

This study has chosen two Ecuadorian associations to illustrate the current regulatory framework and the capacity for complying with its requirements in practice. Below is a brief description of each institution and its self-financing activities, followed by a summary of the legal aspects that affect their development.

4.4.1 CAMARI - Sistema Solidario de Comercialización del Fondo Ecuatoriano Populorum Progressio (FEPP)

The Organization

CAMARI was founded in 1981 as a business unit of the Grupo Social FEPP, and therefore in SRI records it appears under the same taxpayer registration number (RUC). The Fondo Ecuatoriano Populorum Progressio (FEPP) was recognized by the Ministerio de Gobierno as a nonprofit organization in 1970.

FEPP promotes business development among agricultural producers, indigenous people, Afro-Ecuadorians and mestizos and low-income, marginalized urban populations who have succeeded in organizing themselves. FEPP offers them credit, training, and technical assistance to promote integrated, sustainable, and autonomous development, contributing to societal change and promoting hope, justice, peace, and well-being. CAMARI is a system of sustainable commerce based on the principles of Grupo Social FEPP and the principles of fair trade. Its goal is to contribute to improving living conditions for small producers by guiding the production and marketing of their products, while at the same time satisfying the demand for quality from domestic and foreign clients.

The work of CAMARI is geared toward ensuring that the earnings of its beneficiaries go, in part,

toward promoting and improving production as well as community needs such as: education, public health, social and cultural investments, employment for partners and cooperation with other similar groups. In addition, CAMARI promotes the empowerment and participation of members and organizations in decision-making, providing incentives for work in the production chain and emphasizing mutual trust between the producer, the fair trade organization, and the consumer.

Today, the universe of suppliers who are CAMARI beneficiaries totals 8,200 small-producer families¹⁰⁵ from second-tier organizations, grassroots and individual-producer organizations, as well as organizations representing rural and marginal urban communities, located in 18 of the 24 provinces in the country.

CAMARI has seven distribution centers located in Latacunga, Riobamba, Coca, Cuenca, Ibarra, Lago Agrio, and Quito. It also has an office operated as a franchise in Santo Domingo. In total, CAMARI employs 40 people, all of whom are permanent employees. Eighteen work at the organization's central office and another 12 people work as seasonal packers.

Fields of Action

CAMARI's fields of action are:

- *Sale of agricultural products:* CAMARI's focus is on strengthening the sale of organic products, providing small farmers with guidance as they enter this production system.
- *Sale of handicrafts:* these are preferably made of natural raw products.¹⁰⁶
- Services related to product selection and preparation, training and technical assistance in post-harvest management, transformation and commercialization, and export procedures.

¹⁰⁵ Although counting indirect beneficiaries, they reach 13,500 families from 240 grassroots and second-tier organizations.

¹⁰⁶ The handicrafts are made of marzipan, balsa wood, wool, cotton, panama hats, tagua nut, recycled paper, vegetable fibers, wood, leather, silver, ceramic, gourds, and black coral.



Training is provided at no charge to CAMARI's beneficiaries-suppliers and is subsidized by the sale of products and other services, which don't generate significant earnings but do promote the social mission.

In addition to training, CAMARI also runs social impact projects using donated funds, such as recent projects carried out with assistance from the Inter-American Development Bank and the International Institute for Communication and Development,¹⁰⁷ which promote technology usage to improve living conditions:

- The Electronic Commerce Project for small agricultural and artisan producers.
- Information and Training Network Strengthening Project for fair trade producers, with Community Information Centers.¹⁰⁸ The community information centers consolidate information and communication on pricing, trends, and quality standards, which enables producers to develop projections. CAMARI-FEPP makes this system available to organizations representing urban-marginalized communities, peasants, Afro-Ecuadorians and the coastal, mountain and Amazonian indigenous peoples of Ecuador, to help them determine their production volumes and quality.

Although not a donor organization, the IFAT -the World Fair Trade Organization-¹⁰⁹ assists with promoting products abroad.

Self-financing activities

When CAMARI was founded, it created processes that focused on self-management and self-sustainability. Its activities complete the production-marketing circle, within which Grupo FEPP provides assistance at various levels.

Income-generating activities include sales, in Ecuador and abroad, of handicrafts, agricultural

products, biological products and services such as: sorting, packing and export procedures.

Total sales for CAMARI in 2007 were US\$ 2.3 million. For 2008, the organization projected it would generate sales of US\$ 3 million: US\$ 2.4 million in the local market and US\$ 560,000 in exports, with a trend toward increasing international sales, since profits in this market are projected at 20%.

Ninety percent of the exports go to Spain, France, Italy (the primary market), Germany (food and handicrafts), the United States, and Canada (handicrafts). In addition, the organization has signed contracts with partners in Austria, Japan, and the Netherlands. In 2010, CAMARI's goal is to reach US\$ 5 million in sales by increasing exports. The current challenge is to stabilize the volume of exportable production and to produce a higher quality product in greater quantities to meet market demand.

Start-up of self-financing and its management

Since its founding, CAMARI has passed through three stages of organizational development that have influenced its programs and affected its self-financing activities:

- *Start-up.* From its founding in 1981 until 1986, the organization had a strong social vision and paternalistic approach under which it accepted all goods produced by agricultural producers, without regard for quality. Its target market was the Ecuadorian market.
- *Growth.* From 1987 to 1990, it adopted an entrepreneurial outlook and sought to reach the international market with handicrafts and agricultural products. In this period, the organization's goal was to cover costs and expenses and generate a surplus to fuel growth; it focused on product quality and compliance with standards. The organization made the decision to leave out several supplier groups that were

107 International Institute for Communication and Development

108 They provide a systemic vision that interrelates information, communication and trade.

109 The International Fair Trade Association. CAMARI has been a member for 16 years and pays a membership fee that fluctuates according to the volume of exports.



unable to meet the required quality standards. But contrary to expectations, this strategy generated losses, both economic and social.

- *Consolidation.* From 1991 until the present, the organization has continuously sought to balance the commercial and the social goals with an emphasis on ongoing improvement of quality, productivity, and meeting the needs of both Ecuadorian and international customers. During this period, CAMARI established itself as a company. However, given social costs and social challenges that a for-profit would normally not confront, it returned to being a business unit of Grupo Social FEPP, which is the legal status that it currently maintains.

One of the achievements in terms of improving the balance between social and financial objectives has been to transfer greater responsibility to the supplier-beneficiary groups. It is important that they develop a greater understanding of the importance of quality and timing on the entire process.

CAMARI proposed the formation of at least 10 self-run rural business centers to increase efficiency in stocking, selecting and shipping products to the central CAMARI facility. Decentralizing these functions has meant that each center maintains accounting and production records.

Policy and regulatory framework

According to the law, CAMARI, because it is part of FEPP, is exempt from income tax. For local sales, it must charge and declare VAT and its retail locations must pay for municipal permits.

In terms of purchases, it is not always possible to request invoices and create withholding receipts, since CAMARI's suppliers are small farmers living in marginal areas where awareness of tax regulations and fiscal discipline is not common. In addition, it is difficult for many to understand tax laws and regulations. However, because small farmers are the target group of the organization,

Camari makes it a point to strengthen their capacity to meet these accounting requirements.

In terms of the income declaration, donations received to carry out projects are declared under the *Contribution for Program Expenses* account since these funds are used to benefit the farmers and artisans.

Staff goes to great lengths to keep up to date with and comply with current regulations. To keep abreast of updates and new tax laws, employees often consult the SRI's web page and frequently attend training courses.

For exports, CAMARI pays tax to the Corporación de Promoción de Exportación e Inversiones en Ecuador (Corporation for Promotion of Exports and Investment in Ecuador, known as CORPEI): 0.015% of freight on board (FOB) of the goods exported. It cannot recover VAT, since the products purchased, such as food and handicrafts, are exempt from VAT.

Analysis of the impact of self-financing on the organization

Managing self-financing activities has caused some difficulties in terms of liquidity. Due to its size, the net resources CAMARI needs to finance the volume of products it purchases from the communities are significant. At the beginning, since there were few producers, CAMARI paid them in cash prior to delivering the product. As the number of producers grew, the organization began to pay only production costs in advance and pay the balance once the products were delivered. Even so, their liquidity requirements continue to be quite high.

One of CAMARI's ongoing needs is to manage pricing, information and market trends used in running its commercial activities. The organization learned a hard lesson after winning a tender process, offering products at prices that subsequently fell below market levels. They were obligated to sell the products, losing money to fulfill the contract. The loss and the crisis forced CAMARI to take out a loan in 2002 to cover the liquidity gap.



With respect to market diversification strategies, exporting has forced the organization to acquire greater knowledge about demand in specific market niches, to seek quality products, and to form partnerships.

CAMARI has participated in international trade fairs and three years ago conducted a study of trends in Europe, with positive results; it even brought foreign designers to train Ecuadorian artisans in product models and quality. Unfortunately there has been no continuity in replicating these initiatives.

Promotion of the products in Ecuador, on the other hand, is still inadequate. Although electronic sales have been implemented, this shopping venue is still not widely used in the country. All forms of selling require responding to and managing electronic sales, distribution, and purchase guarantees, among other demands that CAMARI is continuously improving.

With regard to partnerships, for the last three years, several exporters of products made by Ecuadorian artisans, including *Camari*, *Maquita Cushunchic*, *Sinchi Sacha*, *Fundación Pro Pueblo*, *Grupo Salinas* and *Fundamylfare* are working together and have some clients and suppliers in common; in fact, they occasionally join together to promote the sale of Ecuadorian products abroad.

Conclusions and lessons learned

Although CAMARI is an organization that is well-known for selling *fair trade* products, it is aware that this market niche is small and that this activity could be complemented by other clients to supply the so-called *nostalgia* market (for emigrants).

CAMARI has recognized the advantages of working with families grouped together around an activity. This, without a doubt, is favorable in terms of product volume and strengthens their power of negotiation, since the market favors trading with one entity rather than several people.

Since entering the export business, CAMARI has formalized the activities of its suppliers, in addition to demanding higher production quality to meet all the requirements of the international market. It is currently in the process of developing a consortium to benefit all members across the board. It has created ten *Self-managed Rural Business Centers* to permit sharing of responsibilities in order to achieve quality products, improve efficiency during the phases of stocking, selection, and shipping to CAMARI's central facility, and also to work toward the decentralization of production and accounting records.

Finally, the need to cover the cost of training suppliers has prevented CAMARI from generating needed revenues to cover administrative costs or to reinvest in promotion and growth of the commercial activity. Thus, the challenge of balancing social and financial concerns remains.

4.4.2 Fundación Mariana de Jesús (FMdJ)

The Organization

Fundación Mariana de Jesús (FMdJ) is part of a group of organizations belonging to the Company of Jesus,¹¹⁰ which, not including this entity, is made up of 14 institutions that work in the social and public education field, in addition to five schools, three educational institutes and a university.

The institution, created by María Augusta Urrutia in 1939, is almost 70 years old. It was founded with a Christian vision of solidarity. María Augusta Urrutia inherited several very large properties (haciendas) in the Imbabura and Pichincha provinces from her mother and grandfather, and also inherited other haciendas from her husband and some properties from her aunt. Together these constitute significant assets, which she then made available to the foundation.

She managed the organization until her death in 1987, leaving these assets to the Jesuit community which continues to manage them today, main-

110 Jesuit organizations. This case study refers specifically to Fundación Mariana de Jesús and not to the Company of Jesus in general.



taining her philosophy and ideals. The mission of the foundation is to assist vulnerable, low-income groups –families, children and the elderly– in the fields of housing, education and health.

Currently, the organization has 115 permanent staff members, of which 60 work on developing housing projects (52%), 20 work in the administrative area, and 35 work in direct social programs. In cases of extraordinary demand, personnel is hired for specific projects.

FMdJ also covers part of the administrative costs of other institutions, including: the *Centro del Muchacho Trabajador (Center for Working Boys)*, the *Servicio Ignaciano de Voluntariado (Ignatian Volunteer Service, or SIGVOL)*, and the *Programa Jesuita de Apoyo al Migrante y Refugiado (Jesuit Assistance Program for Migrants and Refugees, or SJR/SJM)*.

The organization's programs address three areas:

Housing. There are three general programs: low-income housing (some as part of conglomerados, which are planned communities); housing for people with middle- to high-incomes; and construction of classrooms or schools. Conglomerados are projects in small villages that include the construction of houses, medical clinics, schools, preschools, educational centers, a church, parks, gardens, etc. Generally, they build in partnership with the public sector, the private sector, and third-sector organizations.

Health. FMdJ provides medical assistance to low-income people. It receives around 60,000 people each year. For FMdJ, health is an axis that cuts across all the services provided by the organization. There are three forms of medical attention: medical centers (they currently have two); medical brigades; and partnerships with public hospitals, among them: *Hospital Eugenio Espejo* and *Hospital de Niños Baca Ortiz*; it also has a partnership with *Fundación Hermano Miguel*, which primarily attends people with physical disabilities.

Education. The foundation provides educational services through the Child Development Centers, which are preschools for children up to five years old. The foundation supports them with infrastructure, covers day-to-day expenses, and provides the team with operational systems and procedures. The services include: daily care of children, nutrition, training for parents, and support to children in their activities. Notable among them is *La Dolorosa* dining hall for children, which has been operating since 1932.¹¹¹

Other social services

FMdJ has support centers for the elderly (not residences), where they can participate in activities together with people of the same age. The centers provide lunch, access to medical check-ups, infrastructure for personal hygiene, a hair salon, occupational therapy workshops, physical activities, recreational activities, and even support for the creation of small businesses.

In addition, the foundation has donated land to the Municipality of Quito, creating extended areas of green space which provide "lungs" for the city;¹¹² it has also donated land to schools, churches, medical clinics, the police and municipal enterprises, among others.

Self-financing activities

FMdJ's own endowment totals US\$ 27 million, primarily made up of real estate that belonged to the founder. The foundation's board of directors has decided not to reduce this endowment, in order to promote the sustainability of the CSO and its programs.

Its main sources of self-financing are:

- Interest from short-term and long-term financial investments.
- Income from housing and classroom construction services for public and private institutions.

111 Seven years before FMdJ was legally founded.

112 Among them are *La Carolina* Park, a 6-hectare park named after one of María Urrutia's aunts, Carolina Barba, and which is located in the northern-central part of Quito; the park known

as *la Mujer y el Niño (Mother and Child)*, located in a north-western part of the city, on Avenida Mariana de Jesús; and *Solanda* Park, located in the southern part of the city.



- Interest from direct low-income housing financing programs; in some cases, the foundation has even granted credit to enable families to put down the initial deposit for a housing credit, and has also provided second loans when the first loan does not cover the full property value.
- Fees for services; it provides extremely low-cost services in the health centers, where the fee for a consultation ranges from US\$ 2.50 to US\$ 3.00. With the income obtained, it is able to cover certain operating costs; the rest of the services are subsidized.

Start-up of self-financing and its management

Given the need for housing, which became more visible starting in the 1970s, the foundation undertook low-income housing projects that, because of their scope, are made more accessible and affordable to low-income communities.

The foundation then came up with the idea of producing its own materials and FMdJ founded a brick and adobe factory and a tile factory; it also became a minority owner of the HORMASA cement company and later became the majority owner, which it still is today. The brick and adobe factory and the tile factory were closed after operating at a loss, primarily because these materials are no longer used in construction. Since 1996, the foundation has operated a pre-fabricated structure manufacturing plant in Quito, which supplies material to build 600 housing units each year. It has expanded to a second plant in Guayaquil, which began production in December 2008 with the same capacity as the Quito plant.

The housing projects have grown in a sustainable way, contributing to building the capacity of the foundation and to generating revenues for new programs. Since FHM was responding to an obvious housing shortage in the country, it conducted little prior market research and analysis.

The most serious problems faced by FMdJ during the expansion of these projects have been related to infringements and lawsuits associated with the large quantity of land and haciendas donated by its founder, María Augusta Urrutia. Resolving these lawsuits has required significant time and legal assistance.

Policy and regulatory framework

In accordance with the law, the Fundación Mariana de Jesús is exempt from paying income tax on income it uses for its mission and purposes. Regarding value-added tax (VAT), in the case of construction, the law establishes two possibilities which are applicable to the foundation's activities: (1) when it is contracted by another institution to develop projects and provide construction services, VAT is obligatory and is a cost that is included in the housing value; (2) when it is a direct sales process, that is to say when the foundation sells the housing, this tax does not apply. For materials purchases, the foundation pays VAT just like a commercial company.

Starting with the enactment of the Regulation of the Tax Equity Law (May 2008), NPO income is expressly made exempt from income tax. But it also establishes, as we have stated before in this guide, that these earnings must be comprised of in-kind or money contributions or donations. For the foundation, such contributions and donations must amount to 15% of its total budget, since its annual earnings are greater than US\$ 500,000.

This regulatory requirement causes a problem for the foundation, since the majority of its assets are donations but its annual earnings are not. It is considered one of the largest foundations at the national level, and because of its reputation, it receives very little in donations. It has been sustainable over time because of proper administration of its assets and the income obtained from its self-financing activities.

113 The phrase "second-tier organization" is used to refer to an organization that is made up of other organizations, while "second-layer" normally refers to institutions that grant credit

to other organizations, which administer those resources by serving the end beneficiary.



Recently, the Ministerio de Inclusión Económica y Social (MIES) categorized Fundación Mariana de Jesús as a second-tier organization,¹¹³ and it was even registered as an association, because it supports several foundations linked to the Company of Jesus. In fact, this declaration distorts the mission and purpose of the foundation.

Analysis of the impact of self-financing on the organization

Since its creation, this organization has tried not to be paternalistic and has worked for social justice, without losing sight of self-sustainability. It has improved its application of technical and management tools, with better management of projects and investments that combine financial profitability with social investment.

The foundation's leadership believes that all of its programs have a positive impact on its mission and vision. While these terms are more recent than those used 70 years ago, the objectives set down in the bylaws continue to be the same ones: "to support housing solutions and ensure the well-being of the elderly and children". In its ongoing work, it establishes priorities according to the needs of each era. But overall, the foundation has not changed in any significant way since its target group continues to be low-income sectors.

The self-financing activities have forced the foundation to develop new knowledge and skills:

- Strategic planning: every year the organization develops an operating plan and adjusts goals and objectives (most recent period: 2007-2011).
- Management of social projects in the areas of housing, health and education.
- Inter-institutional relations skills (relations with private and state entities that work in the same areas).
- Management of efficiency and efficacy criteria.

- Definition of cost centers, with rigorous accounting and budgetary details. In fact, there are projects that have shown losses from a financial point of view but which are socially "profitable", a concept that prevails when the foundation calculates an overall balance.
- Calculation and analysis of break-even point.
- Guaranteeing quality in processes and maintain ISO 9001-2000 certification.¹¹⁴

Conclusions and lessons learned

Fundación Mariana de Jesús was created with a significant financial-economic foundation, which has enabled its sustainability. That has also given it a solid footing in order to dedicate all of its energies to mission fulfillment.

The strong participatory role of its personnel with the community in the projects that the foundation develops are clearly positive.

In the financial realm, thanks to the stability of income generation, the foundation is able to plan and project in the medium and long-term. However, it must now work to maintain the value of the endowment and the bases for self-financing. Currently, this allows the organization to continue serving a vulnerable segment of the population in an expanding geographic area.

4.5 Conclusions and recommendations for the legal framework

According to the Internal Tax Regime Law and its Regulation, in Ecuador the *destination-of-income tax* approach is applied to assess whether a CSO is exempt from income tax.

However, some ministries require that all activities are mission-focused, which would incorporate the *principal-purpose* approach; thus, a CSO may only engage in commercial activities if they are related to its mission.

114 The ISO (International Organization for Standardization) is the leading and largest non-governmental organization worldwide that has developed and published international quality standard norms. The ISO norms are complied with on a voluntary basis by the companies or institutions that see their implementation

as beneficial to them. In some countries, certain ISO norms –primarily those related to health, safety or environmental matters– have been adopted as part of the legal framework. <http://www.iso.org/iso/home.htm>



The last regulation of the tax reform would allow oversight for these purposes and a registration system that would enable the government to know who the NPOs are, where they are, and what they are doing. Thus, the regulation could be applied efficiently to any organization that is not fulfilling its mission.

To the extent that self-financing activities are carried out transparently, the income generated is put toward appropriate uses and there is increased understanding that these activities represent a vehicle for generating social impact and sustainability for CSOs, there will be less need to implement measures that limit or restrict such activities.

4.5.1 General regulatory framework governing CSOs

The state needs to develop a policy and law regarding CSOs, which recognizes their shared objectives. This will require building strategic alliances among the state, the for-profit private sector, the nonprofit private sector, and international cooperation, in an environment of transparency and through a public participation process.

This law should include definitions that do not exist in the current legal framework and which, as a result, produce legal uncertainty. For example: clarifying the concept of a civil society organization (common or public benefit), refining of CSO classifications, and including concepts regarding self-financing activities.

With respect to oversight and the creation of a single registry, Decree 982 states that all organizations must register with the Secretariat of Indigenous Peoples, Social Movements and Public Participation, and emphasizes the role of ministries, the Servicio de Rentas Internas and the Contraloría General del Estado as oversight authorities. This situation leads to confusion and contradictions in the tax treatment that organizations receive. One oversight entity should be defined, as a Superintendencia de Organizaciones de la Sociedad Civil (Superintendency of Civil Society Organizations), which would centralize approval, registry, and oversight activities.

This superintendency would be responsible for managing a single, national, updated registry,

which would be shared with the various organizations that may need information on the sector: national public institutions, ministries, local governments, and financial institutions. This entity would thus generate a standardized database which would be accessible to the public, in accordance with the current Law of Transparency, ensuring the use of confidential information.

One of the objectives of this process would be to determine the situation of each entity, if it has a RUC number, whether it is meeting its tax obligations, and the possibility of analyzing the fulfillment of such obligations with third parties. The evaluation would be useful from an oversight and transparency perspective, and also, this institution could present statistics about the sector and the use of financial resources and donations. This would serve to evaluate general trends and the impact of the work that CSOs do.

In terms of taxes, the information required of CSOs needs to be simplified. Both the CSO sector and the public sector should undergo an intensive training process, to better understand and work within the system.

An explicit recognition of a CSO's right to carry out self-financing activities requires an assessment of studies of other circumstances in which these alternatives are used.

4.5.2 Regulations applicable to CSOs relating to self-financing (including pending reforms)

To characterize CSO self-financing activities, it is necessary to take into account that these activities are developed in areas that the business sector and the public sector don't reach, either because they do not generate enough profit, in the first case, or because there is no coverage or specialization in that area, in the second case. Also, generally these CSO activities entail social costs –additional or complementary services– that do not exist in other business activities.

For this reason, when there is a favorable legal framework in terms of taxes, this benefit does not result in unfair competition, precisely because of these higher social costs. The spirit behind the tax exemption, in these cases, is an attempt to



compensate such costs and not to obtain greater profitability, in comparison to the business sector.

These activities, which *contribute* to reaching social goals, also *complement* the work of the public sector, lowering the costs of providing certain services in specific areas, and in some instances *they replace* the work of that sector, reducing its costs. These activities also occasionally generate new jobs.

One channel for resolving conflicts regarding unfair competition and disputes are alternative mechanisms such as: mediation and arbitration, which are the most suitable for resolving potential conflicts between CSOs. In that case the arbitration ruling has the force of a sentence and it is only possible to request annulment of the ruling for causes which are defined in the law.

4.5.3 Taxes on CSO commercial activities

Taxes or exemption from them should not be benefits that create distortion in the market. Once they are defined, adequate mechanisms for making them effective must be developed, limiting bureaucratic procedures.

Fines for noncompliance with regulations or formal infractions should be lower or be the minimum contemplated, although payment of these fines usually results from lack of awareness or because the organization has limited physical infrastructure that prevents it from properly complying. A process for training CSOs should be initiated to decrease those areas in which there is lack of knowledge or where formal requirements aren't met.

4.5.4 Other relevant laws applicable to non-commercial sources of financing

- There needs to be some provision in the law that allows donations to CSOs to be deductible from income tax, since CSOs are required to obtain donations.

- The law could also grant the option of hiring personnel to provide professional services in consulting projects.
- A competition and anti-monopoly¹¹⁵ law should be developed to define and regulate what constitutes unfair competition and establish the competent authority to resolve these issues.
- Other relevant laws applicable to non-commercial sources of financing are related to the Social Security Law and the Securities Market Law, which improve the creation of funds and assets to stimulate these activities.

4.5.5 Process of declaring taxes and other reports

It is important that tax information exist and that such information be fluid, which not only implies being able to obtain information but to manage it in a way that is useful.

The tax deduction process should lean towards standardization, the development of user-friendly databases and public access, which would make the information more transparent. This change would be a healthy one for the sector and for the Ministerio de Coordinación Social, which currently carries out this process.

A tax manual should be required to facilitate access to standard inquiries. Although SRI has personnel, they aren't necessarily efficient in answering questions, which are often long and ongoing, given the complexity of the tax declaration.

4.5.6 Knowledge required to engage in commercial activities

Regional conferences are needed to clarify *why* unfair competition with the for-profit sector does not exist, in order to generate opportunities to develop joint projects, in which local governments could also participate.

115 Suggested name at this time: Competition and Consumer Defense Law.



Ideally, when a CSO is formed, its members contemplate the possibility of carrying out commercial activities, either as a department of the organization or –if it makes sense– as an independent institution with a social purpose, in order to ensure the sustainability of the activities.

It is also important to train organizations in the design of self-financing activities, as well as to promote the development of practical manuals regarding accounting and taxation.