Transaction Taxes in Latin America Transform

The Increasingly Digital Nature of Tax Administration Drives Data Management Complexity

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A striking mix of good and bad news sheds light on Brazil's bruising transaction tax compliance requirements. This one-two punch of information, along with some related research, also conveys the magnitude of tax compliance and related data management challenges raging throughout Latin America and helps explain the growing interest in tax automation expressed by companies that operate in the region.

First, the positive news: the average time companies spend complying with Brazil's teeming tax rules dropped by more than 20 percent from 2015 to 2016. Now, the bad news: the average time consumed by Brazilian tax compliance in 2016 amounted to a whopping 2,038 hours —the highest among 190 national economies in the world, according to a joint analysis conducted by PwC and the World Bank Group.[1] Besides Brazil, three other Latin American countries (Bolivia, Venezuela and Ecuador) rank in the top 10 in terms of time-related tax compliance burdens. According to this same assessment, which evaluated compliance time and other parameters, five Latin American countries (Bolivia, Venezuela, Brazil, Argentina and Nicaragua) rank among the 15 countries with the most difficult tax payment environments.

This complexity is driven by a combination of factors, including rulemaking at multiple administrative levels, frequent tax-related legislative changes and a lack of value-added tax (VAT) standardization in the region, among other issues. The region's ongoing transition to electronic invoicing (e-invoicing), electronic reporting (e-reporting) and other forms of digital tax administration —most notably represented by Brazil's sweeping digital accounting effort (SPED)—poses significant challenges that add to tax management complexity while increasing compliance- and audit-related risks.

Latin American tax jurisdictions operate on the leading edge of what *The Economist* has referred to as "electronic arm-twisting:"

> *[W]hen it comes to mandatory e-invoicing – that is, forcing buyers and sellers to register invoices with the tax authorities electronically when a transaction takes place—the region is blazing a trail that others, from the European Union to China, are considering following.*[2]

This tax compliance complexity and widespread adoption of digital tax administration pose new data management challenges for companies conducting business in Latin America. When deploying tax automation with the right core capabilities, tax functions can collect, harmonize, transform and access the data needed to meet all compliance requirements. The discussions that follow highlight the nature of these regulatory and business challenges, examine the tax implications of these issues and provide a look at the specific type of data management capabilities leading companies are deploying to address these tax implications.

Traditional Tax Challenges

Tax compliance burdens throughout Latin America remain significant, even as companies adapt to the electronic invoicing and tax filing numerous that Latin American countries have adopted in recent years.

Country	Ease of Paying Taxes Ranking (Out of 190 Economies)
Panama	170
Nicaragua	176
Argentina	178
Brazil	181
Venezuela	185
Bolivia	186

These digital mandates also pose challenges and tax-related risks. The proliferation of e-invoicing, e-filing and related electronic accounting rules in Latin America reflect governments' efforts to reduce tax evasion while optimizing their tax collection capabilities. As a result, companies paying transaction taxes (and other taxes) in the region should expect auditing activity to increase in coming years.

Of course, Latin American countries' new digital mandates represent just one of many drivers of complexity that tax functions must address. More traditional challenges include:

- Taxation by multiple administrative levels (federal, provincial/state and municipal);
- Frequent tax-related legislative and rule changes;
- A high number of different types of taxes and contributions overseen by a jumble of withholding and collection regimes;
- A staggering number of report and return forms;
- The absence of unified VAT legislation in Latin America; and
- Extended statute of limitation periods that challenge data retention capabilities.

Complex, fast-changing transaction tax requirements throughout Latin America force companies to maintain, and continually adjust and update, different sets of internal controls and monitoring processes.

In the past decade, tax functions addressed these longer-standing tax compliance challenges while struggling to meet new filing requirements and mitigate new risks related to the growth of digital reporting requirements issued by Brazil, Mexico, Argentina, Colombia and other Latin American governments.

Digital Reporting: More Susceptible to Risks

This adjustment process has not been easy: "Computerization, which could permit greater transparency and speed, has ended up making the process even more complex and susceptible to risks," notes a recent Deloitte report on Brazil's complex tax environment. "This is because, due to crosschecking of data practically in real time, the chance for error is even greater, making electronic inspections even more unforgiving than field inspections."[3]

As Deloitte's analysis indicates, the increase in digital reporting requirements produces more data that governments and tax jurisdictions use to cross-check —not only against related data within one company, but also against data from many customers and suppliers.

This increasing supply of data also equips governments with more ammunition for audits while enabling them to more precisely report on their performance collecting a wide range of taxes. Mexico, for example, reported a recent year-over-year 27.4 percent increase in VAT collections. Colombia reported that tax evasions cost the country an estimated $3.1 billion annually.

A global pioneer in digital accounting, Brazil remains at the forefront of digital submission regulations related to accounting, inventory management and payroll. These regulations were designed primarily to combat fraud perpetrated by taxpayers. Referred to as SPED, Brazil's digital accounting system requires companies to submit several different digital reports, including:

- ECD: an annual tax accounting bookkeeping report;
- ECF: an annual net income report;
- Bloco K: monthly inventory and production reports;
- eSocial: reports containing labor, payroll, social security, tax and fiscal information; and
- eFinance: reports containing information about bank transactions conducted by certain individuals and legal entities.

Other pilot programs that expand exchange of data between Brazil taxation authorities and companies are also underway.

Mexico's digital reporting requirements lag behind Brazil's efforts, but not by much. Mexico's government exchanges more e-invoices with companies than any other government besides Brazil, and it has quickly established one of the world's most sophisticated financial compliance capabilities. Mexico's extensive e-invoicing requirements helped it launch automated, real-time e-audits last year. Not coincidentally, the country has significantly increased the total amount of tax it collected each year, according to the Inter-American Center of Tax Administrations (CIAT).

While Brazil and Mexico lead the way in digital accounting and tax administration, other countries appear eager to follow their lead (see below for "Country-by-Country Digital Breakdown").

In addition to country-specific data requirements, new multilateral cooperation focused on curbing tax fraud by corporation and individuals is taking shape among groups of Latin American countries. *Factura Electrónica Internacional* (FEI) marks a new agreement among Argentina, Brazil and Mexico in partnership with the Inter-American Center of Tax Administrations (CIAT). Under the arrangement, the three countries will standardize certain reporting processes to create a unified view of transactions that helps ease cross-border data sharing. Currently in its pilot phase, FEI is expected to expand to other Latin American countries such as Chile, Ecuador, Peru, Colombia and Uruguay.

Given the rise of similar digital tax administration developments in other parts of the world, such as China, it seems likely that some regional agreements will soon become global.

Tax Data Management Difficulties

As Latin American countries mandate the collection of more transaction and tax data, companies doing business in the region confront more data management challenges, including the following issues identified in a recent EY report on the impacts of digital tax administration:

- Lack of data available in the required formats;
- Difficulty submitting data;
- Inefficient processes for transforming data;
- Lack of process support for new data requirements;
- Outdated tax operating models;
- More frequent need for more comprehensive analytics in advance of submission to tax authorities;
- An inability to respond to audit notices in a timely or effective manner; and
- An inability to respond quickly when there is disagreement with a tax assessment.

Country-by-Country Digital Breakdown

Most Latin American governments are expanding their e-invoicing and related digital tax administration rules, as the following summaries demonstrate:

- **Colombia**: In 2013, Colombia's tax authority (the DIAN) proposed a new e-invoicing model similar in scope and complexity to approaches in Brazil, Mexico and Chile. Colombia's e-invoicing pilot phase concluded October 2016, and mandated e-invoicing began this year with all companies expected to comply by 2018.
- **Argentina**: Argentina's tax authority (the AFIP) requires all companies doing business with VAT-related invoices (B2B, B2C and exports) to issue electronic documents.
- **Chile**: A pioneer in the (optional) use of e-invoices more than a dozen years ago, the Chilean tax authority's e-invoicing and e-Accounting rules currently require 10 document types (collectively referred to as *Documentos Tributarios Electrónicos*, or DTE) to be electronically submitted along with monthly and annual accounting reports.
- **Peru**: One of the newest Latin American countries to introduce e-invoicing – requirements took effect in January 2016 —Peru recently added new electronic accounting reporting requirements (concerning sales, purchases and inventory) for its largest corporate taxpayers.
- **Ecuador**: In January 2015, Ecuador's tax authority (SRI) began requiring e-invoicing for all taxpayers. However, in an unprecedented move (for Latin America), the country recently shifted its compliance requirements to an offline approach. Rather than requiring the submission of electronic documents in real-time, the government now provides a 24 hour cushion for submission.

To address these challenges, the EY report continues, companies will need to "implement digital solutions that can work within and across countries and that can respond to evolving compliance and controversy requirements."[4]

Implications for Tax Management

This is no small task—implementing and optimizing the right digital solution requires several key initial process steps, the tax function's involvement in the selection of a tax automation solution, and an understanding of what distinguishes the most effective forms of tax automation.

To begin with, tax functions should consider several initial steps that can lead to swift tax compliance improvements while laying the groundwork for the future implementation of more sophisticated tax automation support. These initial processes include:

1. **Reducing the complexity of existing tax technology**: This work involves consolidating systems where possible and reducing the number of systems containing tax logic throughout the organization.
2. **Mitigating risk**: This work includes identifying all manual tax management processes that can potentially be replaced with automation, pulling business logic out of enterprise resource planning (ERP) systems and placing that logic in a centralized tax automation system, and reducing the tax function's reliance on the information technology (IT) function for maintaining tax content and tax logic.
3. **Increasing efficiency**: This work includes finding various ways to help reduce the time tax functions spend maintaining content and tracking updates so that tax professionals can increase their higher value work. The tax function's overall productivity can also be increased through other forms of automation and internal controls improvements.

When considering an investment in tax automation, it is important to recognize the scope of tax compliance requirements and to have experienced tax professionals play a decisive role in the selection process. Tax requirements reside throughout most transactional systems, and these requirements involve master data as well as transactional data. Tax experts understand this, which marks just one reason the tax function should be involved in the early stages of the selection process. This involvement includes tax professionals documenting their requirements for the tax automation solution.

While tax automation solutions vary in their comprehensiveness and effectiveness, leading tax data management technologies share a core set of enabling components, including:

1. **Unification**: This process harmonizes data from disparate sources for tax purposes. All relevant data is brought together in one place, at the appropriately granular level of detail. This funneling activity imports key information from enterprise resource planning (ERP), other finance and accounting, sales and marketing applications, and payroll and legal systems, among others, into a single, unified platform.
2. **Validation**: Once all the data has been gathered, it needs to be evaluated to determine how it fits into tax processes and whether any data needs to be reconciled in light of recent business changes before this information is used for subsequent tax processing. This activity includes real-time validation that the data reflects the most up-to-date financial results, which is of particular concern at a quarter-end and year-end financial closing periods.
3. **Enrichment**: At this point, the data is converted from financial reporting into tax-ready formats, enriched by global tax content and consolidated by the prevailing accounting standards and currency. This process of readying the financial data for tax processing is typically automated, although it may in some cases require expert input. These activities create a central source of "tax-ready" data that can be leveraged across all tax functions and processes within the tax lifecycle.
4. **Access**: Once the tax calculations have concluded, the data is retained to satisfy all global data retention requirements and to provide an audit trail when necessary. This approach reduces audit exposure and related risks, while keeping the enriched data accessible for a wide range of analyses.

When deploying tax automation with these four core capabilities, tax functions can collect, harmonize, transform and access the massive amounts of data required to satisfy compliance requirements, including the quickly changing and increasingly digital compliance requirements in most Latin American countries.

With supporting tax data management technology in place, the good news is that tax functions can spend less time on manual compliance data collection and more time working on improving their efficiency, managing risk, enabling the business and assisting with strategic planning.

Endnotes

[1] *Paying Taxes 2017, 11th Edition*. PwC and the World Bank Group: http://www.pwc.com/gx/en/services/tax/paying-taxes-2017.html.

[2] "Tax Collection in Latin America: Electronic Arm-Twisting," *The Economist*, May 17, 2014: https://www.economist.com/news/finance-and-economics/21602274-reduce-tax-fraud-governments-encourage-automated-accounts-electronic.

[3] *Tax Compliance in Brazil: Operating in a Complex Environment,* Deloitte survey report. © 2014 Deloitte Touche Tohmatsu International: https://www2.deloitte.com/br/en/pages/tax/articles/compliance-tributario-brasil.html.

[4] *Tax Administration is Going Digital: Understanding the Challenges and Opportunities,* EY. ©2016 Ernst & Young LLP: http://www.ey.com/Publication/vwLUAssets/EY-tax-administration-is-going-digital-understanding-the-challenges/$FILE/EY-tax-administration-is-going-digital.pdf.

[5] *Doing Business: Economy Rankings,* The World Bank, 2017: http://www.doingbusiness.org/rankings.

About Vertex

Founded in 1978, Vertex Inc. is the leading provider of corporate tax software and services to automate, integrate, streamline or outsource tax processes for companies of all sizes, from small to medium-sized businesses to global multinationals. Vertex provides solutions for all tax types with industry-specific solutions for retail, communications, hospitality and leasing industries.

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