A Closer Look at Business Opportunities and Tax Challenges in Latin America

Understanding Transactional Tax Complexity in Brazil, Argentina and Mexico

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INTRODUCTION: OPPORTUNITIES AND CHALLENGES

As more executive teams within U.S.-based companies "look south" to consider business opportunities in Latin America, they may experience a spell of double vision. The extremely valuable business opportunities in the region look clear while the overall tax environment looks blurry, thanks to numerous complex and dynamic transactional tax management challenges.

To fully benefit from these business opportunities in Argentina, Brazil, Mexico and other countries throughout Central and South America, companies must be able to address this tax complexity. Doing so requires deep tax knowledge, familiarity with country-specific tax intricacies and an overall tax-management approach that leverages tax automation wherever possible. Tax managers must carve out time for following and understanding the quickly changing, multi-layered indirect tax rate issues for companies doing business in this region.

Lionel Nobre, the Latin America tax director for Dell and the founding member of Tax Executives Institute (TEI) Latin America, has a law degree, accounting skills and a clear understanding of the skill sets tax professionals need to thrive in the region's complex tax environment. He asserts that the "future in-house tax professional in Latin America will not only need accounting but also informatics and systems skills to be truly successful."[1]

LOOKING SOUTH IS LUCRATIVE

The U.S. Department of Commerce believes Latin America markets can help make U.S. companies more successful. In 2014, the Commerce Department launched its "Look South" initiative to help more U.S.-based companies of all sizes understand why expanding into Latin America markets "will improve their bottom line." The initiative focuses on the growing business opportunities in Mexico, as well as ten other economies – Chile, Colombia, Costa Rica, Dominican Republic, El Salvador, Guatemala, Honduras, Nicaragua, Panama and Peru – that participate in a number of U.S. Free Trade Agreements (FTAs) in the region.[2]

"Our Latin American trade agreements, which cover over 70 percent of our regional trade, do more than just eliminate tariffs," notes Francisco J. Sánchez, former U.S. Under Secretary for International Trade. "Companies in the United States and Latin America benefit from commitments that facilitate transparent rule-making, predictable legal frameworks, strong intellectual property rights protections, and regulatory certainty at home, as well as in global markets."[3]

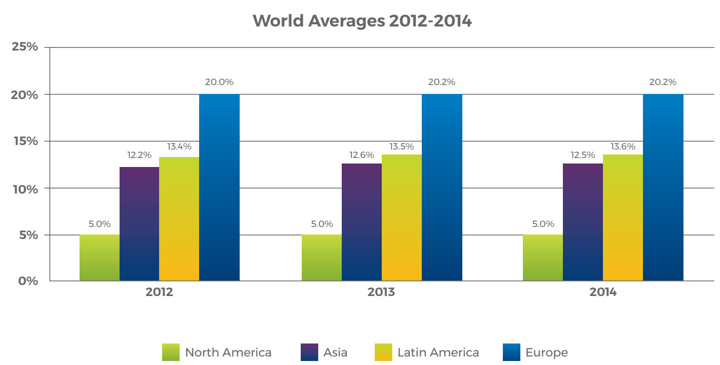
U.S. goods exports to Latin America represent one of the largest and fastest-growing components of all U.S. global exports. Mexico, in particular, is booming, according to year-over-year increases in its economic growth as measured by the International Monetary Fund (IMF). The International Trade Administration's Officer for Export Policy, Promotion and Strategy notes that "Mexico stands out as an excellent place for U.S. Companies to look for new opportunities." Despite a recent downturn, Brazil's long-term economic prospects, propelled by its fast-growing middle-class consumers, also look promising. The U.S. figures as the third-largest trading partner of Argentina, which is one of the largest economies in Latin America thanks to its population of more than 41 million people.[4]

Sánchez has also pointed out that the trade agreements that apply to a number of countries in Latin America serve as a "playbook" for succeeding in these markets by helpfully removing tariff and non-tariff trade barriers and by "providing transparency, predictability and recourse." While that's certainly the case, these playbooks would be incomplete without information and expertise concerning the tax environments.

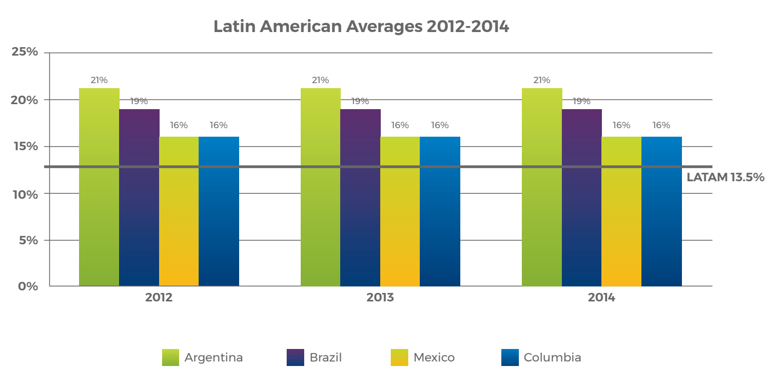
WHY DEEPER LOOKS—AND DEEPER KNOWLEDGE—ARE MANDATORY

Companies and their tax functions must probe deep when looking south. Due to the complexities of the Latin American tax environment, there is almost always more to the tax picture than initially meets the eye. This is certainly the case when analyzing indirect tax rate trends in recent years.

For example, an initial look at indirect tax rate trends by global region shows that rates in Latin America are higher than other regions, but relatively similar to those in Asia. In 2014, the average indirect tax rate was 12.5 percent in Asia and about 13.6 percent in Latin America, according to KPMG research:



However, when focusing a bit closer on Latin America a slightly different picture emerges. The reported average indirect tax rate in 2014 for four countries was notably higher than the regional average. Specifically, Argentina (21 percent), Brazil (19 percent), Mexico (16 percent) and Colombia (16 percent) all had higher indirect tax rates, according to KPMG:



An even deeper look – one amplified by much more information and local expertise – shows a significantly different picture. Brazil offers a vivid example. The country's standard indirect tax is helpfully abbreviated as ICMS, which stands for *Imposto Sobre Operações Relativas à Circulação de Mercadorias e Serviços de Transporte Interestadual de Intermunicipal e de Comunicações*. ICMS is "a value-added tax on sales and services that applies to the movement of goods, transportation and communication services, and to the supplying of any goods."[5]

Although Brazil's Indirect Taxes average rate is indicated as 19 percent in 2014, there are a number of other taxes that figure into indirect taxes, depending on numerous factors, including the location (i.e., federal, state, and municipal taxes) and industries in which a company operates. It is common for a company to be subjected to the ICMS as well as:

- **IPI** (Federal Tax on Manufactured Goods): A tax calculated on transactions with goods produced or imported;
- **PIS** (Federal Contribution for Social Integration Program): This contribution applies to corporate gross revenues;
- **OFINS** (Federal Contribution for Financing of Social Security): This is applied to the monthly invoicing; and
- **ISS** (Municipal Service Tax): A tax applied to the services provided to a third party by a company.

If each of these taxes were applied, ICMS would represent less than half (44 percent) of the total indirect tax rate a company is subject to:

VAT TYPE	RATE*	%**
ICMS	19%	44%
IPI	10%	23%
PIS	1.65%	4%
COFINS	7.60%	18%
ISS	5%	11%
TOTAL TAX BURDEN	**43.25%**	

**Average Rates—Differnt rates may apply, including zero-rated and exemptions.*
***Precentage (5) refers to portion of total indirect tax rate.*

Again, this breakdown consists of common forms of indirect taxes. There are other taxes, and much more complexity to contend with in Brazil, as well as in other countries throughout the region. The following is a high-level summary of the tax environments in these three countries.

Close-Up: Brazil

The Brazilian tax environment is one of the most complex—and dynamic—of the world. There are local daily official newspapers dedicated to reporting new laws, a majority of which relate to federal, state and municipal level taxation.[6] Brazil currently has more than 85 different taxes, which include:

- **IOF:** (Tax on Financial Transactions): Tax applied over loans, international financial transactions and others;
- **CIDE** (Economic Domain Intervention Contribution): A federal contribution that applies to contracts connected to royalty payments and technology transfers;
- **IRPJ** (Corporate Income Tax): A tax calculated over a company's income;

- **CSSL.** Social Contribution Tax on Net Profit): an additional income tax that is imposed over a company's income before taxes; and

- **INSS** (National Institute of Social Security Contributions): A percentage charged monthly from employers and employees – calculated over employees' monthly salary.

It is useful to look at Brazil's most notable forms of indirect tax at the federal, state and municipal level. At the federal level, PIS, COFINS and IPI are important taxes. PIS and COFINS both apply to a company's operational gross revenue. The calculation method varies depending on several factors. Under a non-cumulative regime, companies would have a PIS rate of 1.65 percent a COFINS rate of 7.6 percent; and they would be entitled to input tax credits. Under a cumulative regime, companies have lower POS (0.65 percent) and COFINS rates (3 percent), but are not entitled to input tax credits. Under a monophasic (or tax substitution) regime, rates vary more and companies are not entitled to input tax credits. IPI marks an important federal value added tax that is charged on transactions related to manufacturing or imported goods. The rates for this non-cumulative tax vary widely, from 0 to 330 percent, depending on the item.

The IPI has recently been the subject of Brazilian Superior Court of Justice deliberations with extremely high stakes for the Brazilian Treasury, as well as many importers; the case centered on whether or not importers should be required to pay this tax if they import goods that are not subjected to manufacturing within Brazil.[7] This matter reflects both the complexity and fast-changing nature of the indirect tax environment in Latin America's largest economy.

Close-Up: Argentina

Argentina's standard indirect tax rate ranks among the highest in Latin America. At the federal level, the IVA (VAT) and the Impuestos Internos (excise tax) are the most notable taxes.

IVA is a multiphase non-cumulative tax levied on all stages of transactions. Companies do not have a right to deduct input VAT on exempt transactions, except for exports. While the standard IVA rate is 21 percent, it can vary. For example, there is a luxury rate of 27 percent related to utilities supplied to registered taxpayers and a reduced rate (10.5 percent) for some construction activities, financial transactions, and transactions involving capital goods.

The excise tax is levied on specific goods and services, including tobacco, alcoholic beverages, soft drinks, automobiles, mobile phone services, insurance premiums, luxury items and electronic products. The rate varies depending on the item. This tax is generally levied on the production or importing stage (i.e., first stage), but not on exports; it is levied on the sale price, including this excise tax itself and other taxes, excluding VAT.

At the provincial level Argentina's turnover tax is called *impuesto sobre los ingresos brutos*. This "gross income tax" is imposed on gross revenues from sale of goods and services; rates and regulations of this tax are determined individually among the country's 24 taxing jurisdictions.

Rates of this multiphase cumulative tax (input tax from the preceding stage is not deductible) vary depending on whether the seller is a manufacturer, wholesaler, retailer, or services company; by type of activity; and by turnover. In most cases, exports of goods and services are exempt. Additionally, a multilateral agreement, which includes all provinces, as well as the federal district in Argentina, is in place as a means to deter multiple taxation while distributing the taxable base.

As is the case in Brazil and other Latin America countries, there are numerous other taxes that apply in Argentina. At the federal level, these include a corporate income tax, a tax on minimum notional income (IGMP),and a tax on debits and credits on bank accounts (IDC). At the provincial level, there is a stamp tax (*impuesto de sellos*), and at the municipal level, a safety inspection fee is applied in many situations.

Close-Up: Mexico

Mexico, which ranks as the United States' second largest export market in the world, is the destination for more U.S. exports than all of the BRIC (Brazil, Russia, India and China) countries combined.[8] In terms of its tax environment, Mexico shares some commonalities with Argentina: a VAT regime imposed by the federal government, and an excise tax on production and services.

The standard rate for Mexico's value added tax, or IVA (*impuesto al valor agregado*), is 16 percent. (There was previously an 11 percent reduced rate that applied to some types of transactions performed within the border region, but this reduced rate was abolished in December 2013). The IVA is a multiphase non-cumulative tax levied on all stages of transactions. Unlike other tax regimes in Latin America, Mexico uses a cash-flow system. This means that a seller pays the tax when consideration for a supply is paid (output VAT); on the other hand, a buyer is entitled to an input credit when a payment is made to the supplier (input VAT).

A special tax on production and services (IEPS) marks another crucial federal tax in Mexico. This special excise tax, which was part of the recent tax reforms implemented in Mexico in the past two years, is levied on specific goods and services such as tobacco, alcoholic and sugar added beverages, gasoline, high calorie density food and other items. IEPS is generally levied on the production or importing stage (first stage), but not on exports. This tax is applied using rates, which are levied on the sale price or a fix amount established in the law depending on the good or service sold.

Other federal taxes and duties that are important to note are: a corporate income tax (*impuesto sobre la renta*), compulsory profit-sharing (PTU) and import/exportduties (*aranceles de importación/exportación*).

COMPLEXITY, CHANGE AND TECHNOLOGY

The complexity of Latin American tax issues is abundantly evident, even from a relatively high-level perspective. Zoom in on a specific country's tax challenges and the intensity of managing this complexity quickly becomes apparent. In Brazil, for example, interactions among various indirect taxes, gross-up effects, certain application conflicts (e.g., ICMS vs. ISS), contentious relations between taxpayers and tax authorities, and quickly changing rules pose significant challenges to tax functions.

TEI Latin America's Noble reports that this environment presents tax professionals with risk and opportunities: "Latin America has very complex and always-changing tax systems with increasing foreign investment, which provides major opportunities for tax professionals in this region," he tells Tax Executive. Nobre also points to the increasingly important role tax automation and related technology plays among tax regimes and tax payers.[9]

More Latin American tax regimes are embracing automation to support key tax processes; some are requiring that taxpayers use specific applications when performing reporting and compliance processes. The more tax processes that companies can automate, the more time and energy they can devote to keep pace with tax increase, policy changes, and other challenges, which include:

- **Complexity:** As we have consistently noted, the volume, specificity and interaction of tax rules in Latin America create intricacies that must be managed. This complexity stems from the fact that taxes are usually levied by three different administrative levels (federal, provincial/ state and municipal/city); the sheer number of different taxes and tax rates; and numerous withholding and collection regimes. The fact that a unified approach to VAT does not exist in Latin America also poses difficulties.

- **Change:** Tax rate increases and policy changes occur with greater frequency in many Latin American countries. This year, for example, Brazil introduced a series of tax increases designed to raise government revenue at a time when the Brazilian economy faces headwinds.[10] Frequent legislative changes as well as rulings in court cases related to major tax clashes also complicate tax compliance throughout Latin America.

- **Technology:** As more Latin American countries move to electronic invoicing, auditing and reporting, tax departments need to bring in technical-tax skills to adapt to these changes. More tax authorities are also requiring taxpayers to use new software for compliance and reporting purposes – which also increases the need for internal tax-automation expertise.

CONCLUSION: FINDING CLARITY

As more companies enter or expand their activities throughout Latin America, the need to master the complex challenges of transactional tax management increases. The process of addressing these challenges begins with a high-level understanding of the nature of Latin American tax regimes, followed by a more detailed, country-by-country understanding of unique tax challenges. When looking south, it pays to look very closely at tax.

ABOUT VERTEX

Vertex Inc., has been a leading provider of tax technology and services, enabling companies of all sizes to realize the full strategic potential of the tax function by automating and integrating tax processes, while leveraging advanced and predictive analytics of tax data. Vertex provides cloud-based, on-premise, and hosted solutions that can be tailored to specific industries for every major line of tax, including income, sales and consumer use, value added and payroll. Headquartered in Pennsylvania, Vertex is a privately held company that employs over 900 professionals and serves companies across the globe.

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