SALES TAX SURVIVAL GUIDE

2014

Tactics to negotiate sales tax challenges

Avalara

Imagine you're a business owner in the downtown core of a midsized town. You come in to work on Monday to find your front window destroyed and the supporting frame around it demolished. It doesn't take long to figure out that someone crashed through your storefront. It's clear you won't be able to reopen until repairs are completed. You immediately contact your insurance provider and make repair arrangements. The extent of the damage relative to your coverage means the difference between closing your doors and staying in business.

Insurance in this case provides real protection against loss of capital and is considered a part of doing business. *In other words, the risk of not having insurance usually outweighs the risk of buying it and never using it.*

There are far less obvious sources of risk, such as sales tax.

Imagine you're that same business owner. You've just received notice that you're being audited for sales tax compliance in just three days. You frantically call your bookkeeper and ask her to start organizing for the past 12 months of sales. Your company has never been audited before, but you believe you accurately record all sales and assigned rates, have always filed and remitted on time. You keep all of your exemption certificates in a filing cabinet in the back room and have a master spreadsheet of all the rates, rules and boundary changes as they occur in Ohio, where your business is based. You sell online now and again, but nothing significant and all to customers just over the state line.

You consider your business more or less protected. And while you don't literally have insurance against errors, you do feel assured that your bookkeeper's records are more than good enough. Following the audit, you're totally surprised when you see a proposed fine of $30,000 for missing exemption certificates, and undercharged sales tax rates.

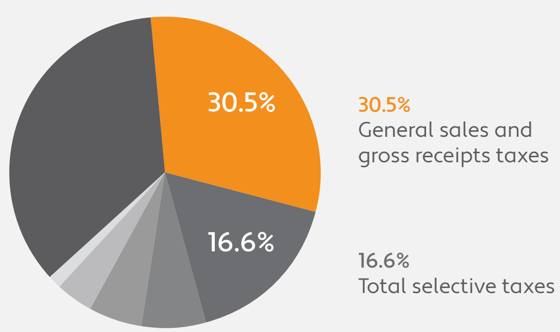
Cold sweat on your brow? Breathing shallow and fast? Well, the story doesn't have to end here. This Survival Guide is not a substitute for professional tax advice, but it is a great place to start creating sales tax management strategies. By understanding the sales tax landscape and developing tactics to address each challenge, you can prepare your company to survive the 2014 sales tax challenge.

Not worried about sales tax? Have it handled? Good for you and fingers crossed that your strategies are sound. For everyone else, read on.

Why States Need Sales Tax

Sales tax provides critical revenue for states. Other than property and income tax, sales tax is the largest source of tax revenue in the majority of the 46 states that collect it. From a government operations perspective, making sure each and every sales tax dollar is collected, through audits, fines, penalties and well-developed rates and rules, is simply good business.

Take a look at the following. As you can see in the graph, general sales tax constituted 30.5% of total state government tax collections in 2012 (2013 numbers will be released shortly). When combined with selective sales tax as applied to fuel, liquor, etc. that percentage rises to 47.1 percent.



Source: U.S. Census Bureau, 2012 Census of Governments: Finance--Survey of State Government Tax Collections at www.census.gov/govs/statetax

It's easy to see why sales tax is both a major source of funding and uncollected sales tax is on the radar of budget-strapped states. After all, wouldn't you rather be the politician who recovers uncollected funds from *existing* tax streams, rather than raise taxes?

Of course, the historically large budget gaps faced by states during the Great Recession only increase the need for sales tax collections.

The tactics needed to survive sales tax in 2014 are directly related to preparing for the worst (audit) while achieving the best (accurate sales tax processes).

Some potentially tough sales tax challenges include:

1. Broadening definitions of nexus and increasing requirements for out-of-state sellers
2. Understanding and following changes in product and service taxability
3. Finding the right sales tax rate to charge customers
4. Tracking sales tax holidays
5. Managing exemption certificates
6. Identifying the forms and remittance processes for each taxing jurisdiction
7. Preparing for an audit
8. Switching from an error-prone manual sales tax management process, to an automated streamlined one

Challenge #1: Broadening definitions of nexus and increasing requirements for out-of-state sellers

Survival Tactic: Determine where your company has nexus

Does sales taxes apply to your business? That depends upon a set of regulations known as nexus rules. According to a series of Supreme Court decisions that culminated in *Quill v. North Dakota (1992)*, a business must collect sales tax on behalf of a state if it has a substantial physical presence in that state. Examples of nexus-creating activities include holding a business license, owning tangible property or establishing a headquarters in a given state. By doing these things, a business agrees to be an agent of that state to collect sales tax and remit the funds back to the government. And as we've seen, states are expanding the types of activities that create nexus. These now frequently include the use of affiliate networks, distributors, independent agents, remote work force and etc.

Whether companies without this connection (or nexus) have to collect and remit sales tax has dominated sales tax debates for years (think Amazon and California or New York). Many online retailers and other remote sellers are not currently required to collect sales tax in states where they have no physical presence. But, states struggling to recover from economic recession see this uncollected tax as a major source of potential revenue.

In addition to recovering revenue lost in the recent economic downturn, state and federal efforts have been associated with arguments about fairness. Specifically, that the de facto tax-free status often associated with online shopping gives an unfair advantage to out-of-state online retailers over their in-state brick-and-mortar competitors.

This came to a head in 2013 during debates over the Marketplace Fairness Act, a federal proposal that would give states meeting certain requirements the option of placing sales tax requirements on out-of-state sellers with more than $1 million dollars in annual remote sales revenue.

BEAT THE AUDITOR:

Nexus–Nexus triggers include: having out-of-date rates and rules, failing to recognize new rules that create remote seller nexus, or using error-prone manual processes to manage complex sales and use tax laws and rates. Watch for more (and more creative) definitions of nexus-creating activities in 2014.

States are drawing encouragement from recent court actions, such as the US Supreme Court's refusal to hear Amazon's challenge of New York's law about so-called "click through" affiliates. And as we've seen, states are always looking for ways to expand the types of activities that create nexus to include the use of affiliate networks, distributors, independent agents, and the like.

For more information: How Nexus Confusion Affects Your Business

Challenge #2: Understanding and following changes in product and service taxability

Survival Tactic: Track your product and service offerings against the unique requirements of each state into which you sell

Historically, most sales of Tangible Personal Property (TPP) have been subject to sales tax. This has begun to shift to include intangibles such as professional services and installation services. Many states now routinely apply sales taxes to services, including specialized training, experience, or project-related staff hours.

Many states are addressing budget gaps by increasing product and service taxability. Your business must determine which items require the collection of sales tax, and capture variations arising from the location of the sale.

For example, many states don't collect sales tax on grocery items but do tax processed foods that contain certain ingredients. Service taxability varies greatly from state to state. States like Delaware, Hawaii and Washington tax a large number of services; other states such as Alaska, Virginia, and New Hampshire tax very few. As taxing jurisdictions change their rules about taxability of goods and services, your business is required to be aware of the changes, and to adjust your accounting systems accordingly.

BEAT THE AUDITOR:

Remember to update product and service taxability as rules change and new products and services are offered.

For more information: Identification and Taxability of Digital Products

Challenge #3: Finding the right sales tax rate to charge customers

Survival Tactic: Don't rely on ZIP codes to determine the right rate

Don't make assumptions about geography. Many businesses make the mistake of searching for the correct tax rate by ZIP code, assuming this will give them accurate information. Unfortunately, taxing jurisdictions do not follow ZIP codes. Individual counties and municipalities can levy sales taxes in addition to state rates, and sometimes tax rates can vary within an individual ZIP code. Geospatial mapping, on the other hand, can pinpoint each location against each relevant taxing jurisdiction.

Greenwood, Colorado is a great example of the inaccuracies inherent in using ZIP codes to find the right sales tax rate. If you're a business with a taxable sale in Greenwood Village, and you use a generic look-up tool to find the correct sales tax rate, you'd enter the address and then ZIP code 80111. You'll be given the sales tax rate of 7.72%. In fact, Greenwood Village has one ZIP code, but four different sales tax rates. When a blunt instrument like ZIP codes is employed to determine sales tax rates and boundaries, calculation mistakes are almost guaranteed. Unlike more accurate tools using geolocation technology, ZIP codes lead otherwise savvy business people to conclude they've got sales tax compliance handled, when in fact they're using the wrong rates most of the time.

BEAT THE AUDITOR:

Once you've put away the generic ZIP code look-up tools, you're ready to take your company's sales tax compliance efforts into the 21st Century. Use Avalara's online tool that uses addresses as well as geolocation to determine the exact point of the taxable transaction.

For more information: ZIP Codes: The Wrong Tool for the Job

Challenge#4: Tracking sales tax holidays

Survival Tactic: Understand tax holidays in each state into which you sell

There were least 17 states with sales tax holidays in 2013, and that will surely change in 2014. Sales tax holidays–specific days when sales tax is not charged on certain products and services. For example, "Back to School" holidays in some states exempt clothing purchases from sales tax on specific days, or below certain dollar amounts. Sales tax holidays give consumers an opportunity to purchase goods and services tax-free.

By their very nature, these tax holidays can be ad hoc and unpredictable. Varying by type of goods, or time of year, over different periods of time, with absolutely no consistency from state to state. It's so haphazard, there's little chance of getting it right consistently. This means potentially disappointing customers expecting to get a sales tax break on a purchase. Incorrect application of holiday tax breaks can lead to over-charging sales tax and ultimately incur additional cost in time and effort to correct the errors, and refund the over-collection to your customers.

For more information: Sales Tax Secrets: Roaming Tax Holidays

Challenge #5: Managing exemption certificates

Survival Tactic: Know which transactions are exempt from sales tax and how to manage certificates effectively

Not all customers are required to pay sales tax. Depending on the rules in your taxing jurisdiction, certain businesses and individuals may be exempt from sales tax. It is incumbent on the *vendor* (you!) to collect and keep on file a valid exemption certificate for each business, organization, or individual with an exemption.

It is also up to you to ensure that exemption certificates are valid for each sales transaction. This requires your business to keep a copy of each exemption certificate and ensure that they are renewed when they expire. For easier accounting, a database or spreadsheet of exemption certificates should be easily accessible. The best solutions tie directly into your point-of-sale system, making it simple to verify that exemption certificates are current, valid and on file.

Businesses that manage large numbers of exemption certificates often confront a difficult challenge when audited to link specific certificates with specific transactions. In other words, to prove that tax was not due on a particular sale. Certificates also expire or may be invalid, potentially leaving the selling business liable for paying uncollected tax.

BEAT THE AUDITOR:

Exemption certificate-related practices that might increase your risk of an audit: inability to quickly generate a summary report, inaccurate, incomplete and missing certificates, or expired certificates.

For more information: Automating the Exemption Certificate Lifecycle

Challenge #6: Identifying the forms and remittance processes for each taxing jurisdiction

Survival Tactic: Know where and how to remit sales tax

For each taxing jurisdiction, a business must meet filing deadlines and provide timely remittance using correct forms and formats.

This step sounds simple. And for many businesses it may be easy, especially those with only one location. In this case, the business would be responsible for collecting sales tax at the rate applied in its home city. Things grow more complex when the business adds a location. And then another. With each new city or state, the complexity and number of guidelines you must understand in order to file and remit accurately expands exponentially.

States are becoming increasingly aggressive in auditing businesses. Most states use a formula to determine which businesses will be audited; examining the results of past audits to see which industries had the most compliance issues.

Some businesses mistakenly believe that if they don't make major mistakes they will not be audited. That is incorrect. Audits are often triggered by external factors, such as revenue shortfalls or changing tax rules.

BEAT THE AUDITOR:

Filing errors that might increase your risk of an audit include failure to prepay where required, late payment, or payment to incorrect jurisdictions.

For more information: 5 Sales Tax Compliance Tips of 2013

Challenge #7: Preparing for an audit

Survival Tactic: Expect the best, prepare for the worst

An auditor reviews a sample of 20 transactions where no sales tax was collected. Exemption certificates for four of those transactions are not on file and immediately available. The auditor will extrapolate from that sample and estimate that 20 percent of your company's non-sales-tax transactions are invalid. Those taxes would then be assessed, as well as penalties and interest.

To survive an audit, the most critical action a company can take is to collect sales tax properly over time. But, while accurate collection is necessary, it's not sufficient. You must also ensure that you have properly documented every step of the way. Audits are much less painful when good documentation, such as transaction history; exemption certificates and other details are at your fingertips.

Accounting must track and apply sales tax law changes across every jurisdiction where your company does business, as well as create and maintain detailed records of sales tax compliance activities.

Sales must help the company determine whether new locations or accounts will bring with them additional sales tax compliance issues.

IT must make changes to accounting systems and ecommerce systems, in addition to allocating adequate electronic storage for compliance records.

For more information, watch 3 Top Reasons Businesses Get Audited for Sales Tax

Challenge #8: Switching from an error-prone manual sales tax management process, to an automated streamlined one.

Survival Tactic: Automate

Unfortunately, addressing sales tax compliance manually is inefficient, error-prone, and diverts resources from revenue-generating activities. Well-run businesses understand that a sales tax strategy is not simply about accuracy, especially given that 100 percent accuracy in sales tax collections and remittances is next to impossible.

The more time spent calculating, collecting, and remitting sales tax, the more company resources are directed away from revenue-generating activities. Yet inaccurate sales tax management can have very negative consequences for your business; automating and outsourcing the process makes good business sense. Rather than creating policies, procedures and records from scratch, thousands of companies choose to fully outsource their sales tax compliance program. A variety of automated solutions is available for both on-premise and hosted (in the cloud) installations.

Hosting is a more efficient way to automate, where a sales tax compliance vendor integrates its software into your existing accounting, point-of-sale, ERP, and other technology systems. In addition, the vendor tracks your company's data as needed, including exemption certificates, sales tax liability data and more. With a fully hosted solution, it's simple for your team members to get immediate access to critical data any time or anywhere, without the headaches of running and maintaining the system.

In addition, outsourcing the sales tax compliance function shifts your company's risk to a third party.

For example, Avalara is a certified provider of the Streamlined Sales Tax Project. As a result, Avalara clients are protected from penalties and interest if any mistakes in sales tax remittances occur.

No system is absolutely foolproof, but with a detailed process in place, an auditor is more likely to give your company a clean bill of health

But don't take our word for it.

What Customers Are Saying

From a compliance standpoint, taking most of the responsibility off your shoulders and putting it onto a company whose on-demand calculation is pretty accurate, I would definitely recommend it. We used to have one staff accountant who was doing every single return and it was just way too time-consuming. At the time, we only had seven states. Now, we're up to 25, so we're really glad we went with Avalara Returns.

> Anthony Carter, ERP Analyst at ESET North America

We have over 6000 clients and customers; we deal with school districts and government entities that have a lot of exemption certificates. Keeping track of that as a single revenue accountant – you can imagine that's one big project. We have very few finance and accounting people in our organization. So to automate the sales transaction process will increase our efficiency and we'll be able to use our resources to better serve our customers and clients.
So it's an easy, quick tool that we feel is worthy of the cost.

> Daren Toy, Revenue Accountant at Apex Learning, Inc.

Our biggest audit hit was the exemption certificates and the no-tax sales. So we decided to go with Avalara CertCapture. We really feel strongly that it is going to be a good tool for us to help with audits, to reduce our liability with states, to reduce the frequency of state and multiple jurisdiction audits. We needed to outsource part of our sales tax to make sure we were compliant. Avalara had what we were looking for. Everything fit.

> Heather Gravelle, Sales Tax Manager at Furniture Row

What You Can Do

Understanding the implications of recent state and federal rule changes and addressing the onerous task of complying with the ongoing jurisdictional statutory changes need not expose your company to audit risk. You can address this today.

1. **Contact Avalara** for a custom analysis of your potential sales tax collection requirements in all of the jurisdictions in which you currently operate or into which you plan to expand.

2. **Take the next step** toward automating your sales tax process.

   CALL: 877-780-4848
   VISIT: www.avalara.com/products/avatax

About Avalara

Avalara makes sales tax compliance simple and automatic for thousands of customers every day. Its SaaS-based, sales tax and compliance automation software solutions span the compliance spectrum; each year these solutions deliver billions of tax decisions, manage millions of exemption certificates, file hundreds of thousands of sales tax returns, and remit billions of tax dollars to states nationwide.

Recognized as one of America's fastest growing technology companies, Avalara is integrated with leading ERP and ecommerce software systems that serve millions of small to medium sized businesses. Founded in 2004 and privately-held, Avalara's venture capital investors include Battery Ventures, Sageview Capital and other institutional and individual investors. Avalara employs more than 500 people at its headquarters on Bainbridge Island, WA and in offices across the U.S. and in London, England and Pune, India.

Avalara

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