Sales Tax Corner

Streamlining Indirect Tax Compliance and Efficiency Through Automation Solutions

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Complying with indirect tax obligations is a significant challenge. Taxpayers must navigate varying nexus and registration requirements, diverse taxability determinations across U.S. states, and thousands of tax rates. Indirect tax automation offers a solution to enhance efficiency and improve compliance compared to the manual preparation and filing of tax returns in multiple states, which tends to be an arduous and error-prone task. Automation can also assist businesses by routinely tracking when sales activities exceed a state's nexus thresholds, updating non-custom taxability determinations and tax rates, and notifying when to renew exemption certificates. Further, automation can enhance a company's procurement process by identifying whether purchases are taxable or exempt and calculating the use tax due on taxable purchases if the vendor did not charge sales tax.

While this column focuses on sales and use taxes (SUTs), automation can streamline the management of other types of indirect taxes and fees, such as gross receipts taxes, value-added taxes (VATs), goods and services taxes (GSTs), harmonized sales taxes (HSTs), utility taxes, excise taxes, telecommunications taxes, food and beverage taxes, hotel taxes, lease taxes, and regulatory recovery fees. This column outlines the key steps for successfully implementing an automated compliance solution, including designing and selecting the right solution for your business; executing configuration, mapping, and testing phases; and ensuring effective post-deployment maintenance and support.

Business Case for Indirect Tax Automation

Many situations can lead to the need for automation.

Sales tax nexus is established when sales exceed specific economic thresholds, such as $100,000 in gross sales or 200 separate transactions in the past or current year. All states that impose sales tax have defined economic nexus standards. Companies involved in e-commerce or in software or digital sales, even with just a few hundred thousand dollars in sales across U.S. states, are likely to have established economic nexus, resulting in compliance obligations in several states. The in-state presence of employees or independent agents providing services on

the company's behalf or of office space and inventory may further expand a company's nexus footprint.

A typical company subject to sales tax rules might be a European-based software firm licensing software as a service (SaaS) with sales nearing half a million across multiple states, a gaming company offering a free app with frequent in-game purchases, a lifestyle company selling subscription to workouts with the help of social media influencers, or an e-retailer selling kitchen utensils through its online store and marketplace facilitators.

The ease of establishing nexus requires the company to know the taxability of their revenue streams and be able to accurately collect tax in jurisdictions with varying state, district, and local rates. Those tasks are nearly impossible without reliance on indirect tax automation tools. Automation can track sales in non-registered jurisdictions and alert companies when they are approaching thresholds and might need to consider registration.

In-house accounting departments often face resource constraints and may lack the capacity to hire dedicated teams to manage monthly sales tax obligations. Personnel changes can disrupt process consistency. For example, when employees leave, they might not pass on critical log-in information for tax-related accounts, or authentication check-ins could be sent to an email account that can no longer be accessed, resulting in delays in compliance and reporting. Consequently, the accounting department may struggle to retrieve important data or meet deadlines, potentially incurring penalties or fines. Automation can centralize passwords and authentication access, ensuring seamless continuity in return preparation and filing despite staff turnover. It also preserves historical compliance knowledge, maintaining consistency and accuracy in tax processes.

Companies relying on "home-grown" systems should evaluate the advantages of transitioning to a commercial solution. Frequent audits, the need for refund claims, and the maintenance of large tax reserves often signal inefficiencies in current tax processes. By leveraging technology for historic data collection and analysis, nexus review, taxability determinations, sales sourcing, and the maintenance of exemption certificates, businesses can streamline audits through comprehensive and organized records. That facilitates quick access to relevant information, ensures accurate compliance checks, and reduces the likelihood of errors or discrepancies. Further, a technology solution can be used to review and test the necessity of and update tax reserves, confirming they are appropriately managed. Lastly, during the due diligence process, a company with a sales tax engine can quickly respond to queries about its nexus and taxability determinations, share past filings, and provide documentation on exempt customers.

Automation can also be used to track and review purchases for taxability, a crucial feature during large capital expenditure projects whose sales tax expenses can be significant. The ability to review purchases in real time for sales tax determinations can prevent overpayments at the time of purchase, saving the company both money and the valuable time that would otherwise be spent on the refund process. If sales tax is not paid on taxable purchases, the system can assist in calculating use tax at the appropriate rate, helping avoid both the underpayment and overpayment of taxes.

A change in legal entity structure or merger and acquisition activity can lead to redundancy when multiple enterprise resource planning (ERP) systems or sales tax compliance tools converge into a single entity, necessitating the migration of information from one system to another. During that transition, the company must decide which system to retain, making it crucial to evaluate each system's capabilities and alignment with the company's compliance needs and strategic plans. By selecting the most suitable system, the company can streamline operations, reduce costs associated with maintaining multiple systems, and enhance overall efficiency.

Post-acquisition, companies with similar products may encounter discrepancies in taxability determinations for the same product type across different systems. Those variations often arise from the customization of code selections by different decision-makers or the selection of codes with similar descriptions in the software mapping without checking if the taxability in the software matches the expected taxability under state rules. Such inconsistencies can lead to confusion and inefficiencies in tax compliance because differing interpretations of tax rules can result in incorrect tax calculations or reporting. Further, inconsistencies will be visible to a customer that was purchasing the same item from the companies before the merger, and the software should be able to identify differences and question the taxability determination. To address those challenges, companies need to analyze the tax code classifications in each system, then select the appropriate taxability and implement and test it in the system selected for compliance.

Implementing a new ERP system or upgrading an existing one offers an opportunity to evaluate which automation solution best aligns with the company's current structure and growth vision. That not only streamlines operations but also helps verify that the chosen solution supports the company's strategic objectives and scalability needs.

Identifying and Inviting Stakeholders to an Indirect Tax Automation Project

Once the business case for SUT automation has been developed, it is crucial to communicate it with key stakeholders, including finance, tax, IT, and operations (procurement and sales). That collaborative effort will help ensure that various inputs are considered in determining the project scope, timeline, and required resource commitment, as well as the preferred technology and best partner to assist with implementation.

The finance, tax, and IT departments must understand the total costs associated with transformation, which include software licensing, implementation support, and ongoing maintenance. Licensing costs can vary depending on transaction volume, company revenue, integration capabilities with existing ERP systems, and other metrics that can change annually. Therefore, it is essential for finance, IT, and tax to understand the expected costs for the initial year and anticipate future expenses.

The tax department should also gather vital information regarding the company's revenue streams, filing requirements, SUT calculations, accrual procedures, exemptions, and purchasing activities. As part of that process, the tax department should collaborate with the company's sales and marketing teams to gain a comprehensive understanding of the products, contract language, and invoicing methodologies. Such collaboration ensures that all aspects of the sales process are considered, allowing for accurate taxability determinations. The tax department should share the results of prior audits and refund claims identifying key area points that should improve through automation.

The IT department should evaluate how the sales tax software integrates with the organization's ERP system and aligns with the overall IT strategy. That includes addressing any data security and compliance requirements upfront to certify they are compatible with the software's capabilities, as well as with industry standards and company policies. Understanding the availability of IT resources is also crucial for successful integration because it allows for the proper allocation of skilled personnel to the project.

Operations should describe the company's procurement functions and decisions related to sales tax payments on purchases or the accrual calculation of use tax. If procurement is decentralized, each location may have its own purchasing procedures and methods for reviewing invoices for tax purposes. Decentralization often exists with either manufacturers that have several plants in different states or businesses that grew through acquisition but never integrated their purchasing function. Further, procurement and accounting departments might not identify when assets are purchased in one state but used in another and might not account for differences in tax treatment or rates. For example, if a company purchases non-exempt property in Pennsylvania, which has a sales tax rate of six percent, but uses it in Massachusetts, where the sales tax rate is 6.25 percent, the company should have Massachusetts use tax obligation on the difference of 0.25 percent. That is often the case in leasing businesses, where movable assets purchased in one state can then be used or released in another. However, a similar situation may arise with software, with the vendor using the bill to address for invoicing sales tax, but the software being used by the company's personnel in other states. With difference in rates, that can result in overpaying or underpaying tax.

On the sales side, it is important for operations to share information with the tax department to compare the states where the company files tax returns to those where it has operations. The company may have nexus in several states but has not been filing returns, or it has introduced new taxable products without collecting sales tax or sold taxable products to exempt customers without obtaining the necessary exemption certificates. Operations and tax departments must collaborate to identify and fix issues that may have created past exposure and find solutions that may automate and prevent similar problems in the future.

How to Successfully Implement an Indirect Tax Solution

With numerous stakeholders involved, implementing an indirect tax solution requires collaboration and strong project management. From the outset, it is crucial to determine who will assume the project management role to guide the respective teams in adhering to deadlines and achieving desired outcomes. The company's tax department should consider partnering with a third-party implementation partner such as an indirect automation tax specialist or accounting firm to guide the company for an end-to-end implementation. Those projects can be time-consuming, especially if the tax department's resources already are constrained.

An implementation partner can assist the company by managing or co-managing the project, facilitating communication with stakeholders, assigning responsibilities, and monitoring deadlines. That partnership can help bring a project to fruition by leveraging the consultant's

expertise and allowing the tax department to focus on its core responsibilities.

A successful implementation should be managed through the five phases of the project outlined below.

1. Planning and Requirements Analysis

A proper planning and requirements analysis is essential for determining which business processes are within the scope of the software implementation process. Typically, a company decides whether to include areas such as sales, procurement, movable property, and fixed assets in the software's coverage. The software should be able to determine the appropriate SUT rates for each sale and purchase, generate detailed sales tax reports showing tax collected by jurisdiction, and assist with the remittance process and its documentation. It should also provide an audit trail of all transactions, including the amount of tax collected and remitted for a specific month and state. Finally, it should automatically update changes in the tax rates and taxability of selected revenue streams.

The company should define the project's geographical scope, which affects the taxes involved. For instance, if the scope is limited to the United States, the focus may be only on SUT; however, if the scope includes Canada, the company may also need to incorporate GST/HST and local taxes. Expanding the scope to include other international regions may introduce additional complexities, such as VAT or other region-specific taxes and duties.

Properly defining the geographical scope will assist in evaluating vendors and their international indirect tax capabilities, some of which might cover only specific regions or countries. Such clarity will also facilitate budgeting and resource allocation for the project because teams outside the United States may need to participate in the implementation process.

The company should consider its size, business lines, and growth plans to ensure that the chosen software solution is scalable. If the company plans to transition from wholesale to direct-to-consumer sales, launch an online platform, or begin selling through marketplace platforms, or if it has an increased volume of transactions, those initiatives should be included in the system's design and configuration. Such plans may also affect software and support costs, which should be evaluated during the decision-making process.

During the scoping and as part of the software selection process, the company should consult an experienced integration partner who can provide insights into the potential benefits and shortcomings of available solutions. They can also facilitate communication with stakeholders, including ERP support teams and software vendors, regarding desired requirements. Further, the integration partner can help identify steps and enhancements needed to meet the company's expectations.

The company should identify all in-scope processes for sales and purchases, as well as which processes will include tax determinations. Those should be included in a requirements document that sets out the necessary master data, process changes, tax variations, and reporting and compliance.

2. Solution Design

In the second phase, the company will design the end-to-end future solution process. It will perform a "fit-gap" analysis to assess whether the chosen tax software solution can be integrated "out of the box" into the existing environment, such as e-commerce websites, point-of-sale systems, and accounting software. Further, the company will identify any potential gaps that may need to be resolved during implementation, including the effort it will take for the software to work with the existing or new ERP system.

This phase of the project involves determining the company's revenue streams and mapping them into the software system. To achieve that, a comprehensive review of all the company's products and services is necessary, examining how they are described on the website and in contracts, invoices, and terms and conditions. As part of that, the company should also consider auxiliary revenue streams it may offer, such as installation, maintenance (optional or mandatory), monitoring, and help desk support, as well as whether those services will be provided in person or remotely. Consistency in the description of revenue streams, both internally and publicly, is crucial for accurate system mapping. Any discrepancies in the characterization of revenue streams should be resolved before mapping them into the system because they can lead to incorrect taxability results.

During this phase, companies may discover they have nexus in states where they conducted taxable sales or made purchases without timely self-accruing and remitting use tax. Before activating the tax engine in those states, it is important to assess the materiality of any exposure, which might be mitigated through voluntary disclosure programs (VDAs) and state tax amnesty or negotiated settlement programs, or by filing late returns and requesting abatement of penalties. The solution design and implementation do not need to be paused while the company addresses its exposure through a VDA or other program that may

take an average of one to three months to resolve. When a company registers for sales tax as part of the VDA, its registration and log-in information can be added to the tax engine.

In some scenarios, additional data will need to be passed from the ERP. The details will be outlined in the solution design to be passed in the technical integration.

3. Tax System Policy Configuration

During this phase, the tax engine will be configured according to the functional design. That process includes the company's establishing product and services mapping and customer and vendor-specific scenarios. A company's specific needs and scenarios may require custom rules and tax decisions that must be configured by an experienced implementer.

The ERP or billing/procurement system may also require configuration to connect the systems and enable tax determination. If non-standard data elements or additional fields above the standard integration are needed, then some technical integration development would be required. The implementation partner would work with the software vendor to integrate the tax software into the ERP to communicate flawlessly.

4. Testing

Before going live on real-time transactions with actual customers, it is crucial to thoroughly test the solution. Different phases of testing will ensure that the system configuration and any special rules that were created are tested along with the integration of the source system and tax engine.

The minimum required phases of testing include unit testing, integration testing, and user testing. Unit testing is performed throughout configuration to ensure the tax engine is configured correctly and that any rules or solutions are returning accurate tax results. Integration testing focuses on ensuring that the source system passes the correct data elements to the tax engine and receives them successfully onto the necessary documents. Lastly, user testing involves business end-users mimicking real-life scenarios and ensuring different variations of the process are tested. Transactions are tested from end to end to ensure that the necessary data is available for reporting and compliance. All issues should be documented and rectified before going live.

Additional testing cycles such as parallel testing, in which a full subset of transactional data is run through the system to compare to the existing process, could be beneficial. There are many technology tools that can run a large number of transactions through the system to test all the various combinations of scenarios.

5. Product Cutover and Solution Support

As the project approaches the go-live date and testing nears completion, it is important for all stakeholders to be prepared. As part of the go-live process, individuals who will be using the system should receive comprehensive training so they are comfortable managing the compliance process through the software. For example, users must understand the implications of alerts issued by the software, such as when sales in a particular jurisdiction where the company currently does not file SUT returns are nearing the economic nexus threshold, potentially triggering a sales tax registration requirement. They should also understand that reaching economic nexus and registering for sales tax may lead to the company having to file income/franchise or gross receipts tax returns.

After the go-live date, there is a post-production period when the software implementation team will be available to provide support and address any issues that arise. Stakeholders should hold periodic meetings to discuss how evolving business needs can be accommodated by the software system and whether any changes are necessary. For example, as the company releases new products and services, the mapping in the software should be updated to account for their taxability.

Also, the software system should undergo annual checks and testing to identify and rectify any abnormalities, verifying its continued effectiveness and alignment with the company's requirements. For instance, changes in tax laws generally are not automatically updated in custom codes. Thus, custom taxability codes set up during implementation should be reviewed to ensure they are up to date with state laws. Blind reliance on custom code automation could result in significant exposures.

By understanding the triggers for indirect tax automation and carefully planning its implementation, organizations can achieve major improvements in efficiency and compliance. With the right approach, businesses can navigate the complexities of tax regulations with confidence and precision.