The State of Sales and Use Tax: At a Crossroads

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Executive Summary & Intro: Sales and Use Tax – At a Crossroads

Charles Maniace, Sovos vice president regulatory analysis and design

> **“Before Sovos, we thought we were ready for Wayfair; we were wrong.”** - SOVOS, ECOMMERCE CUSTOMER

It’s my distinct pleasure to pen the introductory comments to our first edition of the Sovos Sales and Use Tax Annual Report. I hope you will find this collection of online information both insightful and practically informative as you chart out the near and long-term compliance plans.

As Sovos has grown from a small company with a single office in Salem, Massachusetts to a multinational organization with more than 1,400 employees across three continents, we have gained a global perspective. We have witnessed the phenomenon of technology-enabled **“continuous transaction controls”** take hold in Latin America and proliferate in Europe and Asia. We understand how countries are ensuring compliance over a nationwide tax base through the gathering of real time information of what is being purchased and sold day-to-day.

In the United States, where sales tax enforcement remains the province of state governments, change has not yet been quite as dramatic. While state revenue authorities surely use data and technology to compel compliance, we have not (yet) fully embraced requirements extending beyond electronic transmission of periodic tax returns. However, that time may be fast approaching.

Since the Supreme Court decision in South Dakota v. Wayfair in June 2018, much has changed. **Most every state has enacted rules extending sales tax compliance to remote sellers.** However, we are still at a stage where many ecommerce companies are not yet compliant, nor are states fully prepared to enforce their sales tax rules against a global taxpaying base. When you consider these facts against the enormous state budget shortfalls caused by the COVID-19 pandemic, the time for change seems at hand.

> **“As a small business, we really have to rely on companies like Sovos and leverage their expertise because we don’t have a large tax compliance team here. No small business has the resources to dedicate an entire team to that function”** - CIO, SOVOS CUSTOMER

While governments will likely consider measures such as increased rates and new taxes as a means of closing the gap, it is evident that technology-enabled processes aimed at facilitating the fullest possible enforcement of existing requirements will be part of the solution. Ensuring your organization is safe from audit risk and exposure will continue to be an important and challenging task over the coming year.

RECENT SOVOS INDUSTRY SURVEY

What's the most difficult for you right now?

Monitoring changes in nexus	38%
Accounting for proper taxation of new products/services	17%
Meeting filing & remittance obligations	31%
Focusing on staff & other core business functions	14%

Chapter 1: Sales and Use Tax by the Numbers

Charles Maniace, Sovos vice president regulatory analysis and design

> **"The endless list of tax obligations was becoming all-consuming. Post-Wayfair, we weren't just dealing with states anymore. It was now a matter of dealing with hundreds, if not thousands of individual counties and cities, all with their own rules and rates. This is why we turned to Sovos"**
>
> - SOVOS, ECOMMERCE CUSTOMER

Sales and use tax has become incredibly complex in recent years. The pace at which businesses evolve and expand and bring new and novel products and services to market, coupled with the sheer volume of changes to tax laws and regulations has made it incredibly difficult for most organizations to remain compliant and guard against audits.

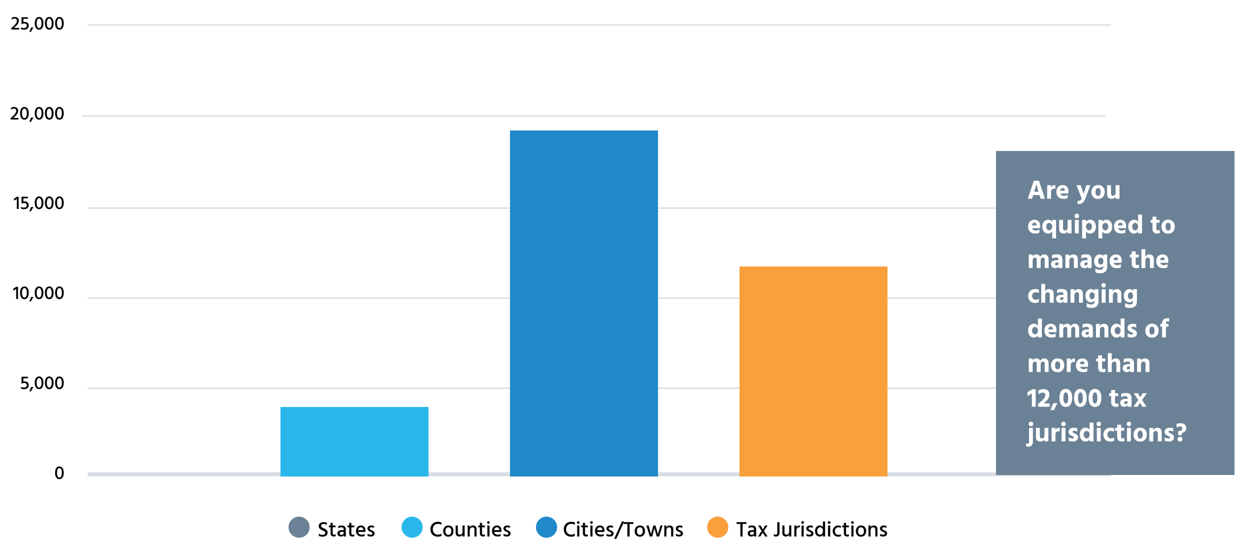
In most of the rest of the world, transaction tax is largely the province of the federal government. Not so in the United States. Because there is no centralized tax authority, organizations are often required to account for rate and rule changes, prepare returns, and remit funds across multiple jurisdictions. Accurate compliance means understanding all the current rates, laws, and forms, as well as staying aware of any future changes impacting your legal obligations. This challenge, which was already difficult before the SD v. Wayfair decision, has now become exponentially more difficult.

To appreciate how vast the tax landscape has become across the U.S., consider some key metrics:

Number of jurisdictions:

Today, in the US there are approximately 22,688 political subdivisions (states, counties cities). Sales tax exists in approximately 12,062 locations, including 44 states (along with DC and Puerto Rico), 2,211 counties, 7,766 cities and 2039 districts.

Number of Current Tax Jurisdictions

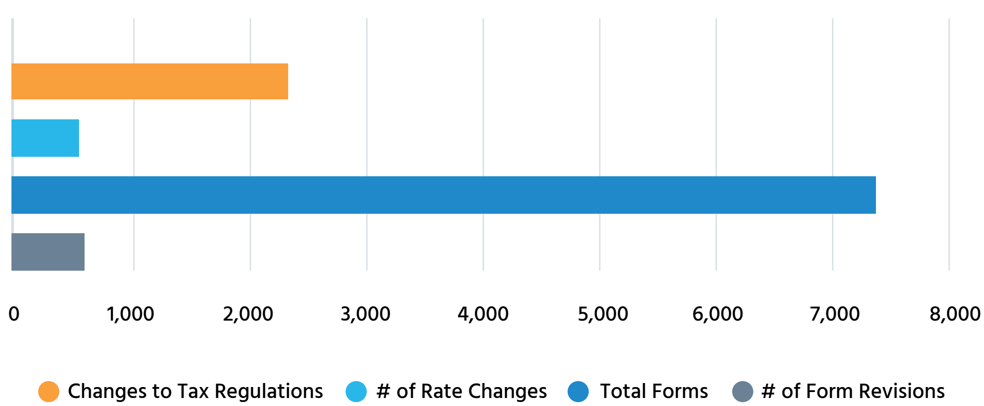


Number of regulation, rate and form changes per year:

The single biggest worry of tax professionals is keeping up with the pace of regulatory change. Rates, rules and forms change every single month. When laws, rates and processes change, organizations must adapt to remain compliant. How big is the problem?

- Since 2017 Sovos has expanded its already extensive tax matrix by 14.3% to support new rules and tax distinctions as they emerge.
- Standard sales tax rates are also being adjusted more and more frequently. In the period from July 1, 2019 to now, there have been 571 rate changes.
- The number of tax forms in use across all jurisdictions are also growing at an astronomical pace.
- As of today, Sovos is tracking 7,291 tax forms and has noted 637 revisions in the past year alone.

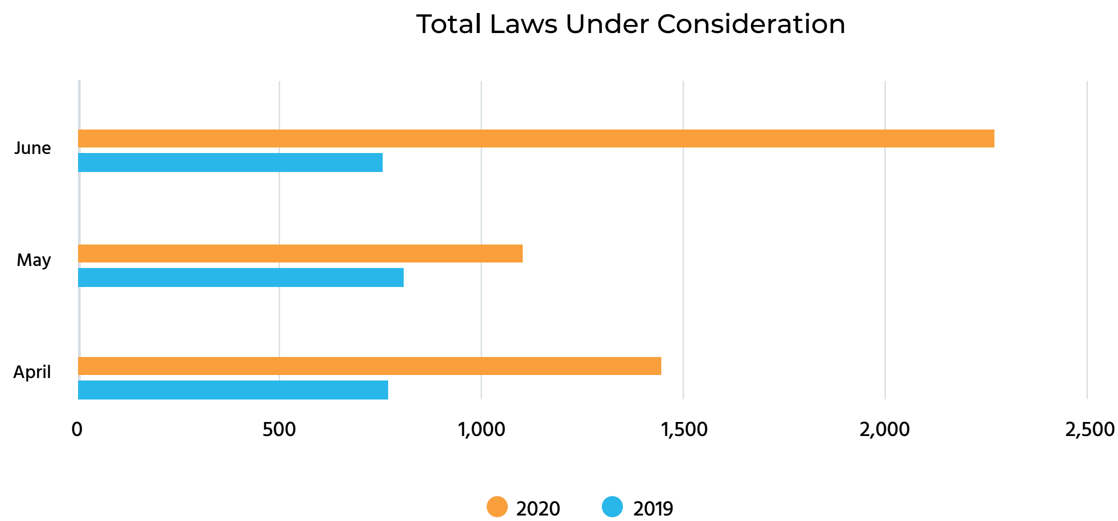
Total Number of Regulation, Rate and Form Changes Per Year



Tax laws under consideration:

While we would all welcome a moment to pause and reckon with compliance challenges as they exist today, a slowdown in the pace and rate of change isn't likely to happen any time soon. Sovos has been tracking all bills possibly impacting sales tax compliance under legislative consideration in 2020, and the numbers reflect a significant increase from the same time in 2019, suggesting things could get even more complicated. As of the writing of this report there were 2,268 pending or enacted bills with sales tax implications under consideration. At the same time in 2019, there were only 756. In April 2019, there were 770 bills with sales tax impact under consideration compared to 1,443 in April 2020. Likewise, in May 2019, 811 such bills were being considered versus 1,096 in 2020.

The metrics bear out what most of us already know - that sales and use tax is complicated and getting more difficult by the day. The only way to stay up-do-date (and more importantly stay ahead) is through efficient and scalable compliance processes and solutions.



The numbers show that sales tax is on a path towards increased complexity. How will you track these changes when they happen?

The numbers bear out that sales and use tax is complicated, and it's getting more difficult by the day. Complexity has crept into every corner of the process, and manually tracking the number of changes and updates for the jurisdictions in which your organization conducts business has become a nearly impossible task.

RECENT SOVOS INDUSTRY SURVEY

How many new states have you had to register in?

0	41%
1-5	8%
6-10	3%
11-20	24%
20+	24%

Chapter 2: The Digitization of Tax and the Role of Technology

Pawel Smolarkiewicz, Sovos chief product officer

> **"Compliance continues to operate with a data and technology architecture that lags the standards required to manage the emerging risk landscape."**
>
> – ACCENTURE

We are undergoing a new form of digital transformation that is putting an unprecedented level of pressure on your business and systems as it relates to tax. Forces at work include business transformation, IT modernization and regulatory change.

Business transformation: As organizations expand to include new business models, such as direct-to-consumer and ecommerce channels, or to move into new cities, counties or states, there is a direct impact on their tax obligations. There are more than 12,000 different tax regulations affecting sales and use tax across the country. As your business evolves to offer new products and sell, reach customers via new channels and enter new markets, you are assuredly going to have to account for new regulations.

IT modernization: Managing regulatory requirements can be complicated based upon your IT structure. The most obvious question is, can your systems keep pace with modern tax environments? The pace of change is swift and requires near constant updating to ensure you meet all obligations. If you do not have a mechanism for automating these updates, the potential for audits and penalties increases significantly. Yet, overhauling your systems to accommodate tax and regulation can be an equally daunting task.

Digital transformation of tax: For perhaps the first time, government investment and application of technology is outpacing private industry. The pace of regulatory change and systems put in place to identify and prevent fraud are putting the pressure on organizations to quickly adjust to and comply with a new standard to avoid potential notices and audits and penalties. Governments are more serious than ever about ensuring they collect the revenue they're owed, completely and on time.

The role of technology in tax: As a result of these pressures converging, a new paradigm for tax is emerging - one in which technology will help companies meet their sales and use tax obligations, guarantee operations continue uninterrupted and avoid financial penalties for non-compliance.

Compliance has become a huge challenge. Companies both large and small are finding that their traditional procedures and business systems and legacy solutions are ill-equipped to manage rapid regulatory change. This is where the right technology partner comes into play.

Remember, you are trying to solve a problem once and for all, not create stop-gap solutions that will need to be replaced six months to a year down the road. Point solutions only increase IT complexity, become difficult to maintain and ultimately become a burden on your business, slowing your potential to grow and adapt. To solve the tax conundrum permanently, you must adopt a global, proactive strategy that offers solutions and opportunities across all tax jurisdictions and compliance regimes, whether you currently conduct business in each of those geographies or not.

Tax is both a financial and IT problem. In order to solve it correctly, you need both parties playing an active role in the solution.

Given the current COVID-19 pandemic, it all but guarantees that we are in for a whole host of changes as local and state governments seek to increase and recoup revenues to offset skyrocketing costs. It is no longer a question of whether you can manage these processes manually. You can't.

Get out in front of the next wave of regulatory change. Select a technology that meets your current needs and can scale along with your business growth. It was the implementation of new technology by regulatory authorities that created the pressure situation that now exists. It will also be technology that ensures you can manage and meet your obligations and minimize impact on your business.

RECENT SOVOS INDUSTRY SURVEY

Where are you at in your compliance journey?

Just starting out	0%
Nexus study in progress	20%
Assessing available business resources	16%
Calculating/filing/remitting both accurately & timley	38%
Proactively monitoring and applying compliance updates	27%

Hope is Not a Plan: Businesses Need to Get Sales & Use Tax Right

Scott Scharf, co-founder and chief ecommerce geek, Catching Clouds

Ask a small to mid-size ecommerce business owner for a shortlist of their challenges, and you will undoubtedly see managing the sales and use tax process featured prominently. Sales tax has evolved in complexity to the point where it is nearly impossible to track and manage through manual processes, and these organizations don't employ large teams of accountants or IT professionals, nor do they have vast resources to tap. This is the conundrum many businesses find themselves in today.

The sheer number of regulations, forms and nuances involved in managing tax across multiple jurisdictions can be overwhelming. The introduction of marketplaces has only added to the complexity and confusion. But despite the difficulty of the process, it's something you need to get right. If not, the risk of audit and resulting financial penalties is very real.

For many, the plan to date has been one of avoidance and hope. Either pretend that the changing regulations don't exist or hope that you are doing it right. Neither is a long-term strategy that will benefit your business. The longer you avoid addressing the problem head on, the more complicated and costly the problem becomes.

So, what should you do? Here are three steps I advise taking as you begin your journey to becoming a fully compliant business:

1. **Identify your gaps** – What are the areas of sales tax management where you are struggling or completely ignoring? You can't address a problem until you fully understand it.

2. **Put procedures in place** – You won't solve all your problems at once, but by installing a set of checkpoints, you are more likely to identify issues early in the process.

3. **Ask for help** – Most people are not tax experts. Fortunately, there is help out there for businesses struggling to solve their sales tax issues. Both government programs and technology exist that can alleviate the burden of tax management. Take advantage.

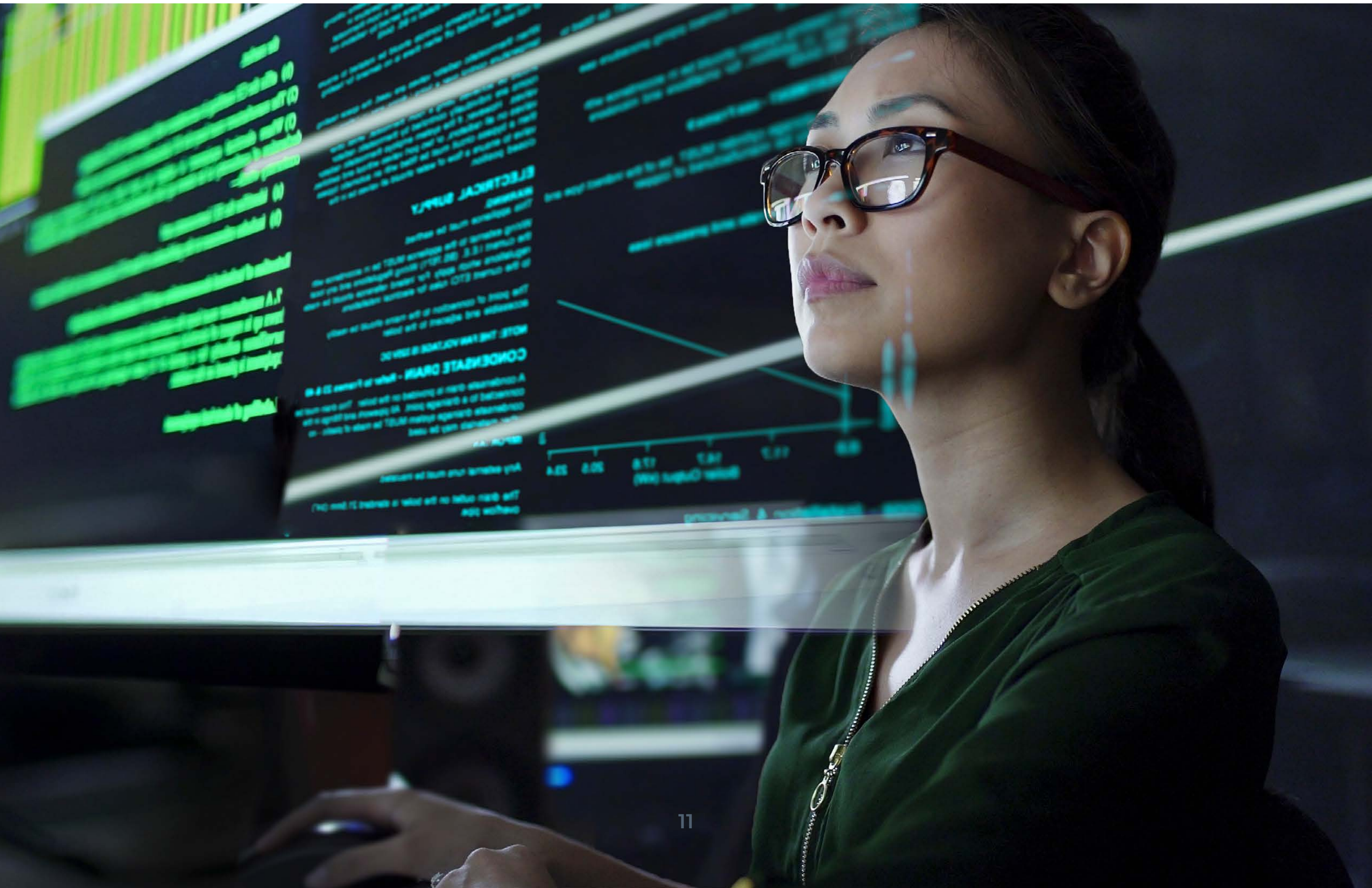
Getting tax right isn't easy, but it is necessary. The longer you avoid it, the bigger and more expensive your problems will become. Start now, follow these simple tips and each day you will find yourself a bit closer to your goal.

Chapter 3: The Case for Tax Having a Seat at the Table

Tim Roden, Sovos solution principal

> **"Changes to the global tax legislative landscape, and companies becoming more digital, mean that tax compliance and reporting are becoming more immediate, digitalised and data intensive."** - DELOITTE

IT and tax have not been traditional allies. While tax plays a critical role in generating increased financial transparency and ensuring cash flow, they have lived on the periphery or outside of many important business and infrastructure decisions. However, with governments of all levels and jurisdictions embracing digital transformation to recover sales tax owed more accurately and quickly, these two units need to become more aligned.



The pace of regulatory change is accelerating. Governments are adjusting tax rules almost daily, and thanks to digitalized tax systems, implementing them in a period of hours and days versus the weeks and months that was the norm for so long. While tax departments have been making do with legacy solutions, these are ultimately not sustainable. Too often, tax is forced to choose between efficiency and accuracy. This is a losing strategy that results in either valuable resources being tied up for non-revenue-generating activities or assuming the risk of noncompliance. Organizations need to design a tax program that not only meets their needs now, but allows for scale and flexibility as regulatory requirements evolve.

The time for standing on the sidelines has long since passed. Considering tax early and correctly is vital, and tax needs a seat at the table.

Why and when to involve tax:

Tax should always have insight into what the organization is doing from a strategic perspective, as many seemingly innocuous decisions could have far-reaching implications. For example, bringing new systems online can impact your ability to remain compliant. Have a new ERP or POS system? If not configured correctly and allowing for the most current regulatory updates, these systems can quickly go from more efficient to serious problems. Failure to properly align systems can increase your risk of an audit and create even more work for IT on the backend.

Changes to business structure is another critical area to involve tax. Mergers, acquisitions and other significant changes to business size and revenue can change tax obligations. Depending upon where new entities operate and the scope of their business, there is a high probability that your tax obligations will be altered in some way. Planning for these issues early in the process will help to avoid any issues with compliance.

Finally, changes to geography or the types of goods and services you sell can have a substantial effect on your reporting and tax obligations. As examples, entering new states through ecommerce channels can establish new economic nexus in states that have to be accounted for. In addition, if you begin selling new types of goods and services that might have exemptions attached to them, this can lead to a whole new level of complexity that must be carefully managed.

Understanding these issues early can save a lot of time, effort and money.

The ramifications of not involving tax:

We just learned about why and when you should involve tax. Let’s take a moment and talk about what happens when you don’t.

There are several possible outcomes to not involving tax early in decisions that impact business processes, and nearly all of them are bad.

> **“If we had been brought in sooner, it would have minimized a lot of back and forth because I don’t think IT knew what we were looking for from the start or what we were expecting. This was a learning experience. For future projects, identifying the key players and getting their involvement sooner will be a priority.”** - SR. TAX DIRECTOR, SOVOS CUSTOMER

The most obvious is that you open your organization up to the risk of a prolonged and costly audit. If you fail to involve tax and don't collect the correct amounts in the jurisdictions you are selling into, there is a high likelihood that you will be called to account for the error by a tax authority. While this can lead to costly fines based on the severity of the infractions, at the very least you are looking at a timely ordeal that takes critical resources away from business priorities.

Failure to properly assess and charge for tax isn't a problem solely reserved for the government. Customers are also a vital consideration for getting tax right. Incorrect charges applied to customer transactions can put a strain on customer relationships. Whether they were overcharged or undercharged, this creates a burden on their finance team to correct. Bottomline, tax is your responsibility, and you must get it right the first time every time.

Finally, if you don't involve tax early enough in the process, you run the risk of having to re-engineer projects. It is far more expensive and time consuming to go back after the fact and automate tax processing capabilities than it is to just include them up front as part of the IT upgrade. In addition to the actual dollar cost, you also run the risk of individual departments creating manual workarounds, which can exist under the radar of both IT and tax, leading to a significant risk for the organization.

How IT and tax can and should work together:

The relationship between IT and tax needs to be an active partnership. It is important that tax understands the system changes being proposed and can advise IT on their potential impacts on tax management.

IT should consult with and look to tax early in the process of identifying new technologies and systems to better understand how each might impact the organization's ability to correctly assess and report tax obligations.

By working together early and often, both sides can come away satisfied and the organization stands to benefit greatly. IT can implement the systems and upgrades it needs with none of the changes adversely affecting tax or leading to manual processes and fixes. Tax will be secure in the knowledge that IT changes will increase efficiency without jeopardizing compliance status or heightening the risk of audit.

Chapter 4: Sales Tax Changes in Response to the COVID-19 Pandemic

Charles Maniace, Sovos vice president, regulatory analysis and design

There are precious few things we can identify as entirely untouched by **the COVID-19 pandemic**. In the world of sales tax, it's unquestionably true that the fundamental obligation tax professionals carry to keep our companies safe from audit risk and penalty exposure will continue during these challenging times and long after we have put COVID in the rearview mirror. However, there are short-term and likely long-run changes to what compliance will entail. Herein, we will explore the near-term changes and speculate on the long-term ramifications.

There are two clear story lines emerging as states react to COVID. One is along the lines of "business as usual." To date, we have not seen a trend of significant delays in planned rate or rule changes in the world of sales tax. Last April, there were 183 standard rate changes across the country, a number largely consistent with other years. Planned sales tax holidays remained on track (perhaps with a bit more emphasis on online shopping). With the exception of an emergency sales tax holiday in Puerto Rico, a handful of localities suspending bag fees, a few cities delaying local meals taxes, and Indiana allowing retailers to donate inventory without self-assessing use tax, jurisdictions have largely shied away from temporary changes to regular taxability rules. Many would consider this "hands off" approach to be particularly wise in an environment where companies managing tax on their own may not be equipped to account for a major change on short notice.

On the other side of the equation, state revenue officials are highly cognizant that companies may not be equipped to file and remit sales tax at this immediate moment, and many states have offered temporary deferments for filing and remittance obligations. These programs come in three flavors.

1. A clearly articulated COVID-related policy that applies across the board to all taxpayers
2. A clearly articulated COVID-related policy that requires taxpayers (or their representatives) to request relief
3. Application of existing policies related to hardships/natural disasters/force majeure

But do not expect these programs to last forever. Many states are reconsidering whether to continue offering deferment on a month-by-month basis, and with state sales tax revenues falling precipitously, it's only a matter of time before every state mandates that sellers return to compliance as normal.

> **"Sales tax is something we have to deal with, but we really don't want to deal with it. We want just to get it done with as least labor as possible on our end."**
>
> - CORPORATE CONTROLLER, SOVOS CUSTOMER

Much of the rest of the world has already recognized the value of directing technology-forward efforts at shoring up enforcement of existing tax rules – it's at the heart of the "continuous transaction controls" movement that has taken hold in Latin America and is migrating quickly to Europe. These measures acknowledge the practical reality that compelling taxpayers to meet existing requirements is far more tolerable from a political perspective than enacting new taxes or raising rates. While it may be too early to speculate as to how this movement may manifest itself in the short run in the United States, increased enforcement either through more audits, more stringent audits, or both, are likely on the horizon.

Proposals are already circulating on **how states may opt to expand their tax base as a means of closing the budget gap**. Governments will likely consider expanding the tax base to cover untaxed services, as well as further measures targeted at taxing digital equivalents to tangible property and digital services. Across the world, there is a growing trend to tax companies based on their revenue derived from selling digital services (e.g., digital advertising, online marketplaces, data collection, sales of digital content, social media platforms, and the like) to their citizens.

> **While not without controversy, states like Maryland and Nebraska have already considered digital services tax (DST)bills in their most recent legislative sessions.**

Keeping Tax in Focus as the Landscape Continues to Shift

by Crowe LLP

The current pace of sales and use tax can be overwhelming for many businesses. Pressure to track and comply with a growing number of tax regulations and ordinances is intensifying at a time when the risks and penalties for noncompliance never have been higher.

Ecommerce companies especially are facing a tremendous burden as they manage tax across multiple states and jurisdictions. Significant U.S. tax reform, including the 2018 landmark decision of South Dakota v. Wayfair that paved the way for states to charge sales tax on purchases made from out-of-state sellers, has created market volatility with the potential to have serious tax implications.

The digitization of tax by governments at every level has accelerated the pace at which organizations must address their ability to comply with regulations across every location in which they conduct business. As the tax landscape continues to evolve and complexity builds, the pressure on companies to optimize their tax position will increase to protect the financial well-being of the organization.

Tax has evolved from a functional area of finance to a critical business driver with the ability to affect bottom-line performance. Now is the time to address any shortcomings. Now is the time to get tax right.

Conclusion: Where Does Sales Tax Go From Here?

Pawel Smolarkiewicz, Sovos chief product officer

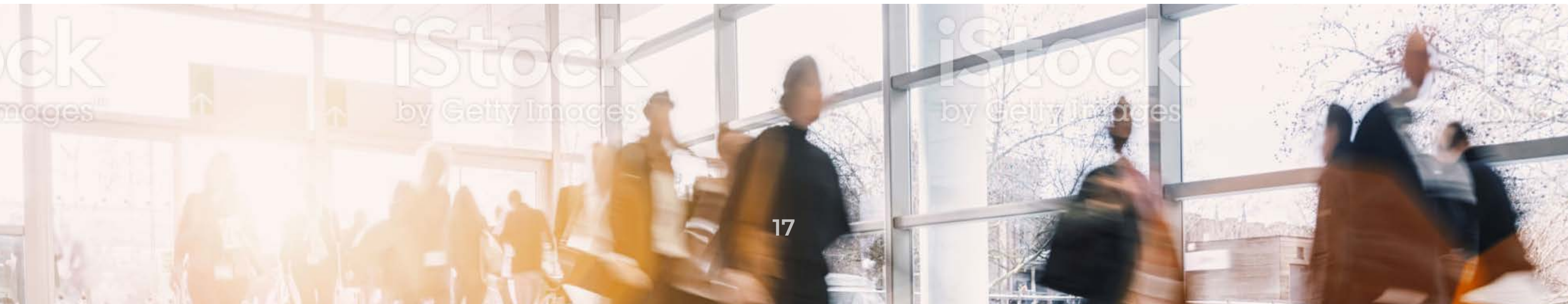
> **“I was always derailed by the unexpected. I never knew what someone was going to ask for and what it would do to my priority list, planning became a total crapshoot. Something would come up and then ‘boom’, there went my whole day.”**
>
> - SOVOS MANUFACTURING CUSTOMER

The question of where tax goes from here is an interesting one. To fully appreciate, we must acknowledge we are talking about two different, yet related paths. First, what changes do government entities make to sales tax regulations, and how many layers of complexity are added to current processes? Second, how do organizations respond in their approach to sales tax management to meet their obligations?

Even prior to the pandemic , governments at every level were aggressively pursuing digital options to help them identify revenue streams and expedite the collection of taxes due. There is a good reason for this. According to the IRS, the United States experiences an annual tax gap of more than $400 billion. This is money that is rightfully owed – based on in-place laws and regulations, but that the government was unable to collect.

Given the stakes and current circumstances, it doesn’t take an oracle to predict the pace of change will accelerate in coming months and the emphasis on enforcement will intensify. Once things begin returning to some semblance of normalcy, we can expect that government action will be swift and wide-reaching to begin recuperating much-needed revenue.

> **“We knew that if that Wayfair decision or another decision anywhere from that perspective came down the line that we would have to do something different than what we’re doing. Because what we were doing, it wasn’t efficient for our team.”** - TECHNOLOGY SOLUTIONS MANAGER, SOVOS CUSTOMER



Now that we likely know where tax is headed from a regulatory standpoint, let's look at the viable options for organizations that need to respond and comply with a fast-moving and always changing tax landscape.

When creating a strategy to effectively manage tax, organizations have some essential considerations. First, what do you have for internal resources? We've exceeded the threshold where tax management can be considered a manual operation. Governments are employing technology to track and enforce revenue collection. To maintain compliance, you need technology capable of responding in turn. However, you can't implement systems that consume an overabundance of IT resources and distract from other critical business functions.

Next, what is your long-term vision for tax? Are you looking to solve tax in the short-term or forever? Assuming it's the latter, which is the prudent course of action, you need to consider technology that scales and continuously adapts to meet your evolving business needs.

> **Finally, and perhaps most importantly, what will ensure you keep up with changing regulatory environments? Departments of revenue are laser focused on collecting taxes due.**

This not only means changes to regulatory standards, but stricter enforcement and more frequent notices and audits made possible by automation. Ensuring that updates are accounted for in real-time is paramount to ensure ongoing compliance.

We started this section by asking, where does tax go from here? There is only one destination that makes sense for organizations, and that's the cloud - software-as-a-service (SaaS) to be specific. No other destination can provide the low-maintenance, highly scalable technology solutions needed to meet the demands of modern tax. SaaS offers the ideal platform because with robust, expert regulatory analysis management, a SaaS technology can continuously adapt and evolve to regulatory changes in real-time.

The numbers bear out that organizations are embracing SaaS for faster, more reliable transactions. In an analysis of use by current customers, we saw continued growth in volume across all business sectors. The most robust being retail with a year-over-year growth of 48.5% for the periods of February through May 2019 vs. 2020. Services and manufacturing also realized significant volume growth during this same time period, with increases of 21.4% and 14.3%, respectively.

Also noteworthy was that eight of the top 10 highest growth customers by volume also appeared on the 2019 top 10 list. This signifies that customers who have shifted sales tax processes to SaaS technology have been able to seamlessly scale operations and have realized a competitive advantage from this approach.

Those attempting to continue to attempt to manage tax through some blend of manual or on-premise strategies do so at their own peril. Collecting taxes is a strategic objective for governments at every level. They have invested heavily in the technology to enable better enforcement, and they will be looking for a return on that investment. It only makes sense for businesses to follow suit and have a strategic approach to addressing new government mandates and timelines.

Visit **sovos.com** to learn more.

About Sovos

Sovos is a leading global provider of software that safeguards businesses from the burden and risk of modern tax. As governments and businesses go digital, businesses face increased risks, costs and complexity. The Sovos Intelligent Compliance Cloud is the first complete solution for modern tax, giving businesses a global solution for tax determination, e-invoicing compliance and tax reporting. Sovos supports 5,000 customers, including half of the Fortune 500, and integrates with a wide variety of business applications. The company has offices throughout North America, Latin America and Europe. Sovos is owned by London-based Hg.

Contact us

+1 866 890 3970
www.sovos.com/contact
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