
SALES TAX
SURVIVAL
GUIDE

We won't leave you stranded!

Sales taxes get little notice outside of the tax and compliance arena. If they are not handled properly, however, sales taxes can become a business' worst nightmare. Unfortunately, businesses that do not understand the intricacies of sales tax compliance and follow it to the letter could face crippling audit penalties.

This guide will help you better understand the challenges and risks associated with managing sales tax compliance. In addition, it will provide strategies and ideas that can minimize these risks for your business, while also enabling you to reduce the resources needed to manage the sales tax burden.

Avalara
Making sales tax less taxing.

Sales Tax Challenges

While the establishment of the early United States may seem far removed from a discussion on modern sales taxes, it actually helps explain the complexity of our current system. The founders wished to give the greatest possible amount of control over local funding issues to the least common denominator of government.

Today, the United States is one of the last Western nation with a decentralized tax system. For state and local governments, the primary funding source is sales tax. The country has more than 17,000 tax jurisdictions with different rates, boundaries and definitions.

So what exactly are sales taxes? There are two kinds of sales taxes typically collected:

A sales tax is a consumption tax charged at the point of purchase for certain goods and services. The tax amount is usually calculated by applying a percentage rate to the taxable price of a sale. A portion of the sale may be exempt from the calculation of tax, because sales tax laws usually contain a list of exemptions. Most sales taxes are collected from the buyer by the seller, who remits the tax to a government agency. Sales taxes are commonly charged on sales of goods, but many sales taxes are also charged on sales of services.

A use tax is the tax imposed upon a consumer for the storage, use, or other consumption of tangible personal property (TPP) that is purchased by the consumer and was not subject to the prevailing sales tax. Use tax is the complementary tax to sales tax and is typically assessed at the same rate as the sales tax that would have been owed (if any) had the same goods been purchased in the state of residence. Use tax applies when sales tax has not been charged. Purchases made over the Internet and out-of-state are the most common type of transactions subject to a use tax.

The sales tax environment in both the United States and Canada has become increasingly complex over the last several years. The current political and economic environment threatens to make it even more difficult for companies to keep up with ongoing changes, as government agencies seek out additional sources of revenue.

As property values have dropped over the last several years, local taxing jurisdictions have collected fewer property tax dollars. These state, city, county and special taxing entities still need to collect taxes to provide government services. As a result, many are changing the way they collect sales taxes. In 2010, there were more than 5,500 tax rule and tax rate changes in the United States and Canada:

- Some jurisdictions are increasing their existing sales tax rates.
- Some jurisdictions are levying sales taxes that they have been eligible to collect in the past, but have not needed until now.
- Some jurisdictions are broadening the sales tax base by changing some items from tax-exempt status to taxable status.

In the past, most services were generally considered nontaxable. In contrast, taxable items were things than could be touched, picked up and held. As jurisdictions become hungry for new sources of revenue, they have begun identifying more services and other items as taxable. For example, the state of Ohio has re-classified dry cleaning services as a taxable item. In the state of Washington, candy had long been considered non-taxable because it was a food item. Last year, the state legislature re-defined candy as a luxury item and made it taxable. The voters then forced a referendum to repeal that change, and now candy is once again non-taxable.

In many cases, sales tax rules are entirely political and make little sense to the general public:

- In one area of Maryland, hot buttered popcorn is taxed differently than buttered popcorn. Why? Because the comptroller's brother had a popcorn concession.
- In Midwestern states, there are convoluted rules governing the taxation of candy, crackers and cookies. In some cases, items are taxed – or not taxed – based upon the amount of wheat or corn syrup they contain. In this case, political lobbies supporting these

ingredients want to prevent taxation on their products as much as possible.

- In New York City, a donut or bagel is not taxable if it is eaten on the premises of the establishment where it is purchased. Put it in a box and take it outside, and the item suddenly garners sales tax.

Political considerations have also inspired tax amnesties and holidays. On certain days in certain jurisdictions, particular products may not carry sales tax. For example, some states have created a sales tax holiday in the late summer when school supplies, backpacks and some clothing items are tax-free on specific days.

Sales tax compliance costs small and mid-sized businesses between 3 and 15 cents for every sales tax dollar collected. According to the U.S. Census Bureau, failure to account for that expense of 3 to 15 percent is the top reason small and mid-sized businesses fail in the United States. Why? The components of this expense are difficult to pinpoint and often overlooked. The costs are hidden in staffing, compliance, accounting systems, information technology, and other business infrastructure.

Avoid becoming a Compliance Castaway!

Each time the rules change, businesses collecting sales tax must change the way they charge customers and remit receipts to the state as well.

Sales tax survival requires:

1. **Determining which jurisdictions can apply sales tax on your business.**
This step sounds simple. And for many businesses, it may be easy. Imagine a retail boutique with just one location. Typically, the boutique would be responsible for collecting sales tax at the rate applied in its home city. Things grow more complex when the boutique adds locations. When expanding into a nearby city, the company must collect sales tax at the appropriate rates for each location. These rates may be different from jurisdiction to jurisdiction. Now, imagine that a business conducts 100 percent of its sales online. Or maybe a company sells items over state lines. Do sales taxes apply? That depends upon a set of regulations known as *nexus rules*. According to a Supreme Court decision, a business must collect sales taxes for a state if it has a substantial physical presence in that state. Unfortunately, the court did not define "substantial physical presence," so each state has established its own set of regulations. Examples of a nexus with the state are holding a business license, owning tangible property or establishing a headquarters. By doing these things, a business agrees to be an agent of the state to collect sales tax and remit the funds back to the government.

2. **Establishing which products are taxable.**
In most states, a majority of grocery items are not taxable, but prepared foods purchased at grocery stores may carry sales tax. Your business must determine which items require tax, and capture variations depending upon the location where items are purchased. As various taxing jurisdictions change their rules about taxability of goods and services, your business is required to track changes in taxability of items and adjust your accounting systems accordingly.

3. **Applying the correct tax rate for the jurisdiction.** 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. The best option is to use geospatial mapping to ensure the correct tax rates are charged. With geospatial mapping, a series of maps can be overlaid upon one another. For example, a map with state boundaries might be overlaid with county or parish jurisdictions, and yet another with city limits. By pinpointing a location on the map you can identify which taxing jurisdictions apply.

4. **Collecting appropriate sales taxes from customers.** Not all customers must pay sales tax. Depending upon the rules in your taxing jurisdiction, certain businesses and individuals are exempt from sales taxes. But your business cannot simply accept their word for it. Rather, you must collect and keep on file a valid, current exemption certificate. Keep in mind that exemption certificates expire after a certain period of time, which varies from state to state. With each transaction that does not collect sales tax, you must ensure that the exemption certificate is still valid. This requires your business to keep a copy of each exemption certificate. Plus, for easier accounting, a database or spreadsheet of exemption certificates needs to 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.

5. **Remitting sales taxes to the controller's office according to its statutory deadlines.** This step relies on two factors: a solid accounting system and a calendar. For each taxing jurisdiction, ensure that your business keeps up with deadlines and provides timely remittance. On the specified day, you must submit a form detailing the taxes collected, along with a check or electronic transfer of funds.

PREPARATION
& Protection of Assets

Why is it so important to remit sales tax correctly? States are becoming increasingly aggressive in auditing businesses. Thanks to the complexity of the laws, it's rare that a company handling its own sales tax remittances will escape from such an audit unscathed.

More than ever before, there is collaboration between departments of revenue to catch non-compliant businesses. With updated technologies, states and their departments can easily share databases that detail information about businesses and the exemptions they claim. As a result, states are becoming more sophisticated and thorough as they place businesses on audit schedules.

Most states have a formula they use to determine which businesses will be audited. The state examines the results of past audits to see which industries, business sizes and types had the most compliance issues. Industries that face the most complicated tax laws are more likely to be audited. These include restaurants, construction, technology and manufacturing, among others. Other triggers include Internet only businesses, as well as those selling clothing, food, software, electronics and digital media.

Some businesses mistakenly believe that, if they don't make major mistakes, they will not be audited. That is incorrect. Audits can come for many reasons outside of your control. There are some actions your business may have taken that can trigger extra scrutiny:

- An inaccurate registration profile on file at the tax collector's office.
- Inconsistencies in marketing and reporting. For example, a company's website may say it has 15 stores, but only report taxes on 14 stores.
- A larger than normal number of tax exemption certificates.

To survive an audit undamaged, the most critical action a company can take is to collect sales tax properly over time. But following every rule will not help your business unless you have properly documented every step of the way. Audits can be made much less painful with good documentation such as transaction histories, exemption certificates

and other details at your fingertips. Perhaps the best – and most challenging – example of maintaining proper documentation is in the area of exemption certificates. As mentioned above, a business should only allow its customer to avoid paying sales taxes if there is a valid exemption certificate present at the time of the sale. If a government auditor finds that a business does not collect, valid certificates, than the auditor can request to see all transactions where no sales tax was charged. The auditor can then ask the business to produce exemption certificates for each and every one of those transactions. If the auditor finds a single error, he or she can audit a representative sample of transactions and then extrapolate the results. Consider this example: 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 can extrapolate the results of that sample and claim 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.

Navigating Compliance Risks

To effectively comply with sales tax regulations, you will need cooperation from several departments on your team:

- **Accounting.** Team members must track and apply sales tax law changes across every jurisdiction where your company does business.
- **Sales.** This group must help the company determine whether new locations or accounts will bring with them additional sales tax compliance issues.
- **Audit.** Team members must create and maintain detailed records of sales tax compliance activities.
- **IT.** They must make changes to accounting systems and e-commerce systems, plus allocate adequate electronic storage for compliance records.

Unfortunately, not all businesses have separate teams dealing with compliance issues. These internal team members will be distracted from their other, value-added duties by compliance efforts. This makes efficiency in sales tax compliance extremely important. The best-managed businesses understand that a sales tax strategy is not simply about accuracy. In fact, it is virtually impossible to be 100 percent accurate in all sales tax collections and remittances.

While accuracy is obviously important, efficiency is paramount. There must be a balance between the two. Imagine a company that runs a chain of donut shops. The team members at that company want to delight customers with tasty donuts and make a profit doing it. They don't want to become experts on the taxability of donuts in each state. So how can a business make the sales tax compliance process more efficient, while also minimizing the risks inherent in compliance? Automation and outsourcing are two key strategies that we will discuss next.

AUTOMATION

The Key to Survival

Small and midsized businesses are disproportionately impacted by sales taxes. Plus, because sales taxes are levied regardless of other business activities and conditions, they are ongoing, constant, immediate and expensive.

To avoid liability in an audit, your business must demonstrate that great efforts were made to comply with sales tax regulations. Unfortunately, manual efforts at compliance throw scarce dollars, personnel and other resources at a problem in order to mitigate risk.

A better strategy is to automate and outsource the sales tax collection and remittance process. Even small organizations can shift their risk to a third party and remove the negative impact to sales and resources, while also streamlining the entire sales tax management process. Let's return to the example above, when the auditor could not find exemption certificates and assumed the business miscalculated its sales tax remittances. How could that problem have been avoided?

The key to reducing risk is creating processes.

When the company has established rules and processes in place to ensure sales taxes are collected and remitted properly, the business is likely protected from fees and penalties – even if mistakes are made. In the example of collecting exemption certificates, the company did not have an established method for collecting, verifying and ensuring that certificates had not expired. With a clear, detailed process in place the business can:

- ☑ Ensure the certificate is the proper form, not a business license or other document.
- ☑ Ensure the certificate is properly completed.
- ☑ Store certificates. The best method is electronic.
- ☑ Collect updated certificates when old ones expire.
- ☑ Ensure that customers are billed properly once their exemption certificates are on file with proper accounting procedures.

No system is absolutely foolproof, but with a detailed process in place, an auditor more likely than not will give your company a clean bill of health.

Rather than create a full book of policies, procedures and records from scratch, some companies choose to fully outsource their sales tax compliance program. Fully automated solutions are available both on-premise and hosted (in the cloud).

Probably the most efficient means of automation is accomplished by choosing the hosted model, where a third party vendor ties its solution directly into your existing accounting, point-of-sale and other technology systems. In addition, the vendor stores your company's data as needed, including exemption certificates, sales data and more. With a fully hosted solution, it's simple for your team members to get anytime, anywhere access to critical data.

In addition, outsourcing the sales tax compliance function shifts your company's risk to a third party. For example, Avalara is certified by the Streamlined Sales Tax Project. As a result, Avalara clients are protected from penalties and interest if any mistakes in sales tax remittances occur.

We won't leave you stranded!

A Customer Success Story

Lisa Schulz is controller for StrongMail Systems, Inc., an online marketing firm based in California. The company sells more than 1,000 software products across the United States.

"We used to compute our sales tax manually with QuickBooks," Schulz says. "Any time we had to calculate the sales tax for a customer's purchase, we had to find the current sales tax rate on a website and calculate it by hand."

At the time, the company was processing between 50 and 60 invoices a month, as well as filing more than 25 state sales tax returns. The company's accounting manager spent up to two weeks each quarter on sales tax calculation, remittance and compliance issues.

"The process was very time-consuming," acknowledges Schulz. "We would manually dump the data into an Excel spreadsheet, validate that the figures were correct and fix any errors. Then, we had to prepare the tax returns one by one." In 2009, StrongMail chose to move its sales tax compliance responsibilities to Avalara. Schultz says moving to Avalara has reduced the time spent on sales taxes from more than two weeks a quarter to less than a day.

"In the past, we were overcharging tax on some items and under-charging on others. In some states our services were taxable, and in others they weren't. The same goes for hosted software. The laws in each state are different, and they are changing all the time," she says. "That doesn't happen now. Avalara keeps up with the sales tax laws for us. The entire process is automated, accurate and easy."

Best of all, the company has saved money on the tax compliance process while minimizing its risk, according to Ms. Schultz.

"The fees for Avalara's services are absolutely minimal, and we've been able to shift the responsibility for tax compliance from an accounting manager to an entry-level employee," she said. "With the savings we've seen, I don't know why any business wouldn't make the same decision we did to choose Avalara."

End-to-end Compliance With AvaTax

AvaTax reduces your sales tax audit risk with cloud-based services that make it simple to calculate rates, manage exemption certificates, file forms and remit payments.

Calculation

Real-time access to the most current rates and taxability rules within any ERP or billing system.

Certificate Management

Timely, accurate and responsive transactional tax filing and remittance—with unprecedented ease.

Returns & Filing

Limit your non-taxed transaction audit liability. Without all the hassle and in real-time.

Avalara's mission is to transform the tax process for customers by creating cost-effective, state-of-the-art solutions through integrated, on-demand, web-based software services. We provide transparent transactions, accurate tax compliance, painless administration and effortless reporting.

Toll Free: (877) 780-4848 • Phone: (206) 780-7000

100 Ravine Ln NE, Suite 220, Bainbridge Island, WA 98110

Customer Service & Sales: sales@avalara.com

Technical Support: support@avalara.com

Avalara

Making sales tax less taxing.