

The Sleeping Giant in the Tax Department: Inaccurate Sales, Consumer Use, and Value Added Tax Payments

*Sales, Use, and VAT Tax Calculations Can Put Your Retail
Business at Risk – Automation Can Help*

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Indirect Taxes: A Complex, Moving Target

Everyday business decisions can have huge – and often unintended – sales, consumer use, and value added tax (VAT) implications. For example, if you are a regional clothing retailer, deciding to allow customers to purchase goods in one location and ship them to another location (or accept store returns from another jurisdiction or from Web purchases) can create significant tax issues; suddenly, every store needs a way to apply the correct tax for customers shipping to any jurisdiction in the entire country – and if your business is global, for any intra-country transactions. If you decide to introduce new products, it's easy to overlook special “tax holiday” exemptions affecting them. In addition, if you operate a chain of grocery stores, simply choosing to sell ice cream treats in a single, eight-ounce serving (rather than larger containers) may put you out of compliance in certain jurisdictions.

These examples help to illustrate the incredible complexity of sales, consumer use, and VAT tax – and why so many companies find themselves either overpaying or underpaying these indirect taxes. As a retailer, you face increasingly complex jurisdictional tax laws, must accommodate special tax rates and rules, and have unique compliance requirements. The tax laws themselves are also constantly changing, making it even more difficult to understand the implications of business decisions. From 1998 to 2008, there have been 2,859 net-new sales tax rules implemented in the U.S. alone, 5,341 sales tax changes, and more than 99,000 total unique rules across sales, consumer use, and VAT taxes.

Tax Departments Are Accountable But Not In Control

Complicating matters is the way that sales, consumer use, and VAT taxes are typically managed on a day-to-day basis by most retailers. Let's take a closer look at sales taxes as an example.

Most likely, your sales tax data – the rates and rules relevant for all of your sales channels – are manually maintained in spreadsheets by tax professionals and then handed off to IT so it can be downloaded to store POS systems overnight; given the complexity of tax laws, there's a high likelihood of manual errors – particularly state and local tax holidays. Complicating matters is the fact that most merchandising systems simply aren't designed to handle the level of tax data complexity retailers need to manage.

Alternatively, you may have a rate file card (using a spreadsheet) that shows generic sales tax rates or bracket schedules relevant for the products you sell in the location where they are being sold. In addition, tax exceptions are typically handled at the store level by sales associates – a risky proposition because these employees lack the tax expertise to correctly handle these exceptions.

Think about the opportunity for error given the number of tax changes that your department needs to maintain and the fact that:

- Not everything is covered by standard tax rates because they are not granular enough. (For example, if a chain of café shops sells a customer a whole pie instead of just a slice, the taxability may be different. In situations like these, sales associates, by default, have control over taxability – not the tax department – and may make uninformed decisions.)
- Acquisitions and mergers can suddenly thrust your tax department into new product categories where they have little or no product-specific expertise.
- The deployment of new business and customer service models – such as allowing customers to ship purchased items to other states – brings with it unexpected, new taxability risks.
- You are responsible for determining who is purchasing certain goods and for what purpose before you can determine taxability. For example, if you are an agricultural supplies retailer, and a clerk in Vermont¹ sells fertilizer to a farmer claiming an agricultural tax exemption, without asking if he's going to use it for commercial (exempt) or personal (non exempt) use, you can be held liable for uncollected tax. Should your sales associate determine that the exemption is appropriate; the transaction must be properly documented and auditable.

As these examples illustrate, the real challenge is not dealing with any single rule or subset of rules – it is that you have to comply with all of them in the face of constant change. It's all too easy to have transactions fall through the cracks between manual effort, fragmented operational systems, POS systems, and changes in both your business and the actual tax legislation.

The High Cost of Inaccuracies

Given the complexities of sales, consumer use, and VAT taxes, it is likely that you are either overpaying or underpaying indirect taxes. In most cases, companies are not even aware of indirect tax problems until it is too late because tax decisions are often handled manually or by disconnected systems that limit visibility and control.

Underpaying indirect taxes can put your business at risk for fines and potentially massive back payments. Auditors can extrapolate these penalties and back payments based on two or three months of recent transactions and determine the amount due on all similar transactions going back three to seven years. Due to the large, error-prone effort to fully comply, companies typically carry reserves for tax penalties as normal operating procedure. While it was easy to carry these reserves as a cost of business in the boom times, it's no surprise that retailers are now looking for ways to lessen their reserve requirements to improve their bottom-line performance.

Alternatively, you may be inadvertently overpaying indirect taxes and having to recover payments from state governments or other countries. Recovery processes are very complex, which is why many customers use consulting firms to handle tax recovery work. Recovery agents can help you recoup these funds. But if for example, you need to recover \$5 million dollars, your business is out those funds for strategic investment, cash flow, and growth. In addition, in order for you to receive refunds, states have to budget for it, so it can take several years for you to receive them. Finally, incorrectly charging sales taxes can jeopardize your brand and customer relationships. For example, if your sales clerks unknowingly charge sales tax on an item impacted by a tax holiday in certain states, your company potentially faces bad press and must contact all customers, apologize for the error, and reimburse for taxes overpaid. In certain cases, high-profile companies have even been sued over indirect tax calculation errors – mistakes that often make headlines.

Can your business continue to afford these types of costs and risks, especially in today's economy? The good news is that by making the right technology investments today, you can fix indirect tax processing going forward – and free your company from the unpredictable, costly impacts of underpayments and overpayments in the future.

Using a Tax Automation Platform to Eliminate Risks

Tax automation is the key to ensuring consistent, accurate indirect tax calculations across all of your multi-channel transactions – today and in the future. Nevertheless, you can't just deploy another stand-alone tax software package, as this would further fragment indirect tax management and tax data. You need a single tax platform that:

- Is built on a scalable, web-based, service-oriented architecture
- Is flexible and enables seamless integration with all of your multi-channel operational systems (such as store, back office, and eCommerce systems), both legacy and new
- Provides a single, data-driven calculation engine that supports real-time transactions
- Determines taxability based on a comprehensive tax data model that covers all possible sales, consumer use, and VAT tax permutations. This data model should be populated with the latest tax rule data and updated continuously so the correct taxability is applied to every transaction, regardless of where it occurs and through which channel.

The benefits of having a single calculation engine for all indirect (and direct) tax types are significant. In addition to greatly simplifying integration (because ERP and financial systems only need to send messages to one calculation engine, regardless tax type), having one, centralized calculation engine also translates into IT spending less time and budget on maintaining tax systems and updating tax rules—and more time available for more strategic activities. In addition, you significantly lower your audit exposure so you can:

- Substantially lower – or eliminate – your reserve funds for Sarbanes-Oxley compliance
- Avoid recovery activities and costs
- Minimize the likelihood of future audits
- Ensure ongoing compliance even as your business changes through geographic expansion, the deployment of new business models, and mergers and acquisitions

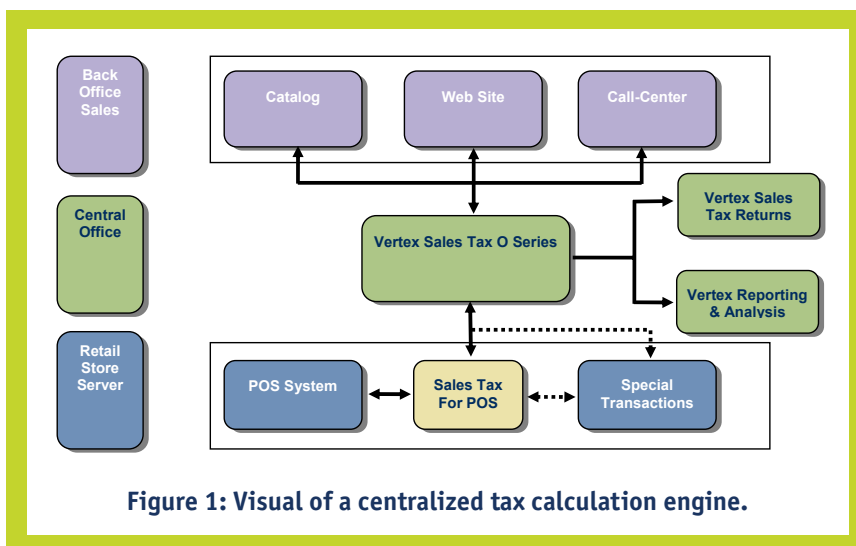


Figure 1: Visual of a centralized tax calculation engine.

Ensure Consistent, Accurate Tax Calculations

A platform-based solution for indirect tax places all tax decisions in the hands of the tax department – not administrative staff and sales associates. For example, without tax automation, if a store manager purchases supplies for her store and the business from which it was purchased did not charge tax on the purchase, the receipt would typically be passed to accounting for reimbursement, and the tax obligation may be neglected. In contrast, with a centralized tax platform, all tax decisions are centralized within the tax department; the “intelligent” consumer use tax software running on the platform would automatically identify that consumer use tax is still owed and make the adjustment. In this way, the application automates the tax process once it knows what was purchased, where it was purchased, and the tax status of the purchasing organization.

Choose an “Intelligent” Tax Calculation Engine

Ideally, you want a platform with an “intelligent” tax calculation engine that automatically knows which type of tax to calculate - and how to calculate it - based on the messages (or data) passed into it from various ERP, POS, and financial systems. Conventional tax solutions, which are built using multiple, disconnected tax products, require that the application calling in (e.g. an ERP system) pre-determine the type of tax to be calculated and then send the data to the correct machine responsible for handling that type of tax calculation. In addition, most tax products require that you develop and maintain complex business logic during integration so they can properly handle multiple tax types. An intelligent tax calculation engine eliminates these hassles and costs right from day one.

Automation – when powered by comprehensive, up-to-date tax data – plays the same role across all types of indirect taxes so you can be confident that taxes are being calculated consistently and accurately. This means, for example, that if a customer buys an item in a store in California and wants it shipped to someone in Pennsylvania, the correct PA tax is determined by your POS system, without your sales clerks having to do anything. Moreover, if the state of Georgia provides a tax holiday exemption on certain items, you automatically apply this to every relevant sale during that time period and instantly generate an audit trail each time, documenting the reason code for the special treatment.

Gain in a Central Hub for Tax Data Persistence and Audit Trail Generation

When automated tax processing modules for sales, VAT, and other taxes share the same data, you benefit from more accurate processing of all taxes, even as saleable items are bought and returned by customers. For example, the sales tax module generates transaction data, and this transaction data is stored in the centralized tax database. A returns processing module can instantly access the transaction data in order to process state and local sales tax returns, even in states where you are required to file by store location. Because all tax processes pull from the same set of data, you can ensure compliance with tax regulations and Sarbanes-Oxley. In addition, with the company's data secured in one location the tax departments can access it for analysis, reporting, and audit defense activities that make compliance easier and businesses more effective.

Insulate Your Tax Department from Business Changes

By acting as a central hub for tax processing, a Web services-

based tax platform insulates your tax department from the effects of business change. Your organization can acquire new businesses and easily link their financial software into the hub, seamlessly upgrade or change ERP software, and add new lines of business by simply integrating related systems into the tax platform. You can also turn tax calculation capabilities into a shared service, enabling you to handle these business changes without any increase in tax staff or IT support (beyond making the initial link to new systems). As a result, your business is more adaptable, and your department can continue to provide highly reliable tax services even during periods of business change.

Aligning Tax Technology with Business and IT Strategies

Deploying a centralized tax platform also allows your tax department to be responsive to the following trends within the retail industry:

- On the IT side: According to independent research, more than 60 percent of executives in retail companies have prioritized centralizing their IT infrastructure in order to eliminate application silos (which drives up costs) and data fragmentation (which limits business visibility and control).
- On the business side: Business executives in retail companies are under pressure to document and manage processes for Sarbanes-Oxley compliance, even as the business changes over time. To do this, they need a flexible, centralized IT infrastructure that supports consistent processes across the entire business.

When you deploy a tax platform, you only need to maintain one platform for all tax types – and when it is Web services-based, the platform does not require the use of a specific infrastructure; rather, the platform can support multiple operating systems, databases, and Web service infrastructure, so that it can compliment, rather than dictate, infrastructure investment. This allows your IT department to eliminate multiple, siloed applications and unify enterprise data. Using a tax platform can also substantially reduce the total cost of ownership (TCO) for tax technology. For example, the solution eliminates the need to maintain separate engines for different tax types, and because it requires only one installed instance (i.e., one database and one server) for multiple tax types, IT departments have fewer systems to manage and keep current.

From a business perspective, a tax platform enables your company to deploy and use consistent tax processes across the entire enterprise, as well as document transactions and tax decisions in real time. Operational systems all leverage the same tax calculation engine and tax data, and automation

ensures consistency and accuracy. With a centralized system in place, everything is auditable – which is essential to ensuring compliance.

Delivering Significant, Rapid ROI

As shown in Figure 1, because automation of indirect taxes delivers consistent, accurate tax calculations across your entire enterprise, you lessen your audit exposure and reduce the need for high cash reserves to cover penalties or class-action lawsuits. For example, Vertex's retail customers that have deployed Vertex® *O Series*® and run modules for indirect taxes have typically been able to reduce their cash reserves by up to 70 percent over a five-year period – simply because they get tax calculations right the first time, every time. In contrast, if they had continued with more manual processes, their reserve requirements would have increased over time.

Learn More

If you wind up having to recover overpaid taxes this year – or negotiate back payments and fines – that's okay. Learn from it and take the right steps to prevent these issues going forward. Tax platforms that automate indirect tax calculations can pay for themselves in under a year – either through reduced cash reserves or savings from not having to pay recovery fees. They can be deployed quickly and without interruption to your business at the store level.

For example, Vertex® *O Series*® – a revolutionary tax platform that centralizes all corporate tax processing and data and supports tax compliance with unrivaled automation capabilities and extensive tax rule research. Designed and built from the ground up by Vertex's U.S.-based software development team, this Web services-based platform allows organizations to deploy a flexible, end-to-end tax solution by implementing a family of integrated

Estimated Change to Tax Reserve



Figure 2: Anticipated reduction in cash reserves of up to 70 percent over a five-year period with Vertex automated tax systems.

Vertex *O Series* tax modules designed to run on it, such as sales, consumer use, and VAT tax modules. As a result, businesses can centralize tax processing on a single-vendor solution, even for global enterprises with multiple instances of ERP and financial systems. In most cases, Vertex *O Series* solutions can be deployed quickly, and start delivering ROI right from day one.

To learn more about tax platforms that automate indirect tax calculations for multi-channel retailers, please visit www.vertexinc.com/go/retail.

ABOUT VERTEX INC.

Since 1978, more than 10,000 corporate customers have relied on us for innovative tax processing solutions. Combining advanced technology, sophisticated software, and an exceptional team of experienced tax experts, we help our customers unlock huge process and productivity gains, limit risk, and make tax a more integral, strategic contributor to business success.

¹ The following states provide for agricultural exemptions that specifically mention fertilizers on their exemption certificates as follows: Alabama, Florida, Georgia, Kansas, Kentucky, Louisiana, Mississippi, South Carolina, Vermont, Virginia. Other states may provide for general exemptions related to the Agricultural and Farming Industries either by specific Farming exemption certificates (e.g. New Jersey) or check off boxes online items (e.g. Pennsylvania).

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