



# **LIMITING YOUR SALES AND USE TAX EXPOSURE THROUGH AUTOMATION**

INSIGHTS AND PERSPECTIVES



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## Executive Summary

Though they represent multiple industries and interests, tax professionals have little trouble agreeing that compliance and audit concerns associated with missing or invalid exemption certificates is significantly challenging - too costly, fraught with errors, and too often leading to assessments that drain revenues and resources.

With that in mind, Vertex Inc. recently surveyed tax professionals and state audit officials. The purposes of the surveys were to identify ways to streamline exemption certificate management, reduce sales and use tax assessments and help companies deal with related tax issues more efficiently. The surveys, conducted separately, revealed that while tax professionals and state audit officials see the challenges from different vantage points, there are many shared concerns. There are also important areas of agreement of how to solve some of the most vexing certificate and tax issues, particularly regarding ways to reduce assessments.

As tax professionals and state audit officials both acknowledged, seldom – if ever – have state audit officials spoken so candidly about the exemption certificate process, assessments, and how automation might help. In that light, this paper will discuss the findings of both studies and will offer concrete, real-life examples of the issues organizations face with exemption certificates and audit assessments. Further, it will show that when organizations automate their certificate and tax processes, they save money, expend fewer resources addressing their tax issues and reduce their audit assessments.

## SIGNIFICANT FINDINGS

In the surveys, tax professionals and state audit officials both identified the inability to produce exemption certificates as a major contributor to companies' audit assessments. As one tax professional noted, "Being able to always locate the exemption certificates we need at audit time would significantly reduce audit assessments." Said another, "Since this is where most of our audit exposure emanates, it would benefit our company greatly to have a better way of keeping this information up to date."

Forty-four percent of the state audit officials surveyed indicated that not having an automated sales and use tax exemption certificate system has at least a medium impact on audit assessments. From the audit officials' standpoint, automation is beneficial because it leads to greater ease of statistical sampling and greater efficiency, both of which mean audit officials spend less time on site at organizations - and less time overall auditing them.

In turn, many tax professionals also agreed that automation could help. When they were asked how they could best focus their efforts to improve sales and use tax exemption certificate and compliance processes, 59 percent said, "Increase automation of the sales and use tax processes."

However, the survey indicated continued reliance on manual processes among tax professionals, even in light of the evidence that automation could reduce assessments and add efficiency. More than two-thirds of companies surveyed still use manual processes to manage and maintain exemption and resale certificates.

Significantly, tax professionals in both the public and private sectors and audit officials indicated that automated solutions may reduce the likelihood of future audits: 77 percent



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indicated that when errors are found on exemption certificates, the companies that made the errors are considered a likely or somewhat likely lead on future audits. A good system equals cleaner audits and audit officials are quick to note good internal controls when found. Since it can be reasonably postulated that automated solutions reduce errors, it follows that automated solutions, when applied correctly, can reduce assessments.

Also significantly, state tax officials reported having a more positive and productive audit experience with companies that have moved to a commercial automation system for ECM sales and use tax calculations and other tax tasks. They reported that commercial software allows for greater ease of statistical sampling, greater efficiency in the audit (less looking at source documents, ease of access to information), and greater accuracy for the taxpayer.

Because automated solutions enable state tax officials to primarily audit an organization through checking rates and jurisdiction coding, time is saved by state tax officials *and* companies using the software. Said one state tax official: "When we audit a company that uses commercial software ... the records are more accurate and there is more information available - there are fewer problems in fewer areas."

## **SURVEY METHODOLOGY**

### **TAX PROFESSIONAL'S SURVEY**

In the study of private companies, 261 tax professionals were asked about their audit challenges and their exemption and resale certificate management processes. Many of these customers surveyed are in the manufacturing, distribution/wholesale and retail industries though other industry groups were also represented.

### **STATE AUDITING OFFICIAL'S SURVEY**

The sample was made up of audit officials from 23 states, including Alabama, Arizona, California, Colorado, Florida, Illinois, Indiana, Maryland, Massachusetts, Minnesota, Missouri, Nevada, New Jersey, North Carolina, Ohio, Pennsylvania, South Dakota, Tennessee, Texas, Utah, Virginia, Washington State, and Wisconsin. This represents 51% of the states that collect sales and use tax. Officials participated in in-depth, conversational interviews on a variety of tax and audit related topics.



## HOW MANUAL PROCESSES ARE HURTING COMPANIES

Most respondents in the tax professional survey (62percent) reported that they had been audited between one to five times in the last 12 months. Not surprisingly, companies that manage more exemption certificates are usually audited more frequently. A little more than half of the respondents managed less than 9,999 exemption certificates, while the rest managed more than 10,000.

Companies also reported that the largest contributors to their audit assessments are unreported tax on taxable purchases, more commonly known as consumer use tax, and missing or invalid exemption certificates, which contributed 31 percent and 28 percent respectively to audit assessments. When assessed for missing or invalid exemption or resale certificates, the inability to produce the certificates accounted for almost half of the total assessment.

Storing Exemption Certificates, searching for them, verifying them, and trying to produce them was cited repeatedly by tax professionals as a challenge - and a resource drain. Yet 68% of the companies surveyed continue to use manual processes to manage and maintain exemption and resale certificates. Most said they cling to manual processes because they: don't believe they can commit the resources; manual processes are adequate; the number of certificates does not justify it; or management lacks interest.

Also contributing to certificate-related audit assessment: Incomplete or inaccurate certificates (wrong tax ID number, wrong form, etc.), inappropriate use of forms (single-purpose exemptions applied to other transactions) and outdated forms. For their part, state tax officials indicated that outdated forms are less frequently the reason for a certificate disallowance. They also said the predominant reason exemption certificates are disallowed is invalid or missing certificates.

**Key finding:** Many state audit officials indicated that a lack of a sales and use tax automated system was from a medium to a high contributing factor to the audit assessment. Seen another way, 78 percent said sales and use tax software has a positive impact for the state and the taxpayer on an audit.

The larger the company the greater impact the lack of a system has on the audit assessment – in other words, the bigger the company, the bigger the assessment.

## STATE TAX OFFICIALS DISCUSS REASONS FOR ASSESSMENTS

When asked about the major reasons for audit assessments, the majority of state tax officials cited unreported tax on taxable purchases and missing or invalid exemption certificates. Incorrectly applied tax rules contribute as well, but they said this may be due to taxpayers attempting to manipulate the gray areas, rather than outright misunderstanding of the rules.

Reported sales and use tax audit collections ranged from \$10 million to \$600 million for the states that participated in the survey. Roughly 60%-90% of this is tax and 10%-40% is interest and penalties. For most states the amount of sales and use tax collections specifically is not available to the public.

One question that may be of particular interest to tax professionals involved which tax issues the audit officials believed would face the greatest scrutiny in the near future. The answer:



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manufacturing exemptions, taxation of services as well as large and small retail business with issues in controlling exemption certificates.

“Telecommunications is a concentration area,” said one state tax official. “The wireless and cable industries continue to grow... the last thing on their minds right now is taxes... they are concerned with expanding.”

Said others:

- “We have been putting a lot of resources in the cash-based retail businesses (and) fast food”
- “We will be very busy with convenience stores. We had a bad problem with fraud in these small businesses.”
- “The emerging tax issue that will face the greatest audit scrutiny is the establishment of the electronic audit criteria.”

## WHAT TAX PROFESSIONALS SAY THEY WANT

Overall, tax professionals surveyed by Vertex indicated they would like to streamline certificate management and reduce audit assessments. Following are some of their “wish list” items to help those things happen:

- A stand alone Web-based application with ease of implementation to manage exemption certificates.
- Improvement in obtaining or verifying certificates upon initial and subsequent sales (a soft warning system indicating that certificates are missing or expired).
- Certificate rules by state to provide a guide of what each state requires for exemptions.
- Ability to easily and quickly scan certificates into electronic form for easier and faster storage and retrieval.
- Ability to generate reports that are customized around exemption certificates
- A numbering system that would tie certificates to customer order numbers or customer names, and interface with billing systems.
- The ability to exempt by ship-to or job instead of customer as a whole.
- The ability to automate the process of sending out letters to customers.
- The freedom to give multiple internal users access to the management system.
- Ability to validate certificate numbers received (for example, through Web access to a state’s Department of Revenue).

Tax professionals were also asked for their comments regarding how changes in their exemption and resale certificate management processes might minimize their audit exposure. There were a variety of answers to this question. Some were working to establish better controls in their tax department, so that decisions can be made by tax experts rather than lower-level employees. Others were working to “clean” their data. Said another: “It would be nice if the customer would submit exemption certificates at the time they place an order for projects ...Currently we do not have the ability to stop/hold a customer's order to obtain new certificate. “



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A recurring theme was the need to move away from the inefficiency of manual processes. Moving to an automated solution, many companies said, would bring multiple benefits in terms of time saved, reduced audit assessments and resources saved.

-“One of the primary reasons for updating our system is to automate the process for updating certificates when needed,” said one company.

-“Getting ready for the audit process would be quicker,” said another. “It would also avoid lost, misplaced, or misfiled certificates.”

### **HOW COMPANIES TRY TO SOLVE ECM PROBLEMS; WHY THEY FAIL**

Recognizing that trying to manually handle exemption certificate management is a clear path to inefficiency, errors and higher assessments, companies have tried various approaches to automation. Not all have been successful. For example, content management systems utilizing thousands of documents such as exemption certificates have proven unwieldy.

As a result, many companies – 68 percent of the companies in the survey - continue to plod along with manual processes to manage and maintain exemption and resale certificates. For most companies this is no small matter. Thirty-seven percent of companies that still process manually manage more than 10,000 certificates.

Asked why they haven't yet automated their processes, most said they were unwilling to commit the resources, or felt manual processes are adequate. Only 13percent reported using a commercially available product. Some relied on homegrown systems, though state tax officials complained that such systems made their jobs more difficult, and adding time and expense to the process. “It is very frustrating when we encounter homegrown software systems,” said one. “It is not good news. Taxpayers usually owe us more than they would if they used tax software developed by a company that specializes in taxes.”

Some 86 percent of the companies surveyed have centralized the management of exemption and resale certificates. However, centralization does not necessarily mean a great gain in efficiency, since those companies are often centralizing a manual process. Many different departments touch certificates and tax records, which is an argument for Web-based processing, not manual filing. For example, the responsibility for managing certificates could lie in any department or in several departments with an organization. The tax departments most often require access to the exemption and resale certificates.

Half of the companies either request certificates upon initial sale only (meaning they have no updating process) or update only when an audit requires them to do so. The other half takes a more proactive approach, performing scheduled updating on a periodic basis or sporadically.

### **THE RIGHT KIND OF AUTOMATION**

The majority of respondents in the government survey indicated they believe that when companies use automated sales and use tax software, the impact on an audit is positive, as long as the software is reliable and the taxpayer is using it correctly. Additionally, 73 percent believe that technology, especially the ability to scan certificates, can improve the exemption certificate management process.



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A recurring theme among state tax officials: Commercial software enables greater efficiency in the audit and greater accuracy for the taxpayer. Because audit officials can primarily audit the software through checking rates and jurisdiction coding, time is saved by audit officials and companies using the software.

“When we audit a company that uses commercial software like Vertex the records are more accurate and there is more information available... there are fewer problems in fewer areas,” said one auditor.

Other state tax officials commented:

-“The one-stop aspect of a commercial software system and the uniformity of the system are beneficial.”

-“If it [the software] has truly captured the results it is a luxury because we do not have to look at source documents”

-“We can obtain and reconcile data in statistical electronic samples ...the auditor doesn’t have to go out to do the audit.”

State tax officials reported that in many cases, taxpayers were able to produce customer exemption certificates within the state’s time frame, for many states up to 75% of the time. The bigger question, state tax officials said, is how much time and resources the taxpayers have to expend to produce those certificates.

-“Eventually the taxpayer is able to produce the customer exemption certificate,” said one auditor. “(But) this is a huge burden on the taxpayer. For multinationals, producing valid customer exemption certificates during a give time frame is a problem because of the volume of certificates.”

## **TAX PROFESSIONALS AND STATE AUDIT OFFICIALS ASSESS IMPACTS OF SSTP/SSTI LEGISLATION**

Though the studies focused largely on ECM, audit assessments and automation, the audit officials and companies were also asked about Streamlined Sales Tax Project (SSTP) legislation. Many companies, understandably, were unsure of the impact of SSTP legislation on their corporate tax processes. Significantly, audit officials indicated that state tax changes anticipated in the near future will be minor compared to what is expected to happen as a result of SSTP legislation.

A third of the tax professionals surveyed were unsure of the impact of SSTI legislation on their corporate tax processes, while slightly more than a quarter (26%) believes it will reduce complexity in their current processes. Thirty-three percent of audit officials anticipate changing the way they administer exemption certificates as a result of SSTP.

Twenty-eight percent have experienced changes: Increased computerization of the process through electronic exemption certificates and Web-based tools that will verify certificates by certification and/or sales tax number, name of account, ZIP code and NAIC code. Their impressions of SSTP legislation range from positive to guarded. Sixty percent of audit officials interviewed said SSTP would have a positive effect on their state.

Perhaps most significant: As previously noted, state audit officials anticipate significant changes as a result of SSTP legislation.



## **SUMMARY**

Though conducted separately, the surveys unearthed common concerns and – perhaps more important – agreement on how those challenges might be best addressed. By far, the most common theme was automation. As state tax officials and many tax professionals noted, a robust commercial system to automate ECM and other tax processes can increase efficiency, saving time and money in the ECM process, and reduce assessments.

## **ABOUT VERTEX**

Vertex's technology solutions address every major line of business tax, including income, sales, consumer use, communications, payroll, property tax, and value added tax. Our solutions, along with our partnerships, are helping bring a powerful global tax network to life - a network that serves all parties involved in the tax process, across all major corporate taxes.

Not only do we partner with leading software providers like Microsoft, SAP, and Oracle to provide their customers with innovative tax software solutions, but these same companies also use Vertex solutions internally.

Today we're moving the industry forward and driving change through initiatives such as the new Vertex O Series, a powerful new technology platform, and our participation in the development of global XML-based standards for the tax industry. Initiatives like these are streamlining processes and decreasing the operating costs associated with managing the tax process.

Since 1978, more than 10,000 corporate customers have come to rely on Vertex for innovative tax processing solutions.

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