

Tackling Consumer Use Tax Challenges and Risks

How a Fortune 500 Company Leveraged Best Practices and Technologies to Enable Full Visibility, Control, and Automation

Executive Summary

As states struggle with growing budget shortfalls, many are seeking ways to boost revenue through changes to a variety of taxes, including consumer use tax. Rates in several states have increased by as much as 1 percent in 2009, and penalties for late payments and underpayments are intensifying. In response, many corporate tax departments are rethinking their approach to consumer use tax, which continues for many to be a manual process with minimal staff and decentralized decision-making. Given the incredible complexity of use tax, this approach often leads to inaccurate monthly filings, underpayments and overpayments, and missed deadlines.

How can you gain the visibility, control, and efficiency needed to ensure use tax is calculated accurately and on time – even as resources for tax departments are shrinking? The answer is use tax automation, which can make your tax department more efficient, ensure the accuracy of monthly returns (so you can eliminate liabilities and refunds), and mitigate use tax risks.

Effective consumer use tax automation requires strategic use of best practices and tax technologies available on the market today. To illustrate how leading companies are leveraging them for competitive advantage, this paper explores how a large, complex, Fortune 500 manufacturing company successfully transitioned to an automated, best practice-driven approach for consumer use tax compliance. You will learn about essential best practices that help ensure a successful transition, as well as the substantial benefits that you can expect. For example, by using Vertex® O Series® to automate handling of consumer use tax, this manufacturer has been able to:

- Centralize taxability decisions within the tax department to reduce errors and inconsistencies
- Reduce the number of tax professionals required to process monthly returns from three people to one person
- Gain visibility, control, and peace of mind
- Free up time and resources to provide better support to the business units
- Eliminate filing inaccuracies that were resulting in annual refunds in the seven-figure range

Introduction

Given the growing budget shortfalls of state governments, it is no surprise that state legislatures are taking a hard look at all types of taxes to find additional revenue sources. Consumer use tax and its corollary, sales tax, are no exception. In 2009, states such as California, Massachusetts, Nevada, and North Carolina have raised their sales and use tax rates – some by as much as 1

percent – to quickly boost tax revenues. Others are closing consumer use tax loopholes and instituting programs to capture lost revenues from small businesses that “fly under the radar,” such as medical offices and landscaping companies that purchase computers and supplies – but may not pay the required sales or use tax.

Increased focus on consumer use tax by state governments comes at a difficult time for understaffed corporate tax departments, which face intensifying pressure to do more with less. Transaction taxes such as consumer use tax continue to be notoriously complex, particularly in environments where products can be manufactured for sale as well as for a company's use. In addition, product purchase from web-based vendors that do not have sales tax calculation responsibilities put the onus of taxability determination on the purchaser. The decision for what to tax and how much to tax becomes dependent on how and where an item or material is used. Managing internal requisitions and billing systems that have traditionally been paper-based and rely on the manual calculation of appropriate taxes contributing to this complexity as goods move throughout the company.

Without a way to streamline and automate use tax determinations, calculations, and filings, many tax departments are coping with the challenges of consumer use tax by:

- When facing higher audit risks, accrue a higher estimate of consumer use tax to offset possible findings and related interest and potential penalty assessments
- Getting consumer use tax returns filed on time to avoid fines – accurate or not – and worrying about the downside of inaccuracies later
- Putting off audits until more tax resources will (hopefully) be available to support them

However, in light of the focus on consumer use tax by state governments, tactics like these are becoming more risky and costly to corporate bottom lines. Many states are hiking up penalties for late filings – for example, if a company's understatements are over \$1 million, California is now charging a 20 percent understatement penalty retroactive to 2002, as well as a 25 percent “failure to furnish information” penalty for organizations that do not respond to requests within specified time frames. Audit activity also continues to be on the rise, increasing the likelihood that tax departments will be bogged down with audit defense activities. States have even turned to third-party auditors to expand their resources and have even given incentives to them to go after bigger audit assessments.

Furthermore, tax departments are no longer able to create a safety net by filing estimates and overpaying to avoid penalties.

Many states are sending acknowledgements of overpayments (essentially IOUs) instead of refund checks because they lack funds, which can hurt a company's cash flow.

Searching for Best Practices to Manage Consumer Use Tax

As the previous examples illustrate, mistakes with regard to consumer use tax can and will hurt businesses today. So tax departments cannot afford not to get monthly filings right the first time. When you consider the increased scrutiny and risks of consumer use tax – and the time value of money, especially in tight credit markets – it is more important than ever to pay the correct amount of tax up front and on time.

However, how can you maintain a consistent process at a time when tax departments within most companies are shrinking? They are often among the first departments to face headcount cuts, as corporate executives often do not understand the complexities of consumer use taxes.

The good news is that there are proven best practices and tax technologies that can help you:

- Increase the efficiency of your department
- Ensure the accuracy of monthly returns so you can eliminate liabilities and refunds
- Mitigate consumer use tax risks, such as penalties for filing late or failing to provide the detailed information requested by auditors in a timely manner
- Reduce audit risks and costs

To better understand these best practices and technologies, take a look at a real-world example of a manufacturing company on the forefront of consumer use tax management. This manufacturer has moved from a fragmented, manual, and paper-based approach to managing, calculating, and generating consumer use tax returns and reports to an automated, best practice-driven approach that helps them realize the benefits described above, reliably and consistently.

A Model for Successful Use Tax Automation

Taking a Closer look at Consumer Use Tax Complexity

From a consumer use tax perspective, this Fortune 500 manufacturer faces incredible levels of complexity. Through acquisitions, the company has quickly grown from an \$8 billion-dollar poultry business to a \$24 billion-dollar prepared foods business. Operations now encompass everything from agriculture and manufacturing to transportation spanning over 30 states, where it is registered to report use tax.

Even as an \$8 billion-dollar business, managing consumer use tax was not easy. For all goods and materials purchased, applicable consumer use tax laws and exemptions varied for each business segment and geographic location. States Jan Nash, Non-Income Tax Manager: “For example, we receive certain exemptions if goods are purchased within a certain part of a plant, but not if they are used in non-production areas such as office space. Purchased materials and goods may also be purchased in one state, stored there, and then transported to another state for actual consumption, or use – and these moves all have consumer use tax implications. So there is an incredible amount of detail to manage in order to generate accurate consumer use tax returns for each state, month after month.”

Reaching the Breaking Point for Manual Tax Processes

To help manage this complexity, the tax department began the process of automating their tax calculation system with a need to eliminate manual taxability determination by non-tax professionals. With the current process, hundreds of company-specific tax rules were maintained in paper documents, Excel spreadsheets, or online references so accounts payable clerks could look up whether or not something was taxable.

More often than not, clerks erred on the safe side and deemed something taxable. This meant that the company paid more tax than it should. In cases where taxability varied by vendor – yet another variable in the taxability decision-making process – clerk decisions proved wrong about half of the time.

Meanwhile, the tax department – which consisted of three individuals – was trying to keep up with the overwhelming volume of consumer use tax transactions. This was quite a challenge as the company grew by acquisition into a \$24 billion-dollar business. Without a fully automated solution in place, this manufacturer struggled to:

- File accurate returns in all 30 states where they had nexus
- Be consistent in terms of how and when the company claimed exemptions
- Keep the tax manual up to date by researching tax rule changes in states
- Certify that use tax returns and data were accurate to meet Sarbanes-Oxley requirements
- Provide executives with accurate use tax numbers for budgeting and planning purposes

A Clear Path to Use Tax Automation

Eventually, the costs and risks of their manual consumer use tax management were too high. States Denton Childs, Non-Income Tax Director: “As we grew from an \$8 billion dollar company to

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a \$24 billion-dollar company, a mere 1 percent use tax error went from an issue we could live with to a problem that seriously impacted our bottom line.” As a result, in 2003, the company started on a path toward a fully automated consumer use tax management system that encompassed taxability decisions, calculations, reporting, and return generation.

In January 2006, they upgraded to the latest version of their SAP financial system. “We found Vertex O Series offered us additional functionality that made sense for our business,” explains Nash. “For example, tax rule maintenance is easier. Before, we had to update the rules state by state – a challenge when you have nearly 1,000 material groups. With Vertex O Series, we could boil material groups down to fewer categories, which vastly simplified tax rule updates.”

Vertex O Series is also able to handle significant business complexity. Notes Cathy Davenport, Tax Accountant, Compliance Specialist: “Not only do we have different types of businesses that need to report consumer use tax, but also multiple entities that need to work through the same process. With Vertex O Series, we can update rules across different entities in real time – and with much less time and effort.” The company estimates that they benefit from considerable time and resource savings each year through the reduction of costly manual processes.

Reaping the Benefits of Consumer Use Tax Automation

Automation has transformed how consumer use taxes are managed, calculated, and filed by the tax department. “With manual use tax processes, we had too many inaccuracies, inconsistencies, and lost claims exemptions that resulted in excessive underpayments and overpayments,” states Childs. “Our annual refunds alone were significant. Often, this money could not be recovered because the statute of limitations had run out by the time we identified losses.”

Since fully automating consumer use tax, overpayments requiring major refunds have been eliminated. “We stay pretty current state by state and can give executives accurate

estimates for consumer use tax for budgeting purposes,” adds Childs. “We also have the centralized data and reporting to easily identify any refunds, should we have any.”

Automating consumer use tax has freed AP clerks (and other non-tax specialists) from having to make taxability decisions – a burden they were happy to relinquish to the tax department. Now the tax department can centralize all consumer use tax decisions and consumer use automation to apply custom tax rules consistently across the enterprise. “We have gained complete visibility and control – and peace of mind that consumer use tax is being handled accurately and consistently,” explains Childs. “If we make a decision – for example, when to take a certain exemption – and it is found to be incorrect, we know that the error is consistent throughout the company. We use the centralized reporting capability in Vertex O Series to quickly find and address the error.”

By increasing the efficiency of the tax department, automation has also enabled the company to reduce the number of tax professionals required to process monthly returns from three people to one person. As a result, the tax department has the time and resources to provide better support to the business units.

“Now that we have centralized consumer use tax decisions within the tax department, the rest of the company views us as the central point of contact for anything tax related,” comments Childs. “It has really opened up the doors of communication with the business. For example, if someone is going to buy a new machine, they call us first to find out what material group to use. In many cases, we can also identify a tax incentive for the company – a win-win for everyone.”

In addition, tax professionals finally have time to cleanse and maintain master data and devote more time to audits. For example, they now have the resources to define and maintain highly detailed functional locations, which are uploaded into SAP ERP. These locations allow them to determine taxability for an item purchased for a specific machine in a specific area of the plant – where usage may indicate an exemption or liability avoidance. Audit defense is also streamlined, as all tax-related data and controls are documented and easy to report on. “Because we have confidence in our data, we are moving to managed audits where we give relevant data to state governments,” adds Denton.

The manufacturer can also automatically track the use of direct pay permits. Direct pay permits enable them to buy goods and materials without paying tax, and then determine for themselves if they have to remit consumer use tax. “This approach gives us far better visibility and control over consumer use tax payments,” adds Denton. “We have found that

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we can reduce the actual taxes paid.”

Finally, automation has strengthened their ability to maintain compliance with Sarbanes-Oxley requirements for transparency, process controls, and audit trails. Using Vertex O Series, the company enforces a control matrix that governs changes to tax rules and data. For example, now only one person is responsible for making changes to consumer use tax processing and material groups. Moreover, the tax department has a formal way of allowing this person to make changes in the system, and everything is documented.

Lessons Learned and Best Practices

This story illustrates the effectiveness of best practices in consumer use tax that can apply to any business, regardless of industry. As you evaluate the effectiveness of your own consumer use tax processes and technologies, consider the following:

- Automate consumer use tax wherever possible. This ensures that tax decisions are made consistently and accurately according to predefined tax rules determined by tax professionals, not purchasing, AP, or other departments who lack the knowledge to make informed, consistent decisions. Automation can also lighten workloads within your tax department so you can manage consumer use tax and generate monthly returns with substantially fewer resources – allowing staff to concentrate on more strategic, value-added activities.
- Simplify your life – and reduce risk – by letting Vertex handle tax rule research and maintenance. The company uses Vertex tax research to update rates across all jurisdictions. Choose a company you trust so you can rest assured that you are always in compliance.

- Use technology to make your returns audit proof. For example, the company deployed a solution that automatically generates an audit trail. This ensures that when they go through the audit process, they have all of the records and reporting on hand to get through them quickly, smoothly, and with few tax resources tied up in audit defense.
- Maximize visibility into – and control over – consumer use tax. Invest in a tax automation tool that provides sophisticated reporting and analytics to catch outliers and exceptions early enough for you to address them and eliminate unpleasant surprises.
- Choose products that already work together seamlessly. For example, this company chose SAP and Vertex O Series because they are highly compatible products that tightly integrate. This integration and compatibility has made it easier for them to automate processes, share data, reconcile accruals, and more.
- Open up communications between the tax department and the rest of the business. For example, the tax department now has continuous communication across business units regarding data element usage (such as cost centers, GL accounts, and material groups), and employees proactively come to the tax department for anything tax related. This communication – which is encouraged when tax decisions are centralized and automated – can help you head off major tax problems.
- Use technology to maximize the value of your tax personnel resources. By leveraging an automated solution for consumer use tax, this manufacturer now needs just one person working on monthly consumer use tax returns instead of three. This means two resources are free to focus on finding refunds, supporting audits, and maintaining more granular master data (such as functional locations that help them determine taxability with more accuracy). When the company was using manual processes to manage consumer use tax, they never had the time and resources to invest in activities like these that can result in significant tax liability savings.

For More Information

Because of its investment in best practices and technologies that automate consumer use tax, this manufacturer is in the enviable position of having full visibility into – and centralized control over – all tax decisions, calculations, reporting, and returns generation. They are also able to determine an acceptable risk threshold with regard to consumer use tax and manage accordingly – an increasingly important capability given the heightened focus on use tax by state governments today.

The good news is that this position is within the reach of any company today. For more information about how Vertex solutions can help you streamline and automate your consumer use tax processes, please contact your Vertex sales representative, or visit us at www.vertexinc.com.

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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.

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