



What Companies with Subscription Billing Models Need to Know About Tax

When it comes to managing tax, companies need to determine where they have nexus, apply applicable tax rates for each transaction, ensure they are adhering to the laws and regulations of each jurisdiction they operate in, understand exemptions and exceptions, and continuously monitor tax rules that are subject to frequent changes.

All of that is required for regular, one-time purchases.

Now, factor in recurring billing through subscription business models — and it gets even more complex.

This eBook was created to help you better understand taxation within a subscription billing model including:

- **Specific tax challenges that companies with subscription and recurring billing models face — and the consequences of those challenges not being addressed.**
- **How a tax engine can help resolve those challenges.**
- **An introduction to Vertex — and our subscription billing partners.**



Taxation challenges facing subscription billing companies.

- 1. Tax rates are not always clear:** Taxation of subscription services can vary by state and local jurisdiction. And the specific tax laws and regulations you must follow are subject to frequent changes. If you sell subscriptions in multiple states, you have the burden of tracking a variety of changing rules, rates, and boundaries. Calculating tax also depends on what's being purchased or sold. Digital subscriptions for media and/or software, for example, is taxed differently than physical goods.
- 2. There are multiple taxation methods (origin-based vs. destination-based):** Origin-based (where the seller is located) and destination-based (where the buyer is located) taxation methods can apply to subscription services. For example, a local fitness club with membership plans utilize origin-based taxation whereas a streaming platform that provides online video content to customers (think Netflix or Disney+) in different states or countries would follow destination-based taxation. It's crucial for your tax team to understand – and remain consistent with – which method to follow to avoid any errors.

“When tax is calculated incorrectly it obviously leads to audit risk and non-compliance – which could lead to fees, penalties, and even lawsuits. Then, on the public relations side, an error affecting customers could create a PR nightmare. What if a major streaming service miscalculated tax on its millions of subscribers? The press and the social media impact of that could be bigger than the legal consequences”, said Pete Olanday, Director of Retail Consulting at Vertex.
- 3. Sales tax holidays, discounts, and exemptions must be accounted for:** Some states consider certain digital services (of which many subscription businesses fall under) as taxable, while others may exempt them. For example, if your business operates in California and you sell educational or healthcare-related services, those are tax-exempt. In addition to exemptions, you may have to account for discounts, sales tax holidays, and emerging technologies. All of these nuances would require your tax team to spend significant time researching specific tax laws of multiple jurisdictions.

4. **Billing frequency affects taxation:** If your company offers monthly, semi-annually, or annual billing you need to decide how to handle those taxes. The specific method of tax calculation you implement can vary depending on your jurisdiction(s), your type of subscription service, and your billing structure. Here are two common approaches:

- **Prorated Tax Calculation:** In this method, the tax amount is calculated proportionally based on the billing period. For monthly payment plans, the tax is calculated for each individual monthly billing cycle. For annual payment plans, the tax is divided equally across the 12 months or prorated based on the number of months remaining in the subscription term.

Olanday explains in this example: “If my cell phone company changes their subscription model, and my original plan was only for the first half of the month, and then the new plan kicked in in the middle of the month, they would need to calculate tax for two different plans and then prorate it. In a lot of instances customers come in at the middle of the month so they need to be reimbursed for the time period that they did not have the service. Also, sometimes there are fees that would not warrant proration too (like a 911 fee for a cell phone bill), so it gets complicated”.

- **Lump Sum Tax Calculation:** Alternatively, you could calculate tax on the total amount upfront for annual payment plans. In this case, the full tax amount for the entire subscription term is calculated and charged at the beginning of the term. This approach simplifies the tax calculation process as it avoids prorating the tax over multiple billing periods.

Being intentional about how often, accurate, and consistently you apply tax is critical so that you don't end up mistakenly over-charging or under-charging your customer.

5. **Billing frequency can also create peak volume times:** Many subscription-based companies choose to bill all of their customers on the first of the month, leaving no bills to generate from day two to the end of the month. This requires extra power from your billing and tax technology to keep up during those peak periods and manage high transaction volumes.

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- 6. There are filing and reporting requirements:** Your subscription business must understand where you need to report and file returns as well as when and how. Managing this process for each state and local jurisdiction can be challenging. If you fail to comply with filing and reporting requirements, your company can face penalties or fines.
- 7. Regulations can change at any time:** Tax laws and regulations related to digital services and subscriptions are subject to change at any time in every jurisdiction. It's important to stay updated on any new state and local laws or modifications that may affect your tax obligations. For companies with no or small tax teams, this can be a big challenge.

As you can see, companies with a subscription business model face an added layer of tax complexity. For this reason, many choose to solve the problem by integrating a third-party tax engine to their billing systems to automate the maintenance of tax data and tax calculation.



How a Tax Engine Can Help

A tax engine can be a valuable tool for companies with a subscription business model by offering the following benefits:

- **Automated tax content and calculation:** A tax engine automates tax calculation by applying the correct tax rates based on the latest tax rules and rates. This helps ensure that your business remains in compliance with tax laws, reduces the risk of errors, and saves time and effort associated with tax researching and manual updating of tax content in billing systems.
- **Tax exceptions and exemptions:** A tax engine can be configured to recognize and apply specific sales tax holidays based on the applicable jurisdictions and the goods or services covered by the holiday. The system can be programmed to suspend or reduce the tax rate during the designated holiday period, ensuring accurate tax calculations for eligible transactions. Similarly, it can also incorporate the rules and criteria for sales tax exemptions.

Olanday explains, “Without a tax engine you would have to go to each state’s department of revenue’s website to stay current on the tax changes. For example, Illinois- based transactions that start in Illinois and end in Illinois, would need to have tax calculated according to the ship-from location, whereas an origin-based state, would determine tax based on the ship-to location. It’s not impossible, but it’s not very realistic to actually determine tax that way.”

- **Nexus threshold determination:** A tax engine can help analyze customer data, sales transactions, and other relevant factors to determine where the business has met nexus thresholds and needs to collect and remit taxes.



- **Scalability and efficiency:** Tax engines can handle increasing transaction volumes without sacrificing performance or accuracy. The system architecture and infrastructure can be designed to accommodate the processing requirements of a large volume of transactions. It eliminates the need for your team to perform manual processes and frees up those resources to focus on other business initiatives.

“A tax engine can be very elastic by ramping up billing runs for peak times. We see a lot of instances where businesses make adjustments to their tax engine infrastructure for Christmas, Black Friday, and Cyber Monday, then scale them back down during those valley times”, said Olanday.

- **Improved customer experience:** A tax engine can help provide a seamless and transparent experience for your customers. The accurate calculation and display of taxes during the subscription process can prevent surprises or confusion. Since it ensures that taxes are collected and remitted correctly, you maintain trust and credibility with your customers.
- **Audit preparedness:** A tax engine helps you maintain accurate tax records and generates detailed reports, which can be beneficial during any tax audits or inquiries from tax authorities. It provides you with a clear audit trail and documentation, demonstrating compliance with tax laws and regulations.

- **Tax content updates:** A tax engine maintains a comprehensive tax content database with up-to-date tax rules, rates, and exemptions for various jurisdictions, including special rules applicable to subscription-based services. It continuously monitors and updates this content to reflect any changes in tax laws, ensuring you have accurate tax calculations based on the latest tax regulations. This content is leveraged across any system the tax engine is integrated with (Billing, CPQ, etc.) which ensures accurate and consistent tax determination at every step of the order-to-cash/invoice-to-cash process.

Implementing a tax engine can streamline tax calculation processes, reduce errors, ensure accurate tax calculations, and improve overall operational efficiency for subscription businesses. It helps businesses stay compliant, maintain customer satisfaction, and mitigate the risks associated with tax-related challenges.



Introducing Vertex TaxCalc for Subscription Billing

Vertex offers a robust integration with many industry-leading subscription management software to automate tax calculation. Our solution delivers location identification as well as a complex taxability logic to deliver a precise tax calculation for even the most complex transactions. Tax rules and rates are updated monthly, which reduces your maintenance burden and improves audit readiness. Vertex offers:

- Robust global tax content including 700 million+ data-driven tax rules
- Custom taxability setup
- Address cleansing for accurate tax jurisdiction identification
- Reporting and data extracts
- Role-based security
- System scalability

Vertex's Subscription Billing Partners

Vertex offers supported integrations to a range of subscription management software platforms including:

zuora

Recurly

ARIA

salesforce

To get started streamlining tax calculation for your subscription billing business, visit vertexinc.com/subscriptionbilling



About Vertex

Vertex Inc. is a leading global provider of indirect tax software and solutions. The company's mission is to deliver the most trusted tax technology enabling global businesses to transact, comply, and grow with confidence. Vertex provides solutions that can be tailored to specific industries for major lines of indirect tax, including sales and consumer use, value added, and payroll. Headquartered in North America, and with offices in South America and Europe, Vertex employs over 1,300 professionals and serves companies across the globe.

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