Multichannel Math: How Retail Sales Tax Complexity Adds Up and Why Tax Automation is the Solution

Getting a handle on sales tax complexity in the retail industry is like solving a challenging math problem: the number of factors and variables in this dynamic equation continually increases. Start with tens of thousands of tax rates and rules, then update the equation to figure in 400 or so annual rate changes (in the U.S. alone). Next, add in a potentially dizzying number of discounts, sales tax holidays, miscellaneous fees, services adjustments, local jurisdictional differences, and relevant exemptions (if you can track them down). Finally, multiply that figure by the number of products your retail company offers and the growing number of sales channels the company uses to reach customers.

For retail CEOs and their organizations, avoiding complexity is not an option – the choice comes in how they respond to it.

Addressing and taming complexity in a compliant manner is enough to send retail industry tax professionals screaming from their whiteboards and spreadsheets. That retreat actually represents a smart first step: Tax professionals should leave manual calculations and spreadsheets behind. The path to clarity and compliance in an increasingly complex retail industry, and its perplexing tax environment, leads to demand for a solution that features optimized, scalable tax automation. The industry's growing complexity has quickly shown the necessity of tax automation while exposing the risks of sub-optimized automation tools.

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The ideal solution requires a firm grasp of:

- High level retail industry trends and how they affect tax functions;
- The sales tax challenges these trends give rise to; and
- The primary industry-specific drivers of tax automation.

Trends: Tax Impacts of Global Expansion and the Omnichannel Revolution

Two of the most important retail trends today—global expansion and the ongoing move toward omnichannel sales and service delivery—mark developments that have the greatest impact on tax functions. To be sure, other forces such as growing competition (a byproduct of globalization), consolidation (a byproduct of intensifying competition), and regulatory changes are also driving transformation in the industry. Global expansion and the rapid adoption of omnichannel are worth examining more closely for their tax impacts.

Global expansion includes the long-standing trend of domestic retailers extending their supply chains and/or their markets to more locations around the world. This expansion naturally exposes a retail company to more tax jurisdictions. A related, more broadly defined type of expansion is also taking place throughout the industry, as domestic retailers expand their regional reach by launching and expanding their e-commerce capabilities. This expansion is being pursued by online pure plays as well as by traditional brick-and-mortar companies, many of which are reinventing themselves as “tech-and-mortar” companies. Retailers are also expanding beyond products into related services offerings.

The staggering expansion of sales channels has been well documented. Driven by customer demand, retailers are busily expanding the number of platforms they use to interact and conduct transactions with increasingly connected and informed consumers (online sales, social media interactions, mobile sales, etc.). Traditional consumer behaviors are disappearing.

People have changed the way they shop. Rather than going to the nearest store to research and make a purchase, many will now research online and buy in-store, or vice versa. Moreover, especially with mobile technology, people expect to be able to shop whenever they want and wherever they are. Retailers have little choice but to react to behavior that has already changed, and to consumers who are increasingly intolerant of being told that they must fit in with a seller’s choice of time and location.

It has also become clear that consumers’ social, mobile, and online activities greatly influence their purchasing decisions, regardless of whether they purchase online or in a physical store.

These overarching drivers of industry change have three noteworthy implications on the tax functions within retail companies:

1. **Tax compliance is getting more challenging.** This is the case from a legislative/jurisdictional perspective as well as from a business-process perspective. Volatile economic conditions have thrust sales tax issues into the glare of the political, legislative, and regulatory spotlight. Many state and local governments are looking for more tax revenue, and they are subjecting tax management practices of retail companies to much greater scrutiny. Previously uncommon types of taxes such as environmental fees are becoming more common, and new tax rules and laws continue to materialize at a rapid clip.

2. **Tax is moving up the decision-making process.** In many retail companies, tax functions traditionally weighed in with their analysis after significant decisions were made. A decision to enter a new region was finalized, and then the tax function figured out the tax implications of the expansion. Today, tax functions are contributing their insights and analyses earlier in the process; they are informing decisions, rather than reacting to the final call.

3. **Next-generation strategic planning involves tax.** The tax function’s growing involvement in major decisions is occurring, in part, because cash reserves are under greater scrutiny as retailers try to increase revenue and decrease cost while improving organizational agility. By demonstrating value in these types of decisions, leading tax functions are taking on a more strategic role in numerous areas, including strategic planning, major technology implementations, and more. Many tax functions appear to be shifting from a reactive, audit-defense mindset and an operations-only mode of operations, to a strategic mindset and a more proactive mode.

Sales Tax Challenges: Tens of Thousands of Rules, Constant Changes

The rise of omnichannel sales and service explains many, but not all of, the unique sales tax challenges that exist within the retail industry.

In practice, omnichannel is designed to enable customers to make a purchase anywhere, take possession anywhere and return anywhere. They expect to experience this flexibility without actually seeing the channels (the "seamless" capability that most retailers strive to reach), while enjoying a consistent experience regardless of which channel they are using. When this state is achieved, it can delight customers and ultimately increase their lifetime value. However, this state also delivers a number of less-than-delightful complications from a tax perspective. Selling a product through one online channel that is delivered to a home address and then returned by the customer to a physical store, creates a fair amount of tax complexity. Multiply that single transaction by dozens of products, thousands of customers, more than 40,000 U.S. zip codes and hundreds of different tax rates (many with their own local wrinkles), and the tax math gets extraordinarily complex very quickly.

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The complexity is evident in the growing number of sales tax challenges facing retailers:

- **The growing volume of tax rules and rate changes:** In the United States, there are tens of thousands of tax rates and rules. Additionally, more than 400 tax rate changes occur each year. Sales tax holidays, discounts and promotions are also becoming more common, which, due to the relatively brief periods of time they remain valid, create additional layers of tax processing complexity, raising tough questions: How well can existing return processes address temporary rate changes? Does a specific discount relate to a tax on net or gross? How are retailers ensuring that tax rates are appropriately applied in "buy one, get-one-free" (BOGOF) offers?

- **Miscellaneous fees:** These fees, especially those related to environmental impacts, are on the rise in numerous jurisdictions. These fees can be applied to the use of disposable bags or the recycling of certain goods (mattresses, for example). Some fees are quantity-based. Other miscellaneous fees may be scenario-based, as is the case with certain public improvement fees, where the fee itself may be taxable.

- **Services:** As retailers strive to differentiate themselves on the strength of their customer experiences, they are providing more services to add value (shipping, alterations, layaway, etc.). Many of these services are subject to tax rules. Shipping-related taxes, for example, can quickly get complicated because the tax rate depends on the product being shipped.

- **Localized complexities:** These issues include a diverse collection of non-standard tax rules applied in different localities. There has also been an increase in the use of highly location-specific tax rules and rate changes—more focused than a nine-digit zip code. For example, some shopping centers impose an extra sales tax of up to one percent above the standard local rate.

- **Tiers and thresholds:** In some cases, a county has a tier or threshold that differs from the state tier or threshold. In more cases, there are multiple rates at each jurisdictional level, and these need to be correctly applied in order to calculate tax correctly.

- **Exemptions:** These include customer-based sales tax exemptions, such as those that apply to foreign diplomats, and organization-based exemptions for non-profit companies, religious organizations and some resellers.

- **Product taxability:** The taxability category tree is growing as legislation gets increasingly specific. This means that the list of items that qualify for a discount is getting longer at the same time that the number of different discounts is increasing.

All of these issues challenge tax functions and the tax solutions they deploy to address an increasingly complex environment.

3 Drivers of Tax Automation

As sales tax compliance becomes more complex due to internal changes (e.g., omnichannel capabilities) and external drivers (e.g., increasing tax rules and rate changes), tax functions in the retail sector find it more difficult to operate in a consistent, tax-compliant, and efficient manner. They spend more time tracking down tax data and in tax-processing mode. They worry more about sustaining tax compliance. And they have less time to invest in more productive activities, such as leveraging the tax implications of strategic decisions.

Tax automation can help tax functions achieve greater consistency, strengthen tax compliance and operate more efficiently. But the industry's tax-specific challenges summarized above are not the only drivers of tax automation. Tax functions should consider investing in tax automation—or optimizing existing tax automation solutions—due to the following factors as well:

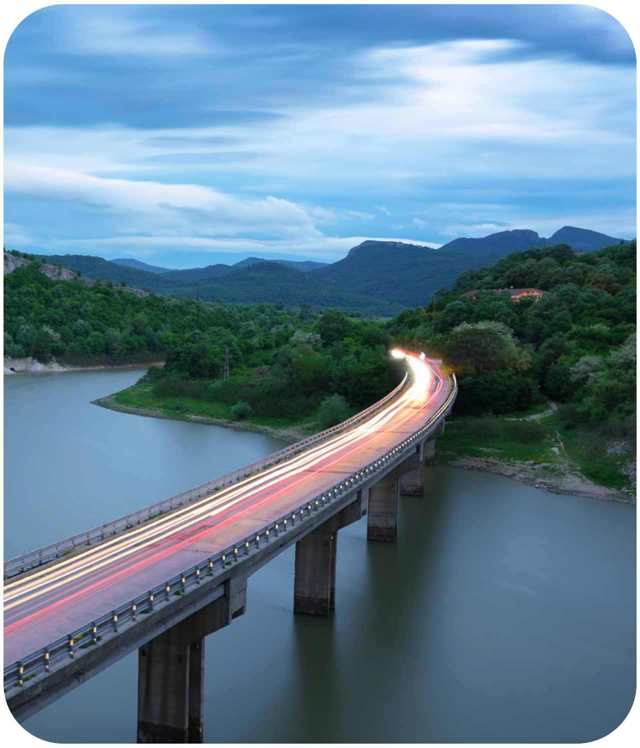
1. **Growth and Expansion:** Growth takes many forms, including geographic expansion, which even in the domestic sense can expand a retailer's nexus footprint and subject it to new tax rules, rate changes, discounts, and fees. Obviously, global expansion subjects a company to additional tax complexity. But expansion also refers to the sudden growth in the number of sales channels — and, in many cases, the number of point-of-sale (POS) devices used by retailers. The handheld tablet or smart phone an in-store sales clerk uses to help customers complete a purchase in a more convenient manner may not always feature an integrated tax calculation engine. The growth of omnichannel means that distribution channels are also expanding: some stores now operate as miniature distribution centers. When a customer orders a product online, the store carrying the item that is nearest to the customer can fulfill the order. The growth of sales and distribution channels is breaking down traditional organizational silos and expanding the need for tax calculations. Tax automation can reduce the complexity associated with each of these modes of growth and expansion.

2. **Stricter Reporting and Filing Requirements:** As the regulatory demand for greater transparency into tax management practice increases, tax-related legislation—and therefore tax compliance—is getting more complicated. By storing, calculating, and accessing tax data electronically, retailers can fulfill reporting and filing requirements more effectively and efficiently.

3. **Technology:** As retailers implement more technology to enhance the customer experience on the front end of the transaction, the tax calculations that have traditionally occurred on the back end of the transaction become more complex. To reduce this complexity, tax functions are becoming more involved during the implementation stage of these customerfacing technology advancements, which include more flexible POS applications, e-commerce systems, and mobile commerce applications.

Today, despite a growing need, many tax functions in the retail industry have yet to become fully automated. A typical approach involves a high number of manual steps and manual monitoring; a tax function conducts rules and rate research (on its own or via a service or third-party vendor), identifies standard tax rules, and then manages exceptions by location. The function also creates schedules by geography or tax scenario and then matches its merchandise to relevant geographies in a chart or matrix that (hopefully) captures all of the current tax rate complexities. This information is then entered into the POS system, and tax professionals must vigilantly monitor and manage any changes to the chart or matrix. The information must be updated frequently; new locations must be added and dropped, and SKUs must be added and removed. Doing so manually, or through a partially automated tool, can give rise to errors and omissions, increasing increase tax compliance risk.

On the back end of a typical approach, compliance requirements raise a host of additional questions related to the transactional data needed to file returns: Is the transactional data tax-sensitized? How can the data be translated into returns-appropriate figures? Are we filing what we think we collected, or what we were required to collect? Are those numbers consistent, and if not, why?



Conclusion: Tax Automation Equals Advantage

A highly manual tax management process—even a partially automated tax management process—can rarely handle all of the tax complexities in the retail industry today. And if it can, it will not be able to do so in the near future, when new modes of customer interactions and transactions, changing consumer preferences and other drivers of additional complexity require additional tax calculations.

An effective tax automation solution is able to scale in order to support a retailer's growth into new regions, countries, channels, and products or services. The tax math is only going to become more and more complex as retailers plunge deeper into an omnichannel era, in which the cost of sub-optimal tax automation will soar. When it comes to solving this growing tax complexity, the most important variable is tax automation from a recognized industry leader.

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