

The new digital economy is placing tremendous strain on the legacy methods of collecting taxes. In response, organizations are turning to SaaS-based tax management systems that incorporate advanced technologies.

Uncertainty and Complexity Drive Sales and Use Tax Transformation

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Introduction

The process of managing the collection, calculation, and filing of taxes has become increasingly difficult as enterprises and their markets have grown in scale and complexity. Companies are selling more products and services in more places (regionally and globally) and in more ways (B2C, B2B, and B2B2C) than ever before. In addition, growth in the digital economy has made the process of managing sales and use taxes more difficult as establishing the nexus to determine tax reporting obligations can be complicated. For digital commerce companies, sales and use taxes and value-added taxes are the most complex areas of tax management because of the constant rate of change in tax regulations. Several external factors are impacting the sales tax, reshaping the direction of both the regulations and the sales tax compliance tools. Figure 1 shows three of the higher-profile external factors reshaping sales tax compliance.

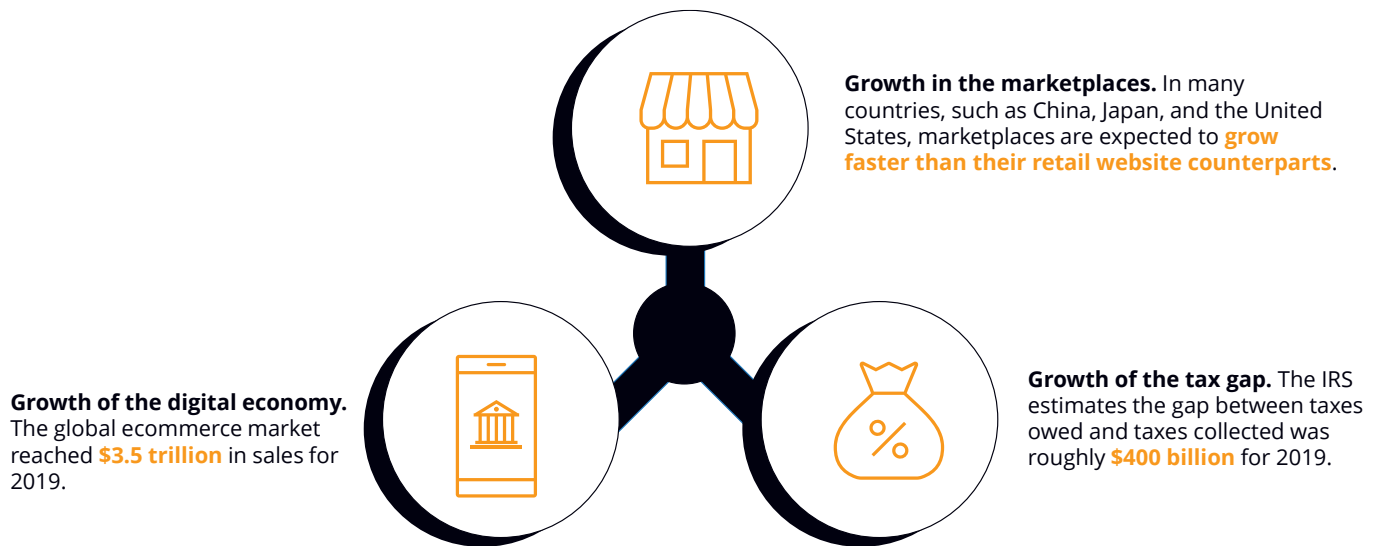
AT A GLANCE

WHAT'S IMPORTANT

Tax management has gained a heightened profile as organizations look for new ways to compete in today's uncertain business market.

KEY TAKEAWAYS

The growth in tax regulations has made it increasingly complicated to sell products globally. Organizations are looking to technology to cope with the ever-changing challenges of managing sales and use taxes as each sales location may have its own tax reporting obligations.

FIGURE 1: *The Whirlwind of External Factors Reshaping Sales Tax*

Source: IDC, 2020

The external factors that are significantly affecting sales tax practices include the following:

- » **Growth in the marketplaces.** Cross-border marketplaces are ecommerce sites where products are provided by multiple third parties (e.g., eBay, Etsy, Alibaba). These sites saw double-digit growth in 2019, and the growth is expected to increase sharply through 2020 as a result of COVID-19.
- » **Growth of the digital economy.** The digital economy is reshaping how business is done at a fundamental level. IDC believes that, in 2020, businesses will spend \$1.3 trillion on the technologies and services that enable the digital transformation of their business models, products, and services. This transformation is impacting the compliance business at every level, including auditing/verification workflows, internal compliance processes, and tax software demands.
- » **Growth of the tax gap.** The new digital economy is placing tremendous strain on the legacy methods of collecting taxes in the United States and Western Europe. There will be increasing energy from tax authorities toward closing this gap. We already see evidence of this in the continued expansion of *South Dakota v. Wayfair* and the proliferation of invoicing laws throughout the European Union.

An Increasingly Complex Regulatory Landscape

The growth in tax regulations has made it increasingly complicated to sell products globally. It is a vicious cycle. Organizations are looking to technology advancements to cope with the ever-changing challenges of global business. The growth in the digital economy has made the process of managing sales and use taxes only more difficult as each sales location may have its own tax reporting obligations (see Figure 2).

FIGURE 2: *Increasingly Complex Sales and Use Tax Regulation*



Source: IDC, 2020

Corporate tax managers were exposed to a rapid rate of change in tax regulations in 2019. The regulatory rules are constantly changing along the following dimensions:

- » **Marketplace facilitator laws.** In the United States, several states, including Illinois, California, and Massachusetts, have implemented or reworked laws requiring marketplace facilitators (i.e., Amazon, Walmart, and eBay) to collect and remit sales tax on behalf of their third-party sellers' transactions. There is significant effort around this issue as states look for stronger visibility and access to the tremendous revenue growth within the digital economy.
- » **South Dakota v. Wayfair.** The South Dakota v. Wayfair Supreme Court decision removed the "physical presence" mandate; now a state has the authority to collect sales tax from retailers and other online sellers that have "substantial nexus" (i.e., conduct a considerable amount of business) in the state. Each state and local tax jurisdiction within it that charges sales tax must now decide how it wants to define substantial nexus. This means that all sales will need to be subject to the collection of sales tax, whether direct or by third-party sellers.

- » **Shifting jurisdictions.** Within a state, each jurisdiction has a unique set of rates and characteristics that makes maintaining compliance more difficult. Further, the tax rates within the United States are constantly changing at both the state level and the local level.
- » **Shifting indirect tax rates.** Indirect taxes such as sales and use tax, value-added tax, and goods and services tax are critical aspects of the emerging global digital economy. Nearly every major economic region is undergoing some level of indirect tax reform; the countries announcing value-added tax/goods and services tax changes include Canada, Malaysia, China, and India. Recent global tax initiatives (e.g., Wayfair, Making Tax Digital, Golden Tax) are promising to make tax determination even more complex in the coming years.
- » **New financial reporting standards.** IFRS 15 and ASC 606 have significant impact on how and when revenue can be recognized. IFRS 16 impacts how leases are accounted for within the corporation. Together, these reporting changes add complexity to the process of corporate tax compliance.

Sales Tax and the Pandemic

Retail customers, quarantined because of the pandemic, turned to online commerce as their lifeline for groceries and other essentials. As a result of this pandemic-driven shift in retail traffic, sales tax software vendors saw an explosion of transaction traffic from online retail. The activity on sales tax compliance software vendors' sites is more aligned with retail's "Black Friday" levels and has been holding there since the beginning of the COVID-19 pandemic.

Given the uncertainty around the global pandemic, digital transactions have accelerated. The pressure to maintain compliance is tremendous as companies of all sizes quickly transition to support a rapidly expanding digital presence.

The pandemic has revealed a large disconnect between current tax department functionality and the needed state of operational efficiency to cope with current tax demands. Many organizations have realized they simply do not have the visibility, flexibility, and agility they need to adjust to the "new normal." As a result, organizations find themselves struggling with manual/legacy tools and antiquated processes. Because of this tipping point of demand and reality, there has been an unprecedented urgency regarding the immediate modernization of tax compliance tools. Tax software vendors, especially companies with a wide footprint in digital commerce tax compliance, are extremely busy as online purchases increase.

Pandemic Demands More from Both User and Software Vendor

Organizations are looking not just to their SaaS software but also to their software vendors for help through the present volatility. Many of these vendors have stepped into the role of advisor more fully during the pandemic than at any other time. The following are some of the advisory activities these vendors are offering:

- » **More educational content.** Vendors are working to create more educational content to place on their websites. They are working to provide more access to product managers for problem solving and ideation to maximize software operation (and thus its value). Dealing with the rapidly changing tax landscape is an area where end users have a need for the vendor to take the lead and provide guidance.

- » **Help beyond software.** Some vendors have rolled up their sleeves and helped customers navigate the state-level auditing process; some vendors have even helped businesses move their tax departments and tax operations to support remote working.

It will be important for software vendors and buyers alike to understand that now more than ever the true value of tax compliance software lies not only in its features and functionality but also in the relationships organizations have built with their software vendors.

Benefits of SaaS Tax Software

Tax compliance is a complex topic in many organizations. As a result, tax compliance was often seen as either a necessary evil or a loss center among upper management. The problem, until recently, has been that technology had not caught up to the desired functionality at the desired price point, especially in smaller organizations (small to midsize) where larger, more complex tax management solutions were thought of as too expensive/complex. As a result, many organizations utilize spreadsheets and paper records as their primary tax compliance tool. In fact, nearly 50% of organizations still consider spreadsheets and paper records as their main tools in tax management. However, the proliferation of cloud computing has drastically changed this equation. A wave of software vendors is offering tax management technology that meets the functionality and price point equation, allowing organizations to effectively move away from spreadsheets and paper records. The numerous benefits of SaaS tax management software technology include the following:

- » **Operational efficiency:** Reduce reliance on spreadsheets
- » **Flexibility:** Adapt to rapid business changes
- » **Auditing capability:** Find/track details of sales transactions
- » **Continuous compliance:** Be up to speed with constantly changing laws
- » **Data visibility:** Gain better insight into sales tax data
- » **Rapid implementation:** Achieve quick implementation
- » **Automatic software updates:** Get the latest software functional updates automatically

Considerations

As always, the heaviest part of the burden from new regulations on digital goods and services will fall on the small and midsize digital commerce retailers with limited tax management resources (e.g., time, money, and people). IDC believes that this burden places a heavy focus on affordable, cloud-based tax compliance software in the coming months, especially among smaller digital retailers. When choosing a tax solution for the digital economy, companies should look for a vendor with expertise in the following areas:

- » **Innovation.** Companies looking for sales and use tax software vendors must strongly consider vendors that are utilizing technology advances such as machine learning and artificial intelligence to support sales tax functions, including the collection and analysis of relevant data to identify possible areas of risk/exposure.

- » **Training and education.** The tax regulatory sands are constantly shifting for corporate tax professionals. Companies should consider looking for sales and use tax software providers that offer training and education in the form of regular videos and white papers. In addition, they should look for software vendors with education portals that provide the latest tax regulatory information.
- » **Movement to the cloud.** The rapidly changing tax rates and the pace of digital business almost necessitate the use of cloud computing when calculating and collecting sales and use taxes because on-premises systems quickly become outdated. Companies looking for sales and use tax software need to strongly consider cloud-based solutions.

Many tax software vendors have invested a tremendous amount of resources in enhancing/launching products that address the taxation of digital goods and services. Such vendors frequently offer dedicated initiatives to provide tools and education for business owners as they navigate the digital goods and services taxation landscape as it continues to evolve.

Trends

Technology Transforming Sales Tax Landscape

Recent technology changes are reshaping the corporate tax management function. The pace of change within corporate tax will only accelerate in coming years. Technology advancements have cleared a path within the very conservative area of corporate tax management. Advances in cloud technology are leading the way for corporate tax management professionals to higher levels of visibility, productivity, and scalability.

Technology Set to Impact Sales and Use Software Market

- » **Optical character recognition (OCR).** OCR is being used by businesses as a way to efficiently capture valuable information on invoices and thus streamline invoice processing.
- » **Artificial intelligence.** Companies are already beginning to use artificial intelligence to perform lower-level repetitive tasks such as calculating the proper sales tax rate for the proper jurisdiction.
- » **Big data and analytics.** Sophisticated big data and analytics will allow tax professionals to identify opportunities and make better tax decisions.
- » **Cloud computing.** There are many new cloud initiatives both from traditional on-premises software providers and from start-up "born in the cloud" tax software vendors.

Future Trends

Given the uncertainty around the global pandemic, digital transactions have accelerated. The pressure to maintain compliance is tremendous as companies of all sizes quickly transition to support a rapidly expanding digital presence.

- » **Digital goods entering focus.** The taxation of digital goods and services is evolving and becoming even more complex. It will be an uphill battle for companies that choose to cope with digital goods taxation via legacy approaches. The companies that understand the importance of a modern tax compliance solution will thrive with upcoming changes.

- » **Cloud leading the way.** The most obvious takeaway is that organizations are planning on spending more on SaaS versus traditional (on-premises, single-tenant, and managed-hosted) software. IDC research shows that we are already seeing a shift toward the public cloud, and survey results also suggest that COVID-19 has accelerated this trend, representing a tipping point for the business world.
- » **DX picking up speed.** COVID-19 presents immense opportunity for technology vendors at the forefront of digital transformation, as nearly 75% of survey respondents from IDC's April 2020 *COVID-19 Impact on IT Spending Survey* specified that technology-led digital transformation projects are a top priority as they go forward. However, various caveats must be established for their "go forward" journey.
- » **Tax compliance burden shifting to marketplaces.** In many countries, such as China, Japan, and the United States, cross-border marketplaces are expected to grow faster than their retail website counterparts. As of July 2020, 43 states have marketplace facilitators responsible for collecting and remitting sales tax for their sellers.
- » **The evolving nature of digital goods tax.** The taxation of digital goods and services (e.g., software, streaming services, media) is still evolving and becoming even more complex. This issue of complexity reaches new heights when dealing with digital goods and services at the state level. The definitions and terms are not universal from state to state, there is no uniformity on how to classify some digital services, and there are issues around the use intent (i.e., permanent use or nonpermanent use). The situation is rapidly evolving on a state-by-state basis, which places incredible pressure on business owners to stay informed.
- » **Digital commerce growth.** Digital commerce presents an opportunity for sales and use and value-added tax vendors to tap into tremendous growth in digital transactions. As a result of the massive shift toward digitalization, the amount of nonphysical digital goods (e.g., on-demand services, software, online gaming, ebooks, music files, digital images) being sold has exploded. This explosion has caught the attention of business owners and tax authorities all over the globe.
- » **Cross-border marketplaces on the rise.** Cross-border marketplaces are ecommerce sites where product is provided by multiple third parties; popular examples include Alibaba, Amazon, eBay, JD.com, and Wish. These sites are growing rapidly. With the rise of these cross-border ecommerce marketplaces, the emphasis will remain on compliance and logistics. Companies must now streamline their customs, logistics, and returns processes to successfully compete in these marketplaces.

Conclusion

Tax management has gained a heightened profile as organizations look for new ways to compete in today's uncertain business market. Organizations are also coming to the realization that, in many cases, effective and efficient sales tax management also has an impact on their cash flow. As business models become more complex, companies must harness the potential of cloud-based tax automation software to keep up with today's unprecedented uncertainty and the pace of regulatory change at the federal, state, and local levels. Technologies such as automation, artificial intelligence, and machine learning are set to reshape highly rule-based and data-centric functions such as tax management. Tax application software providers that quickly incorporate these next-generation technologies and expand the solutions' functionality will have a definite strategic advantage.

Companies must harness the potential of cloud-based tax automation software to keep up with today's unprecedented uncertainty.

About the Analyst



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As a Research Manager with IDC's Enterprise Applications team, Kevin M. Permenter provides insights and intelligence across multiple areas including enterprise resource planning (ERP), order management, financial applications, and project and portfolio management. He assesses the interplay, challenges, and trends regarding various enterprise application deployment models like mobile enterprise applications and cloud models.

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