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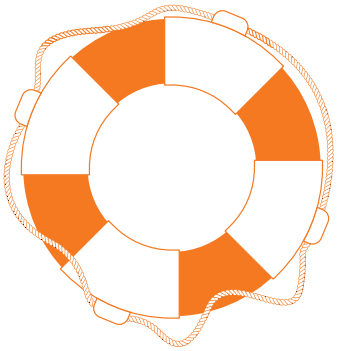

Sales Tax Survival Guide 2015

WELCOME to the 2015 Sales Tax Survival Guide–your strategic defense against sales tax audits, fines, and penalties. This guide is no substitute for professional tax advice; however, it can provide a solid foundation upon which to build effective transactional tax compliance strategies in 2015 and beyond.

States need your money now more than ever.

Sales tax is a critical source of revenue in 46 states (North Dakota, New Hampshire, Montana, Alaska, and Delaware don't have sales tax). Other than property and income tax, sales tax is the largest source of state tax revenue, and one frequently leveraged to fill budget gaps.

Calculating, collecting, and remitting sales tax is not only good business, it is a legal obligation placed on merchants by the states in which they conduct business. Doing it properly is not only an obligation, it's the best defense against hungry state auditors.

The tactics needed to survive sales tax in 2015 require preparing for the worst (audit) while achieving the best (streamlined sales tax processes).

Challenge #1: Keep broadening definitions of nexus from catching you unaware

> **Survival Tactic:** *Track rate and rule changes by state with Avalara's free online tool*

Whether a company has a sales tax obligation is the crux of the sales tax challenge. There are approximately 11,000 jurisdictions within the U.S. and 100,000+ rules changes annually; that's a daunting set of variables few manual systems can handle. The connection between a company and a state, in which the company acts as an agent of the tax authority and collects and remits accordingly, is called "nexus." In addition to a significant physical presence such as a warehouse or headquarters, nexus can also mean a virtual connection. Large online retailers such as Amazon and Overstock now collect sales tax in states in which they have neither distribution centers nor warehouses. Many online retailers and other remote sellers are not currently required to collect sales tax in states where they have no physical presence. But states struggling to recover from economic recession see this uncollected tax as a major source of potential revenue.

Challenge #2: Understanding and following changes in product taxability

Survival Tactic: *Track your product offerings against the unique requirements of each state into which you sell.*

Many states are addressing budget gaps by increasing product taxability. Your business must determine which items are taxable, and whether taxability varies from state to state. For example, many states don't collect sales tax on grocery items but do tax processed foods that contain certain ingredients. Historically, most sales of Tangible Personal Property (TPP) have been subject to sales tax. This has begun to shift to include intangibles such as professional services and installation services. Many states now routinely apply sales taxes to services directly associated with goods (think computer tech support or TV/media installation).

Challenge #3: Know which services are taxable

Survival Tactic: *Use the True Object Test to determine taxability*

In many states, services can be provided tax-free for a number of reasons, including:

- Status of purchaser
- Intended use of the good or service
- Sales tax holiday

Many states use a True Object Test to determine whether the product or the service is taxable. The True Object Test applies to the physical items included in the price of the service sold. If the main purpose of a transaction (the true object) is to receive services, then even if acquisition of tangible property results, the transaction is usually not taxable according to the True Object Test, However, if the True Object of the transaction is the acquisition of tangible property, then the entire transaction may be taxable.

Challenge #4: Finding the right sales tax rate to charge customers

Survival Tactic: *Don't rely on ZIP codes to determine the right rate.*

Don't make assumptions about geography. Many businesses make the mistake of searching for the correct sales tax rate by using ZIP codes, which is similar to using a 1980s map to find a 2010 housing development. Unfortunately, taxing

jurisdictions do not follow ZIP codes. Individual counties and municipalities can levy sales tax in addition to state sales tax, and sometimes tax rates can vary within an individual ZIP code. Geospatial mapping, on the other hand, can pinpoint each location against each relevant taxing jurisdiction.

Challenge #5: Tracking sales tax holidays

Survival Tactic: *Understand tax holidays in each state into which you sell.*

There were at least 17 states with sales tax holidays in 2014 and that will surely change in 2015. Sales tax holidays are specific days when sales tax is not charged on certain products and services. For example, "Back to School" holidays in some states exempt clothing purchases from sales tax on specific days, or below certain dollar amounts. Sales tax holidays give consumers an opportunity to purchase goods and services tax-free. By their very nature, these tax holidays can be ad hoc and unpredictable, varying by type of goods, or time of year, over different periods of time, with absolutely no consistency from state to state. It's so haphazard, there's little chance of getting it right consistently. This means potentially disappointing customers expecting to get a sales tax break on a purchase. Incorrect application of holiday tax breaks can lead to over-charging sales tax and ultimately additional cost in time and effort to correct the errors, and refund the over-collection to your customers.

Challenge #6: Managing exemption certificates

Survival Tactic: *Know which transactions are exempt from sales tax and how to manage certificates effectively.*

Not all customers are required to pay sales tax. Depending on the rules in your taxing jurisdiction, certain businesses and individuals may be exempt from sales tax. It is incumbent on the vendor (you!) to collect and keep on file a valid exemption certificate for each business, organization, or individual with an exemption. It is also up to you to ensure that exemption certificates are valid for each sales transaction. This requires your business to keep a copy of each exemption certificate and ensure that they are renewed when they expire. A database or spreadsheet of exemption certificates should be easily accessible for easier accounting. The best solutions tie directly into your point-of-sale system, making it simple to verify that exemption certificates are current, valid and on file. When audited, businesses that manage large numbers of exemption certificates often find it difficult to link specific certificates with specific transactions--in other words, to prove that tax was not due on a particular sale. Certificates also expire or may be invalid, potentially leaving the selling business liable for paying uncollected tax.

Challenge #7: Identifying registration and remittance processes for each state

Survival Tactic: *Know where and how to remit sales tax.*

For each taxing jurisdiction, a business must meet filing deadlines and provide timely remittance using correct forms and formats.

This step sounds simple. And it may be easy for many businesses, especially those with only one location; such a business would be only responsible for collecting sales tax at the rate applied in its home city. Things grow more complex when the business adds a location. And then another. With each new city or state, the number of rules you are required to follow grows exponentially.

States are becoming increasingly aggressive in auditing businesses. Most states use a formula to determine which businesses will be audited, or examine the results of past audits to see which industries had the most compliance issues. Some businesses mistakenly believe that if they don't make major mistakes they will not be audited. That is a dangerous assumption. Audits are often triggered by external factors, such as revenue shortfalls or changing tax rules.

Challenge #8: Understand sourcing rules

Survival Tactic: *Know whether sales tax rules are based on the ship-from or the ship-to location.*

Sourcing rules govern which state dictates the taxability of a particular sale. Intra-state sales–those made within a single state–follow the taxing rules for the seller's location or "ship from" address. This is called origin sourcing. Conversely, sales between states (inter-state) typically base taxability on the customer's location or "ship-to" address.

This is referred to as destination sourcing. In destination sourcing, nexus rules come into play. This can get very complex for businesses located in multiple states or operating as part of a supply chain, especially those using drop shippers located in other states. Understanding how and when to charge sales tax to consumers and when to issue exemption certificates to distributors becomes complicated and creates added risk for your business.

Challenge #9: Know your use tax responsibilites

Survival Tactic: *Don't assume your customers are the ones on the hook for use tax.*

All states that charge sales tax also charge use tax. Use taxes are meant to minimize unfair competition between sales made in and out-of-state. But knowing when they are owed can be tricky. And because payment is often on a self-reporting basis, most businesses and consumers overlook this obligation.

So how does use tax work? If your business purchases goods from another company within the same state, sales tax is owed, which the seller collects and sends to the appropriate tax agency. If your company buys goods outside your state or online, you may not pay sales tax--but you are required to pay consumer use tax for the storage, use, or consumption of tangible personal property (TPP). Companies are responsible for self-assessing when, and if, use tax is accrued, and to self-report on tax liabilities.

Should any errors be made in computing use tax, they must be reported to the appropriate jurisdiction on your balance sheet as an open liability. You must then remit the correct amount with your next tax return. The burden is on you to prove that the tax has been reported and paid.

Challenge #10: Prepare for an audit

Survival Tactic: *Expect the best, prepare for the worst.*

An auditor reviews a sample of 20 transactions in which no sales tax was collected. Exemption certificates for four of those transactions are not on file and immediately available. The auditor will extrapolate from that sample and estimate that 20 percent of your company's non-sales-tax transactions are invalid. Those taxes would then be assessed, as well as penalties and interest.

To survive an audit, the most critical action a company can take is to collect sales tax properly over time. But while accurate collection is necessary, it's not sufficient. You must also ensure that you have properly documented every step of the way. Audits are much less painful when good documentation, such as transaction history, exemption certificates and other details, are at your fingertips.

Accounting must track and apply sales tax law changes across every jurisdiction where your company does business, as well as create and maintain detailed records of sales tax compliance activities.

Sales must help the company determine whether new locations or accounts will bring with them additional sales tax compliance issues.

IT must make changes to accounting systems and ecommerce systems, in addition to allocating adequate electronic storage for compliance records.

Challenge #11: Switching from an error-prone manual sales tax management process to an automated streamlined one

Survival Tactic: *Automate.*

Unfortunately, addressing sales tax compliance manually is inefficient, error-prone, and diverts resources from revenue-generating activities. Well-run businesses understand that a sales tax strategy is not simply about accuracy, especially given that 100 percent accuracy in sales tax collections and remittances is next to impossible.

The more time spent calculating, collecting, and remitting sales tax, the more company resources are directed away from revenue-generating activities. Yet inaccurate sales tax management can have very negative consequences for your business; automating and outsourcing the process makes good business sense. Rather than creating policies, procedures and records from scratch, thousands of companies choose to fully outsource their sales tax compliance program. A variety of automated solutions is available for both on-premise and hosted (in the cloud) solutions.

Hosting is a more efficient way to automate, where a sales tax compliance vendor integrates its software into your existing accounting, point-of-sale, ERP, and other technology systems. In addition, the vendor tracks your company's data as needed, including exemption certificates, sales tax liability data and more. With a fully hosted solution, it's simple for your team members to get immediate access to critical data any time or anywhere, without the headaches of running and maintaining the system.

One tactic to beat all: Outsourcing

In addition, outsourcing the sales tax compliance function shifts your company's risk to a third party. Avalara is a certified provider of the Streamlined Sales Tax Project. As a result, Avalara clients are protected from penalties and interest if any mistakes in sales tax remittances occur.

Developing a sales tax strategy protects your company against audit fines fees and penalties. Make 2015 the year you manage sales tax, not just survive it.

About Avalara

A privately held company, Avalara was founded by a team of tax and software industry veterans to fulfill a vision of delivering an affordable, scalable sales tax solution. Thus making what was not economically feasible in the past for mid-sized business not only affordable, but more accurate as well – all with the latest and most innovative technology available. From Bainbridge Island, close to Seattle, Avalara's knowledgeable staff works tirelessly to help customers put the hassles of sales tax compliance out of mind. Avalara's mission is to transform the tax process for customers by creating cost-effective state-of-the-art solutions. The company does so through integrated on-demand, Web-based software services that provide transparent transactions, accurate tax compliance, painless administration and effortless reporting.