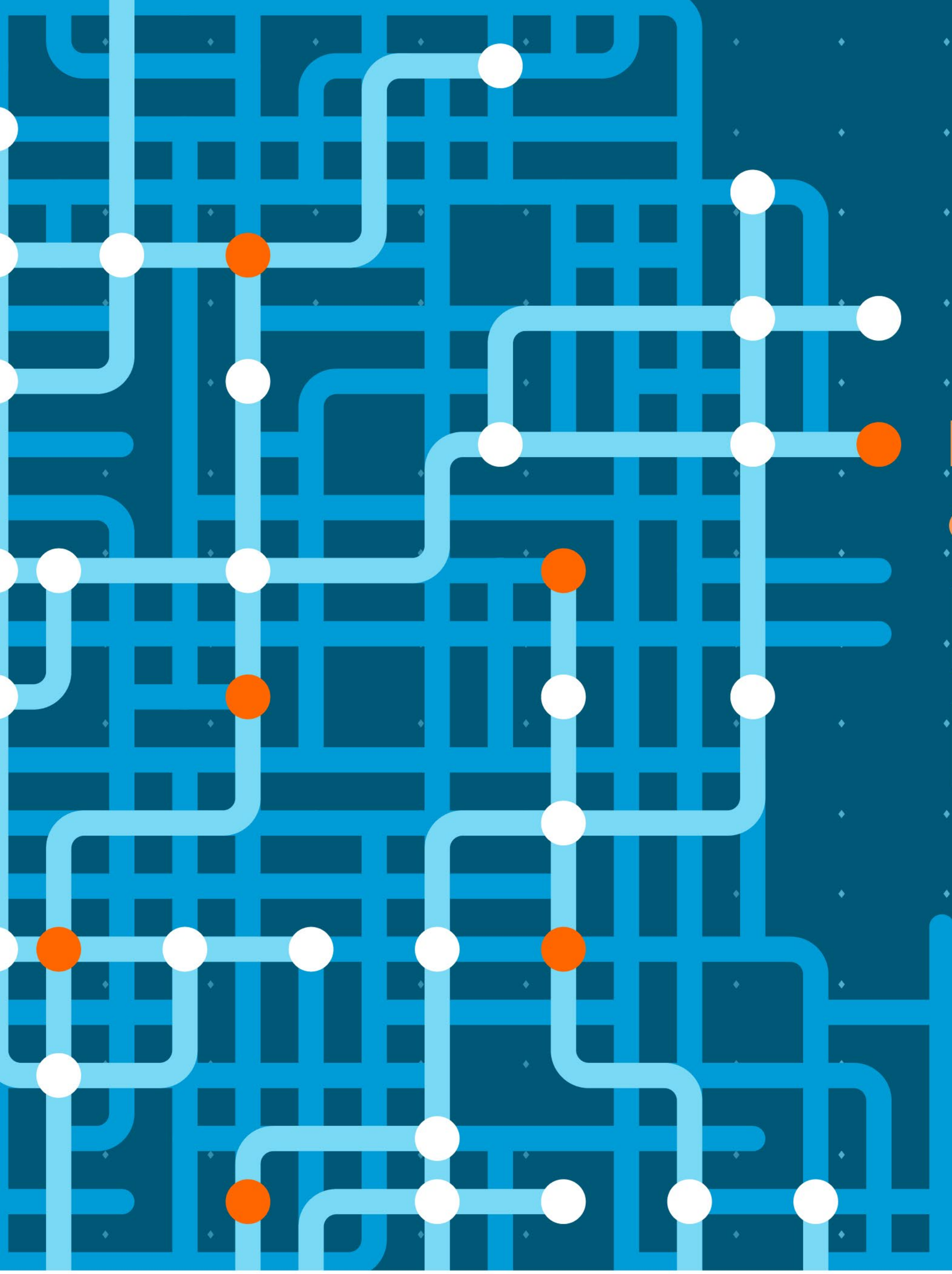


Managing tax compliance in a DIGITAL ECONOMY

GUIDE

Avalara

Tax compliance done right

Contents

ABOUT AVALARA

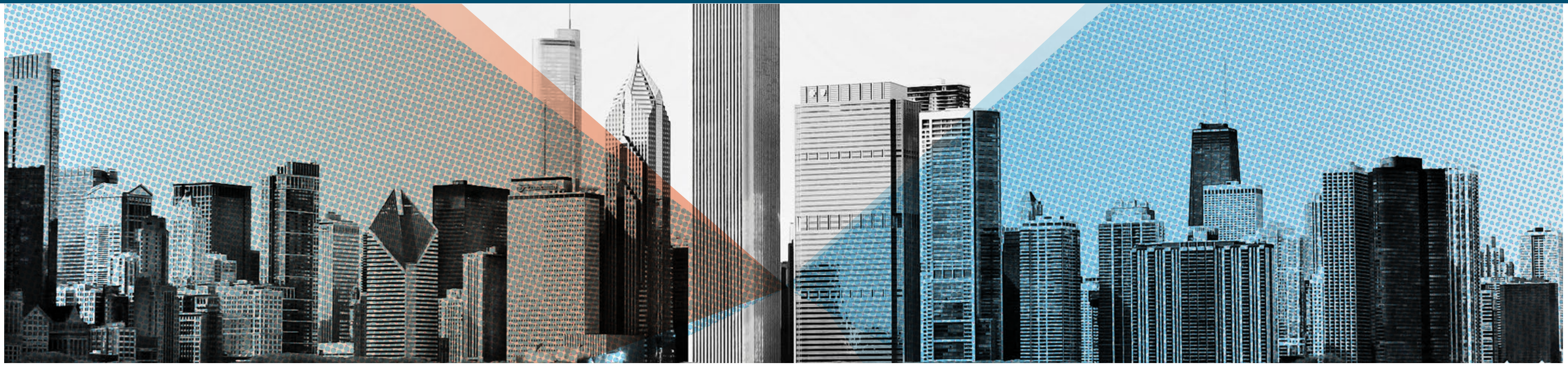
Avalara makes tax compliance faster, easier, more accurate, and more reliable for 41,000+ business and government customers in over 75 countries. Tax compliance automation software solutions from Avalara leverage 1,200+ signed partner integrations across leading ecommerce, ERP, and other billing systems to power tax calculations, document management, tax return filing, and tax content access. Visit **avalara.com** to improve your compliance journey.

Introduction

The digital economy is an essential part of how we do business today. From ecommerce and digital services to fintech and even remote work, the digital economy has radically changed the landscape of retail and business as a whole. Consider the popularity of digital content on platforms like YouTube and TikTok and the explosion of big data artificial intelligence, and it's clear the influence of the digital economy is far-reaching.

The rapid growth of the digital economy has many businesses rushing to keep up with the latest technology. However, tax compliance can fall by the wayside with so much focus on priorities like accelerating growth and maximizing efficiency through these new tools.

But that's old-school thinking. Sales tax compliance is no longer independent of growth and efficiency – it's needed to achieve both. The tax landscape has shifted dramatically, requiring businesses to up their game when it comes to tax compliance.



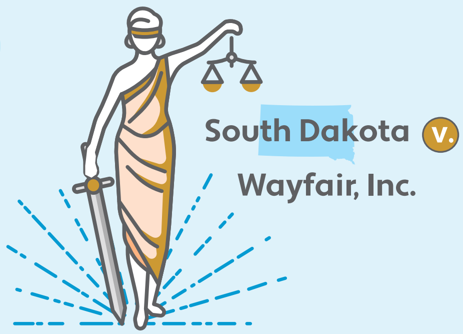
Digital transformation

The surge in digital transactions rides on the wave of technological advancements like digital wallets and real-time payment systems, making transactions more convenient. With ecommerce booming and smartphones becoming ubiquitous, no wonder the adoption of digital payments reigns supreme. Government initiatives encourage this trend to bolster financial inclusion and reduce cash dependency. The COVID-19 pandemic further accelerated this shift toward contactless digital payments and remote work, fostering an environment conducive to payment innovation.

The demand for digital content has ushered in a very real challenge: determining their taxability. It can be different depending on the state, as some may not tax digital goods at all. Identifying this taxability correctly is key to understanding where you may have new sales tax obligations.

As companies have quickly scaled, many have found themselves facing a sudden and extensive increase in tax responsibilities overnight. The issue becomes whether digital goods and services are taxable at all and how those rules are applied throughout the country. Your company may have gone from successfully maintaining tax compliance in just a few states to navigating the complexities of taxability across hundreds of jurisdictions globally, each with its own rules and rates.

So, what do businesses that operate digitally, sell digital products, identify taxability, or provide online services do when they find themselves stuck with new process payments and financial transactions, and supporting remote workers? It can be complicated to juggle multiple jurisdictions, charge the correct rates, and organize tax returns if you don't have the dedicated financial resources or the staff to manage compliance manually.

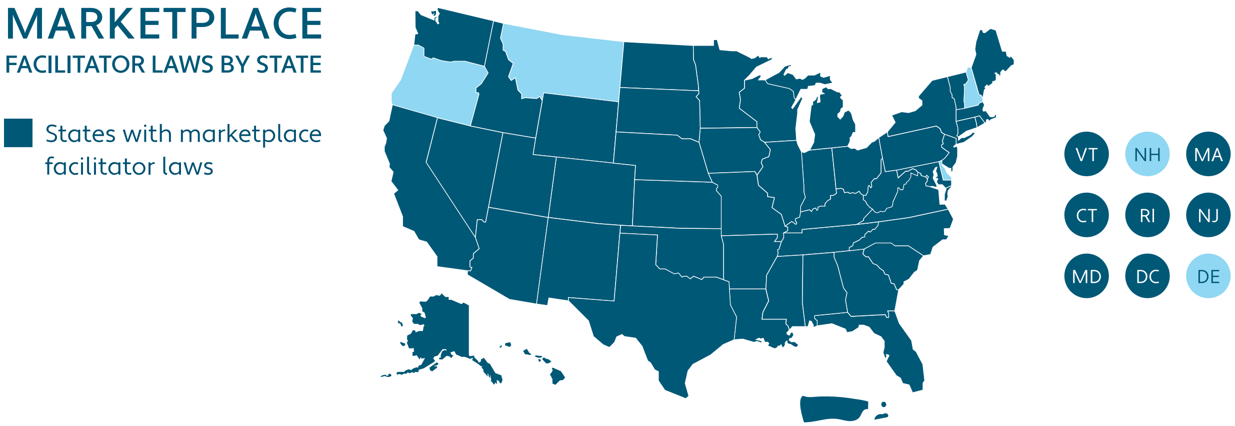


WHAT IS SALES TAX NEXUS?
Sales tax nexus is the connection created between a seller and a state that requires the seller to register, collect, and remit sales tax in that state. For decades, nexus was limited to having a physical presence. In 2018, the physical presence limitation was overruled by the U.S. Supreme Court in favor of the state in South Dakota v. Wayfair, Inc.

Growth in the digital economy creates a complex tax environment

Taxability in the digital economy is far from straightforward. Much like everything else across the world of technology and digital goods and services, tax obligations can pivot on a dime. If your business is evolving – opening new offices, hiring remote employees, launching or migrating new products or services to the cloud like payments and subscription models – your tax liability is likely changing too.

MARKETPLACE
FACILITATOR LAWS BY STATE



If you sell on or operate an online marketplace such as Amazon, Etsy, or Walmart, you need to understand marketplace facilitator laws.

Marketplace facilitator laws require the platform that facilitates the sale (the marketplace facilitator) to collect and remit sales tax on behalf of the marketplace seller. This shifts the obligation to collect and remit sales tax from the seller to the marketplace platform.

Now, in addition to nexus triggers like having remote employees and launching new products, you also have ecommerce sales to monitor. This can include cloud-based products and software downloads, as well as licenses, support, training, upgrades, and other products or services you sell digitally or direct to consumers.

All U.S. states with sales tax require remote sellers to collect sales tax on ecommerce transactions if their economic activity in the state exceeds certain revenue or transaction thresholds.

When it comes to digital products, online services, and digital content, what gets taxed and what is not taxed is unintuitive and the taxability can vary from state to state. The taxability of software, digital products, services, and other digital goods may vary depending on the type of software, how it's used, where it's sold, how it's delivered, and a host of other considerations.

Take into account the new concepts of ownership under subscription and software-as-a-service (Saas) models and you'll find it could be different depending on if the software or digital products were leased, licensed, or purchased.

There are some states that don't tax digital goods, products, and services at all, and there are some that only tax specific goods. For example, digital games are exempt from sales tax in Arkansas and Colorado, but other digital products are taxable. By comparison, digital games are taxable in New York, but there are other digital products which are exempt.

SaaS and other software companies are significant users of online marketplaces, digital advertising, and internet referral programs, and therefore more likely to trigger these types of nexus obligations. Some SaaS companies, like **SWIPEBY**, also function as marketplaces, in which case they need to be aware whether they qualify as a **marketplace facilitator** and any requirements they may have to collect and remit tax on behalf of their customers.

If you offer downloadable goods or services as a subscription model, you run even more of a risk of racking up sales tax obligations in new jurisdictions. **Wondersign** is a good example of a company that faced this issue and solved it by embedding tax compliance automation into its invoicing and financial platforms. Many states set their economic nexus threshold at 200 sales transactions per year regardless of annual revenue. That means if you sell a monthly software subscription, you need as few as 17 customers in the same state to impact your tax obligations.

To better understand the tax implications of all your sales activities, you can conduct an **economic nexus risk assessment** to help determine if you're missing or overlooking any compliance obligations. If you're curious about how your sales activity in a certain state can affect your tax obligations, check out the Avalara state-by-state guide to **economic nexus laws**.

Registration and returns filing requirements

As your customer base, operations, and nexus obligations expand, you may have to register and remit sales tax in more states, all of which have different filing deadlines and requirements. How often you have to file, whether you're required to prepay any of your obligations, and other issues can all change as your sales increase. To add complexity, states adopt new sales tax rules and regulations all the time, requiring you to update your processes.

Tracking due dates and filing schedules, keeping track of notices from each state's Department of Revenue, filing local returns, managing different payment methods, and juggling forms can become a huge burden if you're doing it all manually. There may be some reprieve in the form of the **Streamlined Sales Tax (SST)** program. Participating in SST can help reduce the costs and manual work that go into complying with nexus in multiple states. Qualifying businesses willing to work with a certified service provider can qualify for low-cost or no-cost tax compliance automation services, including registration and returns filing in 25 participating states.

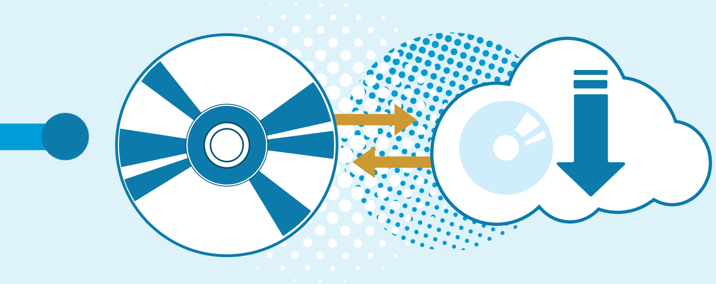
Adding products and services

Adding new products or services can make compliance tricky, especially so for digital products and services, where tax laws are slow to catch up to technology. Product and service taxability can be difficult to determine, and there's little consistency from state to state. Some products or services are taxable in some states while exempt in others – or worse "sometimes taxable", adding another layer of confusion. Digital products and services are currently taxed in numerous ways based on multiple distinct categories.

Remote selling laws

Remote selling laws can cause confusion regarding which state can collect sales tax on a transaction, especially one that is downloaded digitally or accessed remotely from the cloud. This is namely due to sourcing rules. **Origin-based, destination-based, or home rule** determine how states may claim the sales tax collection on the transaction, as sellers are required to source digital products to the location of first use or possession.

Determining the sourcing can be difficult if you only have a customer's billing address or ZIP code, which may not be the same as where the digital products are first used or where possession transfers. There's also the issue of multiple points of use, which occurs when companies sell or purchase software to be concurrently used in multiple tax jurisdictions. This often applies when work is performed (installation, repair, custom configuration) on behalf of the customer.



CONSIDER THIS SCENARIO

Your company launches a new product and allows customers to buy it both as a physical disc and digital download. Support and installation fees are included or available with purchase along with licenses. Depending on the exact nature of the software, any services provided, and the distribution method, this single transaction could be taxed at different rates subject to where it was purchased, who purchased it, and whether it's taxable or exempt or partially exempt based on state or even local jurisdiction rules.

Tackling the taxability of digital products and software

Digital goods and services companies, retailers doing business online, and software companies are some of the hardest hit by the complexity of product taxability. **Tax rules for digital products** vary widely from state to state, nuanced down to such criteria as physical or digital, custom or canned, or a combination. To make matters worse, each U.S. state can set its own rules for **how software is taxed** or exempted. States with multiple tax jurisdictions can be especially challenging when it comes to sales tax calculations since each jurisdiction may have different taxability rules for each service or product you sell.

As expected, states have taken varying and inconsistent positions on these matters. In certain states, the average sales price (ASP), which represents the average price at which a product or service is sold over a specific period, and SaaS may not incur taxation for various reasons. This could be because the states do not levy taxes on electronically delivered software or because there is no transfer of tangible personal property, resulting in no change of ownership or title and no license to use the software on the vendor's website. Alternatively, some states may exempt these activities due to the absence of a server within their jurisdictions, or they may categorize them as non-taxable services if not explicitly listed.

For instance, some states may exempt SaaS from taxation due to its intangible nature, while others may not tax these activities because the service is not physically located within the state's borders or is considered a nontaxable service not specifically enumerated in the statute as taxable. These disparities in tax treatment can lead to confusion and compliance challenges for businesses operating across multiple states.

Recurring billing models or subscriptions
Recurring billing models or subscriptions are often overlooked in the substantial sales tax compliance risk. In many cases, recurring billing translates into a recurring source of sales tax risk, highlighting the need for consistency and reliability in determining taxability. Businesses must accurately identify where their sales tax liabilities lie and apply the correct sales tax rate to each transaction. They also need to be able to apply the right sales tax holiday and exemption to the right product or service when applicable. Any miscalculation or oversight within a recurring billing model can pose significant risks to your entire business.

Navigating sales tax holidays adds another layer of complexity to compliance. Businesses must stay informed about specific sales tax holidays for each jurisdiction and correctly apply them to the relevant products or services. Failure to accurately apply these tax holidays can result in overcharging customers or inadvertently trigger noncompliance with tax regulations or potential audit issues in those jurisdictions.

The SaaS model makes compliance even more involved
The borderless character of SaaS delivery creates a tangle of taxability subject to sourcing rules in the jurisdictions of both the software vendor and the customer. Simply put, for any state where customers are buying your company's software, there's the potential to trigger new sales tax obligations, which may add complexity to your compliance process and extra work for your finance and IT teams.

Communications service tax
Communications tax (or telecom tax) in the digital economy is a complex issue spanning multiple industries. The tax refers to a variety of taxes, fees, and surcharges levied at the federal, state, and local levels on products and services offered paired with differing interpretations and applications of tax laws. For example, as more consumers opt for streaming services over traditional cable TV, states struggle to redefine taxability in order to regain lost revenue from these digital alternatives.

Taxability on digital content
The continuous evolution of how digital content is consumed and delivered, along with the wide range of digital products and services offered, presents a multifaceted amount of taxation challenges. Each type of digital content can be subject to varying tax statutes across different jurisdictions.

Meanwhile, state and local governments constantly adapt their tax structures to obtain revenue from these intangible goods. While some states have clear guidelines classifying certain digital goods as taxable, other states may still be defining or redefining the taxability. This results in a patchwork of tax obligations your business must navigate.

More states are also **taxing services** – that includes everything from social media to digital advertising. Only a few states tax all services, but most tax at least some digital services. Economic nexus laws can also apply to the sales of digital services as well as digital goods in certain states.

Looking ahead for the digital economy

Digital products and services tax regulations are still in flux, with new and frequently changing rules a common occurrence. Given the dynamic nature of this industry and tax complexities that accompany a high-growth business, it might be time to ask some questions and consider a new solution for tax compliance management, for example:

- How can you determine the taxability for online sales, digital products, and services?
- Is audit risk higher because of new or pending digital product, online service, or sales channel changes?
- How do you keep up with registration and filing requirements as your business expands in more states?
- Are you out of your depth trying to navigate international tax compliance requirements?

Getting it right is difficult and resource intensive. Tax compliance automation can help you:

- Create a more efficient, less costly, and less resource-intensive process for managing tax obligations
- Confidently go after new market or revenue opportunities without piling on tax risk
- Adopt a scalable, sustainable tax strategy that supports growth goals

Your business must be able to adapt quickly to new tax rules as you expand. A future-forward sales tax strategy actively addresses where you're likely to grow next and simplifies tax responsibilities proactively.

Avalara

Manage digital products and SaaS tax compliance with Avalara

By far, the best way of avoiding tax challenges and compliance slip-ups is through the correct application of automation technology. And if any industry understands the power of technology to make effort-driven tasks more efficient, it's those that fall under the digital economy landscape. Don't wait until compliance becomes a problem to get set up with a tax automation solution that's right for your business and in line with your growth goals.

Avalara can help. Our **cloud-based sales tax management** technology vastly simplifies procedures that would otherwise be costly and complicated.

As well as having a wide range of functions, Avalara tax compliance automation solutions easily integrate with most ERP and ecommerce platforms, making it a viable and cost-efficient option for managing sales tax compliance, particularly for the digital goods and services industry where the rules are complicated and constantly changing.

Learn more about how Avalara can support the growth of your digital products and SaaS businesses.

DISCLAIMER

Tax rates, rules, and regulations change frequently. Although we hope you'll find this information helpful, this implementation guide is for informational purposes only and does not provide legal or tax advice.