# Tax Compliance Trends

*A Roadmap to Success for Today's Manufacturers*

*Just as enterprises have turned to technology to solve their biggest challenges and find new ways to grow, so too have government entities across the globe.*

With significant tax gaps and increasing globalization, it's not surprising that one the biggest challenges governments are addressing is revenue collections. Like enterprises, these governments are creating new, technology-driven processes to improve tax reporting accuracy and gain visibility into business transactions and taxes owed. In this report, we'll examine major global regulatory trends that are transforming business-to-government compliance, the frustrations these regulations are presenting to global manufacturers and how to prepare for the changes ahead.

## What's Inside?


I. Global Regulatory Trends: A Shifting Landscape ........ 3
- a. Aggressive regulatory environment ........ 3
  - i. The European Union and Latin America ........ 3
  - ii. The United States ........ 4
- b. Audit explosion ........ 5
- c. "Borderless" regulations ........ 7

II. Critical Challenges: Cost and Risk Are the Name of the Game........ 8
- a. Rising compliance costs ........ 8
- b. Increased risks for businesses ........ 9
- c. Technology shortfalls ........ 10

III. Compliance 2020: Preparing for What's Next ........ 11
- a. Centralization & shared services ........ 11
- b. Software automation ........ 12
- c. The Future of Compliance -Strategic........ 12

IV. Organizations to Watch: Who's Doing It Right? ........ 13

# Global Regulatory Trends: A Shifting Landscape

Technology disruption has made compliance a critical component of a manufacturer's strategy. While technology has changed how businesses grow, enabling new business models and expediting globalization, it has also empowered governments to implement innovative tax and reporting regulations with technology-enabled enforcement.
As a result, tax and reporting audits are increasingly rapid-response, with enforcement quickly shifting to the transactional level.

That means errors and delays have nowhere to hide, as the pace and complexity of regulatory changes occurring around the world spins out of control.

## Aggressive regulations are increasingly common worldwide

Recognized for its emerging markets and business opportunity, Latin America is commonly known as the most complex regulatory environment in the world. Tax visibility initiatives here affect not only finance and accounting - but also accounts receivable, accounts payable, inbound receiving, shipping and logistics, and human resources. Countries throughout the European Union, APAC and Middle East are now following Latin America's lead and introducing electronic invoicing and reporting measures, requiring electronic submissions of VAT records and transaction-level data.

It's no secret why electronic tax reporting adoption is becoming so popular. In Latin America, VAT collections represent nearly 60% of tax revenue, so fraud and evasion cost governments across the region trillions of dollars. In 2008, Brazil became the first country to implement electronic invoicing, and the country saw a $58 billion increase in tax revenue as a result of plugging leaks in invoicing and reporting. Similarly, Mexico increased tax collections by 34% in the first wave of its e-invoicing rollout, before mandates on tax information reporting even went into effect.

In the E.U., the VAT Gap based on 2014 data was €159.5 billion – illustrating that collection issues expand well beyond Latin America. Governments throughout Europe, as well, are missing out on a huge amount of revenue – an increasingly important problem to correct amidst volatile economies and tense E.U. relationships – which is why these countries are also adopting automated VAT return processes.

From tax determination and reporting to transaction-level data requirements, companies with operations in Europe and Latin America – as well as APAC and the Middle East – are facing unprecedented scrutiny. Many APAC and Middle Eastern countries, like the E.U. and Latin America, are taking on similar measures to increase tax revenues. For example, the Gulf Cooperation Council and India have both recently introduced new VAT initiatives designed to fulfill budget gaps.

Beyond electronic reporting, increasingly tax authorities in all of these regions are requiring submission of transactional data – sometimes even before the transaction is carried out, requiring government authorization to move forward. This allows governments to track exactly how much tax is owed before VAT reports are ever due, and even allowing for the automation of such reports, since the government already knows the details of each transaction and the actual taxes owed.

This new level of visibility into corporate transactions is requiring a significant shift in companies' global compliance approaches.

### 24 countries currently require electronic submission of transaction-level data:

| | | | | | |
|---|---|---|---|---|---|
| Albania | China | El Salvador | Israel | Paraguay | Spain |
| Argentina | Croatia | Macedonia | Latvia | Peru | Turkey |
| Brazil | Dominican Republic | Georgia | Namibia | Slovakia | Venezuela |
| Bulgaria | Ecuador | Hungary | Pakistan | Slovenia | Zambia |

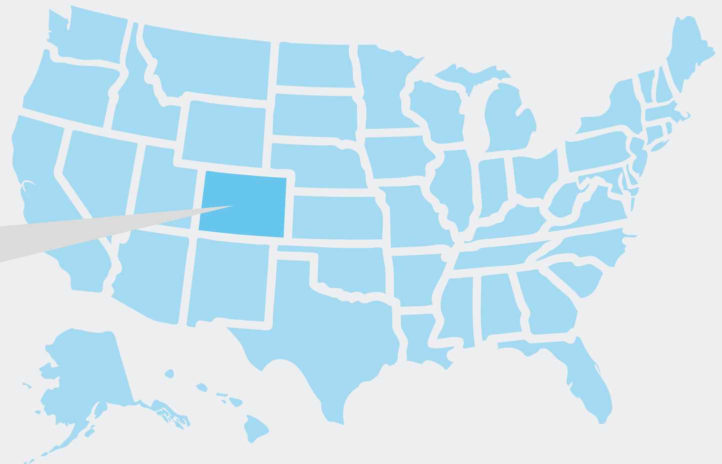
## United States

In the U.S., where sales tax replaces VAT as a major revenue source, municipalities, states and the federal government are constantly issuing changes to the ways companies calculate and report on sales and use tax. In fact, in 2016, Sovos researched and tracked 3,377 total pieces of tax-related legislation in the U.S. alone.

The most complex of these changes surrounds remote sales. As technology has disrupted the way consumers and businesses alike make purchases, sales and use tax laws have scrambled to keep up with remote sales transactions, resulting in a complex web of often conflicting laws. Physical nexus laws have been the most prevalent way remote sales taxation is structured, which are dependent on where businesses have an office, store, manufacturing facility, distribution facility, or even remote employee.

With 10,000+ individual taxing jurisdictions in the U.S. alone, the web of tax determination and reporting requirements is challenging enough for sellers of traditional goods and services; those in highly regulated industries like pharmaceuticals face even more layers of complexity from product registration to distribution.

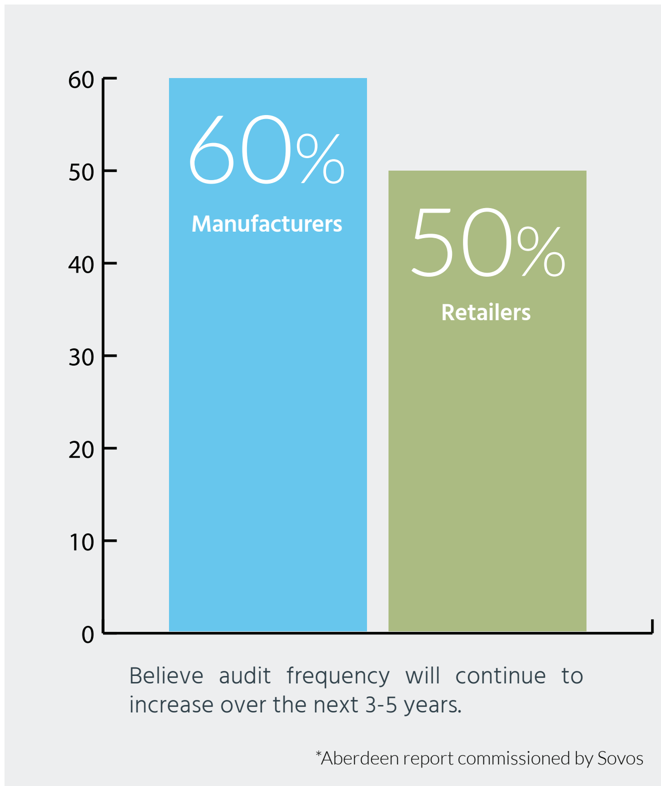
## Spotlight on Colorado



A prime example of the challenges involved in sales and use tax determination and reporting, Colorado is one of the most complex states to do business for both in-state physical and remote sellers. Colorado assesses a state-level base tax, and over 334 local jurisdictions also assess sales taxes. Some of these local taxes are state-administered and others collected by these local entities. This local tax structure creates a complex labyrinth of overlapping tax jurisdictions, which can make it very difficult for businesses to know exactly which taxes apply at a given address, requiring sellers to spend a lot of resources on calculations and validations.

Colorado also introduced a precedent-setting remote tax law, which the Supreme Court upheld. This law requires online retailers with over $100,000 in annual sales within the state to notify buyers that they may owe use tax. The retailer must also provide the state an annual report of all buyers, purchase amounts and contact information. Such tracking and reporting requirements force affected retailers to implement entirely new business processes and invest in additional resources necessary to support them.

# The pace, frequency and depth of audits is exploding




## Audit automation is tax authorities' holy grail – and it's becoming a reality.

The aforementioned initiatives for governments to gain greater visibility into vendor and supplier transactions and tax liabilities rely on technology for determination and reporting. This electronic trail of records means that a single error or discrepancy could automatically trigger an audit. Manufacturers need to be ready with a bulletproof audit trail to avoid significant defense costs, fines and penalties.

In the most sophisticated cases, governments have access to individual electronic invoice or transactional records, goods receipts, and information reports from both buyers and suppliers – all of which must match and justify tax reports.

Mexico is one example of automated, real-time audits in action. After standardizing invoicing and reporting formats, electronic audits were a natural next step to further increase Mexico's tax revenues. Any discrepancies between the taxes a company declares as compared to the tax authority's records for that taxpayer from a variety of sources – including e-invoices, e-accounting reports and those of their customers and suppliers automatically trigger audits. These audits not only maximize tax collections and improve accuracy, but also reduce the labor and costs associated with the auditing process – for both the government and the taxpayer. While Mexico cites this process reduces audit and correction time from more than a year to 4 months, its first electronic audit successes took just over one month to complete.

With such real-time electronic audits, errors will no longer fall through the cracks. Just as other regions followed Latin America's lead with e-invoicing, more countries are poised to adopt this new audit standard to improve revenues and reduce costs.

## Automated Audit Process

## Rolling audits are on the rise

With new tax information reporting requirements expanding across the globe, governments are creating new processes that enable ongoing audits instead of the traditional point-in-time processes. Though automation can streamline aspects of the audit process in some jurisdictions, companies now must dedicate more resources to deal with the expected increase in authorities' queries. As countries move to frequent electronic tax reports, tax inspectors can audit companies on an ongoing basis, typically with line-item transaction data available at any time.

Introduced by the OECD, the Standard Audit File for Tax (SAF-T) is one such process allowing tax authorities to streamline the information reporting and auditing process. This electronic file format facilitates the transfer of tax reporting information from companies to relevant authorities.

Common in the E.U., SAF-T has been adopted by countries including Portugal, Germany, France and Austria. Like CRS, this recommended protocol may be adapted at the jurisdictional level, meaning not all participating countries have the same data submission requirements, further increasing the challenges associated with compliance on a global scale.

SAF-T requires companies to provide governments with full transparency on business transactions. For example, if Company A supplies taxable goods to Company B, Company B's tax inspector will be able to confirm whether Company A has paid over the VAT, before allowing the VAT refund to Company B. While the OECD's SAF-T protocol mandates a monthly submission, some countries may require the largest businesses to keep data available on a real-time basis – facilitating virtually constant audits.

### SAF-T reporting requirements:

The full general ledger and journals

Accounts payable, with vendor master data, payment ledgers and vendor invoices

Accounts receivable, with client master data, payment ledgers and customer invoices

Warehouse inventory product master files and inventory movements

Inbound and outbound flow of goods

Fixed assets ledgers, depreciation and amortizations

## Regulations are no longer confined by borders

Companies that have previously avoided paying certain taxes by shifting profits to less regulated markets are in for a major shift. Commonly referred to as BEPS (base erosion and profit shifting), these tax avoidance practices exploit reporting gaps and ambiguous tax laws to lower tax liability. As tax information reporting is becoming increasingly borderless, governments around the world are leveraging technology for greater transparency to reduce tax fraud and increase revenues.

**Several collaborative efforts exist to share taxpayer data and liability across borders. For example:**

- **U.S./Mexico** – In addition to Mexico's agreement to provide the U.S. with information on Americans with accounts or investments in Mexico under FATCA, the U.S. is also providing similar details to Mexico. The U.S. supplies information on any Mexican account holders that earn more than $10 USD in annual interest.
- **Intra- and inter-state agreements within the U.S.** – States are increasingly sharing data with each other and requesting data from technology provides, like Amazon, to improve audit accuracy. For example, New York and California (which has a $10 billion tax gap annually) have teamed up to ensure residents don't owe tax to the other state. If someone gets a refund in California but still owes taxes to the Empire State, California's tax officials will take a cut of that refund to pay for the debt owed to New York. On an intrastate scale, Florida's tax officials have partnered with the department of highway safety to track auto sales and verify that dealers are accurately reporting their figures.
- **E.U.** – The E.U. has adopted new standards to better facilitate cross-border transactions, streamlining the VAT registration process for triangular transactions – those involving three parties in the supply chain. It has strengthened other rules to require a VAT ID to receive exemptions on inter-E.U. transactions.
- **Latin America** – Already home to sophisticated e-invoicing and reporting legislation, Argentina, Brazil and Mexico unified certain portions of these processes to simplify cross-border visibility. These three countries utilize a set of common fields that are extracted from the original invoice, providing a unified view of all transactions and helping to ensure that each country's tax authority has knowledge of the invoices and receipts transmitted.

# Critical Challenges: Cost and Risk Are the Name of the Game

The ever-increasing pace and complexity of tax compliance and information reporting regulations increases risk and burdens for manufacturers. These challenges can interrupt operations and impede growth for unprepared businesses forced to react to constantly changing requirements.

In 2016, only **55%** of CFOs reported feeling "somewhat confident" in their compliance efforts, down steeply from **84%** in 2014.

**45%** of CFOs list compliance as their "biggest growth challenge."

*Data from EY and Grant Thornton.

## Rising Costs

Compliance is no doubt resource intensive. In fact, 31% of CFOs say that keeping up with the volume and complexity of regulations is their number-one compliance challenge, according to Grant Thornton. The combination of legislative knowledge, technical implementation and process training can take hundreds – even thousands – of hours and months to execute. And that's just implementation. When it comes to ongoing compliance in the U.S. alone, larger manufacturers are spending an average of one to two percent of their total sales on fines and penalties, according to an Aberdeen study commissioned by Sovos.

The number of people that must be involved in compliance is also increasing – technical teams, legal experts, project managers, functional experts, financial analytics, information security, accounts payable, accounts receivable, accounting, operations, supply chain executives, corporate governance teams, human resources – the list goes on. That's a lot of talent that could and should be redirected toward growth and innovation.

Now, add in the constant change management that compliance requires, as well as rising audit defense costs needed to avoid fines associated with increasingly frequent audits, and compliance has a serious effect on the bottom line.

An Aberdeen Group survey indicated penalties per year due to filing errors cost larger manufacturers **1-2%** of revenue.

### The evolving role of tax professionals

The current state of global compliance is causing a major shift in tax departments – from compliance and reporting to strategy and and analysis.

**Old role:** A must do. Tax compliance was a required function, but not one with opportunity for innovation or a positive impact on the bottom line.

**New role:** With access to real-time regulatory analysis updates, tax compliance leaders are looking forward, offering valuable insights to help business predict and prepare for the next change.

Implementation challenges

Constant change management

Inefficiencies and lost productivity

Audit defense

# Increased Risks

Compliance mandates seriously affect business planning, with 90% of respondents surveyed by América Economia and Sovos reporting a relationship between compliance and their business outlooks. And it's no wonder why – the risks associated with compliance are severe.

**Lost customers / decreased trust**
Perhaps no fear keeps organizations up at night more than losing stakeholder confidence, and therefore customers. Especially on the minds of today's fast growing manufacturers is customer experience – ensuring timely and accurate order and invoice management. Billing customers the incorrect tax on invoices or delaying multi-million dollar orders due to an IT backlog issue updating exemption certificate information can mean the difference between customer satisfaction and losing them to a competitor.

**Fines**

Certainly the most commonly known risk of compliance, fines associated with delays, omissions, errors, discrepancies and false statements quickly add up. The California State Board of Equalization is required by law to list the Top 500 Sales & Use Tax Delinquencies every quarter, and manufacturers don't want to find themselves on that, risking damage to their reputation.

**Operational shut downs**
Governments can delay shipments, halt operations or even revoke business licenses for non-compliance. In fact, the América Economia/Sovos survey revealed that 40% of companies in Latin America have experienced operational delays related to e-invoicing issues.

**Cashflow disruptions**
The rise in audits is bound to disrupt corporate cash flows, as tax credits and refunds are held up during the process. For example, at one point $384 million was in limbo in Mexico, withheld from companies like Unilever and Procter & Gamble as the tax authority investigated potential tax reporting issues.

# Data Aggregation and Transmission Issues

Data is essential to accurate compliance – it's the first error-trigger that will fuel audits. Cleaning and aggregating data is a must for error-free compliance, which is why it's critical that every company's strategy include validations and automatic imports, formatting and aggregation. Yet all too often, companies are maintaining data across multiple systems, lacking visibility and control. Mergers and acquisitions, client, employee and vendor onboarding, and complex POS and ecommerce systems compound the data aggregation challenge. Constant data validation is required in today's tax compliance environment to prepare for all of the reporting needed and minimize corrections.

Once that data is in place, it then has to be transmitted correctly into required documents and reports, a second place that can trigger errors. Any manual procedures as part of this reporting increase the risk of audit-triggering errors. Automation is crucial to this process, as Sovos found an error rate of 7% in the manually entered reports it was tracking. Considering that every single error can incur its own fine, the unnecessary expenses associated with these mistakes add up fast.

Next, that information has to be seamlessly transmitted to the government in its preferred format – any delays can disrupt operations or result in missed deadlines – making contingency processes a key component of effective compliance.

When it comes to compliance, data breakdowns can occur at multiple stages in the process, increasing the costs associated with compliance and the risk of fines and penalties.

# Technology Shortfalls

Traditional compliance approaches don't cut it in today's constantly changing regulatory environment. Three of the most common methods – manual, ERP-based and on-premise – leave gaping holes and increase the likelihood of errors. In fact our recent Aberdeen research indicated that even among large organizations with tax technologies and mature processes, as many as 50% of transactions never pass through the solution.

**Manual:** Manual compliance is simply not sustainable. Any manual processes increase the risk of errors, discrepancies and manipulation, triggering audits. And with the increasing number of reports and details required, manual compliance is extremely time and resource intensive, inefficient and costly.

**ERP:** ERPs are ill-equipped to handle customized compliance requirements. They typically address requirements through standardized code releases, which companies must adapt to their individual customizations. With constantly changing requirements, these updates are rarely in alignment with corporate upgrade timelines, yet companies must run the latest version of their ERP to be up to date on compliance. ERPs also don't account for local level details – like certain fields, naming architectures, codes and character limits. All of this equates to implementation nightmares and gaps in compliance measures.

**On-premise:** On-premise software deployments are expensive to maintain, requiring constant fire drills to update with every regulation and to determine the source of any issues. They also require an internal person, or team, to be compliance experts, constantly monitoring and responding to changing regulations and taking the business away from its core competency.

Additionally, no matter the approach used, companies need to be prepared for rapid-response audit defense. That means they need an easily accessible, single source of truth within their ERP framework to quickly, efficiently and accurately provide the necessary records and identify the source of any errors.

Any technological shortfalls in this process increase the headaches already associated with compliance.

# Compliance 2020: Preparing for What's Next

**Intelligent Compliance** [in-tel-i-juh-nt kuh-m-plahy-uh-ns]

noun

1. a proactive approach to global regulatory obligations with greater efficiency, improved accuracy and centralized information, safeguards businesses from compliance risk and burdens.
   *Leading company employs intelligent compliance to reduce costs, increase accuracy and improve operations.*

## Centralized Systems & Shared Services

For corporations with a global footprint, the centralization trend and shift toward shared services may seem incompatible with the influx of local laws. After all, how can a centralized organization possibly keep up with all of the local nuances involved in compliance? How can one centralized system house thousands of jurisdictions?

It's not only possible, it's the only way to maintain corporate visibility into all of these jurisdictions and ensure a bulletproof audit defense. As technology has fueled globalization and the way governments regulate businesses, it will also continue providing the opportunity to overcome challenges – including global tax compliance and business-to-government reporting obligations.

A study by AMR Research found that 65% of the companies surveyed were considering ERP consolidation to provide a single source for financials, supply chains, etc., and reduce risks. This same reasoning applies to compliance. Only with a centralized compliance strategy can corporations ensure an accurate audit trail and streamline regulatory updates.

These global compliance trends also transform – and elevate – the role of shared services within organizations. Global companies are expending significant resources on their shared services departments as they realize the benefits of standardized operations. Deloitte recently found that shared service centers with more than three functions increased by more than 40% over the last few years, and 71% of respondents were looking to increase that number further. It's no wonder why the consulting firm also found that more than 90% of a pool of 300 private-sector organizations reduced costs and improved efficiencies from leveraging shared services. What's less obvious, is that these savings and efficiencies stand to spread even further in light of global compliance measures. Why?

1. Standardized, electronic reports and real-time, transaction level tax calculations eliminate the need for ad hoc or point-in-time tax consulting.

2. As governments begin approving invoices in real-time and requiring that invoices accompany shipments, they can be verified immediately upon shipment and marked okay-to-pay. That means AP teams eliminate the need for manual data entry and verifications, speeding up processes significantly.

These regulatory changes elevate the role of shared services, allowing teams to focus on exceptions, discrepancies and strategy, ultimately providing shared services departments across the globe the greater efficiencies they seek.



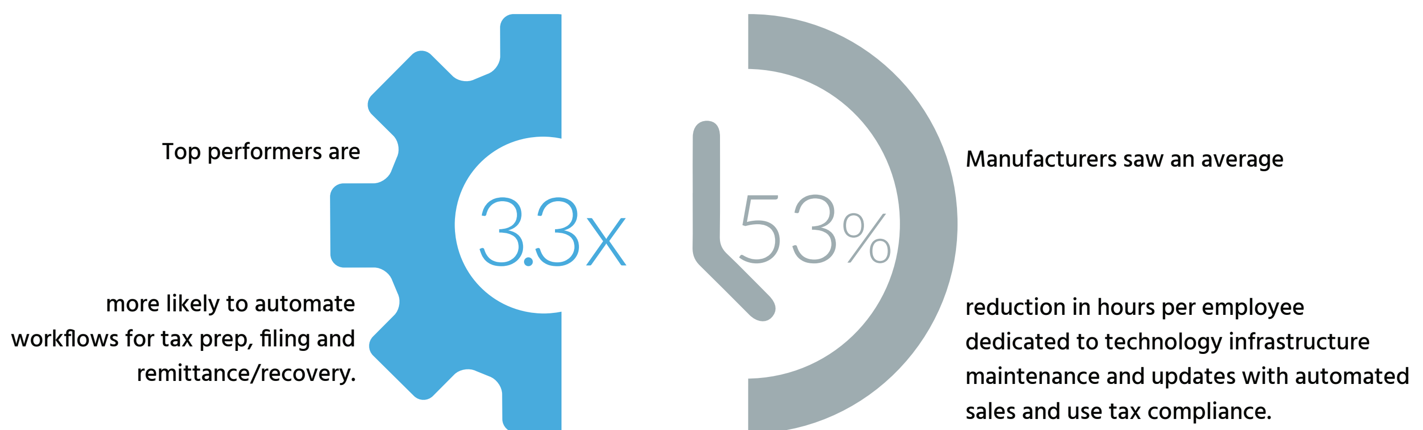
Source: Aberdeen Group, May 2016

## Automation

There is good news hidden within all of these innovative legislative changes. Increasingly standardized processes give businesses the opportunity to automate even more through software.

First, these regulations drive process automation. With real-time, transaction-level tax data being reported, companies and the government alike can essentially auto-fill tax liability reports. Plus, bulletproof audit trails require validated matches between purchase orders, invoices, goods receipts and tax returns. Automating these processes eliminates manual data entry, reduces errors and allows employees to focus on more important tasks. This surge in automation means invoices can be approved in real-time, enhancing cash flow.

Ultimately, businesses can further leverage automation to their advantage with compliance delivery. As mentioned previously, the resources required to constantly update and validate technology to comply with the latest regulatory changes is immense. However, smart companies are finding efficient methods to approach challenges and manage global compliance through the cloud. A testament to the value of cloud-based enterprise solutions, Gartner anticipates that spending on cloud services and related technologies will almost double by 2020 – and compliance is one area poised for high growth. Employing cloud-driven compliance, companies can automate the ERP changes necessary for evolving compliance measures instead of reacting with investments in significant infrastructure projects.




Source: Aberdeen

## The Future of Compliance

All of these changes, their critical business implications, as well as the centralization and automation required for effective tax determination and information reporting, equate to a **new** role for compliance. The future of compliance can be defined as:

- **Accurate:** the only way to safeguard businesses from compliance risks is to ensure 100% accuracy and a bulletproof audit defense. With today's technology and process automation, that's now an achievable task.
- **Data-driven:** the standardization required for effective compliance gives companies new data-driven insights for identifying issues and improving processes.
- **Proactive:** In this ever-changing legislative environment, compliance professionals must constantly look forward, providing insights to help their businesses predict what will change next.
- **Strategic:** With standardization, automation and new levels of data, compliance should be used to enhance business performance.

**Are you ready for the future?**

# Companies To Watch: Emerging Best Practices

In discussing this highly complex and quickly evolving regulatory landscape with some of the world's largest organizations, three keys to success emerged:

1) Create an environment that supports constant learning and improvement.
2) Look for the opportunities to create value hidden within these new regulations.
3) Focus on what your company is best at, and don't try to become a compliance expert.

**Philips**

Faced with antiquated technology and increasingly burdensome regulations, Philips decided to take a strategic, scalable approach to compliance. Looking for ways to decrease costs while improving efficiencies, the electronics giant moved its compliance architecture to a hybrid cloud environment that integrated directly with its SAP infrastructure, while also automating processes like accounts receivable. Ultimately, the company was able to realize an 80% cost savings and 25% improvement in productivity based on this initiative.

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**Kelly-Moore Paint Company**

Kelly-Moore Paint Company is the largest employee-owned paint company in the United States.

With 2,000 employees, almost 200 retail locations and three manufacturing facilities, the company faces challenges in multiple tax jurisdictions. It sells both direct-to-consumer, as well as to contractors/resellers, adding another layer of tax challenges. Kelly-Moore uses an end-to-end tax determination engine to continue its growth.

**"We have a proven system that makes certain that we are charging the correct amount of sales tax to every customer throughout our retail operation. We have reduced the chance that we will be selected for a tax audit, reduced the cost of complying with tax audits, and greatly reduced the potential that we will be subject to penalties."** — Carl Sweetland, chief information officer and vice president of IT for Kelly-Moore Paints

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## About Sovos

Sovos is the leading software provider for global tax compliance and business-to-government reporting solutions, reducing regulatory burdens and risk for customers while helping them grow through Intelligent Compliance.

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