

Sales Tax Compliance Considerations for U.S. Software Providers

Unveiling Current Technology Adoption, Challenges and Future Opportunities

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SOVOS

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Executive summary

The U.S. software industry is witnessing an escalation in sales complexity, attributed to rising sales distribution channels such as through marketplaces, software integrators, resellers and consulting partners. This coincides with businesses encountering significant cost pressures due to intense competition, resulting in aggressive expansion across newer regional markets and segments (media & entertainment, financial services, healthcare, etc). Consequently, enhancing compliance measures for sales and use tax has become paramount to protect profit margins against potential audit penalties.

The increased complexity associated with sales and use tax reporting has led to more operational and compliance challenges for financial and accounting professionals within the software industry.

A survey conducted on behalf of Sovos interviewed more than 200 U.S.-based software organizations,, including finance/accounting and IT professionals. The results highlighted key issues and approaches to sales and use tax compliance across the U.S. software segment:

- Moving toward omnichannel business models: The intricate and multifaceted nature of managing taxation processes within the software industry (i.e., diverse offerings, frequency of tax rate changes, and aggregation from multiple go-to-market channels) remains a key difficulty across organizations.
- Improving operational efficiency: Tracking changing sales and use tax regulations, ensuring compliance, maintaining accurate data, integrating with existing systems and aligning processes across departments pose operational challenges for professionals managing sales and use tax compliance.
- Reducing third-party integration challenges: Integration with third-party modules and systems remains one of the key challenges for most professionals managing compliance.
- Rising audit costs and penalties: An increase in the frequency of audits and associated costs are one of the major challenges faced by software organizations. These are attributed to inaccurate, missing or late filings.
- Building a tax-compliant enterprise via leveraging next-gen technologies: A lack of predictive analytics and tax calculation orchestration remains another key challenge in managing sales and use tax compliance and might hamper the competitive edge in the long run.

This rise in deployment of end-to-end sales tax solutions is predominantly attributed to most software organizations slowly realizing the need for real-time compliance. As the proliferation of indirect channels intensifies across domestic and international markets, there will be a greater need for organizations to deploy an agile end-to-end solution with a modular approach.

Sales and use tax compliance is a critical issue that software organizations must address to reduce their regulatory risks, increase operational efficiency and boost their bottom line. This report reveals how the U.S. software industry is evolving, current sales and use tax challenges faced by software organizations, potential solutions they have implemented to overcome these challenges and future growth prospects.

Report Highlights

60%

of finance/accounting and IT professionals spend a quarter of their monthly time on sales and use tax compliance-related activities

41%

of respondents are focused on improving sales tax-based operational efficiencies in 2024 as a key strategic initiative

41%

of software organizations have paid an annual audit penalty of \$160K in the last 12 months

48%

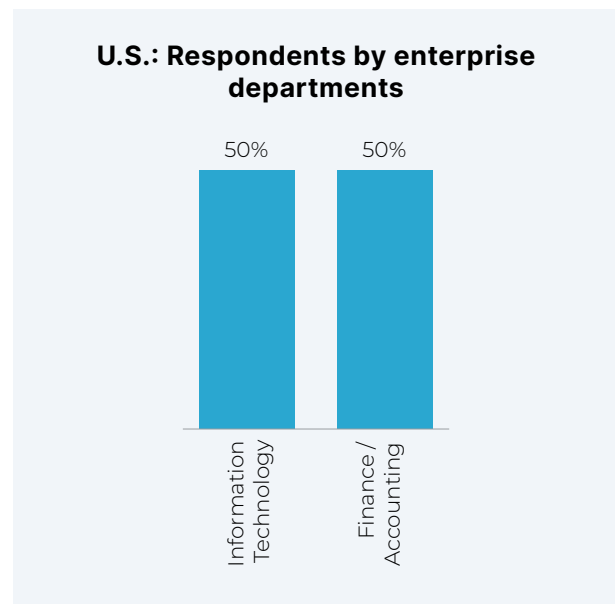
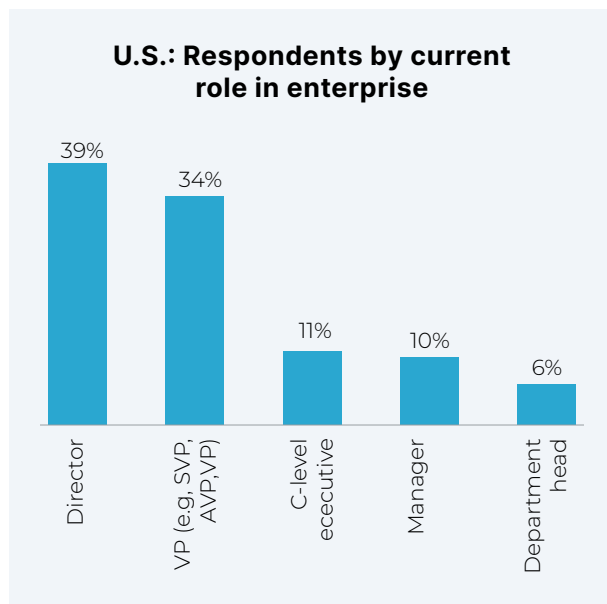
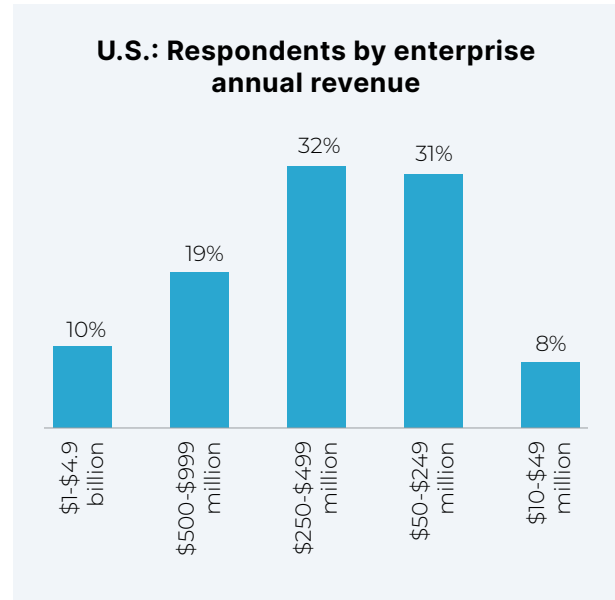
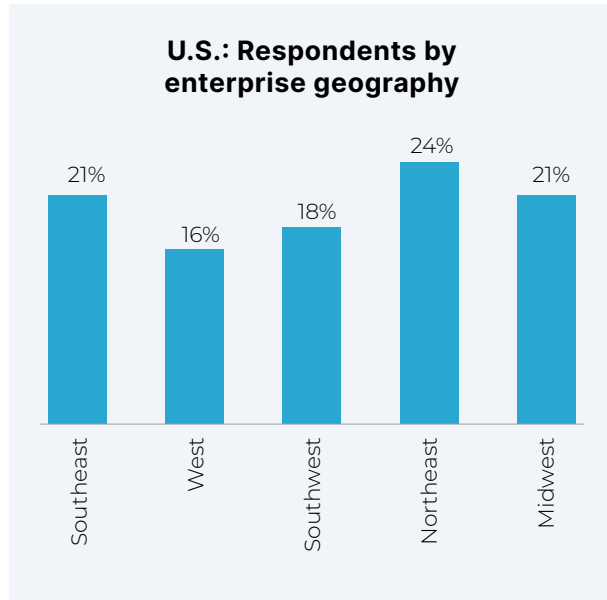
of software organizations are using cloud-based sales and use tax solutions in 2023

83%

of software organizations are planning to migrate to the cloud in the next 24 months



In the survey, respondents were classified under the following demographics:



n = 208 (May 2023)

Source: SG Analytics Sales and Use Tax Survey across the U.S. Software Industry

SAP, QuickBooks, Microsoft, Oracle, and NetSuite are preferred transaction systems in the U.S. software segment.



Current market needs and drivers

Key Insight #1. There is an emergence of vertically diversified business models (more distribution channels, pricing models, etc.), with half of the U.S. software organizations operating in both B2B and B2C sectors.

55% of software organizations have B2C and B2B customers, indicating the significance of this strategic shift.

Building multiple business models aims to achieve revenue diversification, expand market presence, gain customer insights and enhance adaptability. This has led to significant investments in IT projects (hardware, software and services) within the U.S. software ecosystem in the past decade or so. Enterprises are leveraging IT to not only accelerate their digital-first strategy but also enhance operational efficiencies and customer engagement rates within their legacy operations. This allows organizations to capture a wider customer base, maximize growth prospects and fortify their competitive standing, revenue streams and distribution channels, thereby ensuring sustainable profitability.

64% respondents highlight indirect sales channels as the prominent go-to market (GTM) strategy

software sales channels diversify for most of these organizations, it adds complexities in sales and use tax compliance. Software organizations with different sales channels are exposed to challenges like separate contractual agreements for every sales channel, having a variety of solutions on different sales channels, needing customized pricing for every GTM channel, and having to handle consolidation of taxation data from multiple transaction channels.

In the survey, respondents were classified under the following demographics:

Figure 1. U.S. software offerings, 2023

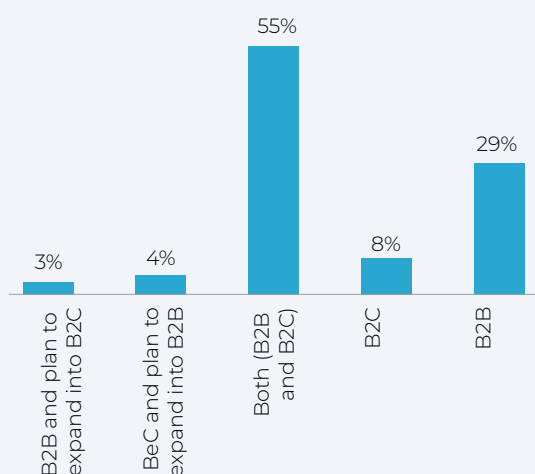
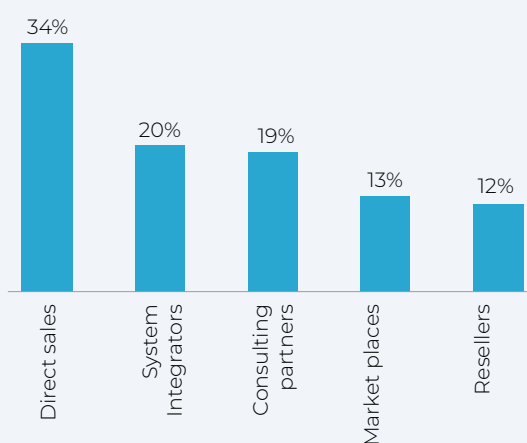


Figure 2. U.S. software go-to-market channels, 2023



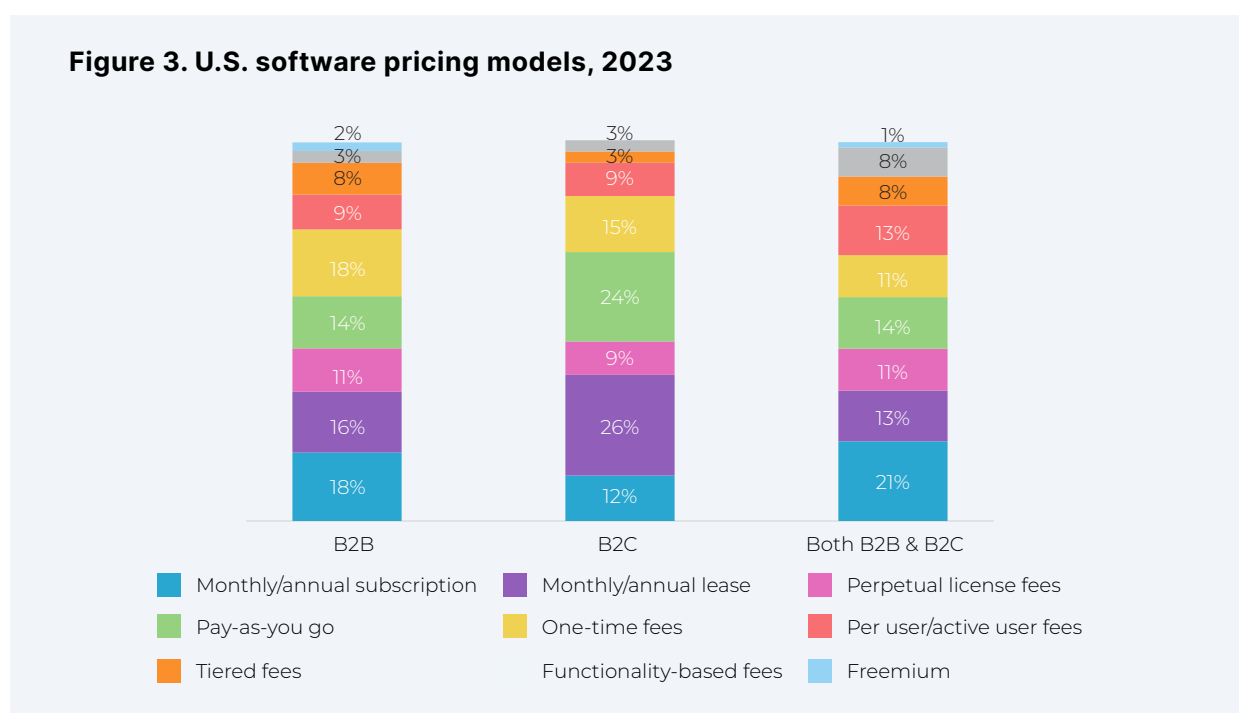
n = 208 (May 2023)

Source: SG Analytics Sales and Use Tax Survey across the U.S. Software Industry



The software industry commonly embraces monthly/annual subscriptions and lease pricing models, with over 30% of software organizations resorting to these pricing arrangements

However, monthly lease and pay-as-you-go pricing models remain prominent for half of the software organizations with B2C offerings, while monthly subscription and one-time fees lead the B2B segment (36%). Although both B2C and B2B software pricing have been highly simplified and transparent traditionally, this has drastically changed due to rapidly evolving IT procurement preferences and volatile budgets. Software organizations have adapted to this change via horizontal diversification of their pricing approach across multiple models, as highlighted in Figure 3.



B2B n = 61, B2C n = 17, both B2B & B2C n = 115 (May 2023)

Source: SG Analytics Sales and Use Tax survey across the U.S. Software Industry

As software market rapidly evolves, enterprise organizations are shifting their priorities toward:

- Embracing software-defined workflows to enhance scalability
- Reducing total cost of ownership (TCO) through pre-configured solutions (software and IT services)
- Extending in-house capabilities to support agile technology deployments.

There are also unprecedented operational and financial tax accounting complexities, such as pricing, channel partnerships and product offerings. This will eventually lead to revenue leakages across sales and use tax compliance, which will hamper long-term sustainability and create a decline in margins.



Tax challenges

Key Insight #2. Real-time change in sales tax rates and regulations across multiple channels, geographies and product offerings remains a top challenge.

1

More than 40% of software organizations grapple with the complexities of the ever-changing sales and use tax ecosystem, especially due to diverse industry offerings, frequent tax rate changes and aggregation from multiple GTM channels. Nearly one-third (32%) of smaller organizations face more challenges in applying taxes on recurring subscriptions and bundled product services as compared to mid-size companies (19%) and enterprises (19%). Understanding the taxability of software is challenging - software is currently taxed in numerous ways based on multiple distinct categories, including physical or digital products, custom versus canned products, software as a service (SaaS) or some combination of those categories. To further complicate matters, each state may make its own rules for how software is taxed or exempted.

2

Just over 40% of respondents spend one-quarter of their monthly time (6 out of 22 working days) on sales and use tax compliance tasks. Moreover, 33% from the enterprise software segment highlighted that they spend six to seven of their monthly workdays in sales and use tax compliance activities.

3

Audit-specific processes account for 29% of total monthly working hours across IT teams and 25% across finance/accounting teams. Of those surveyed, 45% said that real-time information syndication, upgrading systems to reflect latest tax rates/rules and unification of multi-dimensional sales and use tax compliance activities are the leading tasks for both finance/accounting and IT professionals.

Figure 4: Average monthly time spent on sales and use tax compliance tasks, 2023

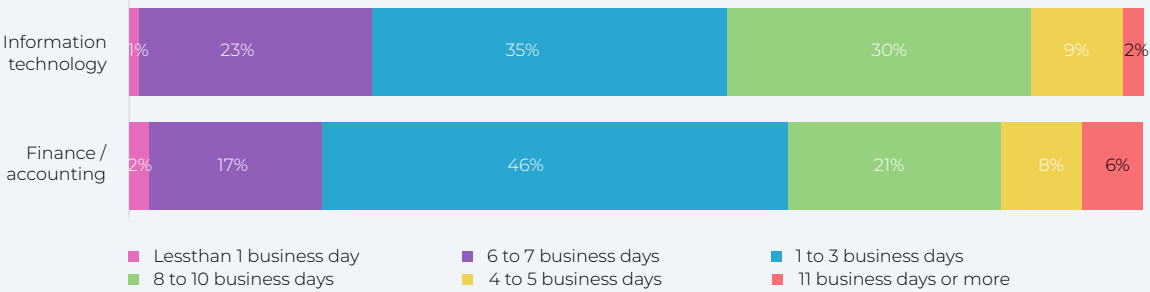
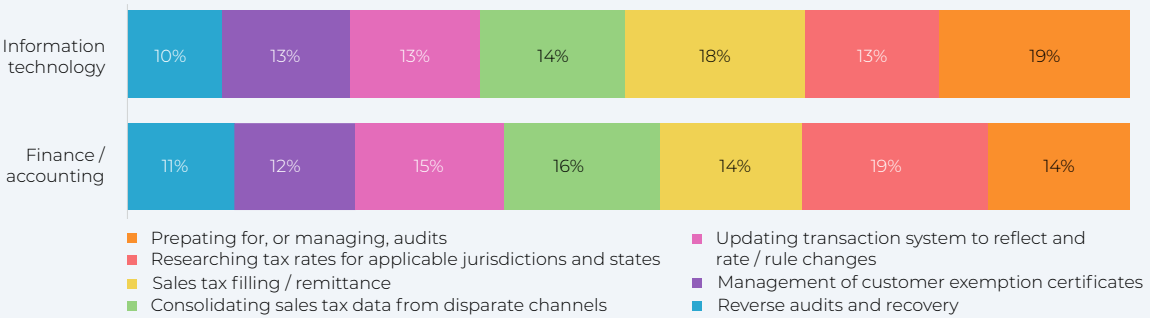


Figure 5: Average monthly time spent on sales and use tax compliance tasks by activities, 2023



Information Technology n = 104, Finance/Accounting n = 104 (May 2023)

Source: SG Analytics Sales and Use Tax Survey across the U.S. Software Industry

In today’s competitive landscape, software organizations are facing significant challenges when it comes to properly allocating their resources for sales and use tax compliance tasks. As customer acquisition costs rise, software organizations are under immense pressure to optimize their resources and technology to meet real-time sales and use tax requirements.

4

41% of respondents revealed integration with third-party modules and systems is a crucial technological pain point. Software organizations in the U.S. are facing increasing sales and use tax compliance risks, primarily due to operational inefficiencies, a changing regulatory environment and technological limitations. Legacy solutions are no longer able to effectively adapt to the evolving local and regional tax laws, leading to a greater potential for audits. Organizations must recognize and understand changing local and regional tax policies across all operational provinces in the U.S., while accounting for diverse product offerings, deployment configurations and pricing dynamics. Additionally, 41% of respondents reported average audit penalties of \$160,000 per year.

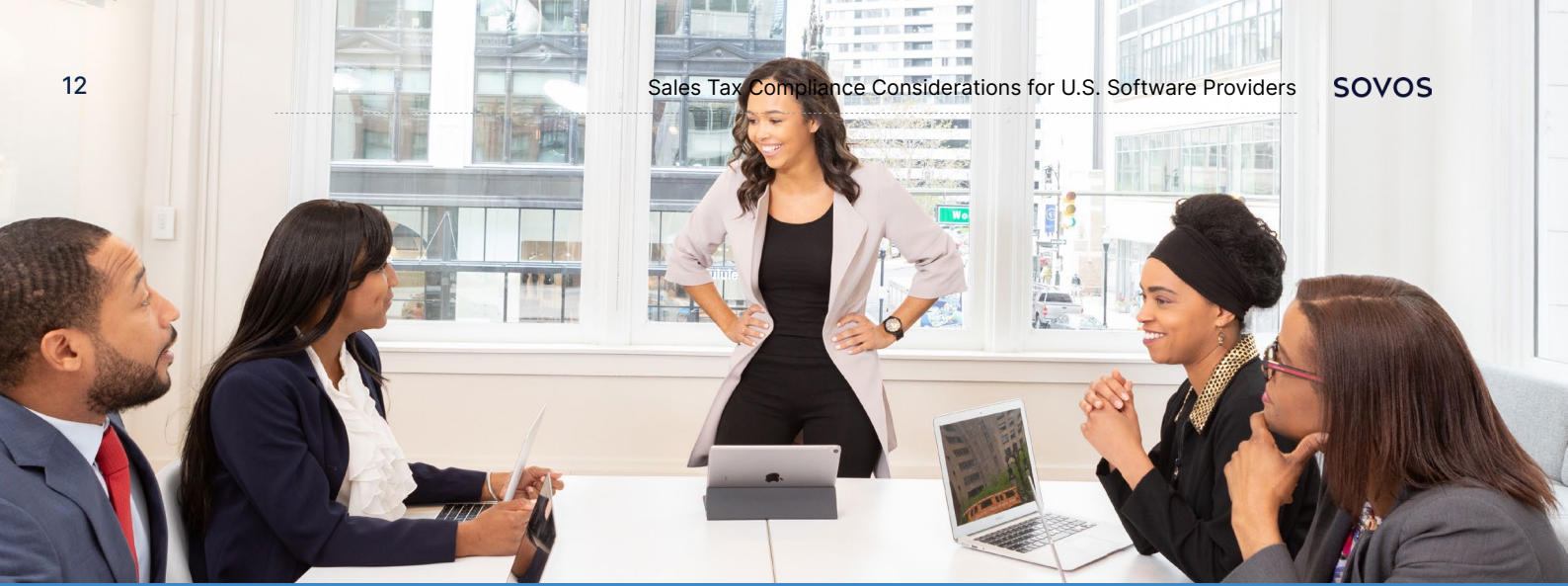
As software organizations expand through new offerings and partnerships, it becomes important to integrate sales and use tax solutions into various third-party systems. This integration helps to create a unified reporting system driven by analytics, which reduces revenue loss. About 31% of respondents identified integration of third-party systems as their main technological challenge. Furthermore, 27% said that their current sales and use tax solutions lack a unified data and analytics-focused approach to address operational inefficiencies, such as forecasting, predictive analysis, unorganized data storage and executive dashboard functionalities.

Figure 6. U.S. current tax solution challenges, 2023



n = 208 (May 2023)

Source: SG Analytics Sales and Use Tax survey across the U.S. Software Industry



Best practices and lessons

Key Insights #3: Most software organizations follow siloed technology procurement approach to manage their sales and use tax compliance needs.

1

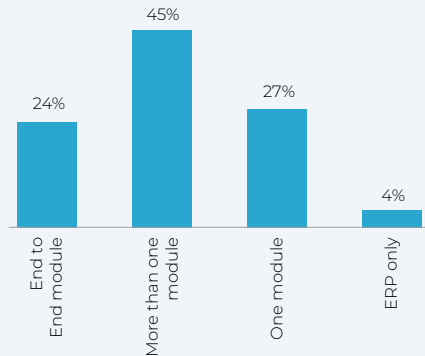
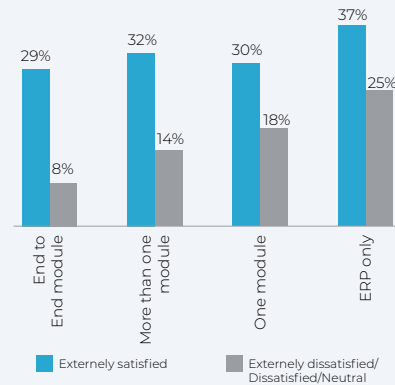
45% of software organizations have a fragmented and siloed tax compliance solution deployment, i.e., leveraging more than one module but not an end-to-end solution. Under one-third of respondents (27%) are leveraging one module across the tax compliance ecosystem (i.e., tax rate calculation, preparation, or exemption certificate management). However, 24% have an end-to-end sales and use tax solution to meet real-time compliance requirements.

2

Just 4% of organizations rely solely on their Enterprise Resource Planning (ERP) systems for managing their sales and use tax-related tasks, underscoring the heightened dependence on tax solutions for managing sales and use tax compliance. This indicates the realization among software organizations that ERP systems may not possess the comprehensive functionality required to handle the complexities of sales and use tax compliance.

3

Close to a third (between 30% and 37%) of respondents leveraging ERP or one of the tax solution modules are extremely satisfied, validating the need for a cloud-based end-to-end tax compliance solution. Comparatively, just 8% of respondents utilizing an end-to-end solution said they are extremely dissatisfied, dissatisfied or neutral.

Figure 7. Tax modules deployed by U.S. software organizations, 2023**Figure 8. Satisfaction index across each of the tax module modes, 2023**

n = 208 (May 2023)

Source: SG Analytics Sales and Use Tax survey across U.S. software industry

The siloed procurement strategy (one module, two modules, end-to-end solution and ERP only) has resulted in numerous technology-specific challenges. These risks, to some extent, have been mitigated with the migration to the cloud.

4

In 2023, almost half (48%) of software organizations have deployed cloud-based sales and use tax solutions. Software organizations, whether they are based in the U.S. or are international, face challenges related to sales and use tax when targeting the U.S. market. These challenges also extend to solutions sold in other regional markets such as Canada and Latin America. There are approximately 100 different tax jurisdictions that impose sales and use tax obligations on international organizations offering digital products and services. These sales and use tax compliance requirements are constantly changing. As software organizations expand into new markets, they need to adopt an adaptable and flexible technology deployment system.

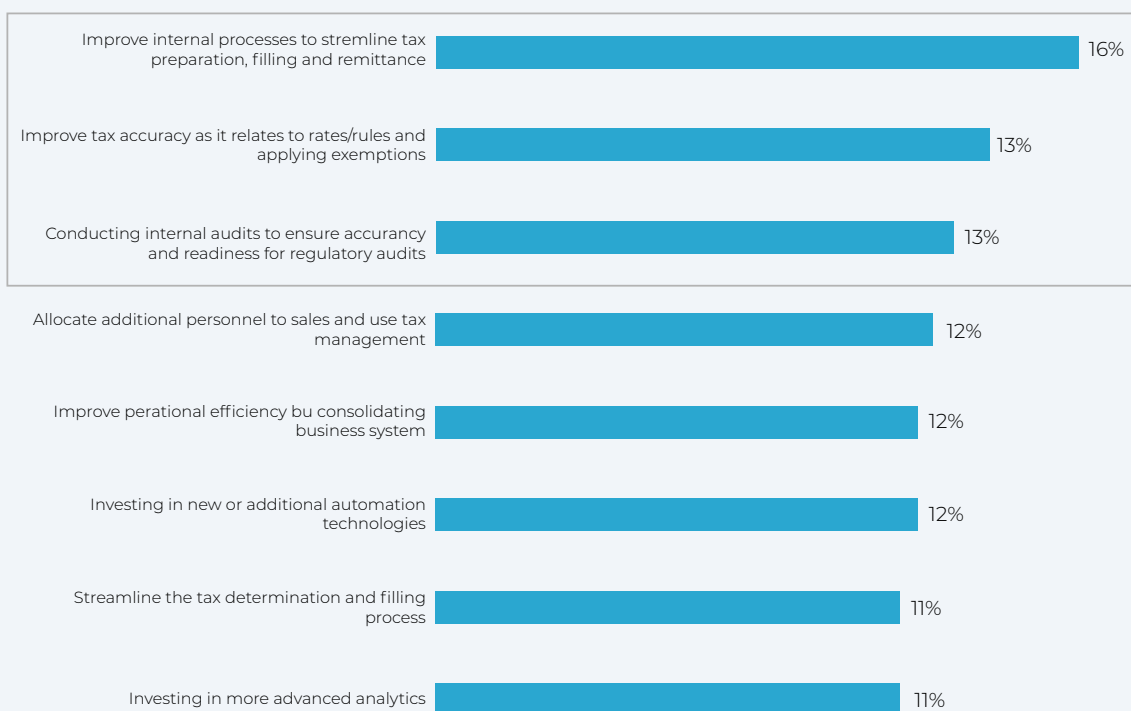
5

53% of respondents said cloud solutions improve sales and use tax calculation and compliance-based operational efficiencies. Furthermore, 84% of respondents with cloud-based solutions are extremely and highly satisfied with their current systems. This slightly differs for respondents with on-premises solutions, wherein only 64% of customers are satisfied with their current systems. In the coming years, on-premises systems will eventually be moving to the cloud to gain operational efficiencies, attributed to the rising demand for unification of sales tax data and documentation of multiple channels, a reduction of audit-based revenue leakage and optimization of finance/accounting and IT resources.

6

The core objective for moving toward an agile solution is to actively reduce operational inefficiencies in sales and use tax compliance-related tasks. For example, 16% of respondents wanted to streamline the workflow for sales and use tax preparation, filing and remittance, while 26% of respondents focused on improving the accuracy of tax exemption filing and audits.

Figure 9. Cloud-based sales and use tax solution enabling software organizations to meet strategic initiatives



n = 84 (May 2023)

Source: SG Analytics Sales and Use Tax Survey across the U.S. Software Industry

7

83% of respondents plan to migrate to cloud-based solutions in the next 24 months. Among software organizations planning to migrate to the cloud, 62% are operating in both B2B and B2C domains. This shift to the cloud is driven by faster automated data feeds, database conversions and effective collaboration between different departments, which improve overall operational efficiency and faster time to market.

8

Some of the other benefits to be garnered via leveraging a cloud-based sales and use tax solution are: Lowered TCO safeguarded profitability margins and improved financial and accounting professional throughput.

Future growth prospects

Key Insights # 4: Annual budget and IT spend on sales and use tax compliance solutions set to exponentially increase in the U.S. software industry in the next 12 to 18 months.

- 1** **71% of respondents said they have a \$1 million annual budget for a sales tax compliance solution.** As sales and use tax compliance solutions become a pivotal differentiator for reducing revenue leakages in the form of audit penalties and improving operational gains, almost 5% of respondents will be spending more than \$2 million on this technology in 2023.
- 2** Of those surveyed, 42% said their sales and use tax software annual budget spend increase in the next few years would be between 1% and 5%. The migration to cloud-based solutions will continue to surge due to most on-premises system lifespans ending, which will drive 30% of software organizations to increase their IT spend by more than 6% in the next two to three years.

Figure 10. Annual sales and use tax compliance solution budgets, 2023

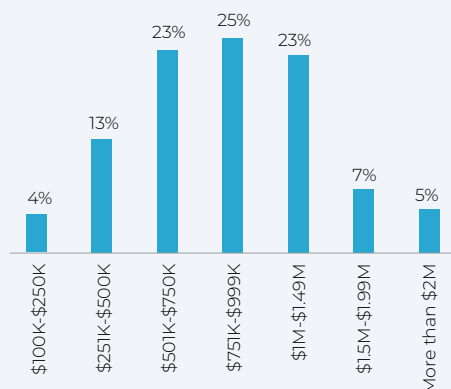
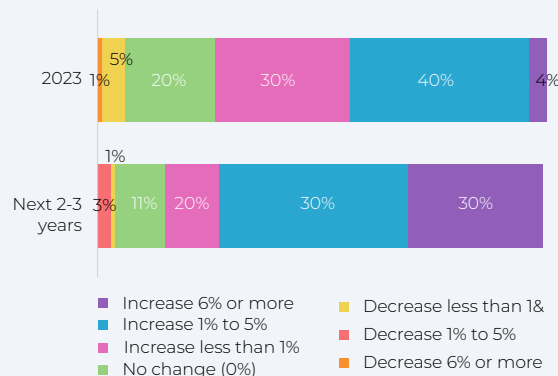


Figure 11. IT spend on sales and use tax compliance solutions, 2023



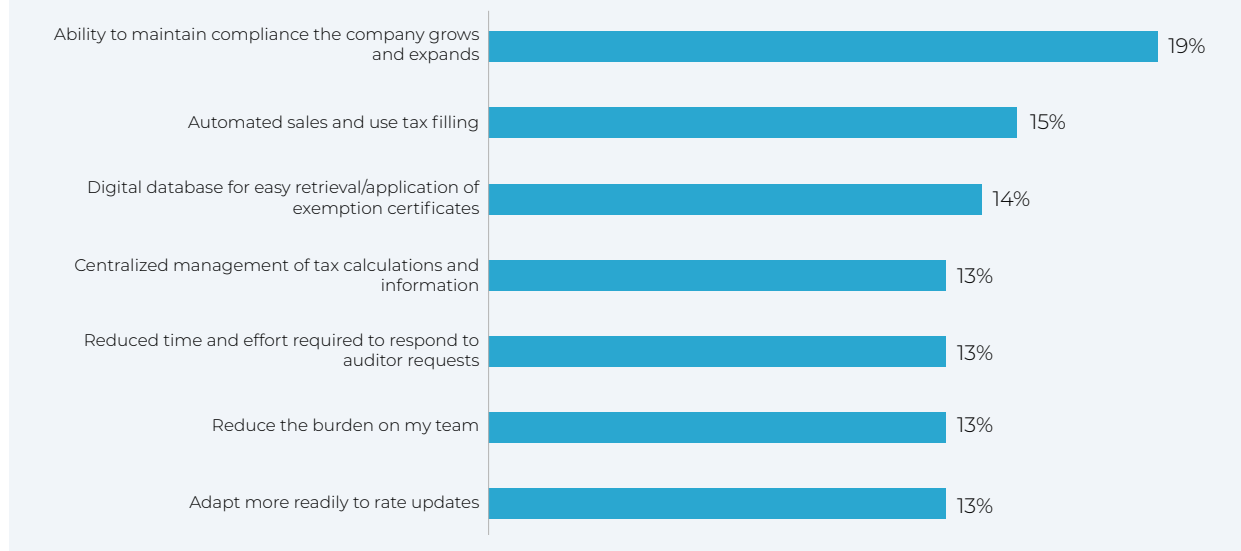
n = 208 (May 2023)

Source: SG Analytics Sales and Use Tax Survey across the U.S. Software Industry

As tax preparation, calculation and exemption certificates for sales channels across different regions undergo changes, there will be an increased demand for software organizations to incorporate new features and provide premium support services.

3 74% of respondents highlighted that the operational efficiency gain is the core ROI for them to embrace a next-generation sales and use tax compliance solution. As shown in Figure 12, operational benefits across the sales tax compliance value chain include compliance management (19%), automated and orchestrated filing workflow (15%), converged single exemption certificate (14%), centralized management of tax calculation (13%) and streamlining external audit collaboration (13%).

Figure 12. Factors and gains driving sales and use tax solution spend, 2023–2025



n = 208 (May 2023)

Source: SG Analytics Sales and Use Tax Survey across the U.S. Software Industry

4 64% of software organizations are looking for scalable sales and use tax solutions with flexible deployment options and data security features. Businesses need smooth data exchanges and automated processes, eliminating the reliance on manual data entry and ensuring accurate and real-time sales tax calculations. Organizations desire data security, robust measures to safeguard sensitive sales tax data and the confidence that they are compliant with relevant data protection regulations.

Software companies will benefit from a horizontally integrated (from preparation, filing, to exemption certification support) sales tax compliance solution offering:

- Flexible deployment with tightly integrated third-party offering to improve scalability
- Multi-faceted regional and local pre-configured templates, along with scenarios to streamline financial and accounting teams' time (i.e., ensure the time spent on tax-related activities does not detract from other key business initiatives)
- Low latency-centric tax calculation capabilities, i.e., closer to the transaction source
- Compliance with local, regional and international security standards and protocols to reduce sales tax operational insufficiencies
- Strong premium customer care and support
- Improved protection from audit risk.

Appendix

Methodology

The sales and use tax survey carried out across the U.S. software industry in five regions using online research methodology is the primary source of the insights detailed in this presentation.

Sample selection for the survey was done from SG Analytics' participant panel, following the below considerations:

- User of any of the key sales tax accounting tools
- Should be involved directly or indirectly in managing sales and use tax compliance for their organization.

FW period: April'23 to May'23



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About Sovos

Sovos provides businesses with the confidence needed to navigate an increasingly regulated world. Offering a modern, IT driven response to compliance, Sovos' solutions are scalable, reliable and secure and provide a great user experience. Sovos has more than 100,000 customers, including half the Fortune 500, as well as businesses of every size operating in more than 70 countries. The company's cloud-based solutions integrate with a wide variety of business applications and government compliance processes. Sovos has employees throughout the Americas and Europe and is owned by Hg and TA Associates. For more information, visit <http://www.sovos.com> and follow us on LinkedIn and Twitter.

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