



The biggest winners of an Internet sales tax

June 19, 2013: 11:04 AM ET

By one estimate, as many as six million retailers in the U.S. could soon owe sales taxes on goods and services sold in other states. Tax software providers are seeing dollar signs.

By Lynnley Browning



FORTUNE -- At Avalara, a sales tax software company near Seattle, it's time to import more orange toilet paper from France.

The private company, where orange-shirted employees call themselves "Avalarians" and the signature color extends to bathroom stalls, is one of a handful of players in a little-known industry poised to become a hunting ground for investors.

Fragmented and unglamorous, the sales tax software business is emerging as ripe for growth, as smaller companies, mom-and-pop businesses and small-scale online retailers shift to automating a process still largely done manually.

"This is an incredibly big market, and it's very nascent," said Chelsea Stoner, a partner at Battery Ventures, a private equity and venture capital firm that invested \$20 million in Avalara last June.

Congressional efforts to allow states to require online retailers with annual gross sales of at least \$1 million to **collect sales taxes** and forward them to the state where the customer lives are just one force spurring smaller retailers for easier ways to cope with the gigantic jumble of state and local tax laws. Some \$23 billion in sales tax goes unpaid each year by retailers making out-of-state sales, many through the Internet, according to the National Conference of State Legislatures.

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Though its fate is uncertain, the Marketplace Fairness Act under consideration in Congress, better known as the "Amazon Tax," "could be a big driver and a catalyst for the industry," said Scott Sedlacek, managing director at investment banking firm Mooreland Partners. The bill, passed by the Senate in May, awaits House consideration.

Multinationals and large companies have used sophisticated tax-compliance software for years, from established providers including CCH, part of Dutch Wolters Kluwer; Vertex Inc.; and Sabrix, part of Thomson Reuters.

But smaller and many mid-sized firms without sophisticated tax-planning strategies or complex cross-border issues have often handled the sales tax function manually.

Blame the truly mind-boggling number of ever-changing laws governing sales taxes. In Iowa, sales of food baskets -- think beribboned housewarming gifts laden with fruits and crackers -- are exempt from sales tax, but only if the value of exempt items, such as tea and chutney, is greater than the value of taxable items, such as caramel-coated apples. In Massachusetts, sports bras and ski pants are tax-exempt, but bowling shoes and shower caps are not. Not even sales tax

software companies can agree on how many different rates exist nationwide -- CCH estimates the figure at 7,600, while Avalara puts it as high as 14,500.

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There are hundreds of tax software companies, but along with Avalara, only five other companies -- CCH, Exactor, Taxware, AccurateTax and Fed-Tax -- are so-called certified services providers allowed under a 24-state "Streamlined Sales Tax and Use" agreement to keep a portion of sales taxes they collect for state coffers from retailers -- anywhere from 2% to 8%, depending on the amount collected. If passed, the Marketplace Fairness Act would give those states authority begin forcing retailers to collect sales tax as early as next year. Other states can join the existing agreement.

Crucially for software providers, the act would require states opting to collect sales tax to purchase and provide, free of charge, to retailers basic software for calculating and filing sales taxes from one those six certified providers. But retailers would have to pay usage, licensing, integration, and other fees to the companies.

Some of those private companies are attracting investor attention. Last November, Vista Equity Partners bought Taxware from Automatic Data Processing (ADP), the [big payroll services company](#). Avalara, located on Bainbridge Island, a ferry hop from Seattle, has also raised around \$49 million from Benaroya, Pioneer Venture Partners, and Sageview Capital. "We are building contacts with institutional investors," said David Campbell, chief executive of FedTax.

There are no reliable industry estimates on the size of the sales-tax software market, said Diane Yetter, founder of the Sales Tax Institute, a think tank. But she added that services for smaller companies "is one of the fastest growing areas in the tax space."

Some investors see a parallel between the nascent sales-tax software industry and the explosive growth of automated payroll, benefits and accounting functions, now worth globally some \$80 billion a year, according to McKinsey & Co. "What ADP did to payroll, one of these companies is going to do to sales tax," said Battery Venture's Stoner, adding that there were six million U.S. businesses with remote sales, many of which could be required to pay sales taxes. "We think this is a wide open space and a huge public" -- read initial public offering -- "story."

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