Vendor Profile

Avalara: Using the Cloud to Reshape the Tax Software Market

Kevin Permenter

IDC OPINION

Tax management has gained a heightened profile as organizations look for ways to increase their operational efficiency to better compete in today's hypercompetitive business market. Organizations are also coming to the realization that, in many cases, effective and efficient tax management — including sales tax, value-added tax (VAT), and goods and services tax (GST) — impacts customer satisfaction. As business models become more complex, companies must harness the potential of cloud-based tax automation software to keep up with the increasing pace of commerce and the pace of regulatory change at the state and local level. Avalara Inc., a tax compliance application vendor, has rapidly grown its presence by building technology that harnesses the cloud to address deep-seated pain points among corporate tax professionals. Further:

- The company has coupled this technology with an aggressive partnering and ecosystem strategy, with hundreds of prebuilt integrations fitting into this new digital economy.
- This approach effectively shortens the distance between Avalara and its customers and has been the "secret sauce" to its rapid growth over the past decade.

IN THIS VENDOR PROFILE

This IDC Vendor Profile focuses on Avalara, whose tax compliance suite aims to relieve the immense pressure on organizations selling to and from multiple locations within the United States and beyond. While Avalara supports the process of collecting, calculating, and filing taxes, the company also provides a layer of insight and visibility from its analytics capabilities that is essential in today's business landscape.

SITUATION OVERVIEW

The process of managing the collection, calculation, and filing of taxes has been growing increasingly difficult because enterprises and their markets have grown in scale and complexity. Companies are selling more products and services in more places regionally and globally and in more ways (B2C, B2B, and B2B2C) than ever before in the human history. The pace of business is also changing; companies that were little more than an idea in 2012 have grown to quickly become Fortune 500 companies (i.e., Uber and Facebook) in a matter of years. In addition to globalization, macrotrends like the rise of ecommerce, the move to cloud-based business applications, and digital compliance requirements imposed by governments are pushing companies of all sizes toward cloud-based solutions for compliance. Marketplaces such as Amazon, eBay, and Etsy enable small businesses to sell everywhere almost overnight, yet these small businesses are ill-equipped to handle the complexity of tax compliance. Amid the unprecedented change in the business landscape, tax management has become a tangle of regulatory constrictions, data management inefficiencies, and lack of tax-related

budgetary restrictions. This tangle is at its most acute when dealing with indirect transaction taxes like sales and use tax management. For sales and use tax, the twin forces of exploding digital commerce and declining state-level revenues have added even more complexity for the individuals and teams who manage compliance at businesses of all sizes.

Sales tax is one of the most complex areas of tax management due to the amount of change that companies have to cope with to be in compliance. Change manifests itself in the following ways:

- **Changing tax rates:** The tax rates within the United States are constantly changing at both the state and local level. There were over 700 rate changes throughout the United States in 2017and over 500 rate changes in 2016. This change makes it difficult for organizations to maintain compliance.

- **Shifting jurisdictions:** The number of tax jurisdictions has increased significantly over the past five years. Each of these jurisdictions has a unique set of rates and characteristics, which make maintaining compliance more difficult without the proper tools.

- **Changing taxability:** As businesses and business models evolve, the taxability of transactions has evolved as well. For example, there have been changes to how software transactions and cryptocurrency transactions need to be handled.

- **Evolving requirements for tax compliance:** In their quest to collect revenue from remote sales (ecommerce), states have created a confusing patchwork of requirements on out-of-state sellers based on varying definitions of "nexus" and also on sellers using marketplaces like Amazon, eBay, and Etsy.

The speed of digital business, coupled with the growing volume and variety of sales transactions, has added an unprecedented amount of complexity to sales tax compliance. This complexity has created a wave of interest in sales and use tax automation software. Businesses need tools to cope with the challenges of tax compliance in the new digital economy. As a result, sales and use tax compliance software is becoming strategic to the future of the digital enterprise. Here are a few market drivers changing the landscape of sales tax management software:

- **Federal- and state-level tax changes:** The tax software market sits on shifting sand in terms of regulations. Regulations for sales and use tax in the United States are constantly changing. In fact, several states including Rhode Island, Minnesota, and Pennsylvania are undertaking major tax restructuring/reclassification initiatives that will have profound impact on the U.S. sales tax landscape.

- **Increased demand for integrations:** In the end, customers want simplicity. That means smooth and simple integrations via APIs and even prebuilt integrations with strategic software vendor partners. These integrations should take hours or days to configure, not months. As digital systems move to the cloud, API-enabled cloud microservices will become essential for businesses that have complex commerce operations.

- **Tax compliance:** In the end, tax compliance begins at the moment of a transaction so the compliance solution must be deeply integrated into the applications companies use to create invoices – enterprise resource planning (ERP), ecommerce platforms, and point-of-sale (POS) systems and so forth. Compliance automation providers must therefore offer prebuilt integrations into those systems and robust APIs to facilitate rapid implementation, simple deployment, and ease of use.

- **eCommerce growth:** eCommerce has experienced explosive growth over the past decade. Yet ecommerce still comprises only a fraction of total global commerce. Thus the ecommerce

market is still in the beginning of its growth and development. Tax management in the digital economy is set to grow as the world of ecommerce grows.

- **Omni-channel commerce:** Fewer and fewer businesses in today's economy perform sales via a single channel. Between storefronts and mobile sales and ecommerce and customer relationship management (CRM) systems, as well as multiple traditional invoicing systems such as financial applications or ERPs, businesses collect taxes within multiple systems. The tax data from all of those systems must be aggregated into a single place to appropriately report collections and remit payments to various taxing authorities.
- **Evolving competitive dynamics:** The market for tax management software is heating up, with several "born on the cloud" software vendors starting up over the past three years. In addition, several traditional on-premises enterprise tax software companies have made heavy investments in the digital commerce transactional tax software market.

Company Overview

Avalara is a leading cloud-based software application provider, delivering a broad and growing array of compliance applications related to sales tax and other transaction taxes such as value-added tax. The company's mission is to help businesses of all sizes achieve compliance by delivering comprehensive and automated cloud-based tools that are designed with speed, accuracy, and ease of use in mind.

Avalara's products automatically determine taxability, identify applicable tax rates, calculate taxes, prepare and file returns, remit taxes, maintain tax records, and manage tax exemption certificates.

Company Strategy

Business Strategy

One of the things that makes Avalara unique is that it is offered in a multitenant public cloud deployment model. The public cloud model allows Avalara to provide a high level of product functionality while keeping the price of the solution relatively low, especially compared with traditional on-premises offerings. Avalara started back in 2004, with midmarket ERP companies as their target segment, so small and medium-sized businesses (SMBs) are in their DNA. Today, Avalara has evolved to serve customers of all sizes, added ecommerce, and other business platforms to their capabilities and continues to push its solution into innovative avenues and new markets. Over the past two years, Avalara has expanded its international customer base with tax solutions for value-added tax in Europe, specialized services in Brazil, and goods and services tax (GST) in India and Europe while continually updating its solution with new features and more capable APIs.

Product Strategy

Avalara has expanded its product portfolio to provide end users a more complete tax compliance solution. The product portfolio for Avalara has grown well beyond its flagship product AvaTax (sales and use tax). Table 1 shows a summary of Avalara's expanding product portfolio.

TABLE 1

Avalara's Products

Avalara AvaTax	A secure cloud-based product that integrates with hundreds of common business applications and automatically calculates and applies the right rates and rules to every transaction within those applications. Avalara offers variations of AvaTax for sales and use tax, excise tax, communications tax, lodging tax, VAT, and UPC.
Avalara CertCapture	A browser-based compliance tool for managing compliance documents such as exemption certificates and excise documents. Avalara offers variations and extensions of CertCapture including CertExpress, VendorCapture, and ExciseCapture.
Avalara Returns	An automated sales tax return software that helps you file accurately and on time. Avalara offers variations of returns for sales and use tax, excise tax, communications tax, and lodging tax. Returns customers can choose to use Avalara's remittance service as well, allowing them to make a single payment to Avalara, which then manages payments to all associated taxing authorities.
Avalara TrustFile	A do-it-yourself sales tax solution for small businesses and ecommerce merchants. Avalara recently introduced Avalara TrustFile GST targeting the rapidly growing India tax compliance market.

Source: IDC, 2018

Partnerships

Avalara understands the role that partners play within the tax compliance software market. Avalara's approach to the market centers on building its ecosystem so that the company's solution is always an option regardless of the end user's mix of business applications driving the company. Avalara has worked aggressively to expand its partner ecosystem to include transactions conducted via CRM, mobile commerce, and retail/point-of-sale platforms. In addition, Avalara has taken strides to extend its market to other channel ecosystems, such as accountants, systems integrators, and large-scale distributors. From a technology standpoint, Avalara has worked to update its solutions via APIs and dedicated integrations to make it easier for partners and developers to add value to the Avalara platform. As a result, Avalara boasts over 600 integrations as of 2017 across many market segments and industries, with more to come.

Strengths and Challenges

In the hypercompetitive market of tax compliance software, companies are always looking for ways to differentiate themselves from their competitors. In this effort, Avalara benefits from the strengths and faces the challenges in the sections that follow.

Strengths

Avalara has built a rapidly growing business by leveraging the following strengths to position its products for maximum impact and position the company as one of the fastest risers in the very traditional tax management market:

- **Partnering/ecosystem:** Avalara has always understood that success in the tax management software market is dependent on building partnerships with publishers of all types of invoicing systems. Avalara has been aggressive about building out its ecosystem to include key players within the enterprise resource planning, digital commerce, point-of-sale, and customer relationship management markets. Further:

  - Avalara boasts over 600 integrations (and growing) across many market segments. This includes top enterprise application software vendors like SAP, Oracle, NetSuite, and Sage. Avalara also offers integrations with leading ecommerce platforms like Shopify, BigCommerce, and Magento.

  - Avalara has partnerships with industry associations and joint ventures like Maryland Association of Certified Public Accountants, Wisconsin Grocers Associations, and Texas Retailers Association. Avalara uses these initiatives to guide its product road map and market strategy.

  - An end-user example includes a midsize North American retail company that leveraged Avalara's extensive list of APIs to connect its financial and POS systems to calculate and apply sales tax as the transactions take place.

- **Technology and data management:** Avalara has invested a lot of resources into becoming a leading tax company from a data management perspective. Over the past 24 months, Avalara has moved its solution to the AWS platform to provide additional hosting capabilities, debuted its cross-border tax calculation capability, updated its REST APIs, and enhanced its developer community forum. Avalara places great importance on being on the forefront of enterprise application development and technology trends.

- **Calculation:** Avalara's AvaTax includes prebuilt algorithms for address verification and geolocation to enhance its ability to increase tax calculation accuracy. The software allows end user to automatically validate addresses and receive up-to-date tax rates. Because it is a cloud-based solution, rates, rules, and boundaries are kept up to date automatically, which significantly reduces errors. Finally, the system also allows for transparency of how these rates were calculated so the end user can trust and verify that the solution is providing precise reporting.

  An end-user example includes a midsize North American candy manufacturer that leveraged Avalara's reporting capabilities to reduce the frequency and overall impact of audits. "We answer (audit request) with such confidence and authority now; the auditors have moved on to someone else."

- **Data security:** Avalara has worked to take full advantage of the security features offered via AWS including whitelisting to protect computers and networks from potentially harmful applications. In addition, all traffic to Avalara is routed through a service provider that filters out potential bad traffic and bad content before it gets through. Avalara works with a security firm to test its systems and proactively find vulnerabilities. Once the vulnerabilities are found, critical updates/patches are automatically deployed to all end users.

Challenges

The following are a few of the most prominent market headwinds that Avalara must contend with to maintain its growth trajectory and market position:

- **Lack of direct tax functionality/modules:** Avalara has a growing portfolio of indirect functionality including enhancement to its GST and VAT management modules. A few of Avalara's competitors have both indirect and direct tax capabilities, which is appealing to larger, more complex companies.

- **Pressure from new market entrants:** Avalara has enjoyed a head start in terms of being an enterprise-grade, cloud-based tax management solution. However, the past 24 months have brought several new entrants in the market, both from new start-ups and large traditionally on-premises tax software companies. Avalara must tackle these products head-on to keep its leadership role in the transaction tax software market.

- **Rapidly changing regulatory landscape:** Avalara along with every other tax software vendor must contend with a constantly changing tax regulatory landscape at every level (local, state, federal, and international). Not only is the regulatory landscape in constant motion, but also the pace of the changes has exploded due to the energy around ecommerce and e-invoicing. In fact, the pace of tax regulatory change both here in the United States and internationally has only served to complicate the process of tax management.

FUTURE OUTLOOK

Not only are there thousands of tax jurisdictions for retailers to traverse but those jurisdictions are also constantly adding new rules or making adjustment to older rules. In the United States alone, over 2,000 new sales and use taxes have been introduced over the past 10 years. Further there have been more than 5,000 rates and rules adjustments occurring every year during this period. These shifting sands create a spiderweb of complexity that simply cannot be navigated without sophisticated tax compliance software.

IDC expects sales tax management to continue to increase in complexity and for the market to continue to change rapidly. In the near term, technology will play an increasing role in helping companies maintain compliance. IDC expects the following technologies to shape the next five years for sales tax software:

- **Artificial intelligence:** Companies are already beginning to use artificial intelligence to perform lower-level repetitive tasks like calculating the proper sales tax rate for the proper jurisdiction. Artificial intelligence will also be used by tax professionals to build more accurate forecasts and perform advanced risk/exposure analysis. IDC expects to see this technology continue to proliferate throughout tax workflows.

- **Big Data and analytics:** The tax department is inundated with data but insights from that data can be hard to find. Sophisticated Big Data and analytics will allow tax professionals to identify opportunities and make better tax decisions. IDC believes that Big Data and analytics will become a must have for tax software end users.

- **Blockchain:** While still in its infancy, blockchain has the potential to change how transactions are done and how they are recorded. It is particularly well suited to address inefficiencies in the auditing process. Cryptocurrency, which is built on blockchain technology, promises to heavily impact the transaction tax landscape.

- **Cloud computing:** The power of cloud computing has reshaped nearly all aspects of back-office enterprise applications. While tax has lagged behind other corporate functions in cloud adoption, that is set to change. There have been a number of new cloud initiatives both from traditional on-premises software providers and start-up "born on the cloud" tax software vendors. IDC expects the cloud momentum to continue in the tax software market.

ESSENTIAL GUIDANCE

Advice for Avalara

Avalara is well positioned to cope with the challenges of today's tax compliance software market, and the company's rapid growth in recent years can attest to that fact. However, as the tax compliance software evolves and becomes more complex and more competitive, Avalara must consider the following factors as a pathway to push its technology and its organizations to new heights:

- **Invest in analytics:** As the volume of business data drastically increases over the next five years, the importance of data management and data analytics will be critical.
- **Build your ecosystem:** Continue building alliances/partnerships with key market segments and spreading your sphere of influence.
- **Explore the SMB market:** The sales tax hammer hits the hardest, in many ways, for ecommerce SMBs; be sure to craft a dedicated marketing message tailored to the SMB market.
- **Go global:** Consider the rising global transactional tax compliance challenges with VAT and GST along with all of the related reporting challenges in countries like China, India, and Brazil.
- **Look toward the future:** Explore new technologies that will impact your market in the coming 5-10 years, namely, blockchain, cryptocurrency, and machine learning.

LEARN MORE

Related Research

- *Digital Commerce Marketplaces in the Age of the 3rd Platform* (IDC #DR2018_LAL1_MNR_JJ, February 2018)
- *IDC MarketScape: Worldwide SaaS and Cloud-Enabled Finance and Accounting Applications 2017 Vendor Assessment* (IDC #US42218017, September 2017)
- *Market Analysis Perspective: Worldwide Financial Applications, 2017* (IDC #US43031316, September 2017)
- *How to Build a Comprehensive Digital Commerce Platform: The Foundation of Digital Transformation* (IDC #US42786917, July 2017)

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Global Headquarters

5 Speen Street
Framingham, MA 01701
USA
508.872.8200
Twitter: @IDC
idc-community.com
www.idc.com