A basic understanding of the different types of taxes levied within the United States is crucial to an understanding of how to integrate tax into an SAP system. Chapter 2 discusses the basic taxes with which large corporate tax departments have to comply and some of the challenges encountered within the SAP system.

2 Overview of Taxation in the United States

U.S. taxation is a very complicated affair due to the myriad of taxes and multitude of jurisdictions involved. Unlike many foreign countries, the United States has attempted to follow the old adage of “No taxation without representation.” This means that many taxes are levied at the local level where people have the most say in how much is collected and what the money is used for. Although this is an equitable way of imposing taxes, it creates problems for companies doing business in the United States.

Many international companies that have SAP systems installed in Europe or other foreign countries feel they can simply roll their template out to the United States. This does not work, however, at least not without many changes. Most companies end up deciding to install a separate U.S. instance instead, rather than making the changes required to a foreign template to facilitate U.S. activities. It is also much easier to use a U.S. template and adopt it for foreign use.

In this section, you will gain an understanding of U.S.-based taxes and the challenges encountered by tax departments using SAP and configuration specialists dealing with SAP-related tax issues. It will be helpful for SAP configuration teams to understand the burdens that corporate tax departments are under to meet tax authority requirements while paying the least amount of tax legally acceptable. In doing so, many tax departments are actually revenue generators for the corporation.
Overview of Taxation in the United States

We'll now look at the different types of U.S. taxes, which include the following:

- Federal income taxes
- State and local income taxes
- Sales and use taxes
- Property taxes
- Payroll and benefits taxes

In addition, we'll briefly look at other taxes to be taken into consideration, international taxation issues and record retention.

### 2.1 Federal Income Taxes

The U.S. Treasury Department and more specifically, the Internal Revenue Service (IRS), has responsibility for collecting taxes at the national level in the United States. Although the IRS collects more types of taxes than just federal income tax, the discussion in this book will be limited to just income taxes because that is what is most pertinent to tax professionals with regard to SAP.

#### Note

Corporations, partnerships, trusts, cooperatives, and individuals doing business in the United States are all required to file a U.S. income tax return. The majority of U.S. companies have adopted a corporate entity as their form of doing business and often use an ERP system such as SAP R/3 or SAP ERP Central Component (ECC). The remaining business entities are generally too small to need an ERP system, although some partnerships do run on SAP. The discussions in this book are limited, therefore, to the corporate form of business entity.

Note

Tax people usually love tax but tend to avoid information technology. Their motto often is "If you can't do it in Excel, it cannot be done." Further, the mantra of many tax professionals is "Achieve consistency with as little manual intervention as possible." That is, if logic can be used to populate a field, that's much preferred to a person populating it. I have certainly come to agree with the latter philosophy as a result of years of experience and aim for that objective when approaching a tax integration project.
2.1.1 Defining Income Tax

Income taxes are often referred to as *direct taxes* because they are paid directly to the taxing jurisdiction by the taxpayer making the money. This is opposed to *indirect taxes*, such as sales and use taxes, which are most often collected by the seller of goods from the purchaser and then remitted to the taxing authority. The remitter in an indirect taxing relationship technically does not bear the tax liability but bears the burden of collecting the tax from others. Once collected, the remitter then acquires a liability and responsibility to remit the tax to the appropriate tax jurisdiction. As mentioned earlier, income tax is a direct tax on income, in this case of a corporation, and the taxpayer (the corporation) is therefore required to pay tax on income produced during the taxable period.

2.1.2 IRS Form 1120

IRS Form 1120, shown in Figure 2.1 is used to report taxable income and tax due for corporations doing business in the United States. Form 1120 is a form filed annually at the corporation’s year end, but the IRS may also require estimated tax payments to be made on a quarterly basis. Form 1120 consists of an income statement and balance sheet but can have a variety of other IRS forms attached to it as supporting detail. The final income tax return can often fill several banker's boxes when filed with the IRS.

The federal government has opted to differ from generally accepted accounting principles (GAAP) in many cases, which results in differences between financial income and taxable income. The basis of the 1120 form is the annual report or financial income of the corporation, but for tax purposes, the income statement and balance sheet are adjusted due to statutory requirements. These adjustments and the difference in treatment between IRS rules and GAAP result in challenges for tax professionals using SAP or any other ERP software. Some differences require calculations that SAP cannot reasonably perform, whereas others can be done if configuration has been completed appropriately.
**Figure 2.1** IRS Form 1120 (Source: IRS website http://www.irs.gov/formspubs/lists/0_id=97817.00.html)
2.1.3 Income and SAP Modules

Income is comprised of a simple formula of *revenues minus expenses for the period*. This means that a tax return is prepared using data from all modules of an SAP system, including the Financials (FI) portion of the system, as well as the Controlling (CO), Materials Management (MM), Sales and Distribution (SD), Project System (PS), Human Resources (HR), and other system modules, to assure that income tax needs are being met.

2.1.4 Tax Classification

The IRS looks at some revenues and expenses with more scrutiny than it does others, requiring some types of income and expenses to be classified in the system so that they are easily identifiable. Tax professionals often ask for additions to the chart of accounts to facilitate these requirements. Sometimes the additional account can be facilitated through the use of a cost object, but often it cannot. For example, meals and entertainment expenses are handled much differently for tax purposes than they are for financial purposes. If only one account is set up called *Travel Expense* for all travel, meals, and entertainment expenses, the tax department will be faced with analyzing that account over the life of the system. Thus, good tax classification is required to easily meet IRS requirements.

2.1.5 Tracing Income

In addition to the income calculation itself, income sourcing is also required for income and other types of U.S. taxes. Tracing the jurisdiction the money came from and the jurisdiction the money flowed to is an IRS requirement to assure that corporations are not shifting income from jurisdictions with high tax rates to those with low taxes. SAP software effectively creates an audit trail for these types of activities if the system is configured properly from a tax standpoint.

2.1.6 International Tax Concerns

Federal income taxation has an international aspect in that U.S. corporations are responsible for reporting transactions in foreign countries and between foreign countries and the United States. The sourcing spoken of in the previous section is helpful in this regard, but intercompany transactions also need to be scrutinized for pricing appropriateness (Transfer Pricing) and for with-
holding issues. Even though a corporation may not be rolling out SAP to its foreign possessions, company codes need to be set up for foreign affiliates to satisfy U.S. requirements.

2.1.7 Audit Requirements
Nearly all tax authorities require corporations to produce data at a transaction level upon audit. SAP software adheres to a document approach, which means it creates a document for nearly everything entered into the system and maintains a linkage and audit trail between documents. The document feature of SAP enables tax auditors to trace transactions through the system, which is a valuable tool for tax departments.

Note

Legacy systems that pass data to SAP software through an interface at a summary level remain the system of record, and the IRS has the authority to request data from the legacy system in addition to the SAP system.

2.1.8 Legal Entity Accounting
Legal entity accounting is also required by the IRS and other taxing authorities. Each corporation in the United States is considered a legal entity and must have a federal tax identification number. Each must file a tax return or be part of a consolidated tax return annually. SAP has designed the system so that each legal entity is assigned a company code. Assignment of a company code is the easiest way to meet the legal entity requirement. Other attempts will be discussed later in this book.

In this section, we’ve discussed several important concepts about federal income taxation:

- Taxable income differs from GAAP income.
- Revenue and expense classification is very important for tax departments.
- Revenue and expense tracing from source to destination is necessary to meet tax requirements.
- Federal income taxation has an international aspect.
- Tax data is required at a transaction level.
- Tax authorities require legal entity reporting and master data concerning the legal entity.
If logic can be used to populate a field, this method is much preferred to a person populating it.

These topics will be discussed in depth as we explore tax integration and configuration in more detail in Chapter 4.

2.2 State and Local Income Taxes

State and local income taxing authorities often follow the lead of the IRS by adopting many federal statutes. States sometimes resist following federal laws, however, when it impacts their revenue streams adversely. This can easily be seen with the current division over the state acceptance of federal bonus depreciation rules. Differences of this kind prevent corporations from simply filing a corporate return and then quickly dividing it by 50 and sending a copy to each of the states. Corporations are responsible for reporting revenues produced in the state and matching them against expenses incurred in the state as closely as possible. The same principles exist for cities with income tax laws.

The concept of tax sourcing mentioned earlier is extremely important for state and local income taxation. Tax departments not only need to know the country but the state, county, and city where the revenue was produced and the expenses incurred. Both R/3 and ECC versions of SAP are equipped to capture and supply this information on a consistent basis, if configured as designed.

2.2.1 Apportionment

State and local income tax compliance cannot be done without some degree of allocation for services or assets that benefit all jurisdictions. This leads to what is known as apportionment. *Apportionment*, in basic terms, involves the determination as to which state gets what portion of revenue and expenses that are not clearly assigned elsewhere. Apportionment will be discussed in detail in Chapter 10.

2.2.2 Differences Between State and Local Tax Laws and Federal Government Tax Laws

State and local governments do not always follow the lead of the federal government when they are adversely affected by IRS laws. When configuring
fixed assets, for example, it is good to know that many states opted out of adopting federal bonus depreciation rules because of the negative revenue impact. When tax professionals ask for an additional depreciation area for depreciation without bonus, it is for this reason.

Other differences also exist. The state of California, for example, has different useful lives on many of its asset groupings than the federal government. If the company has substantial business in California, an additional depreciation area for California may also be required. An addition of a depreciation area such as one for California is not very difficult but may take some negotiation nonetheless.

To summarize, here is a list of the main concepts discussed in this section.

- State and local taxation follows federal rules in most areas, but significant differences do exist.
- Tracing revenue and expense from source to destination is extremely important and must be done down to the county and city level.
- Apportionment presents challenges for tax professionals that must be addressed.

### 2.3 Sales and Use Taxes

Sales and use taxes generally get the most attention during SAP implementations. Tax integration in the sales and use tax area requires attention to facilitate as little manual effort as possible. Sales and use tax is an indirect tax as opposed to the taxes discussed earlier in this chapter, which are direct taxes. During the blueprint phase of the project, it is important to address how sales and use tax is approached. Sales and use tax is a transaction-based tax, and SAP software can be configured to handle the tax calculation and consider exceptions when coupled with third-party bolt-on software or even a
client’s custom system. However, SAP software without bolt-on software typically doesn’t perform as well unless the company does business in very few tax jurisdictions.

Important Considerations

Remember from our earlier discussion that determining the source and destination of the transaction is very important to tax departments. And nowhere is it more important than in the area of sales and use tax. Accurate calculation of sales and use tax requires knowledge of the shipping point and the shipping destination. SAP certified bolt-on software exists in the marketplace that can consistently identify the shipping point and the shipping destination to the ZIP code level if SAP is configured correctly.

While sourcing information is required for accurate sales and use tax calculations, how the product will be ultimately used is equally as important. Tax exemptions exist in some jurisdictions for some products. Information concerning the product and its use must be captured in the SAP system if an accurate tax rate is to be applied.

As with other taxes, sales and use tax authorities require legal entity reporting. Income statements and balance sheets are not necessary for sales and use tax compliance, but tax entities are still registered, and compliance is completed on a legal entity basis. Information about the legal entity is also required for accurate reporting. Master data needs to be captured and maintained concerning the legal entity. This includes the corporate name, tax ID number, address, and other pertinent information. The R/3 or ECC company code master file along with configuration settings under company code global parameters will meet this requirement.

A final element to consider is the multitude of jurisdictions that large corporations must deal with. Many corporations have tens of thousands of jurisdictions, each using different report forms and rules with which to comply. Getting sales and use tax right in the implementation can significantly reduce the compliance and audit effort.

The following list summarizes sales and use tax:

- Tracing source and destination to the ZIP code level is required and is possible with bolt-on software.
- Using SAP tax functionality without bolt-on software is not recommended.
Overview of Taxation in the United States

- The ultimate use of the product or service is required for accurate tax calculations.
- Tax authorities require reporting by legal entity and master data concerning the legal entity.
- Large corporations must report to tens of thousands of tax jurisdictions.

2.4 Property Taxes

Property taxes are often not addressed during SAP implementations, but if approached correctly, can pay for the tax integration project many times over! The property tax calculation differs depending on jurisdiction, but generally, it is based on the asset cost and the property tax rate for the given jurisdiction. Property tax therefore has all of the sourcing needs required by other taxes but needs it driven down to the street address level to accurately compute the tax. Many property tax bolt-on systems rely on the five-digit ZIP code that does not get down to the street address level. The tendency is to move to the nine-digit ZIP code that goes to a much lower level.

The buildup of the asset cost provides opportunities for tax savings and will be discussed in more detail in Chapter 11. If items such as sales tax, embedded software, installation fees, and freight can be separated out of the asset cost, considerable savings can be obtained in certain jurisdictions.

**Note**

Most assets subject to property tax are also subject to depreciation. Unfortunately, property tax depreciation differs by tax jurisdiction. Many companies have made adjustments to the property tax depreciation area supplied by SAP, but there is not much benefit when useful lives, depreciation methods, and asset buildup differ from jurisdiction to jurisdiction.

Low-value assets that are expensed for financial purposes but that need to be captured for property tax purposes also present a challenge for tax professionals. SAP approached this challenge by setting up an asset class for low-value assets. However, these assets need to be classified by the type of asset for correct property tax reporting. At the least, this asset class is a catchall that might be preferable to using G/L accounts as many companies have in the past.
To summarize, some property tax integration challenges to consider include the following:

- Location or jurisdiction of the asset
- Cost buildup of the asset
- Asset depreciation
- Low-value assets

2.5 Payroll and Benefit Taxes

Many payroll and benefit issues impact tax professionals besides filing tax returns. Payroll modules are often implemented on a different instance of SAP or even a different software program. Some corporations have payroll functions outsourced to providers such as ADP or Hewitt. In very few cases does the corporate tax department actually prepare and file payroll and benefit tax returns. These tasks are instead usually handled by the payroll department. However, tax departments do have to face and be knowledgeable with IRS auditors when the time comes for an audit. In addition, tax departments rely on payroll numbers for many other tax calculations. Consider these examples:

- Payroll numbers are an integral part of jurisdiction tax returns. When payroll numbers exist in other software systems or on different instances of SAP, tax integration professionals assist with the decisions regarding how and at what level payroll data will be brought into the financial SAP instance.
- Former employees often end up as independent contractors in the same year, which invites an IRS Information Document Request (IDR) as to why.

As you can see, tax departments require information concerning payroll for many purposes other than just filing payroll and benefit tax forms. Some of the payroll issues that can confront tax professionals during SAP implementations include the following:

- Assuring that information is available for payroll and benefit tax returns
- Replying to jurisdictional document requests on audit
- Obtaining proper payroll data for income tax calculations, especially when data is not on the same SAP instance or the same software
2.6 Other Taxes

Many other taxes exist in the United States that may have to be considered by tax integration specialists and SAP configuration specialists during an SAP implementation:

- Customs and duties
- Franchise taxes
- Bottling tax
- Waste tax

Some of these taxes will be addressed in more detail in Chapter 15.

2.7 International Taxation

As mentioned before, the IRS requires reporting of international affiliates and company codes to handle intercompany transactions and other tax matters. Corporations also have local tax requirements for foreign countries that require compliance. This book is limited to taxation within the United States, however, and therefore does not address local country tax requirements. If the implementation involves local country taxes, considerable effort needs to be given to addressing Value-added Tax (VAT) taxes. Bolt-on software now exists for VAT taxes and is becoming more capable of accurate tax calculations on a global basis.

2.8 Record Retention Issues

IT Professionals often ask how long tax data has to be retained. The answer is that tax departments do not know. Ten years might be a good rule of thumb but that is not long enough in all cases. Tax data has to be kept until the tax department says it can be destroyed. IRS regulations state that tax data must be retained for three years from the due date of the return, including extensions. While this seems easy enough, large corporations are constantly under audit, and audits extend the rule just mentioned.
SAP software produces a high volume of information because of its document approach. Although the document approach is a blessing because it provides excellent audit trails, the large amounts of information it creates can impact system performance in a short period of time. For this reason, SAP created an archive system that removes data from the system as needed.

**Archiving-Related Issues and the Data Retention Tool (DART)**

Although SAP archiving helps with system performance, it also presents tax professionals with the following challenges:

- Archiving removes data from the live system so it can no longer be easily accessed by tax professionals.
- Archiving does not maintain the integrity of the accounting period.
- Archived files are not easily queried.

The challenges just outlined led the *America’s SAP User Group* (ASUG) to work with SAP to develop the *Data Retention Tool* (DART) in the late 1990s. DART allows information to be copied from SAP tables and fields prior to archiving, so it is retained for tax audits. DART and archiving will be covered in much more detail in Chapter 6.

Besides, record retention is a legal requirement. See Table 2.1 for a brief list of IRS record retention requirements.

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<td>Internal Revenue Code Section 6001</td>
<td>Requires retention of records supporting federal tax returns</td>
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<tr>
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<td>Governs records created by automatic data processing systems</td>
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<td>Revenue Procedure 97–22</td>
<td>Governs scanned images</td>
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*Table 2.1* IRS Rules Regarding Record Retention for Tax

---

**Example**

I have worked with some companies that have state audits still going on from the 1980s. Unfortunately, this means that electronic books and records must be retained for many years and that IT professionals have to prepare for that.
All of these regulations have specific retention requirements regarding tax departments, and SAP tax professionals should be familiar with them. In addition, Revenue Procedure 98–25 will be addressed in detail in Chapter 6.

In summary, SAP tax professionals dealing with record retention issues need to address the following issues:

- The absence of clear retention guidelines as far as length of time
- Challenges presented by SAP archiving
- Proper implementation of DART or some other retention tool

2.9 Summary

In this chapter, we briefly covered many U.S. taxes that need to be addressed by tax professionals during an SAP implementation. The remainder of this book will cover these taxes in more detail and delve deeper into specific tax calculations that should be addressed during SAP implementations. You also learned in this chapter that U.S. taxation is complex and consists of multiple jurisdictions that have created many layers of tax requirements. Some of these requirements can be categorized into the following areas:

- Federal income tax
- State and local income tax
- Sales and use tax
- Property tax
- Payroll and benefits tax
- Other taxes
- International income tax issues
- Record retention for tax

Chapter 3 will explore the importance of the implementation approach and organization structure as it pertains to tax integration. It also discusses the important role that cost objects play in achieving good tax integration.
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