

# THE LANDSCAPE OF EMERGING SMALL BUSINESS (ESB) TAX COMPLIANCE

## OVERCOMING HURDLES WITHIN YOUR ESB

### — Research Highlights —

The average number of states that ESBs sell into is **25**, but **32%** of ESBs listed identifying sales tax obligations in new states as a top tax management challenge.

**Page 3**

**72%** of ESBs have been audited within the past 5 years, **69%** of those respondents more than once.

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**70%** of ESBs that have been audited have failed that audit. **41%** of these have incurred penalties.

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Best-in-Class ESBs are **38%** more prepared to expand their sales footprint internationally.

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March 2023

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## Overview

This report analyzes the most prevalent challenges and pressures that emerging small business (ESB) organizations face, and explores how they overcome tax complexities to improve their business outcomes and leverage strategies that position them as Best-in-Class leaders.

## Overview and Research Methodology

Emerging small businesses (ESBs) must meet multiple business standards while navigating various state and international sales tax regulations, which can be difficult to manage and ensure compliance. Considering all the hats that small business owners wear, tax compliance is only a portion of their duties. As a result, whether you are an expert in compliance or not, this report will be useful to you.

For the purposes of this Aberdeen study, sales tax is defined as a tax paid to a governing body for the sales of certain goods and services. This tax is often dependent on the product type and location of sale, making it extremely complex and difficult to calculate accurately and efficiently.

Emerging small businesses are defined as organizations with **\$100,000 – \$5 million** in annual revenue. For analysis, this was further broken out into three segments, defined by revenue:

- ▶ Single Owner Home Office (SOHO): \$100k – \$1 million
- ▶ Target ESBs: \$1 million – \$4 million
- ▶ Large ESBs: \$4 million – \$5 million

Aberdeen Strategy & Research conducted a study of 202 tax professionals (see sidebar) with at least some knowledge of tax management at emerging small businesses in the U.S., to discover the pain points and best practices associated with the tax management process, which affects these businesses. These respondents held various roles ranging from managers of finance through C-level executives. Respondents in the study were required to have at least *some* knowledge about sales tax management and to be involved in making decisions about tax management solutions. If readers have no knowledge or experience in tax management, they're not alone as **102 respondents were eliminated** from this study prior to taking the survey for having no knowledge of tax management. Despite this, readers that have no previous tax management experience or familiarity will still find value in the data presented here, as this figure truly shows that many are in the same position and can leverage these findings to begin to plan a better

## Emerging Small Business Tax Management Survey

In February of 2023, Aberdeen Strategy & Research conducted an online survey among **202** tax management decision-makers at businesses with \$100k – \$5 million in annual revenue.

Respondents had at least *some* knowledge about tax management.

**1/3 of the total respondents were screened out of participating** as they disclosed that they had no knowledge of tax management.

## ESB Sizes

 **SOHO**  
(\$100k - \$1 million)

 **Target ESBs**  
(\$1 million - \$4 million)

 **Large ESBs**  
(\$4 million - \$5 million)

and more confident path forward to lessen tax compliance troubles. They'll begin to understand how financial leaders at ESBs understand tax management and their obligations, as well as the challenges and best practices associated with sales tax management.

## Current Landscape of Emerging Small Business Tax Compliance

Emerging small businesses are utilizing many different types of sales channels to sell their products, with over half using direct to consumer, and another 44% utilizing Ecommerce platforms (Figure 1). The study also found that 77% of ESBs use more than one sales channel.

Figure 1: Channels Utilized to Sell Products and Services



**77%**

of respondents use **more than one** sales channel

In terms of target customers, the average number of states that emerging small businesses currently sell into is 25. However, this does vary slightly when broken down by specific ESB size:

- ▶ SOHO: Avg: 22 States
- ▶ Target ESBs: 24 States
- ▶ Large ESBs: 28 States

Selling into new states also brings about new challenges. As ESBs look to expand their footprint and sell into new states, they also must be prepared to tackle additional tax rate rules and regulations that come with selling into additional jurisdictions.

Though 61% of respondents are *considering* selling internationally, only 18% of total ESBs are currently selling internationally (Note: 38% of Large ESBs currently sell internationally). There are substantial barriers that must be overcome to start doing so (Figure 2). ESBs already have



**25**

Average number of states ESBs sell into

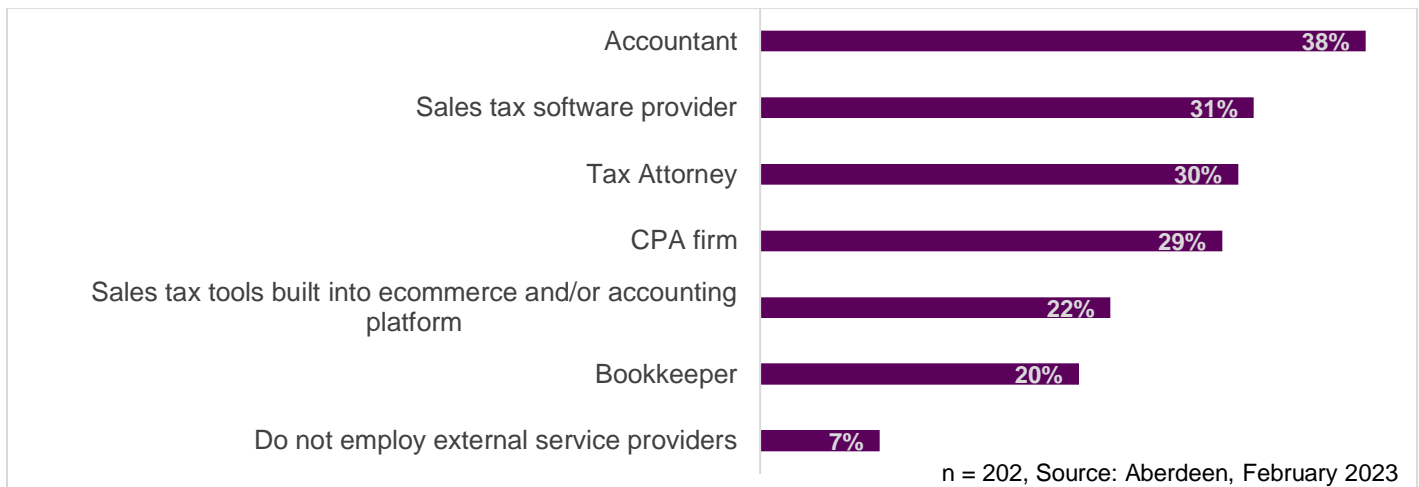
troubles navigating risks when selling domestically, so adding international sales adds an extra layer of complexity. They also run into problems with quality-related customer and regulatory requirements and creating international logistics and selling strategies.

**Figure 2: Barriers to Selling Internationally**



One additional major component in the ESB landscape is outsourcing and how it impacts companies. According to the study, 93% of ESBs outsource some part of their sales and/or use tax compliance process. Bookkeepers are the most utilized external service provider, followed by sales tax software providers, tax attorneys and CPA firms (Figure 3). Not only are a majority of ESBs outsourcing key tax activities, but these external service providers are dedicating an average of 40 hours per month of dedicated work to crucial sales and use tax management activities. This highlights the need for a system that can help streamline critical processes for these companies.

**Figure 3: External Service Providers Utilized in Outsourcing**



## Emerging Small Businesses Must Overcome Several Hurdles in Tax Management in Order to Succeed

Tax rules and rates for emerging small businesses vary state-to-state, so as organizations sell to more states, they need to comply with more and more regulations. Tax professionals at ESBs are feeling pressured by the time spent on overall tax compliance, but also by areas in which staying up to date with different jurisdiction and regulatory changes are crucial such as with sales tax obligations in new states, and differing sales tax rules and regulations (Figure 4).

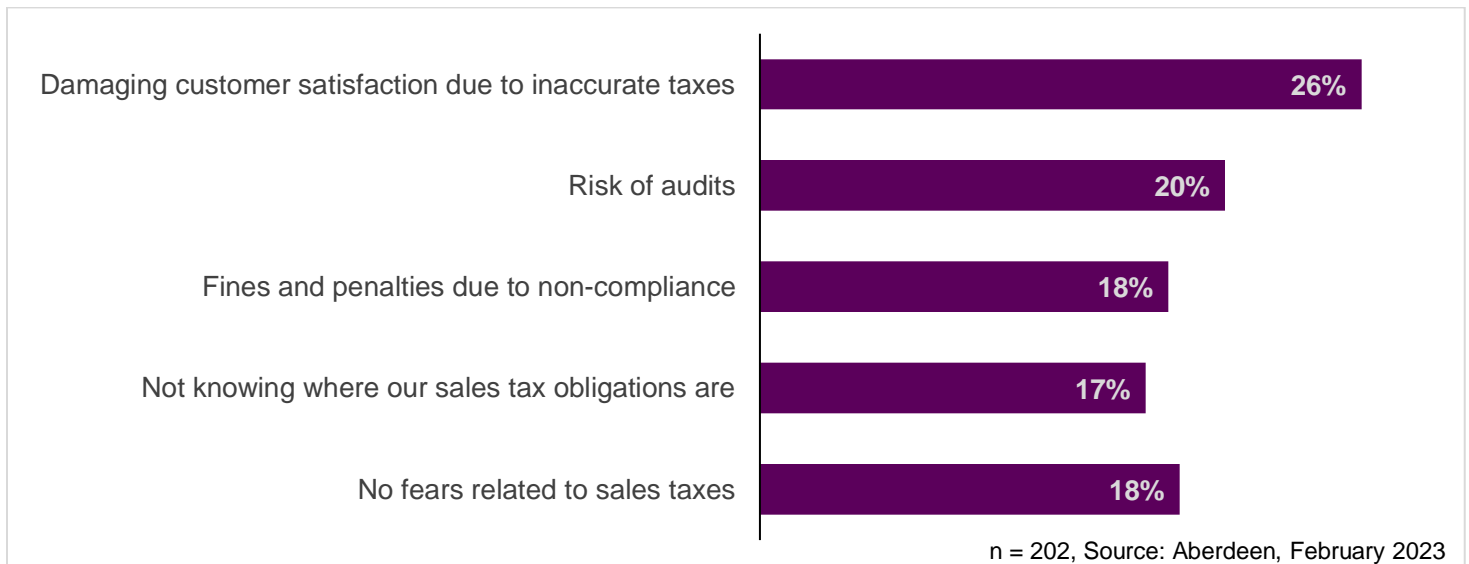
**Figure 4: Key Tax Management Challenges That ESBs Face**



These key challenges do vary when broken down by specific ESB size. SOHO and Target ESBs top challenge remains the time spent on overall tax compliance (**46% and 36% respectively**). However, for Large ESBs, this challenge ranks second-to-last, meaning it isn't much of a challenge for them at all. Interestingly, the main challenge for Large ESBs is pulling information for an audit (**46%**), and this is barely a challenge for SOHO (ranked least challenging) and Target ESBs (second to last) respondents. The study found that there is a perception that the larger a company is, the likelihood of an audit increases which could explain the shift in concern in readying for an audit as the ESBs get larger.

These challenges are always present for ESBs, and are real situations that companies need to overcome, but there are also several fears related to taxes that respondents have top of mind (Figure 5). When looking at the combined data, damaging customer satisfaction due to inaccurate taxes is the top fear that ESBs have (ranked at a 7.3 on a scale of 1–10 on how concerned they are about keeping up with sales tax and regulatory changes). Risk of audits, and fines and penalties due to non-compliance are also major fears.

**Figure 5: Top Fears Related to Taxes**



Similar to the key challenges, the top fears also differ as you analyze the ESBs by size (Table 1).

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### Top Challenges Vary by ESB Size

- **SOHO & Target ESBs:** Time spent on overall tax compliance
  - **Large ESBs:** Pulling information for an audit
-

**Table 1: Top Fears Based on ESB Size**

	Top Fear	2nd Fear	3rd Fear
SOHO	Damaging customer satisfaction due to inaccurate taxes (27%)	No fears related to sales taxes (19%)	Not knowing where our sales tax obligations are (19%)
Target ESBs	Damaging customer satisfaction due to inaccurate taxes (28%)	Risk of audits (22%)	No fears related to sales taxes (19%)
Large ESBs	Fines and penalties due to non-compliance (27%)	Risk of audits (23%)	Not knowing where our sales tax obligations are (23%)

SOHO and Target ESBs are most concerned about damaging customer satisfaction due to inaccurate taxes, where Large ESBs are most fearful of the fines and penalties due to non-compliance. While both Target and Large ESBs second-highest concern is the risk of an audit, not only do SOHO organizations not have this fear, but almost 20% of them said they actually don't have any fears at all as it relates to sales taxes. The same percentage said they fear not knowing where their sales tax obligations are. This can be interpreted that often times having "no fears" really means they aren't even sure of what they should be concerned about. The research found however that **regardless of ESB size, the risk of an audit is always prevalent and something that ESBs should always be prepared for.**

### Audits are Prevalent for ESBs and Can Cause Unexpected Disruption

Audits are something that may not be top of mind for some ESBs, but the research shows that **72% of respondents have been audited in the past 5 years.** More importantly, 69% of those that have been audited have been audited more than once (Figure 6).

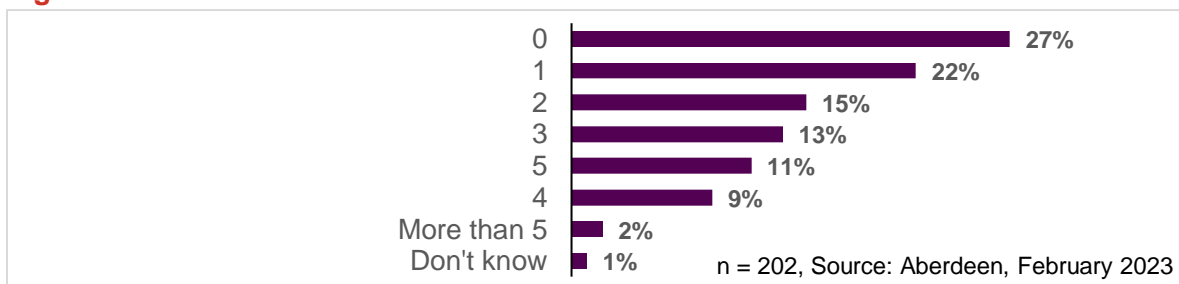
**72%**

of respondents have been audited in the past 5 years

**69%**

of those audited have been audited **more than once**

**Figure 6: Number of Audits in the Past 5 Years**



Audits not only cause stress for those experiencing them, but they also cause a great deal of disruption to the business, with 81% of respondents saying they experienced at least some level of disruption in their role when undergoing an audit. In addition, audits can be lengthy, with 75% of respondents reporting that it took up to a month to complete the audit, but in rare cases it can take up to four months to resolve the audit (see sidebar).

Almost more remarkable than the number of ESBs that have been audited, is the number of those that have failed an audit. The research found that amongst those that have been audited, 70% have failed the audit. The main cause for a failed audit is that the business failed to realize that a product or service was subject to tax (23%) (Figure 7). The next most common reason was the miscalculation of tax rates (21%). Rounding out the top reasons for an audit failure is that the business did not submit the required returns (17%), or had submitted improper documentation (17%).

### Length of Audit

Less than 1 Week: **11%**

1–2 Weeks: **32%**

2–4 Weeks: **32%**

1–2 Months: **15%**

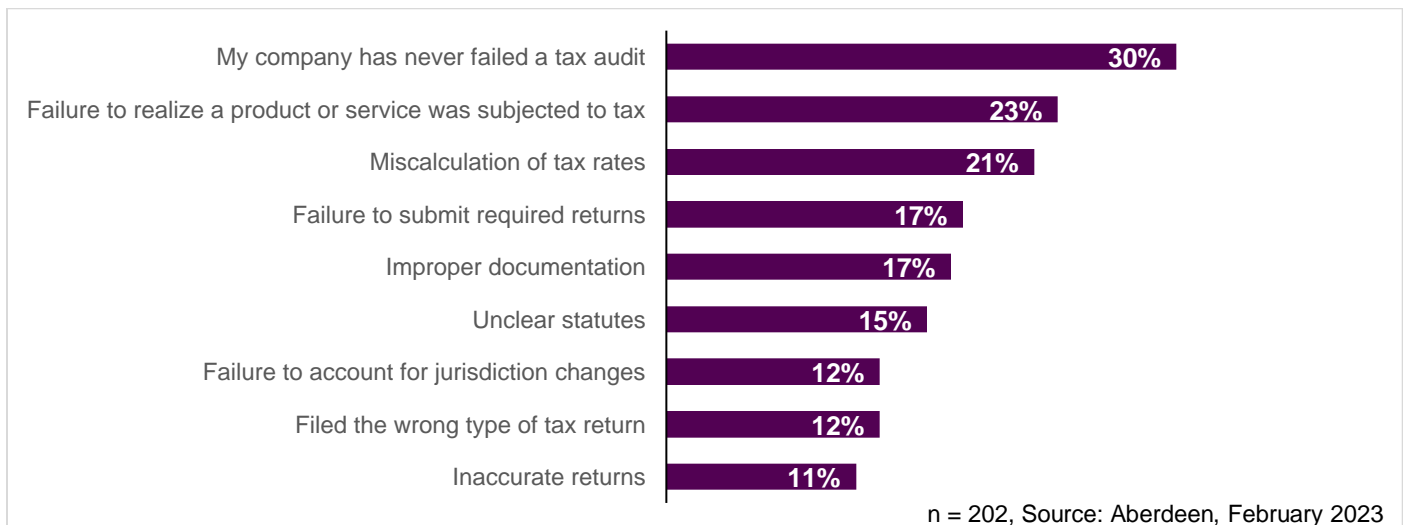
2–4 Months: **9%**

Longer than 4 Months: **1%**

# 70%

of respondents that have been audited have **failed the audit**

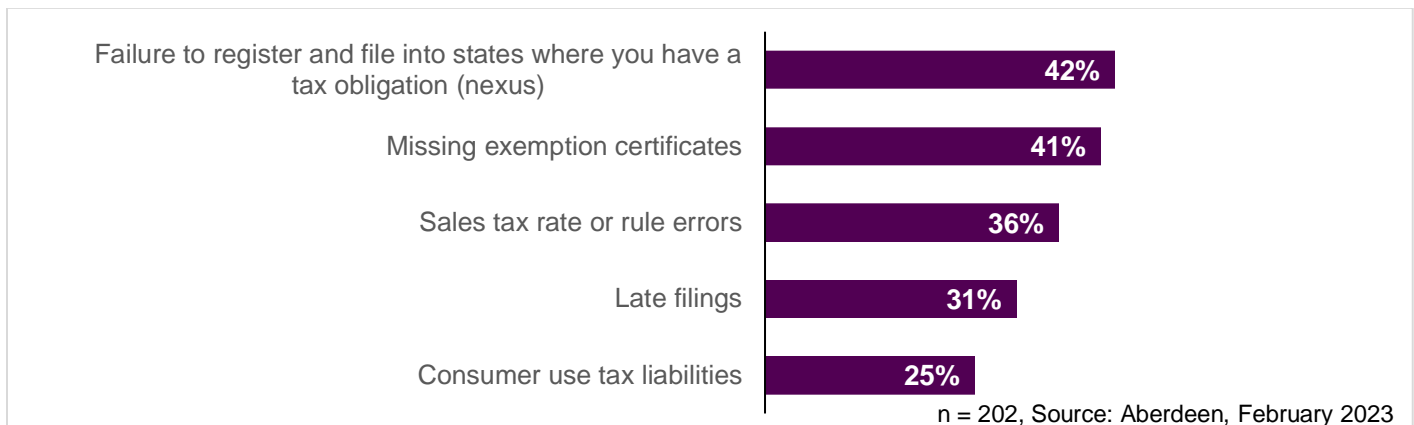
**Figure 7: Top Reasons for Businesses Failing an Audit**



Not only can audits be expensive from a labor perspective, but they can also be costly if penalties were incurred. 41% of respondents had incurred penalties from the audit, for a variety of reasons (Figure 8).



**Figure 8: Top Reasons Penalties Were Incurred from an Audit**



The top reason for incurred penalties was that companies failed to register and file into states where they had a tax obligation (nexus) (42%). Close behind was that they were missing exemption certificates (41%). Sales tax rate or rule errors (36%), late filings (31%) and consumer use tax liabilities (25%) rounded out the top reasons for incurred penalties. The biggest takeaway from the research is that despite the fact that many companies have no fears related to taxes or subsequent audits, with the large percentage of companies that do get audited and have to pay penalties, no business is too small to get audited, and business owners should not be willing to be riskier with their tax compliance process.

## Drive Value and Overcome Challenges by Using Tax Compliance Management Software

Based on the research above, it's evident that tax management burdens are a significant challenge for emerging and small businesses, and tax compliance management solutions are designed to alleviate these burdens. But which technologies and capabilities are the most influential at streamlining and improving the accuracy of calculation and reporting processes? To answer this question, we look at what the Best-in-Class are utilizing.

Best-in-Class organizations are defined by Aberdeen as the top 20% of companies based on their performance in key tax compliance management metrics (see sidebar). Best-in-Class companies have higher accuracy in financial reports, decreased total cost of audits, and fewer time and resources dedicated to monthly tax processing and reconciliation than All Others, resulting in fewer audit costs and greater resource efficiency (Table 2).

To evaluate maturity, Aberdeen classified respondents into one of two categories based on their self-reported performance across several key metrics highlighted in Table 2:

- ▶ **Best-in-Class:** Top 20% of respondents based on performance
- ▶ **All Others:** Bottom 80% of respondents based on performance

**Table 2: Maturity Matrix for Excise Tax Compliance Management**

Performance Metric	Best-in-Class (n=46)	All Others (n=155)
Increase in % of financial reports that were <b>100% accurate</b>	<b>+24%</b>	<b>+3%</b>
<b>Decrease in total cost</b> of audits, including fines/penalties	<b>-16%</b>	<b>-0.4%</b>
<b>Decrease in time/resources</b> dedicated to monthly tax processing and reconciliation	<b>-14%</b>	<b>-4%</b>

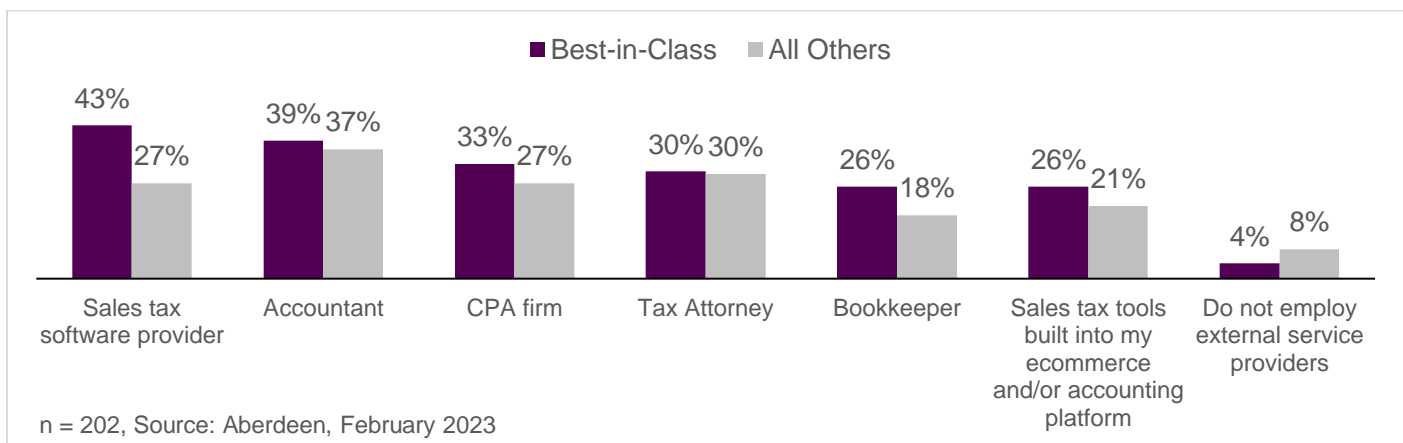
To achieve these higher levels of performance, the Best-in-Class use external software providers for outsourcing sales and use tax compliance (Figure 9) and are **59% more likely** to leverage sales tax software providers than all others.

Best-in-Class ESBs are

**59%**

more likely to leverage **sales tax software providers**

**Figure 9: Types of External Service Providers Outsourced to Manage S&U Tax Compliance**



They are investing in automation to ease the burden on their tax and IT teams and minimize time spent on tedious filing processes. Best-in-Class companies are also more likely to have an automated solution to manage excise tax calculations and are more likely to have an automated solution to manage tax returns.

Greater automation for sales and use tax calculations reduces the number of manual errors and thus costly penalties. Automation for sales and use tax returns eliminates manual data entry and alignment with

changing tax structures, which improves reporting accuracy and frees up employee time for more strategic activities. When combined into a single-source tax management solution, these capabilities become even more powerful.

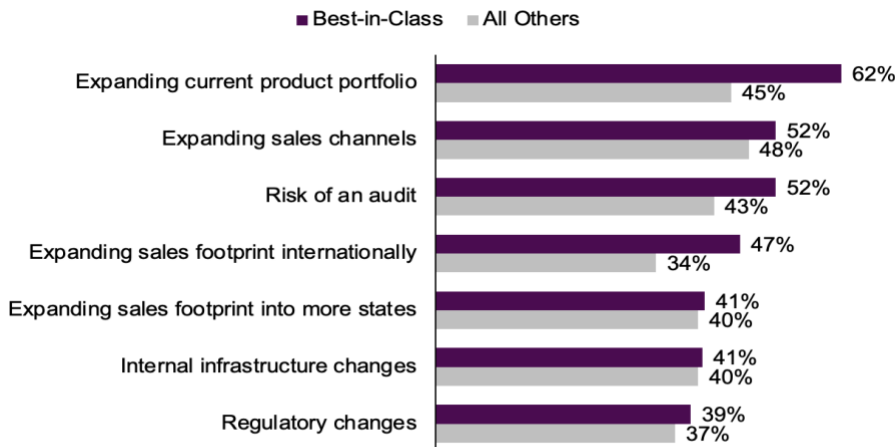
In addition to investing in automation for tax compliance management, Best-in-Class companies integrate their tax management technologies into a single-source solution. Compared to All Others, the **Best-in-Class are 57% more likely to implement a single-source solution** for tax compliance management.

A single-source solution reduces the manual errors and time spent reconciling and aggregating information from multiple disparate data sources. This has helped single-source solution users achieve a greater improvement in not only operating margins, but also in faster time-to-decision. Acting as a centralized location to access information on tax rules and rates, a unified solution makes it easy to keep up with differences in selling not only in multiple states, but **internationally as well**. The time saved by integrating all tax management technologies into one platform can be diverted to decision-making and strategizing growth.

### Best-in-Class Results

Prioritizing automation and integration along with key data management, tax calculation, and tax reporting capabilities, has placed the Best-in-Class above the rest. Best-in-Class ESBs are also better prepared to take on future business changes and plan for growth. Figure 10 shows that the Best-in-Class are **38% more prepared** than all others to expand their current product portfolio.

**Figure 10: Preparedness for Future Business Changes**



% of respondents who are “Extremely prepared”

n = 202, Source: Aberdeen, February 2023

Best-in-Class ESBs are

**57%**

more likely to implement a single-source solution for tax compliance management

Best-in-Class ESBs are

**38%**

more prepared than All Others to **expand their current product portfolio** and

**38%**

more prepared to **expand their sales footprint internationally**

They are also **38% more prepared to expand their sales footprint internationally**. The best-in-class also demonstrate how greater productivity with taxes translates to increased performance metrics.

Best-in-class emerging small businesses experience 94% greater average annual decreases in the time and resources they spend monthly on tax filing than all others (6.6% vs. 3.4%). They also experience nearly 2x greater average annual increase in operating margins than all others (15.4% vs. 5.5%).

## Key Takeaways

Emerging and small businesses need modern solutions to support their tax compliance management processes and alleviate the tax burdens on their tax teams. Best-in-Class companies exhibit the best of modern tax solutions in action, and they deploy comprehensive, unified tax solutions to streamline excise tax management activities. When reflecting on the importance of optimizing excise tax management processes, there are three key points to highlight:

- ▶ **Audits can happen to anyone.** In fact, 72% of ESBs have been audited, and of those, 69% companies more than once. Additionally, 41% of ESBs who have been audited in the past 5 years have incurred penalties. Because a company may be a small business, it doesn't make it any less prone to audits. Companies should be prepared with an efficient and streamlined tax management process to mitigate audit risk.
- ▶ **Best-in-Class companies leverage sales tax software providers to achieve superior results.** The Best-in-Class are 59% more likely to leverage sales tax software providers than all others. As a result, they are seeing greater reductions in time spent on tax management activities and great increases in operating margins. They are also better prepared to manage future business changes and expand their products, channels, and global reach.
- ▶ **Emulate the best-in-class to expand your sales footprint.** Selling internationally is a way to take an emerging small business to the next level. Best-in-class organizations are 38% more prepared to expand their sales print internationally, which helps gain exposure, increased revenue, and sets the ESB up for greater success in the future.

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Best-in-Class ESBs experience nearly

**2x**

Greater **average annual increase in operating margins** than All Others

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## Related Research

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- ▶ [\*The State of Communications Tax: Benchmarking Your Business in 2023\*](#); February 2023
- ▶ [\*The State of Energy and Fuel Tax Compliance: Benchmarking Your Business in 2023\*](#); January 2023
- ▶ [\*The State of Tobacco and Vape Tax Compliance: Benchmarking Your Business in 2023\*](#); January 2023

## About Aberdeen Strategy & Research

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Aberdeen Strategy & Research, a division of Spiceworks Ziff Davis, with over three decades of experience in independent, credible market research, helps **illuminate** market realities and inform business strategies. Our fact-based, unbiased, and outcome-centric research approach provides insights on technology, customer management, and business operations, to **inspire** critical thinking and **ignite** data-driven business actions.

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