Texas Franchise Tax: A Sea Change for Sourcing Services

by Danielle Ahlrich

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In this article, Ahlrich examines recent changes to Texas franchise tax apportionment regarding the sourcing of service receipts arising from the court opinion in *Hegar v. Sirius XM Radio Inc.* and the Texas comptroller's recent rule amendments.

Texas Franchise Tax Apportionment

Texas imposes a franchise tax on each taxable entity that does business in the state or that is chartered or organized in the state.[1] It is a tax on the value and privilege of doing business in the Lone Star State.[2]

To calculate a taxable entity's franchise tax liability, the first step is to determine the entity's "margin." Margin is the taxable entity's total revenue less a subtraction, such as 30 percent of revenue, compensation, or cost of goods sold.[3] Next, a taxable entity must determine its *taxable* margin by apportioning the entity's margin to its business in Texas.[4] To apportion margin, an entity multiplies its "total margin by an apportionment factor," which represents the percentage or fractional proportion of an entity's gross receipts from its business in Texas relative to its gross receipts from its business everywhere.[5] To reach the tax due, the taxable entity then multiplies its taxable margin by the applicable tax rate and subtracts appropriate credits.[6]

Texas Tax Code section 171.103 sets forth high-level sourcing rules for determining gross receipts from business done in Texas — that is, the apportionment numerator.[7] While there are receipt-specific deviations, the general rule for sourcing service receipts provides that Texas receipts include those from "each service performed in this state."[8] The state comptroller then fills in additional details for the statutory apportionment scheme by rule.[9]

Generally speaking, the more receipts apportioned to Texas, the higher a taxable entity's franchise tax liability. Accordingly, understanding *where* a receipt should be sourced is essential to planning for an entity's franchise tax obligation. Unfortunately, recent changes have made this analysis less certain.

The Sources of Apportionment Changes

The two main sources of changes to sourcing service receipts are the *Sirius XM* case,[10] a (not yet

[1] *See* Tex. Tax Code section 171.001(a).

[2] *See Combs v. Newpark Resources Inc.*, 422 S.W.3d 46, 47 (Tex. App. — Austin 2013, no pet.).

[3] *See* Tex. Tax Code section 171.101(a)(1) (determination of taxable entity's "margin").

[4] *See* Tex. Tax Code. section 171.101(a)(2).

[5] *See* Tex. Tax Code section 171.106(a) (describing apportionment); and *Hallmark Marketing Co. LLC v. Hegar*, 488 S.W.3d 795, 796 (Tex. 2016) (explaining that apportionment factor numerator "consists of receipts from business done in Texas and the denominator consists of receipts from all business").

[6] *See* Tex. Tax Code sections 171.101(a)(3) and 171.002 ("Rates; Computation of Tax").

[7] *See* Tex. Tax Code section 171.103(a).

[8] *See* Tex. Tax Code section 171.103(a)(2).

[9] 34 Tex. Admin. Code section 3.591.

[10] *Hegar v. Sirius XM Radio Inc.*, 604 S.W.3d 125 (Tex. App. — Austin 2020, pet. filed).

final!) intermediate appellate decision, and the comptroller's recent amendments to his apportionment rule. *Sirius XM* adopted a unique receipts-producing, end-product act test for sourcing services, which the comptroller codified in his apportionment rule, alongside a host of other significant changes. This article's scope is limited to some of the bigger changes affecting the sourcing of service receipts.

Sirius XM and the Receipts-Producing, End-Product Act Test

Sirius XM concerned the proper apportionment of receipts from satellite radio services. Under Tax Code section 171.103, Texas receipts include the receipts from each service performed in the state.[11] At the time, the comptroller's rule provided that:

> If services are performed both inside and outside Texas, then such receipts are Texas receipts on the basis of the fair value of the services that are rendered in Texas.[12]

Thus, the questions before the court were (1) where Sirius XM performed the service and (2) if an allocation was necessary, how to determine the fair value of services rendered inside and outside Texas.

Most of Sirius XM's operations occurred outside Texas. Sirius XM's headquarters, transmission equipment, and production studios were almost exclusively outside Texas, and its satellites were in outer space.[13] Sirius XM's Texas production was limited to one of its more than 150 channels, for which the host transmitted the programming from his Texas home.[14]

Sirius XM apportioned its subscription receipts based on the locations where it produced its programming for broadcast, using the relative costs of those activities inside and outside Texas.[15] Its approach was consistent with *Westcott Communications Inc. v. Strayhorn*, which rejected a taxpayer's attempt to source receipts from satellite training programs to the locations at which subscribers received the programs and required the receipts to be sourced to the company's Texas headquarters from which the taxpayer created and broadcast the programming.[16]

The comptroller determined that *Westcott Communications* was either distinguishable or wrongly decided and that Sirius XM's service receipts should be sourced using the receipts-producing, end-product act test set forth in a 1980 comptroller hearing decision.[17] According to the comptroller, Sirius XM's receipt-producing, end-product act was not the "production and distribution of" satellite programming.[18] Those were non-receipt-producing, albeit essential, support activities.[19] Instead, the receipt-producing, end-product act was the actual performance of audible radio service for the customer.

The court of appeals ultimately agreed that the receipt-producing, end-product act test was a proper means of determining where performance of a service occurs.[20] Applying the test, the court found that "the service for which Sirius XM's customer contracted, and that resulted in the subscription revenue at issue, was the receipt of Sirius XM programming."[21] The receipt-producing, end-product act that allowed each Sirius XM customer to receive Sirius XM programming occurred at the location of the satellite-enabled radio where Sirius XM decrypted the program.[22] Thus, the court held that the comptroller had correctly presumed that the relevant act occurred at the location where the Sirius XM customer resided. Accordingly, the court sourced 100 percent of Sirius XM's receipts from Texas subscribers as Texas receipts.[23] No

[11] Tex. Tax Code section 171.103(a)(2).

[12] 34 Tex. Admin. Code section 3.591(e)(26) (2009) (before 2021 amendment).

[13] *Sirius XM*, 604 S.W.3d at 128.

[14] *Id.*

[15] *Id.* at 129.

[16] *Id.* at 133-34; *see also Westcott Communications Inc. v. Strayhorn*, 103 S.W.3d 141. The court of appeals attempted to factually distinguish these two satellite programming providers by arguing that the substance of the service in *Westcott* was training programs for customers with specific needs, while Sirius is providing only standard programming. *Sirius XM*, 604 S.W.3d at 134-35. The statute and rule made no such distinction.

[17] *Id.* at 134-35.

[18] *Id.* at 131.

[19] *Id.* at 132.

[20] *Id.*

[21] *Id.* at 133.

[22] *Id.*

[23] *Id.* at 132.

Texas versus out-of-state fair value allocation was necessary.

Unsurprisingly, Sirius XM appealed the decision to the Texas Supreme Court, where it is pending. However, review by the Texas Supreme Court is discretionary. The court has ordered briefing on the merits, which indicates interest in the case, but it could still deny review.

Sirius XM's complaints about the intermediate appellate court's opinion attack both the adoption of the receipts-producing, end-product act test *and* the court's application of the test (because Sirius XM does not perform the act of decryption in Texas). Several amicus parties have weighed in to express concern that the opinion shifts the sourcing test from cost of performance to market-based sourcing or impermissibly mixes the two, is inconsistent with sound judicial precedent, and employs an unclear standard that invites ambiguity and ad hoc rulings that will likely favor the comptroller.

The Comptroller's Rule Amendments

Several Changes Are Retroactive

Effective January 24, the comptroller adopted sweeping amendments to his apportionment rule.[24] The changes incorporate statutory amendments, define new terms, modify existing definitions, incorporate current comptroller policy, and change various sourcing provisions.

The comptroller adopted these changes despite objections from a wide range of stakeholders, many of whom voiced concerns about retroactivity because not all changes were given a prospective effective date. As noted in the comments submitted by the Texas Taxpayers and Research Association, retroactive provisions can result in higher tax bills, surprise audit assessments, and in some cases, require a restatement of financial filings, all of which could cause severe duress for many taxpayers.

Nonetheless, the comptroller proceeded to adopt changes with varying effective dates, so taxpayers must be mindful that some provisions are retroactive. For example, the changes to the general rule for sourcing services do not state an effective date, so they are retroactive to 2008. In contrast, the sourcing rule for receipts from internet hosting services (IHSs) is retroactive to 2014.

Key Changes to Service Sourcing Rules

General Services Rule

The comptroller's general rule for services still tracks the statutory requirement that service receipts be "sourced to the location where the service is performed."[25] But the rule now defines the term "location of performance" as the location of the "receipt-producing, end-product act or acts."[26] If such act(s) exist, all the receipts are sourced to that location, and "the location of other acts will not be considered even if they are essential to the performance of the receipts-producing acts."[27] However, if there is no such act, then "the locations of all essential acts may be considered."[28]

If the inquiry reveals that services are performed both inside and outside Texas for a single charge, the rule now provides additional guidance on how to determine the fair value of the services performed in Texas.[29] The rule prefers units of service (for example, hours worked) as a metric over costs of performance.[30] If costs are considered, overhead costs should be excluded.[31]

The comptroller does not view the amendments as a blanket adoption of market-based sourcing for service receipts. Rather, as recognized in an article drafted by the comptroller's special counsel for tax litigation, there may be situations in which Texas's unique receipts-producing, end-product act test dictates sourcing based upon customer location (which would align with market-based sourcing) and other times it will not.[32] In situations involving a paying audience, the comptroller appears to have

[24] 46 Tex. Reg. 460 (Jan. 15, 2021).

[25] 34 Tex. Admin. Code section 3.591(e)(26)(A) (effective Jan. 24, 2021).

[26] *Id.*

[27] *Id.*

[28] *Id.*

[29] *See id.* section 3.591(e)(26)(B).

[30] *Id.*

[31] *Id.*

[32] Ray Langenberg and Matt Jones, "Sourcing Service Receipts for Franchise Tax Apportionment in Texas," 49 *St. Mary's L.J.* 583, 603 (2018).

staked out the position under the receipts-producing, end-product act test that receipts paid by the audience will be sourced to the audience location and preparatory acts will be disregarded.[33] In contrast, the comptroller seems to allow the sourcing of professional service receipts to be based on the preparatory activities, even though professional services may often result in an end product (for example, a report or a tax return that is delivered to the client).[34]

Whether the flexibility in the comptroller's amended rule provides a workable standard remains to be seen. Its validity may be affected if the Texas Supreme Court grants review of *Sirius XM* and declines to adopt the receipts-producing, end-product act test as a reasonable interpretation of the governing statute. In that event, the comptroller's rule would be in conflict with the high court's construction of the prevailing statute and, thus, presumably invalid.[35]

IHSs

The comptroller's rule amendments also added language to implement the 2013 enactment of Tax Code section 171.106(g), which provides that a receipt from internet hosting is a Texas receipt if the customer to whom the service is provided is located in the state. The Tax Code defines internet hosting by reference to Texas sales and use tax language defining the term as "providing to an unrelated user access over the Internet to computer services using property that is owned or leased and managed by the provider and on which the user may store or process the user's own data or use software that is owned, licensed, or leased by the user or provider. The term does not include telecommunications services."[36]

Considering the statutory definition's breadth of an IHS, the new apportionment rule begins with examples of what the comptroller considers to fall within and outside the definition. An IHS includes real-time, nearly real-time, and on-demand access to computer services over the internet, such as data storage and retrieval, video gaming, database search engine services, entertainment streaming services, data processing, and marketplace provider services.[37] An IHS does not include telecommunication services, cable TV services, internet connectivity services, internet advertising services, or internet access solely to download digital content for storage and use on the customer's computer or electronic device.[38]

The comptroller's rule also provides nine factors for distinguishing an IHS from the purchase or lease of digital property over the internet, which is sourced under different rules.[39] The factors tend to point toward an IHS over digital property, and comptroller representatives have already cautioned taxpayers against using the factors in the Texas sales and use tax context.

Receipts from an IHS are sourced to Texas if the customer is located in Texas.[40] The customer's location is determined by the physical location where the purchaser *or the purchaser's designee* consumes the service.[41] Thus, the rule invokes a look-through feature focused on the ultimate consumer, or end-user, especially in a resale situation.[42] Taxpayers are instructed to make a good-faith determination of the location of consumption, using the most reasonable method under the circumstances and considering the information reasonably available.[43] The rule further provides that receipts from some services may be soured to multiple customer locations or to multiple customers and gives several examples of potential customer locations.[44] The comptroller has stated a willingness to be flexible while the agency and taxpayers sort out the new rule, but the rule's amendment preamble reminds taxpayers that their sourcing method "will be

[33] *Id.* at 607.

[34] *Id.* at 608.

[35] Tex. Tax Code section 111.002(a) ("The comptroller may adopt rules that do not conflict with the laws of this state or the constitution of this state or the United States for the enforcement of the provisions of this title and the collection of taxes and other revenues under this title.").

[36] 34 Tex. Admin. Code section 3.591(e)(13)(A); and Tex. Tax Code section 151.108(a).

[37] 34 Tex. Admin. Code section 3.591(e)(13)(B).

[38] *Id.* section 3.591(e)(13)(C).

[39] *Id.* section 3.591(e)(13)(D); *see also id.* section 3.591(e)(3) (sourcing of digital products).

[40] *Id.* section 3.591(e)(13).

[41] *Id.* section 3.591(e)(13)(E) (emphasis added).

[42] 46 Tex. Reg. 463.

[43] 34 Tex. Admin. Code section 3.591(e)(13)(E).

[44] *Id.*

subject to audit review for reasonableness under the circumstances."[45]

Providers of software as a service (SaaS) should familiarize themselves with the IHS rule because it seems like a statutorily based switch to market-based sourcing, although the comptroller would likely counter that the fact that a service may be performed where the market is located does not necessarily mean that Texas has switched to market-based sourcing. Regardless, taxpayers typically sourced SaaS receipts under the general services rule found in subsection (e)(26), which (before *Sirius XM*'s introduction of the receipts-producing, end-product act test) many taxpayers treated as requiring a cost of performance analysis. Considering that the IHS sourcing change is retroactive to report year 2014, many SaaS providers might find themselves with a fair amount of exposure or overpaid tax if they are to source based upon customer location.

Advertising

The comptroller's recent amendments also consolidated various advertising rules for different media into a single provision. The rule now provides that receipts from the dissemination of advertising (for example, radio, television, and magazines) are sourced to the locations of the advertising audience.[46] To mitigate the impact of a retroactive change, the rule provides that for reports due before report year 2021, advertising receipts attributable to a radio or television station transmitter in Texas may be sourced to Texas.[47]

As noted by comptroller representatives, the rule does not apply to all advertising receipts, but only to those generated by the *dissemination* of advertising. That term is not defined.

Similar to IHSs, the locations of the advertising audience should be determined in good faith and using the most reasonable method under the circumstances, considering the information reasonably available.[48] The rule provides examples of potential reasonable locations to help guide taxpayers.[49] The rule also provides that if the locations of nationwide advertising audiences cannot otherwise be reasonably determined, then 8.7 percent of the gross receipts may be sourced to Texas.[50] Comptroller representatives have resisted characterizing this rule change as a switch to market-based sourcing, and the amendments' preamble states that the advertising sourcing rule is consistent with the amendments to the general sourcing rule, which find a service to be performed at the location of the receipt-producing, end-product act.[51]

Conclusion

Sirius XM and the comptroller's rule changes have substantially overhauled Texas franchise tax apportionment of service receipts. Whether these changes provide workable standards remains to be seen. However, despite the potential headaches, some rule changes may present opportunities for refunds (based on retroactive provisions) or prospective reductions in franchise tax bills. But whether the changes are friend or foe, it is imperative that taxpayers fully understand the new rules. ■

[45] 46 Tex. Reg. 463.

[46] 34 Tex. Admin. Code section 3.591(e)(1).

[47] *Id.*

[48] *Id.*

[49] *Id.*

[50] *Id.*

[51] 46 Tex. Reg. 461.