



TaxNewsFlash

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Texas: Revised rule for sourcing receipts, revised apportionment regulation

A final version of a revised administrative rule—34 TAC § 3.591 “Margin; Apportionment”—was published in the Texas Register on January 15, 2021.

Read the regulation as published in [46 Texas Register](#) [PDF 458 KB] on page 460.

KPMG observation

This release significantly revises the rules for sourcing receipts to Texas, and taxpayers engaged in almost all service industries will be affected by these changes. The final version does not specify that the revised rule applies prospectively only, and the explanatory text in the Texas Register provides that many of the additions or revisions are expositions of existing policy of the state Comptroller. For example, the revised general rule for sourcing service receipts “is an exposition of the Comptroller’s current interpretation of the sourcing statute, which has been endorsed in part by the Court of Appeals opinion in the *Sirius XM Radio* litigation.”

Incorporation of the “*Sirius XM*” decision

Many of the significant changes to the regulation focus on the sourcing of service receipts. Under Texas law, receipts from providing a service are apportioned to the location where the service is performed. If the service is performed both inside and outside Texas, then the receipts are attributed to Texas in proportion to the *fair value* of the service that is rendered in Texas.

The final regulation adds guidance on interpreting the location where a service is considered performed. Generally, a service will be performed at the location of the receipts-producing, end-product act or acts. This new test generally aligns with language adopted by the appellate court decision in *Hegar v. Sirius XM Radio, Inc.* In that case, the court held that the receipts-producing end-product act associated with the provision of satellite radio service was the taxpayer activating a customer’s chip set in a satellite-enabled radio. This occurred where the customer’s radio was located (likely to be the customer’s residence where the customer’s car was located). The *Sirius XM* case is not yet final; the taxpayer’s petition for review before the Texas Supreme Court is pending.

The regulation further provides that if there is a receipts-producing, end-product act, the location of other acts will not be considered even if they are essential to the performance of the receipts-producing act. This is also consistent with *Sirius XM* decision because the appeals court held that producing programming content for satellite radio stations was a non-receipt-producing act, albeit an essential one.

KPMG observation

The revised rule provides scant guidance on how a taxpayer is to determine the receipts-producing, end-product act associated with a service. If there is no receipts-producing, end-product act associated with the service (and again, it is not clear in the rule when this would be the case), then the locations of all essential acts may be considered in determining where a service is performed. However, beyond directing the taxpayer to consider all essential acts to determine the location where a service is performed (assuming there is no receipts-producing, end-product act), the rule provides no examples or guidance on how to measure those essential acts and to reach a conclusion as to the ultimate location where the service is performed.

If services are performed in Texas and another state for a single charge, a fair value analysis is required, and the finalized regulation provides guidance on determining fair value as well as a few examples that illustrate that for certain types of services (e.g., legal services), the fair value analysis will apply and receipts will be sourced proportionately based on where the legal services are performed.

Capital assets and investments

The final regulation also revises the rules around capital assets and investments, and clarifies that only the net gain from the sale of a capital asset is included in gross receipts. A net loss from the sale of a capital asset or investment is not included in gross receipts. Net gain or loss is determined separately for each sale of a capital asset or investment.

This is a substantive change, and the final regulation notes that for reports originally due prior to January 1, 2021, a taxable entity may add the net gains and losses to determine total gross receipts from such transactions. If the combination of net gains and losses results in a loss, the taxable entity may not net the loss against other receipts. The net gain from the sale of a capital asset or investments is sourced based on the type of asset or investment sold.

New definitions and sourcing rules

The final regulation includes new and revised definitions and provisions addressing the sourcing of certain types of receipts and services—including advertising receipts, loan-servicing activities, and internet-hosting services. A new provision consolidates the sourcing rules for advertising receipts across all media. “Advertising receipts,” as defined, are sourced to the location of the advertising audience, which can be determined, in good faith, by the physical locations of the advertising, the recorded locations of the advertising audience, and the locations listed in published rating statistics. If the locations of nationwide advertising audiences cannot otherwise be reasonably determined, then 8.7% of the gross receipts are sourced to Texas. For reports originally due prior to January 1, 2021, advertising receipts attributable to a radio or television station transmitter in Texas may be sourced to Texas.

The guidance on sourcing “loan-servicing” fees has been updated to provide that gross receipts from servicing loans that are not secured by real property are sourced under the general rule addressing services.

The revised regulation creates a new category of receipts for certain internet-related services and adopts market-based sourcing rules for these services that generally looks to the physical location

where the purchaser consumes the service. Certain of these services extend beyond what might be ordinarily be thought of as internet-hosting services.

"Internet-hosting service" is newly defined to include real-time or on-demand access to several computer services, including but not limited to, data storage and retrieval, video gaming, database search services, entertainment streaming, data processing, and marketplace-provider services. "Internet-hosting" excludes telecommunication services, cable television services, along with internet-connectivity services, internet advertising, and internet access to only download digital content. Receipts from internet hosting are generally considered Texas gross receipts if the customer is located in Texas. The customer location is determined by the physical location where the purchaser or the purchaser's designee consumes the service. The location is to be determined in good faith, using the most reasonable method under the circumstances and considering the information reasonably available. Receipts from some services may be sourced to multiple customer locations or to multiple customers. Locations that may be reasonable under the circumstances include the customer's principal place of business, the customer's business unit that is using the computer services, the delivery addresses for individual units of services provided to the customer, the primary place or places of consumption by the customer, the service address of the customer, the billing address of the customer, or a combination of methods. Numerous examples are provided to illustrate these provisions.

The current rule that addresses "computer software services and programs" has been revised to provide guidance on sourcing receipts from "computer hardware and digital property." The finalized regulation includes several new examples.

The revised regulation also makes minor changes to the provisions addressing the sourcing of interest, which continues to be sourced to the location of the payor. A new provision clarifies that interest received from a national bank is a Texas gross receipt if the bank's principal place of business is in Texas, or the bank is organized under the Texas Banking Code. Interest on federal obligations that is excluded from total revenue and interest exempt from federal income tax is excluded from gross receipts entirely.

In addition, the final regulation provides guidance on the sourcing of the sale of a single member limited liability company (SMLLC). The sale of an SMLLC interest is considered the sale of an interest in an intangible asset and is to be sourced to the location of the payor.

KPMG observation

These comprehensive rule changes will require companies to take a fresh look at how they are sourcing receipts for Texas franchise tax purposes.

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