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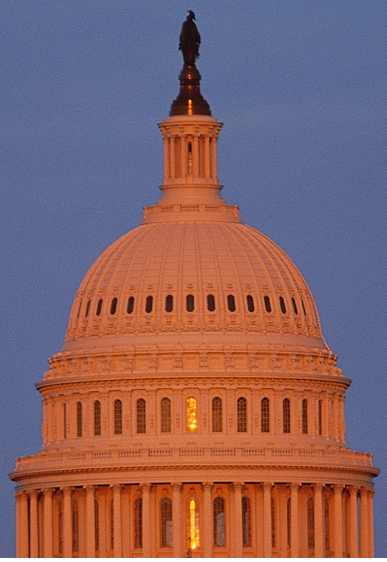

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# Texas: Leasing company entitled to use lower wholesale franchise tax rate; Texas high court to review satellite radio sourcing rules

A Texas state appeals court held in *Hegar v. Xerox* that an office equipment company was entitled to use the lower franchise tax rate applicable to wholesalers.

The Texas Supreme Court has also agreed to review a lower court decision holding that a satellite radio provider's services were sourced based on where a customer utilized its satellite radio.

**Franchise tax rate, leasing company**

The key dispute in *Hegar v. Xerox* was whether the taxpayer was entitled to use the lower rate applicable to wholesalers.

The taxpayer distributed high-end printing systems and related supplies, as well as provided maintenance services. Certain customers purchased the equipment, whereas others rented the equipment or entered into finance/sales-type leases or operating leases. Under FAS 13, the revenue from the taxpayer's sales-type leases was treated as sales revenue recorded at the inception of the lease.

For franchise tax purposes for the 2008 and 2009 reporting years, taxpayers "primarily engaged in retail or wholesale trade" were entitled to use a 0.5% rate (note that the rate currently is 0.375%). The taxpayer filed its reports using the 0.5% rate on the basis that its total revenue from wholesale activities was greater than the total revenue from other activities. The Comptroller disagreed that the taxpayer qualified for the reduced rate and also alleged that the taxpayer's costs of goods sold (COGS) deductions for the report years were overstated. After the taxpayer paid the assessment under protest, the matter went to trial. At trial, the court determined that the taxpayer was entitled to use the rate applicable to wholesalers and rejected the Comptroller's counterclaim on the COGS issue. The Comptroller timely appealed.

"Wholesale trade" for franchise-tax purposes means "the activities described in Division F of the 1987 Standard Industrial Classification Manual published by the federal Office of Management and Budget." Division F "includes establishments or places of business primarily engaged in *selling* merchandise to retailers; to industrial, commercial, institutional, farm, construction contractors, or professional business users; or to other wholesalers. . . ." [Emphasis added.] To qualify as being in a wholesale trade, a business entity must be engaged in selling. There is no definition of the term "selling" in Division F. The Comptroller argued that the taxpayer was not engaged in the business of selling when it leased equipment to customers because title to the equipment never passed to the customer. In other words, the Comptroller's position was that "selling" required the transfer or passage of title. The Comptroller also challenged the trial court's conclusion that the sale-types leases constituted wholesale trade revenue.

At the outset, the Fourteenth Court of Appeals noted that whether the ordinary meaning of "selling," "sold" or "sale" requires the transfer or passage of title appeared to be an issue of first impression in Texas. Without any statutory guidance as to the intended definition, the appellate court concluded that the ordinary meaning of a "sale" or "selling" does not require a transfer of title, but does require the transfer of the item being sold (i.e., the equipment in this case). The appeals court next turned to address that while the sales-type leases were referred to as "leases," the court applied a substance-over-form analysis and concluded that it was proper to classify the revenue from sales-type leases under FAS 13 as revenue from sales falling within the scope of wholesale trade under Division F. The appeals court then rejected the Comptroller's position that the taxpayer's revenues from wholesale activities were not greater than its revenues from other activities. Applying much of the same analysis to the COGS issue, the court rejected the Comptroller's contentions that the trial court erred when it failed to reduce the taxpayer's COGS deduction.

**KPMG observation**

It is not yet known whether the Comptroller will appeal, but the court's holding that a "sale" does not necessarily involve the transfer of title may be beneficial for other taxpayers that are transferring possession of goods.

**Source of service receipts, satellite radio**

The Texas Supreme Court on September 3, 2021, agreed to review a case (*Hegar v. Sirius XM Radio)* addressing how taxpayers are to source service receipts, and set oral arguments for November 30, 2021.

Under Texas law, receipts from providing a service are apportioned to the location where the service is performed. If services are performed both inside and outside Texas, then the receipts are attributed to Texas in proportion to the **fair value** of the services that are rendered in Texas. In this case, the Third Court of Appeals held that a service was deemed performed where the "receipts-producing end-product act" associated with service occurred. In that court's view, the provision of satellite radio service involved the taxpayer activating a customer's chip set in their satellite-enabled radio. The court held that this activity occurred where the customer's radio was located, which was likely the customer's residence where their car was located.

Earlier this year, Texas Comptroller Rule § 3.591, which sets forth the apportionment rules for the Texas franchise tax, was revised to align with the *Sirius XM* holding that a service is performed at the location of the receipts-producing, end-product act or acts.

At least four amicus briefs were filed urging the Texas Supreme Court to hear the case. Collectively, the briefs point out that the *Sirius XM* decision conflicts with the 2003 *Westcott* decision from the same appellate court, which addressed similar facts. The briefs also note that the holding in the case coupled

with the rule change that, per the Comptroller, is "a straightforward reading of the Tax Code as embodied in existing precedent," creates significant uncertainty for taxpayers for both past and future tax years.

**KPMG observation**

Although the Comptroller has incorporated the "receipts-producing, end-product act" test into a rule, it is arguably a strained interpretation of the statute, which looks at where services are performed. To the extent the Texas Supreme Court rejects the lower court's application of this test as a means of determining where a service is performed, such a holding may invalidate the Comptroller's rule. Service providers will want to carefully consider how service receipts should be sourced on 2021 reports.

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