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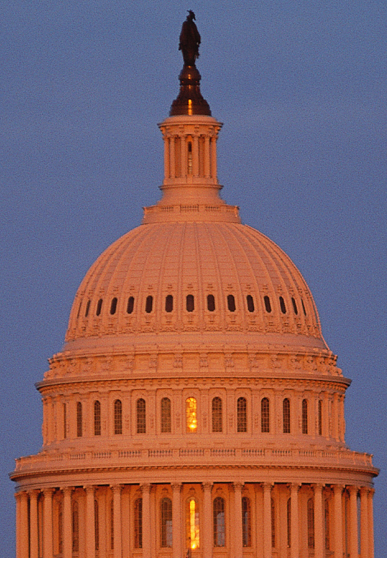

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Texas: Comptroller's sourcing position in satellite radio case rejected by state's high court

The Texas Supreme Court today issued a decision reversing a state appellate court's decision addressing how satellite radio subscription revenues are sourced for Texas franchise tax purposes.

The case is: *Sirius XM Radio, Inc. v. Hegar,* No. 20-0462 (Tex. March 25, 2022). Read the Supreme Court's **opinion** [PDF 184 KB]

The Texas Supreme Court rejected the Comptroller's use of the "receipt-producing, end-product act" test to determine where a service is performed. Instead, the high court focused on the statutory language that requires receipts from services to be sourced to Texas if the services are performed in Texas, and the court concluded that a service is performed in Texas when a taxpayer's personnel or equipment is physically doing useful work for the customer in Texas.

Background

Under Texas law, receipts from performing 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.

The taxpayer (an out-of-state headquartered entity) developed, produced, and delivered radio programming via satellite to customers across the United States. Almost all of the taxpayer's production and transmission equipment was located outside Texas. Additionally, most of the taxpayer's audio content was produced and transmitted outside of Texas, although there were a few programs transmitted from Texas at various times.

On its originally filed returns, the taxpayer apportioned its subscription revenues based on the locations where its primary production facilities were located, which was primarily outside Texas.

The Comptroller reapportioned the subscription receipts to Texas based on the locations where the satellite transmissions were received by the taxpayer's customers. In the Comptroller's view, the taxpayer was performing the service of "unscrambling a radio signal"—not the production of satellite programming—and this service was performed "at the radio receiver" (i.e., the customer's location).

Refund suit, lower court decisions

The taxpayer paid the assessment, then filed a refund suit. After a trial, the district court concluded that Texas uses an origin-based method, and the apportionment factors reported on the original return were consistent with the fair value of the taxpayer's services performed in Texas.

On appeal, the Texas appellate court (Court of Appeal, Third District) reversed. In the appeals court's view, the "receipt-producing, end-product act" that allowed each of the taxpayer's customers to receive satellite radio programming occurred when the taxpayer decrypted the program by activating (or deactivating) the customer's chip set in the satellite-enabled radio. This act was performed where the satellite-enabled radio (i.e., a customer's car) was located, which could reasonably be presumed to be where the taxpayer's customer resided. As such, the act was considered to be performed in Texas when a customer resided in Texas, and there was no need to resort to a fair value analysis.

The taxpayer subsequently petitioned the Texas Supreme Court for review.

Texas Supreme Court decision

Noting that there was no reason to depart from "straightforward understandings of the everyday words" that the apportionment statute used, the Texas Supreme Court determined that a service is performed in Texas if the labor for the benefit of another is done in Texas. This conclusion was supported by previous Texas case law, including the *Westcott* decision (2003) that almost directly contradicted the appellate court decision in the instant case.

In determining where the taxpayer performed its services, the Texas Supreme Court declined to focus narrowly on the act of "decrypting" a customer's radio, which the appellate court had determined occurred in Texas.

> *Characterizing the service [the taxpayer] performs for Texans as 'decryption of radio sets in Texas' is like saying the service performed by The Wall Street Journal Online is a 'paywall-removal service,' rather than the creation and distribution of news and opinion content its subscribers want to read.*

Rather, the Texas Supreme Court determined that the taxpayer had little personnel or equipment in Texas that performed the radio production and transmission services for which its customers paid monthly fees. As such, the lower appellate court's decision was reversed, and the case was remanded to consider whether the taxpayer offered sufficient evidence at trial to support its fair value analysis as to the limited number of services performed in Texas.

KPMG observation

In its decision, the Texas Supreme Court observed that the "receipt-producing, end-product act" test had first been applied in the context of determining what qualified as a service performed—not the location where the service was performed. In the Texas Supreme Court's view, using this test to determine the location of the service was inconsistent with the statute because mechanical application of the test would often require courts to focus on the location where the service is received.

The legislature, however, chose not to look to receipt location but to source receipts to where a service is performed.

> *The focus should be on the statutory words themselves, not on extraneous concepts like receipt-producing or end-product act, which do not appear in the statute and, when applied, may or may not yield the same result as a straightforward application of the words chosen by the Legislature.*

Last year, the "receipt-producing, end-product act" test was incorporated into Administrative Rule § 3.591 Margin; Apportionment. To the extent the test is inconsistent with the Supreme Court's interpretation of the statute in the instant case, the rule may be invalidated.

Tax professionals have observed that this decision is a significant victory for service providers located outside Texas, as it reiterates that the proper focus is where a provider's equipment and personnel are located. And to the extent that services are performed both within and without Texas, a fair value analysis is crucial to support the allocation of service receipts on audit.

For more information, contact a KPMG State and Local Tax professional:

Jeff Benson | jefferybenson@kpmg.com
Steve Lyell | slyell@kpmg.com
Doug Maziur | dmaziur@kpmg.com

kpmg.com/socialmedia