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Texas: Fair value analysis under satellite radio sourcing rules for franchise tax purposes (appeals court decision)

The Texas Third Court of Appeals issued the latest decision in a dispute concerning how satellite radio subscription services are sourced for Texas franchise tax purposes.

The case is: *Hegar v. Sirius XM Radio*.

Background

The case was back before the appeals court on remand after the Texas Supreme Court invalidated the “receipts producing end product act” test that the Comptroller had applied—and that the appeals court had upheld—to source the taxpayer’s receipts. Under this test, it was determined that the taxpayer performed its services “at the point of decryption” with the chip in the subscriber’s radio that enables the subscriber to listen to the programming. As a result, the appeals court had originally concluded that receipts from Texas subscribers were from “a service performed in this state.”

The Texas Supreme Court disagreed and held that receipts are sourced to Texas if the service is performed in Texas. If services are performed in more than one state, a fair value analysis is done to determine the extent to which the receipt is attributable to Texas. In the court’s view, to apply this test requires looking to the physical location of the taxpayer’s personnel or equipment that performs the service for which the customer pays. Applying that standard, the court rejected the Comptroller’s contention that the taxpayer performed its service where its transmission was decrypted. Rather, the court concluded that the relevant service provided by the taxpayer was radio production and broadcasting and that the taxpayer “has little personnel or equipment in Texas that performs the radio production and transmission services for which its customers pay monthly subscription fees.” The court then remanded the case to the appeals court to address whether the comparative costs-of-performance method employed by the taxpayer to calculate its apportionment factor for its services was proper.

Fair value analysis

On remand, the Comptroller asserted that the evidence presented by the taxpayer to establish fair value was legally insufficient for two reasons: (1) as a matter of law, a taxable entity cannot rely on costs-of-performance data to apportion the fair value of its services, and (2) in the alternative, the taxpayer failed to “meet its burden of proving the costs that represent the fair value of services performed in Texas.”

The appeals court noted that the phrase “fair value” was not defined in the Comptroller’s rules. As such, it relied on the dictionary definition of “fair” and “value” and determined that “fair value” meant “the monetary worth of the services at issue, based on an objectively reasonable assessment.” The Comptroller’s position seemed to be focused on the fact that when the state adopted the “fair value” standard in its rule, something other than the Uniform Division of Income for Tax Purposes Act’s costs of performance standard was intended. Although the terms may have different meanings, the appeals court concluded that nothing in the plain language of the rule dictated a specific method for calculating fair value or excluded costs of performance as a reasonable means of assessing fair value for purposes of apportionment. The appeals court did not necessarily say that costs of performance is how fair value should be determined, but rather that nothing specifically prohibits the use of a costs-of-performance study to determine fair value.

The appeals court next addressed whether the taxpayer’s costs-of-performance evidence was sufficient. The Comptroller did not object to the admission of the taxpayer’s expert testimony at trial; because a challenge to the expert’s methodology would require an evaluation of the foundational data and underlying methodology relied on to draw his opinions, the appeals court concluded that the Comptroller could not bring this challenge now. As such, the appeals court concluded that there was no reversible error, and the trial court judgment approving the taxpayer’s methodology for calculating apportionment was upheld.

KPMG observation

The appeals court decision provides that utilizing a costs of performance methodology to determine fair value of services provided in Texas is not prohibited. However, there does not appear to be any specific methodology required to determine fair value. Thus, service providers need to be prepared to support their fair value analysis on audit with a costs of performance study or other documentation. In addition, taxpayers need to watch for further guidance from the Comptroller’s office, which is in the process of proposing a revised apportionment rule to address the Supreme Court decision and could add language to address the fair value analysis.

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