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Texas: Subscription revenue sourced to customer location, for franchise tax purposes

The Texas Court of Appeals, Third District—in reversing a Travis County district court decision favoring the taxpayer with regard to how subscription revenues are sourced for Texas franchise tax purposes—held that the proper standard to apply in determining the location where a service is performed is the place where the "end-product, receipt-producing" act occurs. In the court's view, under the facts of this case, this act presumably occurred where the taxpayer's customers resided.

The case is: *Hegar v. Sirius XM Radio, Inc.,* No. 03-18-00573-CV (Tex. Ct. App. May 1, 2020). Read the appeals court **decision** [PDF 250 KB]

Background

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. There were a few programs transmitted from Texas at various times during the audit period.

On its originally filed returns, the taxpayer apportioned its subscription revenues based on the locations where its primary production facilities were located—primarily outside Texas. On audit, 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 providing the service of "unscrambling a radio signal," not the production of satellite programming, and this service occurred "at the radio receiver" (i.e., the customer's location).

The taxpayer paid the assessment, then filed suit for a refund. 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. The Comptroller appealed the sourcing conclusion, and the taxpayer appealed the court's decision to not allow it to deduct certain costs as costs of goods sold (COGS).

Appeals court decision

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 parties agreed that the phrase "service performed in this state" meant "the act is done in this state." Citing to a 1980 Comptroller decision, the Comptroller argued that the place where the "service is performed" means where the "receipt-producing end-product" act is done. In the Comptroller's view, the taxpayer's acts of "production and distribution" of content were "non-receipt-producing, albeit essential, support activities." The only activity that could "even plausibly be described as the receipt-producing, end-product act was the actual performance of audible radio service for the customer."

Applying this standard, the appellate court concluded that 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 customer's satellite-enabled radio. This act occurred 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, because the act was considered to be done in Texas when a customer resided in Texas, the service was performed in Texas and there was no need to resort to a fair value analysis. In sum, the court concluded that the trial court had erred when it held that the taxpayer's original returns properly reflected the fair value of the taxpayer's services performed in Texas for the tax years at issue.

The appeals court also held that the trial court did not err when it concluded that the taxpayer could not deduct certain revenue share and hardware subsidiary expenses paid to car manufacturers as COGS. The taxpayer argued that it sold "goods"—namely, "tangible personal property" in the form of "live and prerecorded . . . radio programs"—and that these goods were "produced" when the programs were actually heard by subscribers in their vehicles. Because the satellite-enabled radios were necessary for subscribers to receive programming, the taxpayer asserted that the payments to car manufacturers were deductible as COGS. Relying on the recent Texas Supreme Court case, the appeals court observed that the taxpayer's customers received only the right to listen to and access radio programs. The transfer of creative content in a radio program was not the sale of tangible personal property or goods, and therefore, the taxpayer was not entitled to the COGS deduction.

KPMG observation

It remains to be seen as to whether the taxpayer will appeal to the Texas Supreme Court.

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