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MULTISTATE INCOME/FRANCHISE TAX

Texas Supreme Court rules in taxpayer's favor regarding apportionment dispute

Tax Alert

Overview

On March 25, 2022, the Texas Supreme Court held in *Sirius XM Radio, Inc. v. Hegar* that Sirius XM Radio, Inc. ("Taxpayer") properly computed its apportionment factor for Texas franchise tax purposes by sourcing receipts to Texas based on where Taxpayer's programs were produced and not the location where the customer received the benefit of Taxpayer's service. As a result of the decision, the case has been remanded to the court of appeals to determine the fair value of Taxpayer's services performed in Texas.

This Tax Alert summarizes the Texas Supreme Court's decision and provides some taxpayer considerations.

Texas Supreme Court decision

Background

Taxpayer broadcasts more than 150 satellite-radio channels, over 70% of which use exclusively original content produced by Taxpayer. Taxpayer primarily develops its radio content in New York City and Washington, D.C. The content is then broadcast by transmitting the information to satellites from facilities in New Jersey, D.C., and Georgia. Taxpayer's satellites transmit the signals received back down to Earth where the information either reaches radio sets or one of Taxpayer's seven hundred terrestrial repeaters. Once a signal reaches a customer's radio, a pair of integrated circuits decrypts the radio signal, allowing the listener to hear the content.

Customers access Taxpayer's content by purchasing a specific radio set and paying a subscription fee. As a result of Taxpayer's agreements with auto makers, subscribers generally purchase or lease vehicles with the radios installed rather than purchasing and installing their own sets. Subscription fees are the primary source of Taxpayer's revenue. None of Taxpayer's equipment or personnel that assist with decryption are in Texas and very little of Taxpayer's content is made in Texas. Taxpayer has many subscribers located in Texas.

Under Texas Tax Code ("TTC") § 171.002, Texas franchise tax is calculated by multiplying a taxable entity's taxable margin by the tax rate. To compute taxable margin, the apportioned margin is determined by multiplying the margin by an apportionment fraction where the numerator is the taxable entity's gross receipts from business done in the state, and the denominator is the taxable entity's gross receipts from its entire business. In the context of receipts derived from services, TTC § 171.103 states the receipts from a taxable entity's business in Texas is the sum of the receipts from "each service performed in this state."

In 2009 and 2010, Taxpayer filed Texas franchise tax returns and sourced its subscription receipts based on the locations its programming was produced and the corresponding production costs were incurred. On audit, the Texas Comptroller of Public Accounts ("Comptroller") determined Taxpayer should source receipts to the location of its subscribers, not the location where its programs were produced, based on a finding that the service Taxpayer provided to its customers was decryption of the radio signals. The Comptroller maintained that services must be sourced to the state in which the "receipt-producing, end-product act" takes place. Taxpayer paid the assessment under protest and brought suit in Travis County District Court.

As noted in our previous alert, the district court found that Taxpayer's "receipt-producing, end-product act" was producing and broadcasting its content over satellite radio, not decrypting radio signals. Thus, Taxpayer was required to source its receipts to Texas based on the fair value of the services performed in Texas. The Comptroller appealed the district court's decision. The court of appeals reversed and explained in its decision, agreeing with the Comptroller, that "service performed in this state" under TTC § 171.103(a)(2) refers to the "receipt-producing, end-product act," and the service performed by Taxpayer for Texas subscribers was unscrambling the radio signal or decryption (see this previous alert for additional details regarding the appellate decision). Taxpayer petitioned for review to the Texas Supreme Court ("Court").

Texas Supreme Court's analysis

The primary issue before the Court was whether Taxpayer's receipts from Texas subscribers were receipts from a "service performed in this state." Relying on Texas precedent, the Court stated there was "no reason to depart from these straightforward understandings of the everyday words the statute uses" meaning a "service is performed in this state if the labor for the benefit of another is done in Texas." The Court also emphasized the Texas Legislature could have easily designated the location of the customer as the site of taxation as evidenced by the immediately preceding statutory provision concerning tangible personal property, which attributes receipts to Texas to the extent "the property is delivered or shipped to a buyer in [Texas]." Thus, the Court ultimately held the appellate court's decision to attribute to Texas all of Taxpayer's receipts from Texas subscribers must be reversed.

The Court rejected the use of the "receipt-producing, end-product act" test as argued by the Comptroller, particularly as a basis for determining *where* a service is performed (as compared to *what* qualifies as the "service performed") when determining receipts attributable to Texas. The Court explained such test also yields inconsistent results as compared to the "straightforward application of the words chosen by the [Texas] Legislature."

The Court stressed the economic realities of the receipts generated by Taxpayer. Specifically, Taxpayer was a radio production and broadcasting company operating outside of Texas. Taxpayer did not perform decryption for the benefit of the customer. Instead, decryption was performed as part of Taxpayer's business model – a barrier to access that induced customers to remit subscription payments. Thus, in terms of receipts, customers paid

Taxpayer to listen to radio content, and without the decryption, Taxpayer's content would essentially be free. Additionally, the presence of equipment in Texas (i.e., the car radios that receive signals from Taxpayer) was virtually irrelevant. The receipts at issue were derived from subscriptions paid for access to radio content, not from the sale of radio sets.

The parties agreed that some amount of Taxpayer's services were performed in Texas. However, the evidenced submitted by Taxpayer showing the cost of performing its services in Texas was rejected by the appellate court after agreeing with the Comptroller as to the underlying apportionment question. As a result, the Court remanded the case for further proceedings consistent with the Court's opinion.

Considerations

Taxpayers engaged in providing services in Texas, or to Texas customers, should consider consulting with their tax advisers to determine the potential Texas franchise tax implications of this decision, particularly given the apportionment regulations published by the Comptroller in the January 15, 2021 issue of the Texas Register with application to "franchise tax reports originally due on or after January 1, 2008, except as otherwise noted." As noted in our previous alert, Rule 3.591(e)(26) of the recently adopted regulations states that in the context of sourcing receipts derived from services, "a service is performed at the location of the receipts-producing, end-product act or acts."

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