



# The Texas appeals court allowed taxpayers to apportion subscription receipts for services to Texas using cost-of-performance data

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In a recent Texas Court of Appeals decision, the court provided guidance on determining the "fair value" of services provided within the state. To determine the "fair value" of state services, the cost of performance can be used. Following the recent Sirius XM rulings, Texas companies that derive gross receipts from the sale of services should review their apportionment methodologies.

The Texas Court of Appeals, Third Circuit (appeals court) has issued its latest ruling in Sirius XM Radio Texas' franchise tax rigmarole. It found on remand from the Texas Supreme Court that the Taxpayer provided adequate evidence to support its cost-based analysis of the "fair value" of services in the state to determine gross receipts from service sales. In this way, the Taxpayer can allocate its subscription receipts for services performed in Texas based on its cost-of-performance data.

### Brief background

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The taxpayer, Sirius XM Radio, produces and distributes radio programs via satellite. A monthly fee is charged to Sirius subscribers to access radio programming. Sirius has over 150 radio channels, most of which are produced in studios located in New York City and Washington D.C., with one show broadcasting from Texas. The taxpayer's content is transmitted via uplink facilities in New Jersey, Washington, D.C., and Georgia to its satellites launched from Kazakhstan. Upon returning from the satellites, signals are sent either directly to the radio or to repeaters (used in densely populated areas), some of which are located in Texas. Control of the satellites is conducted from Panama, Ecuador, and Georgia. When the signal reaches the radio, it is decrypted, allowing the customer to hear the program.

There was a disagreement over the proper source of the taxpayer's receipts from these satellite radio subscriptions in Sirius. Taxpayer revenue was initially derived from the locations where its programming was produced and the relative costs of those activities in Texas and elsewhere. In an audit, the Texas Comptroller of Public Accounts determined that the taxpayer should apportion its receipts based on its subscribers' locations, not its production locations. In its view, the Comptroller determined that services should be apportioned according to the state where receipt-producing, end-product acts occur.

Under protest, the taxpayer paid the assessed tax and sued for a refund. Upon finding that Sirius performed most of its services outside Texas, the Texas district court ruled in favor of the taxpayer and refunded over \$2 million for the 2010 and 2011 tax years. In response, the Comptroller appealed the decision.

By interpreting the Texas apportionment statute, the Texas Court of Appeals reversed the district court's ruling and agreed with the Comptroller that the service is performed in Texas if the receipt-producing, end-product act takes place there. Consequently, receipts were sourced to Texas if the radio, or subscriber, was located there. Upon receiving this decision, Sirius appealed it to the Texas Supreme Court.

The Texas Supreme Court reversed the Texas Court of Appeals and held that receipts should be sourced to the state in which the radio programming is produced. As the Supreme Court noted in its administrative ruling, the "receipt producing, end-product act" test used by the Comptroller was only intended to distinguish between the "support services" that enable taxpayers to conduct business and the "receipt-producing" services for which customers actually pay, and that it was used to determine what the services are, but not where they should be purchased. The court found that the "receipt producing, end-product act" test was not well-founded in prior case law because the relevant act was the process of producing and distributing content. The court ruled that the useful labor done in Texas for the benefit of another qualifies as a service in Texas. The court agreed with Sirius that subscription fees should be sourced to the location where Sirius produces its programming, not to the location where the subscribers' radios are housed. As a result, the case was remanded to the Texas Court of Appeals so that it can determine the fair market value of Sirius' services in the state.

## A supporting argument for the taxpayer's apportionment method

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A review of the trial court's finding by the appeals court on remand confirmed that based on the comparative cost-of-performance evidence presented by the Taxpayer, the method used by the Taxpayer to allocate the fair value of its services performed in the state was supported by the trial court. The appeals court upheld the trial court's finding, rejecting the Comptroller's argument that the Taxpayer had failed to establish "fair value" since a taxable entity cannot assign the fair value of its services based on cost-of-performance data. Under former Rule 3.591(e)(26), neither the Comptroller's rules nor the applicable Tax Code provisions defined "fair value," so the appeals court consulted the dictionary, which defined it as "an objectively reasonable assessment of the value of the services at issue." In addition, the appeals court rejected the Comptroller's alternative argument that the taxpayer failed to prove the costs represent the "fair value" of services performed in Texas, since the Comptroller failed to raise this challenge at trial by not objecting to the admission of expert witness testimony.

## Conclusion

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In the case, Texas was determined to be a "source-based" jurisdiction rather than a "destination-based" jurisdiction. According to the appeals court's ruling, the cost of performance, along with other methods, can be used to determine the "fair value" of services performed outside of Texas and inside of Texas. With this ruling and the Texas Supreme Court's decision earlier this year, companies doing business in Texas that generate gross receipts from service sales should revise how they apportion these receipts.

Especially for clients in advertising and broadcasting, origin-based sourcing conflicts with sourcing guidelines promulgated by the Comptroller. Following these sourcing rules, clients should evaluate whether refund claims need to be filed.

For queries, please contact



**Shishir Lagu**

Partner,  
US Tax Services



[markets@knavcpa.com](mailto:markets@knavcpa.com)



**Neerali Shah**

Manager,  
US Tax Services



[www.knavcpa.com](http://www.knavcpa.com)

**India Offices:**

Mumbai

7th floor, Godrej BKC, Bandra Kurla Complex, Mumbai 400051

Bangalore

306, 3rd Floor, Embassy Square, 148, Infantry Road, Bangalore 560001

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