

## Texas Comptroller proposes amendments to franchise tax apportionment rules

### Overview

On November 2, 2020, the Texas Comptroller of Public Accounts (Comptroller) filed proposed amendments (Proposed Amendments) with the Office of the Texas Secretary of State to incorporate numerous changes to apportionment rules surrounding the Texas franchise tax as contained within title 34 of the Texas Administrative Code (TAC) § 3.591 (hereinafter referred to as "Rule 3.591").<sup>1</sup> The Comptroller has indicated the Proposed Amendments will be published in the Texas Register on November 13, 2020. In addition to incorporating recent statutory amendments, the Comptroller indicated the Proposed Amendments also update the regulations to reflect current guidance and improve readability. Publishing of the Proposed Amendments on triggers a 30-day public comment period on November 13. This tax alert summarizes certain provisions of the Proposed Amendments, effective dates, as well as offers some taxpayer considerations.

### Proposed Amendments to Texas Franchise Tax Apportionment Rules

#### **Advertising**

Currently, the sourcing rules for advertising are addressed in various subsections depending on the media type (e.g., Rule 3.591(e)(20) addresses advertising in newspapers or magazines, while Rule 3.591(e)(22) addresses radio/television advertising). The Proposed Amendments related to receipts derived from advertising have been consolidated to provide a uniform sourcing rule across media types. The Proposed Amendments contained within new subsection (e)(1) of Rule 3.591, indicates gross receipts from the dissemination of advertising would be sourced to the "locations of the advertising audience...determined in good faith using the most reasonable method under the circumstances." Locations identified in the Proposed Amendments as potentially reasonable for such purposes include: the physical locations of the advertising; advertising audience locations recorded in the books and records of the service provider; and locations listed in published rating statistics. The method ultimately utilized by the taxpayer should be consistently applied from year to year and supported by records retained by the service provider. To the extent the audience locations of nationwide advertising audiences cannot be reasonable determined, then 8.7% of a taxpayer's gross receipts are sourced to Texas.

#### **Net Investments & Capital Assets, Hedging Contracts, and Other Financial Derivatives**

Rule 3.591(e)(2) of the Proposed Amendments would revise the sourcing treatment related to receipts derived from the sale of capital assets and investments. Only the net gain from the sale of a capital asset or investment would be included in gross receipts. More specifically, net losses are not included in gross receipts, which the Comptroller noted in the preamble of the Proposed Amendments is consistent with recent Texas Supreme Court guidance. In addition, net gains and/or losses will be determined on a sale-by-sale basis under the Proposed Amendments. Based on recent Texas Supreme Court guidance, the removal of net losses from gross receipts would apply both retroactively and currently, regardless of the Proposed Amendments. However, the Proposed Amendment requiring a transaction-level analysis would only be effective for reports originally due on or after January 1, 2021.

The Proposed Amendments would renumber subsection (e)(16) to (e)(17), and revise the title from "Loans and securities" to "Loans and securities *treated as inventory of the seller*" (emphasis added). Renumbered subsection (e)(17)(A) would also be amended to provide "securities and loans held for investment or risk management purposes are not inventory."

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<sup>1</sup> Franchise Tax Margin: Apportionment, Issue 11/13/2020 (as filed with the Office of the Secretary of State on November 2, 2020) (to be codified at 34 Tex. Admin. Code § 3.591) (Tex. Comptroller of Pub. Accounts). A copy of the Proposed Amendment that will ultimately appear in the *Texas Register* is available [here](#).

## **Computer Hardware and Digital Property**

Under Rule 3.591(e)(3) of the Proposed Amendments, gross receipts from the sale or lease of computer hardware together with any software installed on the hardware would be sourced as the sale or lease of tangible personal property under Rule 3.591(e)(29). As a result, any software installed on computer hardware is treated the same as the sale of the computer hardware (i.e., sourced based on the location where the property is ultimately delivered and no longer treated as receipts derived from an intangible that would be sourced to the location of the payor under Rule 3.591(b)(8), which the Proposed Amendments would renumber to subsection (b)(9)).

Gross receipts from the sale or lease of digital property (e.g., computer programs) transferred by fixed physical media (such as compact discs) would also be sourced as the "sale or lease of tangible personal property" under Rule 3.591(e)(29) in an effort to be consistent with the Comptroller's treatment of other intellectual property sold in non-digital fixed physical media (e.g., books).

Rule 3.591(e)(3) of the Proposed Amendments would further provide the following sourcing methodologies for other, specific types of receipts derived from computer hardware and digital property:

- Digital property not transferred as fixed physical media: sourced as an intangible to the location of the payor under revised Rule 3.591(e)(21)(B); such treatment is consistent with the prior regulation regarding computer software.
- Digital property as a service: sourced consistent with Rule 3.591(e)(26) regarding services (i.e., sourced to the "location of performance" defined as "location of the receipts-producing, end-product act" under Rule 3.591(e)(26)(A)).<sup>2</sup>
- Digital property as part of an internet hosting service: would be sourced as receipts from internet hosting services (i.e., considered Texas gross receipts "if the customer is located in Texas" under revised Rule 3.591(e)(13).
- Use of digital property (as opposed to receipts derived from the sale or licensing of digital property): sourced under Rule 3.591(e)(21) that applies to patents, copyrights, and other intangible assets.

Rule 3.591(e)(3) also provides detailed examples illustrating the proposed sourcing of receipts derived from digital products for Texas franchise tax purposes. However, there are instances where specific provisions may ultimately result in the same conclusion (e.g., the location where a service is performed and the location where the customer is located may be the same location).

## **Internet Hosting Services**

Under Rule 3.591(e)(13) of the Proposed Amendments, receipts from internet hosting services are sourced to the location of the customer consistent with Texas Tax Code § 171.106(g). "Internet hosting" is defined under the Proposed Amendments consistent with the corresponding statutory provision.<sup>3</sup> Several examples of what constitutes "internet hosting" are also provided within the Proposed Amendments, along with factors to distinguish between the purchase of access to computer services over the internet versus the purchase or lease of digital property over the internet.

## **Loan Servicing**

Under Rule 3.591(e)(16)(A) of the Proposed Amendments, gross receipts from servicing loans secured by real property would continue to be sourced to the location of the real property. Alternatively, Rule 3.591(e)(16)(B) indicates gross receipts from servicing loans not secured by real property would be sourced under Rule 3.591(e)(26) (i.e., receipts derived from services sourced based on the location of the receipt-producing, end-product act).

## **Expanded Use of Updated Texas Population Percentage for Sourcing Purposes**

Under the current version of Rule 3.591(e)(25), gross receipts from the sale of securities are sourced to the location of the payor. However, to the extent the payor cannot be identified, then a census percentage applies. As part of the Proposed Amendments, the Texas census percentage increases from 7.9% to 8.7%. As mentioned above, the revised census

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<sup>2</sup> Under Rule 3.591(e)(26) of the Proposed Amendments, several examples of receipts derived from services and the applicable sourcing methodology have also been incorporated.

<sup>3</sup> Under Texas Tax Code § 151.108(a), as referenced by Texas Tax Code § 171.106(g), internet hosting service means providing to an unrelated user access over the Internet to computer services using property that is owned or leased and managed by the provider and on which the user may store or process the user's own data or use software that is owned, licensed, or leased by the user or provider.

percentage would also apply in the context of advertising receipts when the location of the audience cannot otherwise be reasonably determined.

### ***Sale of Membership Interest in a Single Member Limited Liability Company***

Rule 3.591(e)(27) of the Proposed Amendments dictates the sourcing of receipts from the sale of a single member limited liability company (SMLLC) by its sole owner would be treated as receipts derived from the sale of an intangible and sourced to the location of the payor.

### **Considerations**

Taxpayers should consider the potential impact of the Proposed Amendments for Texas franchise tax purposes. The Proposed Amendments can be adopted as early as December 13, 2020. The Comptroller's Tax Policy Division will be accepting comments on the Proposed Amendments for 30 days beginning on the date the Proposed Amendments are published in the Texas Register (i.e., November 13, 2020 through December 13, 2020). Comments may be submitted to Teresa G. Bostick, Director, Tax Policy Division, P.O. Box 13528, Austin, Texas 78711-3528.

### **Contacts:**

If you have questions regarding the changes in the Proposed Amendments or other Texas tax matters, please contact any of the following Deloitte professionals:

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