

## Texas Comptroller Issues Rulings Related to Sourcing of Online Receipts

### Background

Numerous states have begun implementing market-based sourcing into their tax regimes, including, to some degree, Texas.<sup>1</sup> Under Texas law, gross receipts from the performance of services are generally sourced to Texas to the extent the services are performed in Texas or if the services relate to real property located in Texas.<sup>2</sup> In the context of online receipts, the Texas Comptroller (“Comptroller”) has released two private letter rulings (“PLRs”) involving the proper sourcing methodology for purposes of the Texas franchise tax (commonly referred to as the Texas margin tax).<sup>3</sup> As described in more detail below, each ruling arrived at what appears to be different outcomes based on the specific facts surrounding the taxpayer’s online service receipts, including one that appears to effectively result in a market-based outcome.

In this Tax Alert, we summarize and compare the recent PLRs and offer some taxpayer considerations.

### Private Letter Ruling No. 163050613 (March 15, 2017)

In the most recent ruling, the Texas-based taxpayer provided real-time payment risk and fraud prevention solutions that enabled lenders, retailers, and other businesses (“Lenders”) to make decisions about whether to accept payment from or extend credit to customers.<sup>4</sup> Taxpayer earned revenue from contracts with Lenders whereby the payment risk and fraud prevention solutions were delivered and accessible through the taxpayer’s website, which resided on the taxpayer’s servers.

In a typical transaction, Lenders would enter information relevant to a customer on the taxpayer’s secure website. When the request was received, the taxpayer accessed a third-party vendor’s database, which contained account information contributed by financial institutions. Taxpayer then relayed relevant information from the inquiry to Lenders through its secure website. Lenders would view the response on a computer at the Lender’s location. Lenders would then make a determination to accept payment or extend credit. The time period from a Lender’s initial inquiry to taxpayer’s response would usually be measured in seconds.

Ultimately, the Comptroller held the taxpayer’s gross receipts from sales of payment risk and fraud prevention solutions were receipts from the sale of services and should be based on the location of the Lender’s location. Under 34 Tex. Admin. Code § 3.591(e)(26), receipts from a service are apportioned to the location where the service is performed. In addition to this guidance, the Comptroller relied on Hearing No. 104,224, which explains that in determining where a service is performed, “the focus is on the specific, end-product act for which the customer contracts and pays to receive, not on non-receipt producing, albeit essential, support activities.”<sup>5</sup>

As noted by the Comptroller, here, the end product for which a Lender contracts and pays to receive is the taxpayer’s response to a request for information. Specifically, “Customers pay to receive payment risk and fraud prevention information at their own locations, on their own computers, by opening Taxpayer’s secure website.” Although the processing of information was essential to the taxpayer’s service, it was considered a support activity and not the service

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<sup>1</sup> For example, effective January 1, 2014, Texas statute provides for customer or market-based sourcing for internet hosting receipts. See Tex. Tax Code § 171.106(g).

<sup>2</sup> Tex. Tax Code § 171.103(2); see also 34 Tex. Admin. Code § 3.591(e)(23). If a service is performed both inside and outside Texas, some proration of the receipts associated to Texas is necessary relying on the facts and circumstances.

<sup>3</sup> See Private Letter Ruling No. 163050613, Accession No. 201703005L (March 15, 2017), available here:

<https://star.cpa.texas.gov/view/201703005L?terms=163050613>; see also Private Letter Ruling No. 142830363, Accession No. 201604750L (April 12, 2016), available here: <https://star.cpa.texas.gov/view/201604750L>.

<sup>4</sup> Private Letter Ruling No. 163050613, Accession No. 201703005L (March 15, 2017).

<sup>5</sup> In Hearing No. 104,224 (2013), the Comptroller determined that revenues generated from the sale of cable satellite television programming to Texas-based customers should be sourced to Texas because the signal descrambling activity that completed the transaction and produced the cable satellite television programming receipt—the activity for which the customers contracted—occurred in the receiver at the customer’s location. Hearing No. 104,224, Accession No. 201305715H (May 17, 2013), available here:

<https://star.cpa.texas.gov/view/201305715h?terms=104,224>. However, it should be noted that this matter is the subject of ongoing litigation before the Texas District Courts.

for which the taxpayer's customers contract. As a result, the location of the taxpayer's servers did not determine the location of the taxpayer's receipts. Instead, the specific end-product that the taxpayer's customers paid to receive was the display of taxpayer's response at the Lender's locations (*i.e.*, via customer's computers). Consequently, the Comptroller found the taxpayer's receipts were properly sourced based on the Lender's location.

### **Private Letter Ruling No. 142830363 (April 12, 2016)**

In an earlier 2016 letter ruling, the Comptroller considered the appropriate method for determining the sourcing of receipts from another type of online service—specifically, the service of matching shipping customers and transportation carriers through a proprietary online software platform.<sup>6</sup> The facts indicated Company A's online software allowed a shipping customer to post its shipping needs and view bids on their request from several potential transportation carriers. The shipping customer would then use the software to select a carrier. The online transportation bids included a flat-rate percentage mark-up by Company A above the amount actually bid by the transportation carrier. Based on the terms of the agreement with the transportation carriers, Company A would then invoice its shipping customers for the services charged for the transportation services and retain the mark-up as a sales commission for its services. Company A had one sales employee and various independent contractors working in Texas who were primarily engaged in solicitation activities.

Similar to Private Letter Ruling No. 163050613 discussed above, the Comptroller referenced its earlier Hearing No. 104,224 guidance indicating that the determination of where services are performed is based on the location at which the "specific, end-product acts for which the customer contracts" (*i.e.*, the matching of shippers to customers) take place, not the location at which "non-receipt producing, albeit essential, support activities" (*e.g.*, sales solicitation activities, the actual shipping services or assisting a customer in setting up their account in the software) are performed.

Ultimately, the Comptroller concluded the revenue-generating service provided by Company A was the matching of customers and carriers through its online proprietary software, which was located and maintained on a server outside Texas. Activities ancillary to the matching activity were determined to not be the activities for which the transportation carrier/customer contracted with Company A. Neither the presence of customers or carriers in Texas nor the performance of shipping activities in Texas by the transportation carriers was deemed to create Texas receipts related to in-state activity. Consequently, no portion of the revenues earned by Company A for matching shipping customers and transportation carriers were sourced to Texas.

### **Considerations**

Although the two PLRs issued by the Texas Comptroller reached different sourcing results (*i.e.*, sourced based on the location of the customer versus sourced based on the location of the software), both PLRs are in force. Taxpayers providing services should closely analyze the specific act they have been contracted to perform and consult with their tax advisors to evaluate their sourcing conclusions in light of the recent guidance provided by the Comptroller.

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<sup>6</sup> Private Letter Ruling No. 142830363, Accession No. 201604750L (April 12, 2016).

## **External Multistate Tax Alert**

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