

## Texas District Court - Apportionment Based on Location of Production Activities and Fair Value of Services Performed in Texas

### Overview

On August 3, 2018, the 261st Travis County Texas District Court (District Court) held in *Sirius XM Radio Inc. v. Glenn Hegar* that Sirius XM (Taxpayer), a satellite radio subscription service, properly apportioned its subscription receipts for purposes of the Texas franchise tax (commonly referred to as the Texas margin tax) based on the location where the Taxpayer produced its satellite subscription services.<sup>1</sup>

In this tax alert, we summarize the District Court's decision as well as offer some taxpayer considerations.

### Texas Statutory and Regulatory Guidance

Under Texas Tax Code (TTC) § 171.103(a), the Texas apportionment factor numerator is determined based on: "the sum of the taxable entity's receipts from...each service performed in this state."<sup>2</sup> Tex. Admin. Code § 3.591(e)(26) further provides that "receipts from a service are apportioned to the location where the service is performed. If services are performed both inside and outside of Texas, then such receipts are Texas receipts on the basis of the fair value of the services that are rendered in Texas."<sup>3</sup>

### Background

Taxpayer operated as a satellite radio subscription service delivering music, sports, news, talk, and entertainment to subscribers throughout the United States, including Texas.<sup>4</sup> Taxpayer's headquarters, studios, and production services were located almost exclusively outside of Texas.<sup>5</sup> During report years 2010 and 2011 (collectively, Report Years), a large majority of the programming consisted of original content, with over 70% produced by Taxpayer in studios located outside of Texas.<sup>6</sup> Until 2011, Taxpayer produced a radio show that was transmitted five days a week, for no more than four hours a day, from a location in Hillsboro, Texas.<sup>7</sup> Taxpayer did not own or lease the studio in Texas.<sup>8</sup> In addition, there were also occasional broadcasts transmitted from Texas by Taxpayer.<sup>9</sup>

To deliver the programming, Taxpayer transmitted its programs to satellites from facilities outside of Texas.<sup>10</sup> For the Report Years, Taxpayer filed franchise tax returns apportioning its subscription receipts based on the locations where its primary production facilities were located, which were outside of Texas.<sup>11</sup> Taxpayer did not operate any permanent studios in Texas.

On audit, the Texas Comptroller of Public Accounts (Comptroller) argued Taxpayer's subscription receipts should be apportioned to Texas based on the locations where the satellite transmissions were received by subscribers and adjusted Taxpayer's Texas apportionment factor accordingly.<sup>12</sup>

Taxpayer paid the additional tax assessed by the Comptroller, and subsequently sued the Comptroller for a refund by timely filing a petition with the District Court.<sup>13</sup> According to Taxpayer, the receipts from satellite subscription revenues

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<sup>1</sup> *Sirius XM Radio, Inc. v. Hegar*, Cause No. D-1-GN-16-000739 (261st Dist. Ct., Travis County, Tex. Aug. 3, 2018).

<sup>2</sup> Tex. Tax Code § 171.103(a).

<sup>3</sup> 34 Tex. Admin. Code § 3.591(e)(26).

<sup>4</sup> *Sirius XM Radio, Inc. v. Hegar*, Cause No. D-1-GN-16-000739, \*1 (261st Dist. Ct., Travis County, Tex. Aug. 3, 2018).

<sup>5</sup> *Id.*

<sup>6</sup> *Id.* \*3.

<sup>7</sup> *Id.*

<sup>8</sup> *Id.*

<sup>9</sup> *Id.* \*4.

<sup>10</sup> *Id.*

<sup>11</sup> *Id.* \*2.

<sup>12</sup> *Id.*

<sup>13</sup> *Id.*

should have been sourced based on the location of the fair value of the services in Texas and the location where Taxpayer's services were produced.<sup>14</sup>

At trial, Taxpayer called two expert witnesses to discuss the methodology used to determine the percentage of Taxpayer's value-producing activities in Texas, as compared to those outside Texas, based on the costs of those activities. Without providing details related to the methodology used, the District Court held the experts' methods to be credible for determining the location of the fair value of the services rendered.<sup>15</sup> The Comptroller did not provide an expert witness or other analysis to support its proposed apportionment methodology.<sup>16</sup>

### District Court's decision

Based on the facts and evidence provided, the District Court held that Taxpayer correctly apportioned its subscription receipts based on where its production and distribution activities occurred and fair value of its services rendered.<sup>17</sup> In its ruling, the District Court referenced the "end product act test," which focuses on the taxpayer's receipt-producing activities and the location where such activities are performed for purposes of determining the Texas apportionment factor.<sup>18</sup> Here, Taxpayer's "receipt-producing, end product act" was the production and distribution of its largely original content that occurred outside Texas.<sup>19</sup> Since Taxpayer performed its production and distribution activities outside of Texas, the District Court held Taxpayer's apportionment methodology was consistent with the fair value of services performed in Texas.<sup>20</sup>

### Considerations

On September 4, 2018, the Comptroller filed a notice of appeal.<sup>21</sup> Thus, the case remains outstanding. During the pendency of this appeal, taxpayers engaged in providing multistate services are advised to consult with their tax advisers to determine potential Texas franchise tax implications.

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<sup>14</sup> *Id.* \*5-6.

<sup>15</sup> *Id.* \*5.

<sup>16</sup> *Id.*

<sup>17</sup> *Id.* \*6.

<sup>18</sup> *Id.* (citing Texas Comptroller of Public Accounts, Accession No. 8011H0320C09, Comptroller Hearing No. 10,028 (Nov. 12, 1980); see also Pl.'s Original Pet. & Req. for Disclosure 6 (Feb. 18, 2016) (citing *Humble Oil & Refining Co. v. Calvert*, 414 S.W. 2d 172, 180 (Tex. 1967) explaining "end product act" test for Texas apportionment purposes).

<sup>19</sup> *Sirius XM Radio, Inc. v. Hegar*, Cause No. D-1-GN-16-000739, \*5 (261st Dist. Ct., Travis County, Tex. Aug. 3, 2018).

<sup>20</sup> *Id.* \*6. The District Court also held Taxpayer was entitled to deduct its cost of goods sold for the costs of producing, acquiring, and using radio programs. See *id.*

<sup>21</sup> *Sirius XM Radio, Inc. v. Hegar*, Cause No. D-1-GN-16-000739, Comptroller's Notice of Appeal, Court of Appeals No. 03-18-00573-CV (Sept. 4, 2018).

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