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Texas Supreme Court Rejects Texas Comptroller's "Receipt-Producing, End-Product" Act Test for Sourcing Receipts from Services

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On March 25, the Texas Supreme Court issued a highly-anticipated decision concerning the proper test to source receipts from services for purposes of Texas franchise tax. By statute, receipts from a "service performed in this state" must be sourced to Texas, as the first step in calculating the amount of franchise tax owed by a service provider. *See* Tex. Tax Code § 171.103(a)(2).

The primary issue before the Court was whether Sirius XM's receipts from Texas subscribers were receipts from a "service performed in this state." Sirius XM contended they were not; the Comptroller disagreed and took the position that all subscription receipts from subscribers in Texas must be sourced to Texas.

Sirius XM is a satellite radio provider that provides its services on a subscription basis. Sirius XM's signal is encrypted so that people who want access to its content must pay for its service. The signal is decrypted for subscribers so they can access the radio content.

Sirius XM characterized its service as the production and broadcasting of radio content, not the

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decryption of radio signals. However, the Comptroller argued that Sirius XM's receipts must be sourced to the customer location because the decryption of the signal for the customer was the "receipt-producing, end-product act."

As the Court recognized, the "receipt-producing, end-product act" does not appear in the Texas Tax Code. It is a formulation originally used by an administrative law judge in 1980, and subsequently taken out of context by the Comptroller. *See* Op. at 11-12 and n.4.

Importantly, the Court rejected the Comptroller's "receipt-producing, end-product act" test to determine the location of where a service is performed: "Setting aside the atextual and unhelpful "receipt-producing, end-product act" test, the most natural reading of "service performed in this state" supports locating the performance of the service at the place where the taxpayer's personnel or equipment is physically doing useful work for the customer." Op. at 12. In so doing, the Court confirmed that Texas applies an "origin-based approach to the taxation of services." Op. at 13.

After discarding the "receipt-product, end-product" act test, the Court held that the most natural reading of the statute "supports locating the performance of the service at the place where the taxpayer's personnel or equipment is physically doing useful work for the customer." Op. at 12.

Applying the statutory language, the Court looked to the "economic reality" of the transactions and agreed with Sirius XM that its service was fundamentally not a decryption service:

"Characterizing the service Sirius performs as 'decryption' elevates the technicalities of the transaction over the economic reality of the service performed. . . . Characterizing the service Sirius performs for Texans as 'decryption of radio sets in Texas' is like saying the service performed by *The*

Wall Street Journal Online is a 'paywall-removal service,' rather than the creation and distribution of news and opinion content its subscribers want to read. But Sirius is no more in the 'decryption business' than *The Wall Street Journal* is in the 'paywall-removal business.'"

Op. at 17. As a result, the Court reversed the decision of the Texas Court of Appeals that apportioned all receipts from Texas subscribers to Texas.

Sirius XM agreed that some small amount of its services were, in fact, performed in Texas, but the parties disagreed about whether the evidence Sirius XM introduced at trial was sufficient evidence about the value of the services performed in Texas. The Court remanded the case to the Court of Appeals to address this discrete issue.

Our Take: The "receipt-producing, end-product" act test, as interpreted and applied by the Comptroller in recent years, focused on the location of the customer receiving the service rather than where the service provider actually performed the service – essentially transforming Texas into a market-based sourcing state rather than a place-of-performance state as contemplated by the plain language of the statute. The Texas Supreme Court applied a straight-forward statutory analysis and common-sense approach to correctly reject the "receipt-producing, end-product" act test. Now, consistent with the statutory language, to determine whether a particular service is performed in Texas, it is clear that one must look to the physical location of the people and equipment involved in performing the service.

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without seeking the advice of legal counsel. Prior results do not guarantee a similar outcome.