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Sourcing Service Receipts for Franchise Tax Apportionment in Texas


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ARTICLE

SOURCING SERVICE RECEIPTS FOR FRANCHISE TAX APPORTIONMENT IN TEXAS*

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A state business activity tax, such as a state income tax or the Texas “margin” tax, has to fairly apportion a company’s interstate business activity to the state. Texas uses single factor apportionment based on the ratio of the company’s Texas gross receipts to the company’s everywhere gross receipts. But what are Texas gross receipts? The question is particularly difficult with regard to service receipts because the preparatory activities may occur in one state while the service may be ultimately delivered to the customer in another state. This article traces the evolution of service receipts sourcing in Texas. With exceptions for specific services, Texas determines whether there was a specific end-product act for which the customer contracted and paid to receive. If there was, Texas sources service receipts to that location and disregards the locations of non-receipt producing, albeit essential support activities. If there was not a specific end-product act for which the customer contracted and paid to receive, then Texas will consider the locations of preparatory acts. With these guidelines in mind, seemingly disparate outcomes may in fact have a principled reason for differentiation.

* The views expressed in this article are the views of the authors and do not necessarily represent the views of the Texas Comptroller of Public Accounts.

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*This little piggy went to market,
 This little piggy stayed home,
 This little piggy had roast beef,
 This little piggy had none,
 And this little piggy cried wee wee wee all the way home.*

I. INTRODUCTION

The Texas franchise tax is a tax on the privilege of doing business in Texas.¹ Currently, the value of a company's business is measured by a company's "margin," which is roughly a company's gross revenues with a limited choice of deductions from gross revenues.² In times past, the value of a company's business has been measured by "earned surplus,"

1. See TEX. TAX CODE ANN. § 171.001 (West Supp. 2017) (imposing a tax on taxable entities doing business in the state of Texas).

2. *Id.* § 171.101(a)(1). The deduction choices are either: compensation expenses, cost-of-goods-sold, a thirty percent standard deduction, or \$1 million. *Id.*

which was roughly a company's net income, and "capital," which was roughly a company's net worth.³

When a company's integrated business—or "unitary business"⁴—is conducted in Texas and other states, its business activity must be apportioned between the states.⁵ In Texas, a company's margin is multiplied by its Texas apportionment factor to determine the company's "taxable margin."⁶

States apportion in different ways—creating the possibility that some business activity may be taxed here, some there, some here and there, and some nowhere. The United States Supreme Court has acknowledged the possibility of these outcomes and has conceded that apportionment is at best "a rough approximation" of business activity.⁷ Nevertheless, in the absence of a Congressional mandate for uniformity, the Constitution tolerates disparate treatment by the states except in extreme circumstances.⁸

A common apportionment method used in other states is a three-factor formula based on the percentages of property, payroll, and sales receipts in each state.⁹ Texas, however, uses single-factor apportionment based on the ratio of Texas sales receipts to nationwide sales receipts.¹⁰

3. Act of Aug. 13, 1991, 72d Leg., 1st C.S., ch. 5, § 8.031(a), sec. 171.002, 1991 Tex. Gen. Laws 134, 154 (amended 2006) (current version at TAX § 171.101).

4. See TAX § 171.0001(17) ("Unitary business" means a single economic enterprise that is made up of separate parts of a single entity or of a commonly controlled group of entities that are sufficiently interdependent, integrated, and interrelated through their activities so as to provide a synergy and mutual benefit that produces a sharing or exchange of value among them and a significant flow of value to the separate parts.').

5. See *Mobil Oil Corp. v. Comm'r of Taxes*, 445 U.S. 425, 436 (1980) ("[T]he entire net income of a corporation, generated by interstate as well as intrastate activities, may be fairly apportioned among the States for tax purposes . . ." (quoting *Northwestern States Portland Cement Co. v. Minn.*, 358 U.S. 450, 460 (1959))).

6. See TAX § 171.101 (explaining the calculation of taxable margin).

7. *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 273 (1978).

8. See *id.* at 274 ("[T]he States have wide latitude in the selection of apportionment formulas and that a formula-produced assessment will only be disturbed when the taxpayer has proved by 'clear and cogent evidence' that the income attributed to the State is in fact 'out of all appropriate proportions to the business transacted . . . in that State,' or has 'led to a grossly distorted result.'" (citations omitted) (first quoting *Hans Rees' Sons v. North Carolina ex rel. Maxwell*, 283 U.S. 123, 135 (1931); and then quoting *Norfolk & Western R. Co. v. State Tax Comm'n*, 390 U.S. 317, 326 (1968))).

9. See BENDER'S STATE TAXATION: PRINCIPLES AND PRACTICE § 3.10[4] (2017) (showing the various apportionment factors that states employ).

10. TAX §§ 171.101(a)(2), 171.106.

Locating or sourcing receipts¹¹ from the sale of tangible personal property is relatively easy. The receipts are sourced to Texas “if the property is delivered or shipped to a buyer in this state regardless of the FOB point or another condition of the sale[.]”¹²

The sourcing of receipts from the sale of services is trickier. The statute says that the sale is in Texas if the “service [is] performed in this state.”¹³ With the exception of receipts derived from servicing loans secured by real property, the statute provides no guidance for determining *where* a service is performed. Consider the following examples:

- Example A. A traveling Broadway theater company creates and rehearses a show in New York but performs the show in theaters across the country. Where should its ticket receipts be sourced?
- Example B. A boxing promoter stages a boxing match in Las Vegas and sells tickets for closed-circuit television viewing at venues in other states. Where should the ticket receipts be sourced?
- Example C. An accounting firm prepares and e-files a federal tax return for a lump sum fee. Where should the accounting fee be sourced?

The Comptroller would probably say that the receipts from Examples A and B should be sourced entirely to the location or locations of the audience and that the receipts from Example C should be sourced to the location or locations where the accountants did the work, without regard to the customer location and filing location.¹⁴

Superficially, these determinations of *where* the services were performed might seem as arbitrary as the destinations in “This Little Piggy.” This article will consider the experience of Texas and other states to determine whether there are any unifying principles for service revenue sourcing that will make sense of seemingly disparate results. The conclusion will be that there are such principles, but that they should not be universally applied to every situation.

11. The Comptroller rule sometimes refers to the apportionment of gross receipts. 34 TEX. ADMIN. CODE § 3.591(e) (2015). The more precise terminology is that margin is apportioned, and gross receipts are sourced.

12. TAX § 171.103(a)(1).

13. *Id.* § 171.103(a)(2).

14. Again, the views expressed in this article are the views of the authors and do not necessarily represent the views of the Texas Comptroller of Public Accounts.

II. THE EVOLUTION OF SERVICE RECEIPTS SOURCING IN TEXAS

A. *Sourcing Service Receipts Before the 1980s*

The Texas franchise tax dates back to at least 1889.¹⁵ In 1907, the tax was expanded from a tax on stated capital to a tax on stated capital, surplus, and undivided profits, essentially resulting in a tax on the net worth of a corporation.¹⁶ However, because the tax was imposed on the entire net worth of interstate companies, the United States Supreme Court held that the tax violated the Due Process Clause and the Interstate Commerce Clause.¹⁷ In anticipation of the decision, the Texas Legislature in 1917 adopted an apportionment formula based on the ratio of a corporation's gross receipts from business done in Texas to its total gross receipts from its entire business.¹⁸

In the 1930s, the Ford Motor Company sensed a violation of due process because Texas's gross receipts apportionment formula resulted in the apportionment to Texas of over \$23 million in capital while the value of the company's assets in Texas were only approximately \$3 million.¹⁹ However, the United States Supreme Court found otherwise:

In laying a local privilege tax, the state sovereignty may place a charge upon that privilege for the protection afforded. When that charge, as here, is based upon the proportion of the capital employed in Texas, calculated by the percentage of sales which are within the state, no provision of the Federal Constitution is violated.²⁰

15. See *Looney v. Crane Co.*, 245 U.S. 178, 184 (1917) (discussing the development of the franchise tax in Texas).

16. Act approved May 16, 1907, 30th Leg., 1st C.S., ch. 23, § 1, 1907 Tex. Gen. Laws 502, 502, (amended 1917), *repealed by* Act of Aug. 6, 1959, 55th Leg., 3d C.S., ch. 1, § 1, 1959 Tex. Gen. Laws 187, 374; see also *Looney*, 245 U.S. at 185 (stating the 1907 enactment provided that “the franchise tax should be calculated upon the aggregate of” a corporation's stated capital, surplus, and undivided profits).

17. *Looney*, 245 U.S. at 187.

18. Act of Mar. 17, 1917, 35th Leg., R.S., ch. 84, § 1, 1917 Tex. Gen. Laws 168, 168, (repealed 1959); see also *Clark v. Int'l Harvester Co.*, 115 S.W.2d 1022, 1025 (Tex. Civ. App.—Austin 1938, writ *ref'd*) (discussing the 1917 amendment that changed the manner of computing corporate franchise tax).

19. *Ford Motor Co. v. Beauchamp*, 308 U.S. 331, 334 (1939). As a historical note, in 1936, the total gross receipts of Ford Motor Company were approximately \$888 million, and its total capital was approximately \$600 million. *Id.* at 333–34.

20. *Id.* at 335.

The Texas Legislature, having found a constitutional apportionment formula, stuck with it, and in 1959, added the detail that gross receipts from business done in Texas would include “[s]ervices performed within Texas.”²¹

In 1969, the Texas Legislature provided for alternative apportionment, allowing a taxpayer to petition the Comptroller for an alternative method if the standard method did not fairly represent the taxpayer’s business in Texas.²² But by 1989, the legislature had changed its mind and repealed the provision.²³ As a result, the alternative apportionment discussion in other states²⁴ has been of little consequence to Texas.

Meanwhile, the Comptroller was busy adopting apportionment rules so that by the 1980s, the Comptroller had special sourcing rules for certain services such as transportation services, stockbroker services, telephone services, newspaper advertising, and radio and television services,²⁵ and a generic sourcing rule for other services that stated: “A corporation’s commissions or other receipts for services performed in Texas for an out-of-state customer constitute Texas receipts.”²⁶

B. *Sourcing Service Receipts in the 1980s*

The Comptroller saw little action on the service receipts front until the 1980s when it decided a trio of hearings in relatively rapid succession. Those hearings are described as follows.

21. Act of Aug. 6, 1959, 56th Leg., 3d C.S., ch. 1, art. 12.02(b), § 1, 1959 Tex. Gen. Laws 306, 307, *repealed by* Act of May 31, 1981, 67th Leg. R.S., ch. 389, § 1, 1981 Tex. Gen. Laws 1490, 1697. The current version is located at TEX. TAX CODE ANN. § 171.103 (West 2015).

22. Act of Sept. 6, 1969, 61st Leg., 2nd C.S., ch. 1, art. 7, § 1, 1969 Tex. Gen. Laws 61, 95–96 (*repealed* 1981).

23. Act of Mar. 1, 1989, 71st Leg., R.S., ch. 3, § 2, 1989 Tex. Gen. Laws 200, 200.

24. See Christopher T. Lutz, Robert P. Merten, III & Nicholas J. Kump, *Trends and Developments in Alternative Apportionment of State Income*, 84 ST. TAX NOTES 559, 560 (2017) (addressing “recent cases, rulings, and developments among the states regarding alternative apportionment”).

25. See 4 Tex. Reg. 848, 848–50 (1979), *adopted by* 4 Tex. Reg. 1470, 1470–72 (1979), *repealed by* 17 Tex. Reg. 4432, 4432 (1992), *adopted by* 17 Tex. Reg. 7663, 7663–67 (1992) (former 34 TEX. ADMIN CODE § 3.403) (Comptroller of Pub. Accounts, Tax Admin., Franchise Tax) (showing the Comptroller’s proposal and adoption of sourcing rules for various services).

26. 4 Tex. Reg. 848, 850 (1979), *adopted by* 4 Tex. Reg. 1470, 1470–72 (1979), *repealed by* 17 Tex. Reg. at 4432, *adopted by* 17 Tex. Reg. at 7663–67 (former 34 TEX. ADMIN CODE § 3.403(d)(2)) (Comptroller of Pub. Accounts, Tax Admin., Franchise Tax).

1. Hearing No. 10,028 (1980)²⁷

This hearing involved the sourcing of advertising receipts of a local television station. The station had a studio and transmitter tower in Lubbock, and a second tower that transmitted the same broadcast from a location in New Mexico.²⁸ The Comptroller's Tax Division argued that the advertising services were being performed where the station had property and payroll, which was 83% in Texas and 17% in New Mexico.²⁹ The television station asserted that the advertising revenues should be sourced to the locations of its transmitter towers.³⁰ Because 32% of its audience was served by its New Mexico tower, the station wanted 32% of its advertising revenues to be sourced to New Mexico, with the remaining 68% sourced to Texas.³¹

The decision noted, as the Ford Motor Company had previously noted, that because the franchise tax was levied on the net worth of the company, it might "logically follow" that the geographic location of the assets "would be a factor if not the sole factor of franchise tax apportionment."³² The decision further observed that many states also include a payroll factor "as a means of more accurately reflecting a corporation's activities."³³ However, the decision concluded that "whatever merit there may be of having a property or payroll factor in a franchise tax apportionment formula, Texas has rejected that concept and has instead opted for a single receipts factor."³⁴

27. Tex. Comptroller of Pub. Accounts, Comptroller's Decision, CPA Hearing No. 10,028 (Nov. 12, 1980) (final agency decision), <http://star.cpa.texas.gov/view/8011h0320c09> [<https://perma.cc/NV4W-K9HV>].

28. *Id.*

29. *Id.*

30. *Id.*

31. *Id.* Neither the Comptroller's Tax Division nor the television station asserted sourcing based on the location of the audience, and the decision did not state what that factor would have been. *Id.* However, since the taxpayer's New Mexico tower could broadcast to Texas as well as New Mexico, the New Mexico audience factor was presumably less than 32%, and less favorable to the taxpayer. *Id.* Perhaps the Comptroller's Tax Division should have argued the audience factor in the alternative.

32. *Id.* Ford alleged that "it must pay a tax on property neither located nor used within the State of Texas and on activities beyond the borders of Texas." Ford Motor Co. v. Beauchamp, 308 U.S. 331, 334 (1939).

33. Tex. Comptroller of Pub. Accounts, *Comptroller's Decision*, CPA Hearing No. 10,028 (Nov. 12, 1980) (final agency decision), <http://star.cpa.texas.gov/view/8011h0320c09> [<https://perma.cc/NV4W-K9HV>].

34. *Id.*

If not property and payroll, then what? The decision noted, as has this article, that “the statute is silent regarding the geographical character of receipts derived there from” services.³⁵ Accordingly, the decision announced the following standard, which has been repeated in subsequent Comptroller rulings:

To accomplish the goal of giving independent meaning and significance to the receipts factor from sales of services of a corporation, the phrase “services performed within Texas” as used in Art. 12.02(1)(b)(ii) must be construed as “units of service sold, the performance of which occurs within Texas,” thereby shifting the focus geographically from every activity performed by a corporation that generates service receipts, to those *specific, end-product acts for which a customer contracts and pays to receive*. If no distinction between *receipt-producing activities versus non-receipt-producing, albeit essential, support activities* were made, no independent meaning could be given to the “receipts from sales of services” factor, since the determination of the dollar amount of such services performed within Texas would always be ascertained by looking at other factors, such as the property and payroll located in Texas, on the theory that no activity of a corporation that generates service receipts is any more important than any other activity, since all are essential to the end-product performance of the service that is sold.³⁶

Using this standard, the Comptroller approved the taxpayer’s proposed sourcing based on the locations of the transmission towers, giving no weight to the taxpayer’s studio or other activities.³⁷

2. Hearing No. 10,386 (1981)³⁸

This hearing involved the sourcing of fees for management of apartment projects located in multiple states. The taxpayer’s employees were based in Dallas but traveled around Texas and other states performing their services. The decision held that “the location of the employees performing the services is a better indicator of place where the services were performed than is the location of the company or apartment

35. *Id.*

36. *Id.*

37. *Id.* The “specific end-product acts” theory would have also supported apportionment based on the audience factor, if either party had asserted it.

38. Tex. Comptroller of Pub. Accounts, *Comptroller’s Decision*, CPA Hearing No. 10,386 (July 27, 1981) (final agency decision), <http://star.cpa.texas.gov/view/8107h0355d07> [<https://perma.cc/5RJG-MNFW>].

project for whom the services were performed.”³⁹ However, because the taxpayer was unable to show the amount of time spent outside of Texas, the decision sourced all the service revenues to the employees’ home base in Texas.

The decision cited Hearing No. 10,028, indicating that it was intended to compliment, rather than contradict, Hearing No. 10,028. The decisions can be harmonized by recognizing that in Hearing No. 10,386, there was no specific end-product act for which the customer contracted and paid to receive. Instead, the parties agreed that the receipts-producing activities were the various management activities. The question was whether the Comptroller should source the receipts-producing activities to the various locations where the benefits were received, and the Comptroller answered in the negative.⁴⁰ Accordingly, the Comptroller sourced the receipts based on the locations where the employees worked.

3. Hearing No. 11,786 (1982)⁴¹

This hearing involved the sourcing of fees for loan servicing. The loan servicing consisted of “communicating with the debtors and keeping an accurate record of their various payments.”⁴² The taxpayer argued that “its loan servicing consists primarily of its employees dealing face-to-face with its debtor customers, and that its loan servicing receipts should therefore be distributed geographically on the same percentage basis its payroll is distributed.”⁴³ The Comptroller’s Tax Division “agreed that Petitioner should be allowed to use the payroll cost method during the audit period but that in the future it should use the total cost method,” rather than payroll costs alone.⁴⁴

The decision observed that if “a taxpayer provides one general service for a single fee but performs the various component parts thereof in more than one state, a definite problem arises, since there is no readily apparent way to divide the fee among the various states in which the tasks are

39. *Id.*

40. By contrast, the Comptroller applies the service-benefit rule in determining the situs for sales taxation of services. *E.g.*, 34 TEX. ADMIN. CODE § 3.330(e) (2015) (Comptroller of Public Accounts, Data Processing Services) (“Service benefit location.”).

41. Tex. Comptroller of Pub. Accounts, *Comptroller’s Decision*, CPA Hearing No. 11,786 (Dec. 10, 1982) (final agency decision), <http://star.cpa.texas.gov/view/8212h0483d14> [<https://perma.cc/S856-SGG6>].

42. *Id.*

43. *Id.*

44. *Id.*

performed.”⁴⁵ The decision then stated the following principle for resolving future disputes:

Since Petitioner's payroll expense is only one of the total costs incurred by Petitioner, it is concluded that it is not as representative an indicator of where Petitioner is performing its services as would be a method that took all costs incurred in performing the service into consideration. There[fore] it is concluded that the method proposed by the Business Tax Division for Petitioner to follow in the future is a better, more refined method for determining what portion of Petitioner's total receipts represent receipts from services performed in Texas.⁴⁶

Hearing No. 11,786, also cited Hearing No. 10,028, indicating that the decision was intended to complement, rather than contradict, Hearing No. 10,028.⁴⁷ Neither party claimed that there was a single, specific end-product act for which the customer contracted and paid to receive. Instead, the parties agreed that there were multiple receipts-producing activities and that sourcing should be based on the locations of those activities. The dispute and the decision were not about where the services were performed, that is, identifying the receipts-producing activities. Instead the dispute and the decision were about which costs should be included in sourcing the receipts-producing activities.⁴⁸

C. *Sourcing Service Receipts After the 1980s*

1. Changes to the Tax Base and Amendments to the Sourcing Rule

Beginning with Report Year 1992, the Texas Legislature added an earned surplus component to the franchise tax, which was essentially a tax

45. *Id.*

46. *Id.*

47. *Id.* Also, the two decisions were drafted by the same Administrative Law Judge.

48. Tex. Comptroller of Pub. Accounts, *Comptroller's Decision*, CPA Hearing No. 11,786 (Dec. 10, 1982) (final agency decision), <http://star.cpa.texas.gov/view/8212h0483d14> [<https://perma.cc/S856-SGG6>]. The Comptroller issued this decision before it had a rule sourcing multiple services based on fair value. 17 Tex. Reg. 4332, 4335 (1992), *adopted by* 17 Tex. Reg. 7667, 7670 (1992), *repealed by* 38 Tex. Reg. 3763, 3764 (2013), *adopted by* 38 Tex. Reg. 5109, 5109 (2013) (former 34 TEX. ADMIN. CODE § 3.557) (Tex. Comptroller of Pub. Accounts, Tax Admin., Franchise Tax). Therefore, its pronouncements on costs may or may not be relevant to current practice.

on net income.⁴⁹ Thereafter, taxpayers paid the larger of the tax on earned surplus or tax on capital.⁵⁰ The Legislature also added a new section to the Tax Code which provided that sourcing of service revenue for earned surplus purposes would be the same as taxable capital, based on “each service performed in this state.”⁵¹

The Comptroller responded with a new rule for earned surplus, which added a second sentence that was not previously in the rule for taxable capital: “(33) Services. Service receipts are apportioned to the location where the service is performed. If services are performed inside and outside Texas, such receipts are Texas receipts on the basis of the fair value of the services rendered in Texas.”⁵²

In 1998, the Comptroller amended the rule for taxable capital to track the rule for earned surplus.⁵³ Prior to that revision, the taxable capital rule simply said, “Service receipts are apportioned to the location where the service is performed.”⁵⁴

Beginning with Report Year 2008, the legislature replaced the tax on capital and earned surplus with a tax on “margin.”⁵⁵ The statutory apportionment formula for the margin tax continued to be based on “each service performed in this state,” with a proviso that “receipts . . . from servicing loans secured by real property” would be sourced based on the location of the property.⁵⁶ The Comptroller responded with a new sourcing rule for a taxable entity’s margin that tracked the prior rules for taxable capital and earned surplus:

Services. Receipts from a service are apportioned to the location where the service is performed. If services are performed both inside and outside

49. Act of Aug. 13, 1991, 72nd Leg., 1st C.S., ch. 5, § 8.031(a), 1991 Tex. Gen. Laws 134, 154 (amended 2006) (current version at TAX § 171.002).

50. *Id.*

51. Act of Aug. 13, 1991 § 8.06, 1991 Tex. Gen. Laws at 156.

52. 17 Tex. Reg. at 4335, *adopted by* 17 Tex. Reg. at 7670.

53. 22 Tex. Reg. 12702, 12702 (1997), *adopted by* 23 Tex. Reg. 3013, 3013 (1998) *repealed by* 38 Tex. Reg. at 3764, *adopted by* 38 Tex. Reg. at 5109 (former 34 TEX. ADMIN. CODE § 3.549) (Tex. Comptroller of Pub. Accounts, Tax Admin., Franchise Tax).

54. 21 Tex. Reg. 8905–07 (1996), *adopted by* 21 Tex. Reg. 11510, 11515 (1996), *repealed by* 38 Tex. Reg. at 3764, *adopted by* 38 Tex. Reg. at 5109 (former 34 TEX. ADMIN. CODE § 3.511) (Tex. Comptroller of Pub. Accounts, Tax Admin., Franchise Tax).

55. Act of May 2, 2006, 79th Leg., 3d C.S., Ch. 1, § 5, 2006 Tex. Gen. Laws 1, 19 (amended 2013) (current version at TAX § 171.103).

56. TAX § 171.103(a)(2).

Texas, then such receipts are Texas receipts on the basis of the fair value of the services that are rendered in Texas.⁵⁷

2. The Comptroller's Application of the New Sourcing Rule

The new sourcing rule added the sentence: "If services are performed both inside and outside Texas, then such receipts are Texas receipts on the basis of the fair value of the services that are rendered in Texas."⁵⁸ Although this sentence explained the manner of sourcing *if* services were performed inside and outside Texas, it did not explain *when* services would be considered to be performed inside and outside Texas. Thus, the rule did not repeal the 1980s receipt-producing, end-product acts approach, which narrowed the performance in some cases to a single place even though other preliminary, albeit essential, acts might be performed in other locations.

The Comptroller, which should have some say in interpreting its own rule,⁵⁹ continued to articulate the receipt-producing end-product acts approach in its rulings, indicating that the Comptroller did not interpret its sourcing rule as trumping that approach.⁶⁰ In these rulings, the Comptroller sourced the taxpayers' revenues to a single location even though the taxpayers may have conducted activities in more than one state, applying the principle of Hearing No. 10,028 that non-receipts-producing activities are disregarded.

57. 32 Tex. Reg. 10047, 10047 (2007) (codified at 34 TEX. ADMIN. CODE § 3.591(e)(26) (2015)).

58. *Id.*

59. *Sw. Bell Tel. Co. v. Combs*, 270 S.W.3d 249, 263 (Tex. App.—Amarillo 2008, pet. denied) ("[A]n agency's interpretation of its rule essentially becomes a part of the rule itself because the agency's interpretation represents the view of the regulatory body that drafted and administers the rule." (citing *BFI Waste Sys. of N. Am., Inc. v. Martinez Envtl. Grp.*, 93 S.W.3d 570, 575–76 (Tex. App.—Austin 2002, pet. denied))).

60. Tex. Comptroller of Pub. Accounts, *Comptroller's Decision*, CPA Hearing No. 104,224 (May 7, 2013) (final agency decision) (satellite television subscriptions), <http://star.cpa.texas.gov/view/201305715h> [<https://perma.cc/J8M4-J6XP>]; Tex. Comptroller of Pub. Accounts, *Private Letter Ruling*, Ruling No. 142830363 (Tax Policy Div. Apr. 12, 2016) (private letter ruling) (transportation management company), <http://star.cpa.texas.gov/view/201604750l> [<https://perma.cc/EB5M-369B>]; *see also* Tex. Comptroller of Pub. Accounts, *Private Letter Ruling*, Ruling No. 163050613 (Tax Policy Div. Mar. 15, 2017) (private letter ruling), <http://star.cpa.texas.gov/view/201703005l> [<https://perma.cc/5SY6-6WHL>] ("Thus, Taxpayer's service [real-time account verification] is not performed both inside and outside of Texas.").

For example, in a case involving technical training services developed in Oklahoma but delivered live in Texas, the Comptroller sourced the training revenue at issue entirely to Texas.⁶¹ Because the Comptroller sourced the taxpayers' revenues to a single state, the Comptroller held that the second sentence of the service receipt sourcing rule did not apply to these situations.⁶² As a result, the Comptroller did not make a "fair value" determination of the various activities that went into the service.

In other situations, when there was no single receipts-producing end-product act, the Comptroller sourced revenue based on the fair value of the services rendered in Texas.⁶³ For example, with regard to online stock trading fees, a Comptroller letter ruling stated, "The costs attributed to the services in Texas relative to the costs attributed to the out-of-state processing may be the best means of determining the fair value of the services performed in Texas."⁶⁴

3. *Westcott*—the Comptroller's Inconsistent Application of Its Sourcing Rule

The Comptroller's application of these principles has not been perfect. The most notable example is the *Westcott*⁶⁵ case, which was decided at the

61. Tex. Comptroller of Pub. Accounts, *Comptroller's Decision*, CPA Hearing No. 107,606 (July 28, 2014) (final agency decision), <http://star.cpa.texas.gov/view/201407943h> [<https://perma.cc/9MJN-94T6>].

62. *See id.* ("The brokerage company's service required the performance of work that was done both inside and outside Texas. That is not true in the instant matter. The training services at issue were provided in Texas."):

63. *E.g.*, Tex. Comptroller of Pub. Accounts, *Private Letter Ruling in Response to Request from Engineering Service Company Concerning Franchise Tax Apportionment*, Accession No. 200209824L (Tax Policy Div. Mar. 29, 2002) (private letter ruling), <http://star.cpa.texas.gov/view/200209824L> [<https://perma.cc/HL4T-2NJ9>] ("For example, the corporation provides engineering services to another entity and charges that entity \$100 for the services. It is determined that on the basis of the fair value of the services rendered in Texas, \$40 of the charges would be Texas receipts. The remainder of the work is performed outside Texas. Therefore, \$60 of the receipts from the charges would not be apportioned to Texas."):

64. Tex. Comptroller of Pub. Accounts, *Tax Policy Memorandum*, Accession No. 200807139 (Tax Policy Div. July 24, 2008) (tax policy memorandum), <http://star.cpa.texas.gov/view/200807139l> [<https://perma.cc/N6WN-QZYR>].

65. *Westcott Commc'ns, Inc. v. Strayhorn*, 104 S.W.3d 141 (Tex. App.—Austin 2003, pet. denied).

administrative level in Hearing No. 35,481⁶⁶ and later affirmed on appeal.⁶⁷

Westcott provided professional organizations, such as law enforcement agencies, with satellite dishes and supporting equipment through which the organizations could receive Westcott's exclusive training programs for the organizations' employees.⁶⁸ The Comptroller sourced the subscription revenues entirely to Westcott's production studio location.⁶⁹

On appeal, Westcott contended that its service was analogous to cable television, which the Comptroller sourced to the subscriber location.⁷⁰ The court of appeals rejected this contention:

Westcott misstates its service. Westcott is not paid to broadcast *or* produce television programming. It is paid to provide training to its customers. This training can include live broadcast sessions, interactive question-and-answer sessions, testing, and other educational and training services, all done by employees from its Texas facilities. Westcott is unlike a cable television provider because its services go well beyond providing a broadcast signal to its customers. In light of these facts, we hold that it was reasonable for the Comptroller to conclude that Westcott's training services were performed in Texas and are therefore covered under the franchise tax statute as gross receipts from business done in the state.⁷¹

The court of appeals deferred to the Comptroller's "reasonable" sourcing of subscriber revenue entirely to the location of Westcott's Texas production facility.

Several observations can be made about the court of appeals decision. First, the court did not rely upon or even cite to the second sentence of the Comptroller rule regarding situations in which "services are performed inside and outside Texas,"⁷² even though Westcott conducted activities

66. Tex. Comptroller of Pub. Accounts, *Comptroller's Decision*, CPA Hearing No. 35,481 (July 29, 1998) (final agency decision), <http://star.cpa.texas.gov/view/9807733h> [<https://perma.cc/5HVN-49NC>].

67. *Westcott*, 104 S.W.3d at 150–51.

68. *Id.* at 144–45.

69. *Id.* at 145.

70. *Id.* at 147.

71. *Id.*

72. 34 TEX. ADMIN CODE § 3.549 (1997) (Tex. Comptroller of Pub. Accounts, Tax Admin., Franchise Tax), *repealed by* 38 Tex. Reg. 3701, 3763 (2013), *adopted by* 38 Tex. Reg. 4957, 5109 (2013).

inside and outside of Texas.⁷³ If the court had determined that the services were performed inside and outside of Texas, it would have sourced the subscription revenues between the states based on fair value rather than assigning them entirely to Texas.

Second, the court did not repudiate the Comptroller's revenue-producing, end-product acts approach. In fact, the court cited Hearing No. 10,028 and endorsed the decision as a "longstanding interpretation" worthy of legislative acceptance.⁷⁴

Third, the Court could have more closely scrutinized the Comptroller's application of its longstanding interpretation. Was Westcott's service really different from a cable television service? For cable television, the programming content is undoubtedly essential. Subscribers may pay different fees for different program packages. But the Comptroller has determined that the revenue-generating, end-product act is the delivery of the cable television signal to the customer's location, even though the programming is essential to the service.⁷⁵

Similar to cable television, Westcott's training videos were essential to the service. Some of the classes were live and some were not.⁷⁶ Some of the classes were interactive while some were not.⁷⁷ But, even for the interactive classes, Westcott's primary advantage over in-person training was that the classes could be conducted at the customer locations. Therefore, similar to cable television, the delivery of the training programs to the subscriber locations via satellite would seem to be the revenue-producing, end-product act.

73. *Id.* at 145–46 ("Westcott produced, filmed, edited, and broadcast its training services in and from Texas. Westcott provided its subscribers with satellite dishes and supporting equipment to receive the programming.").

74. *Id.*

75. Tex. Comptroller of Pub. Accounts, *Comptroller's Decision*, CPA Hearing No. 35,481 (July 29, 1998) (final agency decision), <http://star.cpa.texas.gov/view/9807733h> [<https://perma.cc/5HVN-49NC>].

76. Five of the seven Westcott networks were primarily broadcast to subscribers from videotape. *See* Tex. Comptroller of Pub. Accounts, *Comptroller's Decision*, CPA Hearing No. 35,481 (July 29, 1998) (final agency decision), <http://star.cpa.texas.gov/view/9807733h> [<https://perma.cc/5HVN-49NC>] ("Most of the programs are broadcast live through various networks operated by Petitioner. The live programs are tape recorded and are sometimes broadcast from the tapes. Programs delivered through LETN, ASTN, FETN, HSTN, and LTCN are primarily produced and taped in Petitioner's facilities and broadcast to subscribers off of videotape. Programs supplied by AREN and the TI-IN are delivered live by satellite.").

77. *Id.*

For some Westcott programs, there may have been a few unique, customer-specific activities that were conducted at the Westcott production studio, such as grading papers. Based on those isolated acts, perhaps a portion of the subscription fee might have been justifiably sourced to the Westcott studio. However, the only way to source Westcott's revenue entirely to Texas is to conclude that all of the revenue-producing, end-product acts occurred at Westcott's Texas studio and to completely disregard the subsequent activities required to distribute the programming to customers nationwide. This outcome seems diametrically opposed not only to cable television subscription sourcing, but also to Hearing No. 10,028—the genesis of the Comptroller's revenue-producing, end-product acts standard.⁷⁸ In Hearing No. 10,028, the Comptroller sourced the broadcast television advertising receipts entirely to the local television station's distribution activity and completely disregarded the studio location, where at least some of the local television station programming was produced.⁷⁹

Thus, while the court of appeals deferred to the Comptroller's interpretation, the interpretation was inconsistent with the Comptroller's other applications of the revenue-producing, end-product acts standard. The Comptroller would have been more consistent if it had determined that the revenue-generating, end-product act was the delivery of the programming signal to the customers' locations.

D. *Sourcing Service Receipts in the Future*

Two pending cases may affect the future of apportionment in Texas. The first is *Sirius XM Radio*,⁸⁰ which is pending in the Travis County District Court at the time of this writing. Sirius XM, a satellite radio company, is contesting the Comptroller's sourcing of subscriber revenues based on subscriber location. Sirius's Original Petition alleges that its service is “performed entirely outside of Texas.”⁸¹ However, the

78. Tex. Comptroller of Pub. Accounts, *Comptroller's Decision*, CPA Hearing No. 10,028 (Nov. 12, 1980) (final agency decision), <http://star.cpa.texas.gov/view/8011h0320c09> [<https://perma.cc/5BE5-QK7N>].

79. *Id.*

80. *Sirius XM Radio v. Hegar*, No. D-1-GN-16-000739 (261st Dist. Ct., Travis County, Tex. (pending)).

81. Plaintiff's Original Petition and Request for Disclosure at 6, *Sirius XM Radio v. Hegar*, No. D-1-GN-16-000739 (261st Dist. Ct., Travis County, Tex. (pending)).

company has produced a cost study to source its service receipts between Texas and other states.⁸²

The second case is *OGCI Training, Inc.*,⁸³ which is also pending in the Travis County District Court at the time of this writing. The case involves a protest payment appeal of the tax assessed in Hearing No. 107,606, a decision previously referenced in this paper.⁸⁴ OGCI generated revenues from various consulting activities, the bulk of which were revenues from training tuitions.⁸⁵ Hearing No. 107,606 held that “Petitioner’s Oklahoma headquarters was involved in preparing and marketing the services, but the ‘act done’ that produced the revenues at issue was performed completely in Texas[,]” where the training occurred.⁸⁶ In the litigation, OGCI asserts that its receipts-producing activities were performed both inside and outside of Texas and that a “proportionate cost of performance” analysis should be applied.⁸⁷

These cases may influence the extent to which the “receipts-producing” acts are determined narrowly as the Comptroller has found, or, more broadly, as taxpayers advocate. If the courts determine that there were multiple receipts-producing acts in multiple states, the courts will also have to determine the “fair value” of the various acts under the second sentence of the Comptroller’s service receipt sourcing rule.

III. WHAT LESSONS CAN TEXAS LEARN FROM OTHERS?

Many other states have followed the Uniform Division of Income for Tax Purposes Act (UDITPA) and sourced service receipts for apportionment purposes based on the location of the “income-producing

82. Expert Report of Michael Starkey, On Behalf of Sirius XM Radio, Inc., Sirius XM Radio v. Hegar, No. D-1-GN-16-000739 (261st Dist. Ct., Travis County, Tex. (pending)).

83. *OGCI Training, Inc. v. Hegar*, No. D-1-GN-14-005375 (345th Dist. Ct., Travis County, Tex. (pending)).

84. Tex. Comptroller of Pub. Accounts, *Comptroller’s Decision*, CPA Hearing No. 107,606 (July 28, 2014) (final agency decision), <http://star.cpa.texas.gov/view/201407943h> [<https://perma.cc/9MJN-94T6>].

85. Plaintiff’s First Amended Petition at 11, *OGCI Training, Inc. v. Hegar*, No. D-1-GN-14-005375 (345th Dist. Ct., Travis County, Tex. (pending)).

86. Tex. Comptroller of Pub. Accounts, *Comptroller’s Decision*, CPA Hearing No. 107,606 (July 28, 2014) (final agency decision), <http://star.cpa.texas.gov/view/201407943h> [<https://perma.cc/9MJN-94T6>].

87. Plaintiff’s First Amended Petition at 12, *OGCI Training, Inc. v. Hegar*, No. D-1-GN-14-005375 (345th Dist. Ct., Travis County, Tex. (pending)).

activity.”⁸⁸ And if the “income-producing activity is performed both inside and outside” of a state, the service receipts are then sourced to the state with the greater income-producing activity as measured by the cost of performance.⁸⁹

The “receipts-producing activities” standard articulated in Hearing No. 10,028⁹⁰ sounds similar to the UDITPA “income-producing activity” standard.⁹¹ And the “services are performed both inside and outside Texas”⁹² portion of the Comptroller’s sourcing rule resembles a similar phase in UDITPA.⁹³ Neither Hearing No. 10,028 nor the preambles to the Comptroller rules give any indication that they were drawing upon UDITPA, and in practice, the Comptroller does not base its decisions on UDITPA precedent.⁹⁴ However, as Texas applies its own standard, there may be lessons that can be learned from the studies and applications of the UDITPA standards in other states.

88. UNIF. DIV. OF INCOME FOR TAX PURPOSES ACT § 17 (NAT’L CONFERENCE OF COMM’RS ON UNIF. STATE LAWS 1957), <http://www.uniformlaws.org/shared/docs/uditpa/uditpa66.pdf> [<https://perma.cc/9EMN-2KFN>]; *see also* 1 JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, STATE TAXATION ¶ 9.01 (3d ed. 2001) (noting several states have adopted the Uniform UDITPA or a closely analogous statute).

89. UNIF. DIV. OF INCOME FOR TAX PURPOSES ACT § 17 (NAT’L CONFERENCE OF COMM’RS ON UNIF. STATE LAWS 1957), <http://www.uniformlaws.org/shared/docs/uditpa/uditpa66.pdf> [<https://perma.cc/9EMN-2KFN>].

90. Tex. Comptroller of Pub. Accounts, *Comptroller’s Decision*, CPA Hearing No. 10,028 (Nov. 12, 1980) (final agency decision), <http://star.cpa.texas.gov/view/8011h0320c09> [<https://perma.cc/5BE5-QK7N>].

91. UNIF. DIV. OF INCOME FOR TAX PURPOSES ACT § 17 (NAT’L CONFERENCE OF COMM’RS ON UNIF. STATE LAWS 1957), <http://www.uniformlaws.org/shared/docs/uditpa/uditpa66.pdf> [<https://perma.cc/9EMN-2KFN>].

92. 34 TEX. ADMIN. CODE § 3.591(e)(26) (2015) (Tex. Comptroller of Pub. Accounts, Tax Admin, Franchise Tax, Margin: Apportionment).

93. The remainder of the standard is different. The UDITPA provides that if the income-producing activity is performed inside and outside the state, receipts are sourced entirely to the state where “greater proportion of the income-producing activity is performed . . . based on costs of performance.” UNIF. DIV. OF INCOME FOR TAX PURPOSES ACT § 17 (NAT’L CONFERENCE OF COMM’RS ON UNIF. STATE LAWS 1957), <http://www.uniformlaws.org/shared/docs/uditpa/uditpa66.pdf> [<https://perma.cc/9EMN-2KFN>]. The Texas rule says that in that circumstance, receipts are sourced “on the basis of the fair value of the services[.]” which may or may not be the same as cost-of-performance. ADMIN. § 3.591(e)(26). The determination of fair value is beyond the scope of this article.

94. *See* Tex. Comptroller of Pub. Accounts, *Comptroller’s Decision*, CPA Hearing No. 10,028 (Nov. 12, 1980) (final agency decision), <http://star.cpa.texas.gov/view/8011h0320c09> [<https://perma.cc/5BE5-QK7N>] (making no mention of the UDITPA with regard to the formulation of the Comptroller’s conclusion).

One commenter observed that a “fundamental problem” with the income-producing activity test is that the test attempts to isolate the activities that produce unitary business income, while the concept of unitary business income presupposes that all of the activities of the unitary business are interrelated.⁹⁵ On the other hand, as Hearing No. 10,028 observed, if the legislature intended all of a company’s unitary property and payroll to be considered, there would be no need for an apportionment factor based on receipts.⁹⁶ Accordingly, even though there may be some interrelationship of activities, the legislature’s use of the receipts factor inherently suggests that some differentiation of activities is required.

Another “fundamental objection” to the UDITPA test for services is that it “fails to serve the purpose of the sales factor to reflect the contribution of the market state to the taxpayer’s income.”⁹⁷ Given that purpose, it should not be surprising that states tend to focus on the activities at the customer location.⁹⁸ This focus may be especially appropriate when there is ambiguity regarding the location of the income-producing activities, and when the delivery of the end product to the service recipient’s location is an important part of the service. In those instances, administrative agencies may view the acts leading up to the delivery as mere preparatory acts instead of income-producing acts, even though the service could not be delivered without the preparatory acts.

The income-producing activity test has also been criticized as an “indeterminate test”⁹⁹ with “inherent ambiguities.”¹⁰⁰ Commentators observe that state courts have reached different conclusions on essentially similar facts.¹⁰¹ For example, a Tennessee court held that the “earnings-producing activity” that resulted in advertising receipts from the

95. RICHARD D. POMP, *STATE & LOCAL TAXATION* 10–39 (8th ed. 2015).

96. Tex. Comptroller of Pub. Accounts, *Comptroller’s Decision*, CPA Hearing No. 10,028 (Nov. 12, 1980) (final agency decision), <http://star.cpa.texas.gov/view/8011h0320c09> [<https://perma.cc/5BE5-QK7N>].

97. John A. Swain, *Reforming the State Corporate Income Tax: A Market State Approach to the Sourcing of Service Receipts*, 83 TUL. L. REV. 285, 298, n.56 (2008) (quoting HELLERSTEIN, *supra* note 88, ¶ 8.06).

98. See Catherine A. Battin, Maria P. Eberle & Lindsay M. LaCava, *Demystifying the Sales Factor: Market-Based Sourcing*, 72 ST. TAX NOTES 403, 404 (2014) (“Some state tax authorities have employed a market-based sourcing method without statutory support.”).

99. HELLERSTEIN, *supra* note 88, ¶ 9.18[3][a].

100. Swain, *supra* note 97, at 304–05.

101. HELLERSTEIN, *supra* note 88, ¶ 9.18[3][b][i].

distribution of Yellow Pages was a “series of integrated, interdependent steps to the satisfaction of the advertisers from whom [the taxpayer] derives its income.”¹⁰² On the other hand, a Wisconsin court found that the Yellow Pages services “was, at bottom, the provision of access to a Wisconsin audience[,]” and agreed with the tax agency that apportionment should be based “on the last activity in its chain of service activities, the distribution of directories[.]”¹⁰³

Another example of disparate outcomes is the sourcing of telephone company receipts.¹⁰⁴ The Oregon Supreme Court accepted the tax agency’s argument that AT&T’s income-producing activity was “the activity that produced each individual interstate and international phone and data transmission billed to an Oregon customer[,]” and thus the only costs to be considered were the “incremental costs associated with each individual call or billing, not overall network costs.”¹⁰⁵ On the other hand, the Massachusetts Appellate Tax Board found that AT&T’s income-producing activity was the operation of its global network.¹⁰⁶

The Texas approach leans towards a narrow interpretation of the “receipts-producing activities.” Hearing No. 10,028, and the decisions that follow it, focus on the “specific, end-product acts for which a customer contracts,” and not on the “non-receipt producing, albeit essential, support activities.”¹⁰⁷ Hearing No. 10,028 used the example of an aerial advertising company that displayed messages in Texas but had its facilities in Oklahoma where it prepared the messages and maintained its fleet of airplanes.¹⁰⁸ The decision concluded: “The fact that property, payroll and essential activities to the success of the business had a situs in Oklahoma would be considered irrelevant to the question of where its receipt-producing activities occurred.”¹⁰⁹

102. *Bellsouth Advert. & Publ'g Corp. v. Chumley*, 308 S.W.3d 350, 364 (Tenn. Ct. App. 2009).

103. *Ameritech Publ'g, Inc. v. Wis. Dep't of Revenue*, 788 N.W.2d 383, 29, 34 (Wis. Ct. App. 2010).

104. *See Swain, supra* note 97, at 302, n.72 (“The place-of-performance rule has the unintended consequence of attributing service receipts to their origin rather than destination.”).

105. *AT&T Corp. v. Dep't of Revenue*, 358 P.3d 973, 977, 986 (Ore. 2015).

106. *AT&T Corp. v. Comm'r of Revenue*, No. C293831, 2011 WL 2243933, at *11 (Mass. App. Tax Bd. June 8, 2011).

107. Tex. Comptroller of Pub. Accounts, *Comptroller's Decision*, CPA Hearing No. 10,028 (Nov. 12, 1980) (final agency decision), <http://star.cpa.texas.gov/view/8011h0320c09> [<https://perma.cc/5BE5-QK7N>].

108. *Id.*

109. *Id.*

The narrow approach in Texas is also reflected in litigation comparable to the aforementioned Yellow Pages controversy in other states. A Texas court ruled that the advertising revenues derived from trade magazines delivered free of charge to recipients should be sourced to the circulation of the magazines, and not to the location of the company headquarters and printing operations.¹¹⁰ The Comptroller followed with a rule amendment incorporating the decision.¹¹¹

In a hearing involving the apportionment of satellite television revenue, the Comptroller sourced subscription fees to the locations of the subscribers, disregarding the fact that “[e]ach of the actions Petitioner takes in receiving and transmitting the programming is essential to its survival as a business.”¹¹² The outcome of this hearing was comparable to the outcome of a recent South Carolina decision that also involved satellite television revenue. The South Carolina decision disregarded the “‘preparatory’ activities that [the taxpayer] engages in for the production of its programming and marketing.”¹¹³

In these instances, it could be said that the results were market-based because the receipts-producing end-product acts occurred where the customers were located. But the results may not always be market-based. For example, in Hearing No. 10,386, which involved the management of apartment complexes, there was no receipts-producing end-product act.¹¹⁴ Accordingly, the Comptroller recognized that the receipts should be sourced to multiple locations where the work was performed and not to the locations that benefitted from the work.

110. Gulf Publishing v. Rylander, No. 98-04208, TAX POL. NEWS, May 2001 (Dist. Ct., Travis County, Tex. Feb. 2001), <http://star.cpa.texas.gov/view/200105772l> [<https://perma.cc/89J5-XF25>].

111. 34 TEX. ADMIN. CODE § 3.549(e)(28) (2006) (Comptroller of Pub. Accounts, Tax Administration, Franchise Tax), *repealed by* 38 Tex. Reg. 3701, 3763–64 (2013), *adopted* 38 Tex. Reg. 4957, 5109–10 (2013). The current rule is located at 34 TEX. ADMIN. CODE § 3.591(e)(20) (2015) (Tex. Comptroller of Pub. Accounts, Margin: Apportionment).

112. Tex. Comptroller of Pub. Accounts, *Comptroller's Decision*, CPA Hearing No. 104,224 (May 17, 2013) (final agency decision), <http://star.cpa.texas.gov/view/201305715h> [<https://perma.cc/J8M4-J6XP>].

113. DirectTV, Inc. v. S.C. Dep't of Revenue, 804 S.E.2d 633, 643 (S.C. Ct. App. 2017).

114. Tex. Comptroller of Pub. Accounts, *Comptroller's Decision*, CPA Hearing No. 10,386 (July 27, 1981) (final agency decision), <http://star.cpa.texas.gov/view/8107h0355d07> [<https://perma.cc/5RJG-MNFW>].

Finally, the commentators have recognized that when it comes to service revenue sourcing, “one size does not fit all.”¹¹⁵ “[N]o formula seemed to be satisfactory for every possible situation.”¹¹⁶ For that reason, UDITPA authorizes alternative apportionment for particular taxpayers and the possible employment of “any other method to effectuate an equitable allocation and apportionment of the taxpayer’s income.”¹¹⁷ “Any other method” does not “foreclose the use of one method for some business activity and a different method for a different business activity.”¹¹⁸ Under this authority, the Multistate Tax Commission (MTC) drafted, and many states adopted, special rules for specific industries, including airlines, construction contractors, publishing, railroads, television and radio broadcasting, trucking companies, and telecommunications providers.¹¹⁹ These special rules often use a market-based approach to sourcing, even though the general rule may use a cost-of-performance approach.

Texas on its own, has learned that one size does not fit all. Although the Texas apportionment statute does not allow for alternative apportionment for individual taxpayers, the Comptroller has over time adopted specialized rules for specific industries.¹²⁰ While not based on the MTC model regulations, and in some cases, preceding the MTC model regulations, the Comptroller’s specialized rules cover many of the same industries.¹²¹ For example, Texas avoided the aforementioned dispute

115. RICHARD POMP, REPORT OF THE HEARING OFFICER, MULTISTATE TAX COMPACT ARTICLE IV [UDITPA] PROPOSED AMENDMENTS 19 (2013), http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Pomp%20final%20final3.pdf [<https://perma.cc/K45S-RUL5>].

116. HELLERSTEIN, *supra* note 88, ¶ 9.18[3][a].

117. UNIF. DIV. OF INCOME FOR TAX PURPOSES ACT § 18 (NAT’L CONFERENCE OF COMM’RS ON UNIF. STATE LAWS 1957), <http://www.uniformlaws.org/shared/docs/uditpa/uditpa66.pdf> [<https://perma.cc/9EMN-2KFN>].

118. *Id.*

119. *Adopted Uniformity Recommendations*, MULTISTATE TAX COMM’N <http://www.mtc.gov/Uniformity/Adopted-Uniformity-Recommendations> [<https://perma.cc/W6NE-9DQW>].

120. *See* 34 TEX. ADMIN. CODE § 3.591(e) (2015) (Tex. Comptroller of Pub. Accounts, Tax Admin., Franchise Tax, Margin: Apportionment) (providing sourcing rules for industries such as newspapers and magazines, radio and television, Internet, and loan servicing of real property).

121. *Compare Adopted Uniformity Recommendations*, *supra* note 119, (detailing guidelines for industries such as financial institutions and trucking companies), *with* 34 TEX. ADMIN. CODE § 3.591(e) (2015) (Tex. Comptroller of Pub. Accounts, Tax Admin., Franchise Tax, Margin: Apportionment) (listing specific rules for companies and banking institutions).

over the “income-producing activity” of telephone companies by adopting a special apportionment rule for telephone companies.¹²²

IV. CONCLUSIONS

The overall lesson learned is that the sourcing of service receipts for apportionment purposes is difficult. To avoid the challenges of the income-producing act or cost-of-performance approach, the MTC and many states have moved to a market-based approach for sourcing receipts for services.¹²³ Under that method, service receipts are generally sourced to the location of the recipient of the service. However, market-based sourcing has its own difficulties, including the fact that one size still does not fit all. Accordingly, the Multistate Tax Commission model regulations for market-based sourcing of services provide specific standards for in-person services, services delivered to the customer or on behalf of the customer, and professional services.¹²⁴

Any statutory method for sourcing service receipts will have inherent shortcomings. Nevertheless, tax administrators have to accept those shortcomings and the limitations of their statutes and attempt to fashion standards and outcomes that have some logic for consistent, if not universal, application.

As a general unifying principle, however hard it may be to apply, Texas makes a “distinction between receipt-producing activities versus non-receipt-producing, albeit essential, support activities.”¹²⁵ As previously explained, in some instances, if the receipts can be attributed to a single receipts-producing act, that distinction may result in sourcing based

122. 34 TEX. ADMIN. CODE § 3.591(e)(30) (2015) (Tex. Comptroller of Pub. Accounts, Tax Admin, Franchise Tax, Margin: Apportionment). That is not to say that Texas avoided a controversy. As is often the case, the adoption of a rule merely shifted the controversy from the application of the statute to the application of the rule. *See generally* Sw. Bell Tel. Co. v. Combs, 270 S.W.3d 249, 258–72 (Tex. App.—Amarillo 2008, pet. denied) (litigating whether the receipts were for “receipts from interstate calls” and “revenues from calls in interstate commerce” as provided in the Comptroller rules, instead of litigating whether the receipts were for “service performed in this state,” as provided in the statute (citing ADMIN. §§ 3.549(e) (39), (43))).

123. *See* MODEL COMPACT ART. IV DIV. OF INCOME § 17 (MULTISTATE TAX COMM’N, rev. 2015), <http://www.mtc.gov/getattachment/Uniformity/Article-IV/Model-Compact-Article-IV-UDITPA-2015.pdf.aspx> [<https://perma.cc/SJ48-BLK4>] (“Receipts, other than receipts described in Section 16, are in this State if the taxpayer’s market for the sales is in this state.”).

124. *Id.*

125. Tex. Comptroller of Pub. Accounts, *Comptroller’s Decision*, CPA Hearing No. 10,028 (Nov. 12, 1980) (final agency decision), <http://star.cpa.texas.gov/view/8011h0320c09> [<https://perma.cc/5BE5-QK7N>].

entirely on the location of the recipient of the service. In other instances, if there are multiple receipts-producing acts, that distinction may result in sourcing to multiple locations, none of which may be the location of the recipient of the services.

Can the focus on the receipts-producing end-product acts be universally applied? No. In some instances, the result is not optimal. For example, it could be said that transportation services have a receipts-producing end-product act—the delivery of the goods or passengers to the final destination. However, sourcing all the receipts from the service to the point of delivery seems intuitively wrong because the transport of the goods or passengers may occur over an extended period of time in multiple states in more or less equal increments of effort. One mile of transportation is about the same as any other. Accordingly, Texas has a rule contrary to the receipts-producing end-product acts approach that allows sourcing based on the “total mileage in the transportation of goods and passengers that move in intrastate commerce within Texas divided by the total mileage everywhere.”¹²⁶

If a standard cannot be universally applied, should it be rejected? No. Even the critics acknowledge that it is “difficult to argue that every single activity engaged in by a taxpayer[—]no matter how ministerial[—]should be an income-producing activity[.]”¹²⁷ So a tax agency must articulate some standards for differentiating between acts, even if the standards cannot be universally applied. And the lack of universality means that a tax agency should be allowed to apply the standards with some flexibility, unless the agency crosses the line into arbitrary and capricious territory.

126. ADMIN. § 3.591(e)(32)(B).

127. Catherine A. Battin, Maria P. Eberle & Lindsay M. LaCava, *Demystifying the Sales Factor: Costs of Performance*, 71 ST. TAX NOTES 153, 158 (2014).

EPILOGUE

With these conclusions in mind, consider the examples from the beginning of the article. Example A involved a performance with an audience at the same location. Example B involved a performance with an audience at different locations. Example C involved the filing of a federal tax return.

All of these examples could be said to involve a receipts-producing end-product act. However, the authors have speculated that the Comptroller would source the revenues from Examples A and B entirely to the location of the audience, while the Comptroller would source the revenues from Example C to the location or locations where the accountants prepared the tax return without regard to the end-product act of filing the tax return. Is it possible for those outcomes to be reasonable applications of the Comptroller's standard without being arbitrary and capricious or violations of equal and uniform taxation?

In situations involving a paying audience, the Comptroller has staked out the position under the receipts-producing end-product acts standard that receipts paid by the audience will be sourced to the audience location and preparatory acts will be disregarded.¹²⁸ The amount of the admission fee might vary depending on the preparatory acts required, but none of the preparatory acts in Examples A and B are performed uniquely for a particular customer. The only unique act particular to a customer may be the transfer of the right to occupy a particular seat. And that right is location specific. Thus, the location of the end-product act is material—it must be performed where the recipient is located. In isolation, this outcome seems reasonable, and courts in various jurisdictions have found similar outcomes to be reasonable.¹²⁹

If the Comptroller's sourcing of admission fees based on audience location is reasonable in isolation, will the Comptroller be acting arbitrarily

128. Tex. Comptroller of Pub. Accounts, *Comptroller's Decision*, CPA Hearing No. 104,224 (May 17, 2013) (final agency decision), <http://star.cpa.texas.gov/view/201305715h> [<https://perma.cc/J8M4-J6XP>] (satellite television subscriptions); Tex. Comptroller of Pub. Accounts, *Comptroller's Decision*, CPA Hearing No. 107,606 (July 28, 2014) (final agency decision), <http://star.cpa.texas.gov/view/201407943h> [<https://perma.cc/9MJN-94T6>] (technical training seminars).

129. See *DirectTV, Inc. v. S.C. Dep't of Revenue*, 804 S.E.2d 633, 646 (S.C. Ct. App. 2017) (finding satellite television subscription revenue sourced to subscriber locations); *Ameritech Publ'g, Inc. v. Wis. Dep't of Revenue*, 788 N.W.2d 383, ¶¶ 33, 41 (Wis. Ct. App. 2010) (concluding yellow pages advertising revenue sourced to delivery locations).

and capriciously if it sources professional service fees based on the locations of the preliminary acts that culminate in a tangible work product? Or conversely, if the Comptroller sources professional service fees based on the locations of the preliminary acts that culminate in a tangible work product, will the Comptroller be acting arbitrarily and capriciously if it sources admission fees based on audience location and disregards the preparatory acts? And if the conduct is arbitrary and capricious, do taxpayers get to choose the way they want the system to work?

In Example C, there is an end-product act—the filing of the tax return. And the failure of the accounting firm to file the federal return would probably be a material breach of the contract. But is the filing really material for sourcing purposes and is the location of the end-product act material? Suppose the contract called for the final tax return to be delivered to the client for review, signature, and filing, rather than filed directly with the government by the accounting firm. Would the fee be materially different? Probably not. So, although filing the return may be an end-product act, albeit an essential act to avoid a material breach of the contract, it may not be a material receipts-producing act.

Perhaps for these reasons, the Comptroller has allowed the sourcing of professional service receipts to be based on the preparatory activities¹³⁰ even though professional services may often result in an end-product, such as a report or a tax return that is delivered to the client or the client's designee. On the surface, this outcome may seem contrary to the sourcing of audience-based receipts that disregard preparatory acts. But the seemingly disparate outcome may in fact have a principled reason for differentiation. Some pigs go to market; some pigs stay home.

130. Tex. Comptroller of Pub. Accounts, *Private Letter Ruling*, Accession No. 200209824L (Tax Policy Div. Sept. 20, 2002) (private letter ruling) (engineering services), <http://star.cpa.texas.gov/view/200209824l> [<https://perma.cc/HL4T-2N9J>].