



## Texas Amends its Service Revenue Sourcing Rules

On January 15, 2021, the state of Texas published new regulations that alter its means of sourcing service revenue for the state's margin tax. As detailed below, these changes affect sourcing various types of services revenue, including internet hosting, advertising, digital property, capital assets and investments, single-member LLC interests and financial derivatives.

Despite the recent publishing of these regulations, the Texas Comptroller may apply these changes retroactively to report years dating back to 2008, unless otherwise noted.

### Overview of Texas' New Sourcing Rules

Texas has historically sourced service revenue to the location where the service was performed (i.e., the cost of performance method). To the extent a service was rendered both inside and outside the state, Texas would historically have sourced the service revenue to Texas based on the portion of the "fair value" of the services that were performed in the state.

The amended rule clarifies that the service is deemed to be performed at the location of the receipts-producing, end-product act(s), regardless of other acts, no matter how essential.<sup>1</sup> In doing so, the regulations creates a bifurcated distinction between receipts-producing and non-receipts producing activities. For example, when an audience pays to observe a live or pre-recorded performance, the receipts-producing, end-product act takes place where the recipients observe the performance, not where the performance was rehearsed, recorded or where admission fees are paid. As such, the revenue would be sourced to where the audience observed the performance.<sup>2</sup> In effect, these regulatory changes serve as a continuation of the state's shift to interpreting its cost of performance sourcing statute to be more in line that of market-based sourcing rules.

Notably, the regulations caution that when determining the "fair value" of services performed, factoring actual costs for performing a service, such as hours worked, can be helpful but does not necessarily represent a service's fair value.<sup>3</sup>

### Additional Changes for Texas Sourcing

- **Internet Hosting:** The recent amendments expand the definition of internet hosting to include "real-time, nearly real-time and on-demand access to the internet" and computer services. The examples provided in the amendments may also include software-as-a-service ("SaaS").<sup>4</sup> Also, service providers must source the revenue to the physical location of where the end-customer "consumes the service," regardless if the

<sup>1</sup> See Texas Admin. Code § 3.591(e)(26)(A).

<sup>2</sup> See Texas Admin. Code § 3.591(e)(26)(A)(i).

<sup>3</sup> See Texas Admin. Code § 3.591(e)(26)(B).

<sup>4</sup> See Texas Admin. Code § 3.591(e)(13)(A).

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service provider's initial customer resold the internet hosting service to a secondary party.<sup>5</sup>

- **Advertising:** Receipts from advertising services are sourced to the locations of the advertising audience, whether the advertising is delivered in a physical or digital medium.<sup>6</sup>
- **Digital Property:** Gross receipts from the sale or lease of digital property that is transferred by means other than by fixed physical media are sourced as the sale of intangible property.<sup>7</sup>
- **Single-Member LLC Interest:** The sale of a single-member LLC by its sole owner is the sale of a membership interest in the single-member LLC. The membership interest is an intangible asset and receipts from the sale of a SM LLC are sourced to the location of payor.<sup>8</sup>
- **Capital Assets & Investments:** The net gain from the sale of a capital asset or investment is sourced based on the type of asset or investment sold.<sup>9</sup> The net gain from the sale of an intangible asset is generally sourced to the location of the payor, except in certain cases for securities.<sup>10</sup> The net gain from the sale of real property is sourced to the location of the property.<sup>11</sup> The net gain from the sale of tangible personal property is generally sourced to the location of delivery, with numerous clarifications on title passage, mode of transportation and subsequent shipment outside of Texas.<sup>12</sup>

It is important to note that only the net gain from the sale of a capital asset or investment is included in gross receipts and not the net loss.<sup>13</sup> This rule applies to loans and securities, so long as the loans are not treated as inventory.

- **Financial Derivatives:** Gross receipts from the settlement of financial derivatives contracts, including hedges, options, swaps, futures, forward contracts and other risk management transactions, and gross receipts from the sale of securities are generally sourced to the location of the payor.<sup>14</sup> However, if securities are sold through an exchange and the payor is unidentifiable, then 8.7% of the revenue is sourced as a Texas

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<sup>5</sup> See Texas Admin. Code § 3.591(e)(13)(E).

<sup>6</sup> See Texas Admin. Code § 3.591(e)(1).

<sup>7</sup> See Texas Admin. Code § 3.591(e)(3)(E).

<sup>8</sup> See Texas Admin. Code § 3.591(e)(27).

<sup>9</sup> See Texas Admin. Code § 3.591(e)(2)(D).

<sup>10</sup> See Texas Admin. Code § 3.591(e)(21)(B).

<sup>11</sup> See Texas Admin. Code § 3.591(e)(23).

<sup>12</sup> See Texas Admin. Code § 3.591(e)(29).

<sup>13</sup> See *Hallmark Marketing Company, LLC, v. Hegar*, 488 S.W. 3d 795 (2016).

<sup>14</sup> See Texas Admin. Code §§ 3.591(e)(10) and 3.591(e)(16).



gross receipt for reports due after January 1, 2021.<sup>15</sup> For reports originally due prior to January 1, 2021, 7.9% may be used instead of 8.7%.<sup>16</sup>

### **What Does This Mean?**

The changes mentioned above will have a direct impact on service providers inside and outside of Texas. Accordingly, service providers conducting business in Texas may bear the burden of determining and documenting where their customers are located as Texas shifts to its sourcing principles to be more in line with market-based sourcing.

### **We're Here to Help**

If you would like to discuss how your business may be impacted by these changes or for more information about Bennett Thrasher's State & Local Tax practice, contact [Brian Sengson](#) or [Stephen Bradshaw](#) by calling 770.396.2200.

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<sup>15</sup> See Texas Admin. Code § 3.591(e)(25).

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