

**PRESENTED AT**

The University of Texas School of Law  
70<sup>th</sup> Annual Taxation Conference

November 30 – December 1, 2022  
Austin, TX

**Texas Taxes – Recent Developments****Lacy Leonard**

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# Table of Contents

<b>I.</b>	<b>FRANCHISE TAX</b> .....	<b>1</b>
	COST OF GOODS SOLD (COGS) .....	1
	COMPENSATION.....	2
	APPORTIONMENT.....	3
	RATE .....	12
	RESEARCH & DEVELOPMENT CREDIT .....	14
<b>II.</b>	<b>SALES TAX</b> .....	<b>19</b>
	LOCAL SALES TAX SOURCING FOR ONLINE SALES.....	19
	MANUFACTURING EXEMPTION .....	22
	DATA PROCESSING .....	26
<b>III.</b>	<b>JURISDICTION &amp; PROCEDURE</b> .....	<b>28</b>
	PROCEDURAL RULE UPDATES FOR 90-DAY CERTIFICATE DEADLINE.....	28
	NEW RULE FOR BANKS SHARING DELINQUENT TAXPAYER RECORDS. ....	28
	ADDING SUBSEQUENT TAX PERIODS TO PENDING LITIGATION .....	30
	THE JURISDICTIONAL SAGA OF <i>EL PASO ELECTRIC COMPANY V. HEGAR</i> .....	30

## I. Franchise Tax

### Cost of Goods Sold (COGS)

**Satellite Radio Service Not Engaged in Sale of Goods.** In *Hegar v. Sirius XM Radio, Inc.* the Third Court of Appeals found that Sirius was not engaged in the sale of goods and was therefore ineligible to claim the cost of goods sold subtraction.<sup>1</sup> Sirius provides subscription-based satellite radio service, producing most of its radio content exclusively for customers, transmitting content to satellites, and then receiving and unscrambling the satellite signals in its customers' vehicles.

Sirius paid car manufacturers to install satellite-enabled radios in vehicles, hoping to later sell subscriptions to those vehicles' owners. Sirius claimed that it was entitled to amend its cost of goods sold subtraction to include the payments to manufacturers to subsidize the installation of the satellite radios.<sup>2</sup>

To claim the cost of goods sold subtraction, a taxable entity must sell "goods," which are real or tangible personal property.<sup>3</sup> The subtraction is generally unavailable to an entity selling only services. "Tangible personal property" is defined as "personal property that can be seen, weighed, measured, felt, or touched or that is perceptible to the senses in any other manner."<sup>4</sup> This includes "films, sound recordings, videotapes, live and prerecorded television and radio programs, books, and other similar property embodying words, ideas, concepts, images, or sound."<sup>5</sup> A taxpayer engaged in the sale of goods is entitled to include all direct costs of producing the goods in its cost of goods sold subtraction.<sup>6</sup>

The Third Court of Appeals rejected Sirius XM's argument that it sold "live and prerecorded . . . radio programs" that were "produced" by its unscrambling of the satellite signals in the vehicles.<sup>7</sup> The court relied on the Texas Supreme Court's finding in *American Multi-Cinema* that "property with a physical or demonstrable—that is, tangible—

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<sup>1</sup> *Hegar v. Sirius XM Radio, Inc.*, Cause No. 03-18-00573-CV (Tex. App.—Austin, May 1, 2020), *reversed on other issues*, No. 20-0462 (Tex. 2022). The Third Court of Appeals also rejected an argument by Sirius that it was entitled to apportion its Texas receipts using the location where it produced and broadcast its content, but the Texas Supreme Court reversed. See **Apportionment** below.

<sup>2</sup> Sirius also paid a share of revenue to these manufacturers. Slip op. at 6.

<sup>3</sup> Tex. Tax Code § 171.1012(a)(1).

<sup>4</sup> Tex. Tax Code § 171.1012(a)(3)(A)(i).

<sup>5</sup> Tex. Tax Code § 171.1012(a)(3)(A)(ii).

<sup>6</sup> Tex. Tax Code § 171.1012(c).

<sup>7</sup> Slip op. at 18-19.

presence must be transferred.”<sup>8</sup> The Attorney General filed a supplemental brief in *Sirius XM*’s case just after the *American Multi-Cinema* Texas Supreme Court Opinion was published, noting that Sirius XM had “analogized satellite radio to the exhibition of films” in Sirius XM’ briefing to the Texas Supreme Court.<sup>9</sup> The Court reasoned that, just like AMC’s theatergoers, Sirius’ customers did not transfer property with a physical or demonstrable form to its customers, but merely provided them temporary access to creative content.<sup>10</sup> Amicus curiae briefs were submitted by Tax Executives Institute (TEI), Texas Taxpayers and Research Association (TTARA), and Council on State Taxation (COST).

The Texas Supreme Court did not review the cost-of-goods-sold determination, but reversed the Third Court of Appeals on separate apportionment issues. The Texas Supreme Court held oral argument on November 30, 2021 and issued its Opinion on March 25, 2022.

## Compensation

**Comptroller Adopts Compensation Rule Amendments.** On April 15, 2022, the Comptroller adopted amendments to Rule 3.589 governing the franchise tax compensation subtraction.

Texas franchise tax law limits the amount of wages and cash compensation paid to a taxable entity’s officers, directors, owners, partners, and employees per year, adjusted based on the Consumer Price Index.<sup>11</sup> The adopted rule contains annual compensation caps (now referred to as “thresholds”) through Report Year 2023. For Report Years 2020 through 2021, the maximum amount of compensation that may be subtracted for any one person is \$390K in any 12-month period. For Report Years 2022 through 2023 the compensation cap is \$400,000.<sup>12</sup>

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<sup>8</sup> *Sirius XM* slip op. at 19 (citing *Hegar v. American Multi-Cinema, Inc.*, No. 17-0464 (Tex. 2020)) .

<sup>9</sup> Appellant’s Supplemental Brief at 1, *Sirius XM Radio, Inc.*, Cause No. 03-18-00573-CV (Tex. App.—Austin, May 1, 2020), *reversed on other issues*, No. 20-0462 (Tex. 2022).

<sup>10</sup> Slip op. at 20.

<sup>11</sup> Tex. Tax Code §§ 171.1013(c) (providing compensation cap), 171.006 (requiring Comptroller to adjust caps based on Consumer Price Index every two years).

<sup>12</sup> Although the adopted rule amendment lists \$380,000 as the compensation cap for report years 2020 and 2021, the Comptroller confirmed during the 2022 Annual Briefing that the identification of the compensation cap as \$380,000 was a typo and would be corrected in a later amendment.

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First appeared as part of the conference materials for the  
70<sup>th</sup> Annual Taxation Conference: Day 1 - Controversy session  
"Texas Taxes: Recent Developments"