

Martens, Todd & Leonard

Texas Sales Tax Update: Texas Comptroller Changes Local Tax Responsibilities for Online Sales

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The Comptroller has once again amended his local tax sourcing rule as part of his years-long effort to shift local tax sourcing for online sales to the customer’s location. The amendment, however, is not limited to online sales so it could affect taxpayers in a wide variety of circumstances.

On January 5, 2024, the Comptroller adopted an amendment to his local tax sourcing rule to implement his interpretation of the term “received.”¹ Where an order is “received” plays a critical role in determining the local tax rate imposed and which local government entities will receive funding from the tax collected.

Background - Local Sales Tax in Texas

To understand the significance of the rule amendment, it’s important to review a few terms of art used by the local sales tax statutes.

Consummated. A sale of a taxable item is treated as occurring within the local tax jurisdiction where a sale is “consummated.” Texas has a fairly complex set of rules for determining where a sale is consummated, but once a retailer completes the analysis and determines where a sale is consummated, that location determines the local tax rate that will apply and the local government entities who receive the local tax revenue.

Place of Business. A “place of business” is an “established outlet, office, or location operated by the retailer . . . for the purpose of receiving orders for taxable items and includes **any location at which three or more orders are received by the retailer during a calendar year.**”² Local sales taxes in Texas are generally based on the seller’s “place of

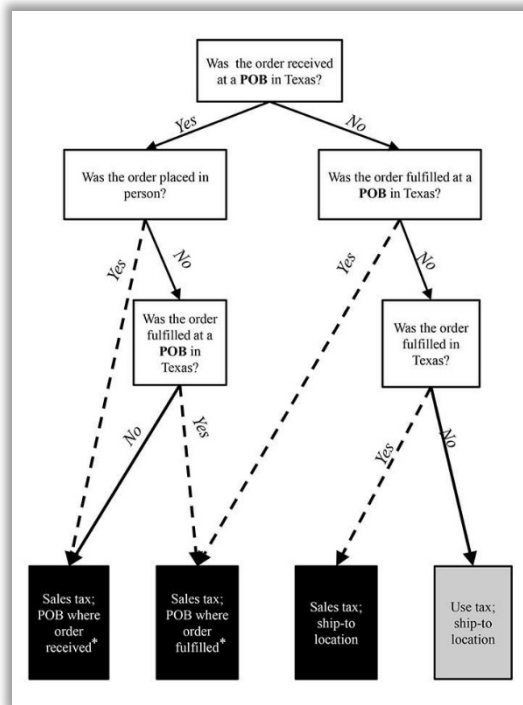
¹ 49 Tex. Reg. 53 (codified at 34 Tex. Admin. Code § 3.334) (adopted January 5, 2024).

² Tex. Tax Code § 321.002(a)(3)(A) (defining “place of business” for municipal local sales tax) (emphasis added); *see also* Tex. Tax Code § 323.002(a) (adopting municipal local tax definitions for county local sales tax).

business.” For a retailer with only one “place of business” in Texas, all of the sales are generally treated as being consummated at that place of business.³

Fulfilled. An order is fulfilled at the place of business “from which the retailer ships or delivers the item.”⁴ Unless an order is placed in person, when an order is received at a place of business of the seller in Texas, and fulfilled at a place of business of the seller, the sale is consummated where the order is fulfilled. Regardless of whether an order is placed in person, if it is not received at a place of business of the seller in Texas, but it is fulfilled at a place of business of the seller in Texas, the sale is consummated where the order is fulfilled.

Received. In the most recent amendments, the Comptroller shined light on the location where an order is “received.” The location where an order is received is significant in the first step in determining where a sale is “consummated.” The Comptroller has provided the following diagram showing that the first step is to ask whether the order was “received” at a “POB” (place of business of the seller) in Texas:⁵



³ Tex. Tax Code § 321.203(b); *but see* Tex. Tax Code § 321.203(e) (providing that sales are consummated at the location to which an item is shipped or delivered if shipment or delivery originates from a location in Texas other than a place of business and (1) the retailer is an itinerant vendor with no place of business, (2) the retailer’s place of business where the order is initially received is outside Texas, or (3) the purchaser places the order directly with the retailer’s supplier and the supplier ships or delivers the item directly to the customer).

⁴ Tex. Tax Code § 322.203(c-1)(1).

⁵ TEXAS COMPTROLLER OF PUBLIC ACCOUNTS, Publication 94-105 Local Sales and Use Tax Collection – A Guide for Sellers (revised April 2022), *available at* <https://comptroller.texas.gov/taxes/publications/94-105.php>.

As the diagram shows, when an order is “received” at a “place of business of the seller” in Texas, the sale is generally consummated at the seller’s place of business. Even if the order is not received at a place of business of the seller in Texas, if the order is fulfilled at a place of business of the seller in Texas, the sale is consummated at that place of business. This is generally referred to as “origin” sourcing and represented by the left half of the bottom row on the above diagram.

When an order is not received at—or fulfilled from—a place of business of the seller in Texas, the sale is consummated at the location to which the order is shipped. This is generally referred to as “destination” sourcing and is represented by the right half of the bottom row.

2024 Rule Amendment

The Comptroller’s January 2024 change identifies the place where an order is “received” as follows:

The location where the order is received by or on behalf of the seller means the physical location of a seller or third party, such as an established outlet, office location, or automated order receipt system operated by or on behalf of the seller, where an order is initially received by or on behalf of the seller and not where the order may be subsequently accepted, completed, or fulfilled. . . .

The new rule language provides that the order is “received” at the location where it is “first received” and not where the order is later forwarded.

This change is significant when combined with the Comptroller’s prior amendments to Rule 3.334(b)(5), which provided that “[a] computer that operates an automated shopping cart software program . . . does not constitute a place of business of the seller.”⁶ Taken together, these amendments would dictate that an order initially received and processed by an automated system (such an online order received by a web server) is considered to be “received” by that system, **but not at a place of business of the seller. The result would often be “destination” sourcing.** This means the local taxes would be based upon where the customer took delivery of the taxable item.

After proposing this rule amendment, the Comptroller held a public hearing on November 8, 2023, and received many oral and written comments. Most comments were in opposition. Opponents argued that orders received elsewhere then transmitted to a fulfillment center are “received” by the fulfillment center, albeit not initially. These opponents noted that the new rule language would inhibit local tax sourcing to fulfillment centers. They argued that the rule amendment is without statutory support and adopts

⁶ 34 Tex. Admin. Code § 3.334(b)(5) (unenforceable under a temporary injunction entered by the Travis County District Court on July 13, 2022).

language from the Streamlined Sales and Use Tax Agreement, which has been considered and rejected (or at least not enacted) by the Texas Legislature.

In support of the amendment, the Comptroller posed hypothetical scenarios to show the difficulty of determining where an order is received. One such scenario involves an order received by cloud servers that can operate from multiple locations simultaneously. Another scenario involves orders relayed to multiple seller locations for different purposes (including order approval, credit checks, manufacturing, bundled shipping to a fulfillment center, fulfillment to the customer, billing, and collection). The Comptroller noted that the local tax statutes appear to contemplate an order being “received” at a single location as his justification for rejecting the notion that a relayed order is “received” by a fulfillment center. The Comptroller also surveyed the history of the local tax statutes’ use of the phrase “the place of business” to support the notion that an order is only received at a single location.

In response to one comment, the Comptroller shed some light on the agency’s interpretation of the term “automated order receipt system.” The rule preamble provides that a website may qualify, depending on whether it is “automated to receive orders,” and that the term could also include a “telephonic system” even if it does not use a server, IP address, domain name, website, or software application.⁷ While providing these comments in the preamble, the Comptroller declined to include them in the text of the adopted rule amendment.

Example

A Texas retailer, E-Widgets, Inc. sells widgets on the internet. It operates with no sales personnel. Instead, it has a single location in Round Rock where its web servers receive orders and relay them to the seller’s e-commerce software program hosted on the same servers. The program processes the payment and sends the order to the on-site fulfillment center. Robots at the fulfillment center pack the order and place it on a truck for delivery to the customer. Prior to the Comptroller’s rule amendments, the Round Rock location appears to have been the seller’s sole “place of business” because it is a “**location at which three or more orders are received by the retailer during a calendar year.**”⁸ That would mean that the sales are sourced to Round Rock (origin sourcing). After the combined rule amendments, the order is still treated as being “received” at the Round Rock location, but the location would no longer qualify as a “place of business” of the seller. As a result, the same sales would now be sourced to the ship-to locations (destination sourcing).

⁷ 49 Tex. Reg. 58 (Rule 3.334 amendment preamble).

⁸ Tex. Tax Code § 321.002(a)(3)(A) (emphasis added).

Economic Development Agreements

Whether the applicable local sales tax is determined using origin or destination sourcing is especially important for taxpayers and municipalities who have entered into economic development agreements. Under the “origin” sourcing that has been prevalent in Texas for decades, many cities offered incentives to attract out-of-state businesses, encouraging them to establish facilities in their cities by sharing a portion of the sales local tax revenue the cities collected. Dell Computer Corporation, for example, entered into an agreement with the City of Round Rock back in 1993 that allows Dell to receive a monthly payment of a percentage of the sales tax revenue it generates for Round Rock.⁹ Neither the taxpayer nor the city that entered into such an economic development agreement benefit, however, if the taxes for online sales are sourced to the delivery locations.

Comptroller Hegar has argued that the origin-based sourcing that these agreements relied upon is unfair to counties, cities, and other local tax jurisdictions that do not benefit from local tax revenue when the goods are delivered to their residents in other parts of Texas. After many cities realized they faced losing substantial tax revenue from the Comptroller’s recent rule amendments, they sued the Comptroller to block enforcement. In response to the legal challenges, Travis County District Court Judge Karin Crump issued a temporary injunction in late 2022. That injunction remains in effect pending a trial on the merits which is currently set for the week of May 6, 2024.

Pending Litigation

In discussing the implications of the rule change for pending litigation, the Comptroller acknowledged he is enjoined from enforcing subsection (b)(5) which provides guidance on whether certain facilities are “places of business.” Since subsection (b)(5) could affect whether a fulfillment center is a “place of business,” the Comptroller will not attempt to reallocate local taxes allocated to these facilities while the injunction remains in place. To the extent that new subsection (c)(7) provides guidance on the issue of “when and where an order is received” and affects the consummation of sales to locations other than fulfillment warehouses, the Comptroller appears to be poised to apply it to locations other than fulfillment centers notwithstanding the temporary injunction.

The adopted rule became effective January 9, 2024. Counties and cities who have benefited from economic development agreements—and any others whose tax revenues are generally dependent on origin sourcing—face significant revenue losses if local tax revenues are redirected away from them. Taxpayers and local governments find themselves in a state of continued uncertainty pending a final adjudication of the court challenges to the

⁹ Economic Development Program Agreement between Dell Computer Corporation and the City of Round Rock (August 26, 1993) *available at* <https://assets.comptroller.texas.gov/open-data/ch380/0006234-Round%20Rock.pdf>.

Comptroller's rule amendments. That uncertainty is compounded by the Comptroller's recent propensity to enforce new policies retroactively.

The text of the adopted amendments, along with the Comptroller's explanation of the changes is available in the January 5, 2024 issue of the Texas Register, available in HTML here: <https://www.sos.state.tx.us/texreg/archive/January52024/Adopted%20Rules/34.PUBLIC%20FINANCE.html#53>

About MARTENS, TODD & LEONARD

MARTENS, TODD & LEONARD is a trial and appellate law firm headquartered in Austin, Texas. It handles only Texas tax cases, specifically those involving the Texas sales tax and Texas franchise tax. The firm's attorneys have handled cases all the way through the Texas Supreme Court and U.S. Supreme Court. They speak and write frequently on a variety of Texas sales tax and franchise tax topics and have published articles in publications such as the Journal of State Taxation, the Texas Bar Journal, the Texas Lawyer, and the Texas Tech Administrative Law Journal. For more information, please visit texastaxlaw.com.

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METATAGS:

Texas

Sales tax

Local sales tax

Comptroller Rule 3.334

Economic development agreements

Place of business