

Texas Supreme Court and Third Court of Appeals issue Opinions on apportionment for Texas Franchise Tax purposes

Overview

On May 1, 2020, the Texas Supreme Court (Supreme Court) and the Texas Third Court of Appeals, Austin (Court of Appeals) issued opinions centering on apportionment for Texas franchise tax purposes.¹

In *Lockheed Martin Corp. v. Hegar*, the Supreme Court reversed and remanded the lower court's decision, holding sales of tangible personal property (TPP) by Lockheed Martin Corporation (Lockheed Martin) should not be sourced to Texas under the former Texas Tax Code (TTC) § 171.1032(a)(1) even though the title and possession of the TPP passed to an intermediate buyer in Texas.²

In *Hegar v. Sirius XM Radio, Inc.*, the Court of Appeals reversed the decision by the Texas 261st District Court of Travis County (District Court), holding the receipt-producing service contractually provided by Sirius XM Radio, Inc. (Sirius XM) occurred at the subscriber's radio, and thus required Sirius XM to source receipts from Texas subscribers to Texas under TTC § 171.103, even though production and broadcasting of Sirius XM's programming were performed almost entirely outside of Texas.³

In this Tax Alert, we summarize the decisions made by the Supreme Court and Court of Appeals in both the *Lockheed Martin* and *Sirius XM* opinions as well as offer some taxpayer considerations.

Lockheed Martin Corp. v. Hegar

Background

For the years at issue, Lockheed Martin manufactured F-16 fighter jets in Texas destined for foreign-government buyers.⁴ Under federal law, foreign-government buyers purchasing certain items from contractors like Lockheed Martin were required to do so through the Foreign Military Sales ("FMS") program.⁵ The FMS program requires the foreign government and the U.S. Government enter into a contract directly for the specified item or service, and the U.S. Government will subsequently enter into a contract for the procurement of the item or service from a private contractor.⁶ Lockheed Martin sold its jets to foreign-government buyers through the FMS program.⁷ Importantly, upon final inspection of the jets, legal title transferred to the U.S. Government at Lockheed Martin's Texas facility. The U.S. Government subsequently delivered the jets to the foreign-government buyer.⁸

¹ *Lockheed Martin Corp. v. Hegar*, No. 18-0566, 2020 Tex. LEXIS 374 (May 1, 2020); see also *Hegar v. Sirius XM Radio, Inc.*, No. 03-18-00573-CV, 2020 Tex. App. LEXIS 3730 (Tex. App. May 1, 2020, no pet. h.); Deloitte Multistate Tax Alert, "Texas District Court – Apportionment Based on Location of Production Activities and Fair Value of Services Performed in Texas," (Sept. 19, 2018) (previous Deloitte Tax Alert on the District Court ruling of *Sirius XM Radio, Inc.* may be found [here](#)).

² *Lockheed Martin Corp.*, 2020 Tex. LEXIS (May 1, 2020) (while the statute at issue is no longer effective, current TTC § 171.103(a)(1) contains the same language at issue). TTC § 171.1032(a)(1) (effective 2005) provides that a taxpayer's Texas numerator for apportionment purposes includes "each sale of tangible personal property if they property is delivered or shipped to a buyer in this state regardless of the FOB point or another condition of the sale, and each sale of tangible personal property shipped from this state to a purchaser in another state in which the seller is not subject to any tax on, or measured by, net income, without regard to whether the tax is imposed." Current TTC § 171.103(a)(1) provides that a taxpayer's Texas numerator for apportionment purposes includes "each sale of tangible personal property if the property is delivered or shipped to a buyer in this state regardless of the FOB point or another condition of the sale."

³ *Sirius XM Radio, Inc.*, 2020 Tex.App. LEXIS 3730 (May 1, 2020).

⁴ *Lockheed Martin Corp.*, 2020 Tex. LEXIS (May 1, 2020) at *1. It should be noted Deloitte Tax LLP did not advise Lockheed Martin on any aspect of the recent Texas Supreme Court case.

⁵ *Id.* at *2.

⁶ *Id.* at *3.

⁷ *Id.* at *5.

⁸ *Id.* at *5.

On its original 2005, 2006, and 2007 Texas franchise tax reports, Lockheed Martin sourced the sales of these jets to Texas.⁹ Lockheed Martin timely filed claims for refund for 2005, 2006, and 2007 arguing the receipts from these sales should have been sourced to the location of the foreign-government buyers.¹⁰ The Texas Comptroller (“Comptroller”) denied the claims, and, after exhausting administrative remedies, Lockheed Martin brought suit.¹¹ The trial court rendered judgment for the Comptroller, and the Court of Appeals affirmed.¹²

Texas Supreme Court Opinion

On appeal to the Supreme Court, Lockheed Martin argued it was entitled to source sales of its jets to the ultimate buyers (*i.e.*, the foreign-government buyers) under TTC § 171.1032.¹³ More specifically, Lockheed Martin contended the “buyer” for purposes of TTC § 171.1032 was the foreign-government buyer and not the U.S. Government.¹⁴ For the year at issue, TTC § 171.1032 stated the Texas gross receipts of a corporation from its business include “each sale of tangible personal property if the property is delivered or shipped to a buyer in [Texas] regardless of the FOB point or another condition of the sale.”¹⁵

The parties primarily disagreed on the identity of the “buyer” for purposes of TTC § 171.1032.¹⁶ The Comptroller contended the U.S. Government was the buyer because Lockheed Martin’s contract to sell the jets was with the U.S. Government.¹⁷ As such, the Comptroller argued when Lockheed Martin passed title to the U.S. Government in Texas, the sale was completed and the receipts were properly sourced to Texas.¹⁸ Conversely, Lockheed Martin argued the foreign government was the buyer of a single transaction, albeit effectuated with two interrelated contracts with the U.S. Government acting in its sovereign capacity rather than as a mere reseller.¹⁹

In finding the foreign governments were the “buyers,” the Supreme Court concluded the required contracting through the U.S. Government was a “condition” of the contract that should be disregarded for purposes of determining the buyer.²⁰ While the Supreme Court noted prior decisions involving resellers did not look to the ultimate buyer, the facts of the present case were distinguishable as the involvement of the U.S. Government as an intermediary amounted to a condition of sale.²¹ Because TTC § 171.1032 requires the inclusion of “each sale of tangible personal property if the property is delivered or shipped to a buyer in this state regardless of the FOB point or another condition of the sale,” the condition that the U.S. Government be an intermediary should be disregarded, and the “buyer” for purposes of the statute was the foreign government.²² Further, the Supreme Court distinguished Lockheed Martin’s facts from a general reseller in that the jets were custom built and uniquely designed to the foreign buyers’ specifications, thereby constituting more than a sale for resale.²³

Hegar v. Sirius XM Radio, Inc.

Background

For the years at issue, Sirius XM provided a subscription-based satellite radio service, consisting of numerous entertainment programming channels.²⁴ Sirius XM produced and broadcasted its programming from locations almost exclusively outside

⁹ *Id.* at *6.

¹⁰ *Id.* at *6.

¹¹ *Id.* at *6.

¹² *Id.* at *7.

¹³ *Id.* at *9.

¹⁴ *Id.* at *9.

¹⁵ *Id.* at *9; *see also* Tex. Tax Code § 171.1032(a)(1) (effective 2005) provides that a taxpayer’s Texas numerator for apportionment purposes includes “each sale of tangible personal property if they property is delivered or shipped to a buyer in this state regardless of the FOB point or another condition of the sale, and each sale of tangible personal property shipped from this state to a purchaser in another state in which the seller is not subject to any tax on, or measured by, net income, without regard to whether the tax is imposed.” Current Tex. Tax Code § 171.103(a)(1) provides that a taxpayer’s Texas numerator for apportionment purposes includes “each sale of tangible personal property if the property is delivered or shipped to a buyer in this state regardless of the FOB point or another condition of the sale.”

¹⁶ *Lockheed Martin Corp.*, 2020 Tex. LEXIS (May 1, 2020) at *9.

¹⁷ *Id.* at *9.

¹⁸ *Id.* at *9.

¹⁹ *Id.* at *11.

²⁰ *Id.* at *11-12.

²¹ *Id.* at *10-12.

²² *Id.* at *12 (emphasis added).

²³ *Id.* at *13.

²⁴ *Sirius XM Radio, Inc.*, 2020 Tex.App. LEXIS 3730 (May 1, 2020) at *3-4.

of Texas.²⁵ Sirius XM provided its programming through satellite-enabled radios that can unscramble and decode Sirius XM's satellite radio broadcast signals.²⁶

Sirius XM timely filed its Texas franchise tax returns for tax years 2010 and 2011, sourcing its subscription receipts to the locations in which its programming was produced and broadcast (*i.e.*, almost entirely outside of Texas).²⁷ Following an audit, the Comptroller determined Sirius XM's apportionment of its subscription receipts was incorrect because the service provided by Sirius XM was the unscrambling of the radio signal, which occurs at the radio receiver of the subscriber.²⁸ Upon exhausting its administrative remedies, Sirius XM filed suit in District Court, which rendered a judgment in favor of Sirius XM.²⁹ The Comptroller appealed the ruling.³⁰

Texas Court of Appeals Opinion

Under TTC § 171.103, taxpayers must include receipts from each service performed in the state in its apportionment formula. The Comptroller's rules provide that receipts from sales of a service are apportioned to the location where the service is performed.³¹ The parties disagreed as to whether a Texas subscription receipt was derived from a service performed in the state.³²

The District Court held that Sirius XM's receipt-producing, end-product act was the production and distribution of entertainment programming.³³ The Comptroller challenged this finding, arguing the production and distribution services were non-receipt producing support services, and the only activity that could be described as the "receipt-producing, end-product act" was the performance of audible radio service for the customer based on its contracts with such customers.³⁴ The Court of Appeals ultimately agreed with the Comptroller, finding the "receipt-producing, end-product act" was the proper standard for determining where a service is performed, and access to the Sirius XM programming was the receipt-producing, end-product act that Sirius XM's customers were provided.

The Court of Appeals addressed Sirius XM's argument that Texas's standard for sourcing services are "origin based" and not "market based," *i.e.*, the relevant activity for determining where the act is done is where the taxpayer performs the service related activities rather than where the audience is located.³⁵ Based on the contractual language with its subscribers, the Court of Appeals found the purpose of the contract, from the standpoint of the subscriber, was the ability to receive the programming through his or her satellite-enabled radio.³⁶ Sirius XM did not contract with specific parties to provide targeted programming, but rather gave subscribers access to its pre-planned programming.³⁷ Thus, by holding the service for which customers contracted with Sirius XM was the enabling of their Sirius XM radios, the Court of Appeals held the service was performed at the location of the Sirius XM radio rather than at the locations in which Sirius XM created and broadcast its programming.³⁸

It must be noted that this decision is not yet final as Sirius XM may appeal the decision to the Texas Supreme Court.

Considerations

Taxpayers with similar facts and circumstances should consult with their tax advisors to analyze potential Texas franchise tax implications.

Contacts:

If you have questions regarding the decisions of the Supreme Court and Court of Appeals or other Texas tax matters, please contact any of the following Deloitte professionals:

²⁵ *Id.* at *4 (there was one channel produced in Texas by Billie Mack, who transmitted from his home in Fort Worth, Texas).

²⁶ *Id.* at *4.

²⁷ *Id.* at *5.

²⁸ *Id.* at *5 (Sirius XM also requested an adjustment to COGS, which was subsequently denied by the Comptroller, District Court, and Court of Appeals).

²⁹ *Id.* at *6.

³⁰ *Id.* at *6.

³¹ *Id.* at *8; *see also* 34 Tex. Admin. Code § 3.591(e)(26) (2017).

³² *Sirius XM Radio, Inc.*, 2020 Tex.App. LEXIS 3730 (May 1, 2020) at *9.

³³ *Id.* at *10.

³⁴ *Id.* at *11.

³⁵ *Id.* at *13-14.

³⁶ *Id.* at *16.

³⁷ *Id.*

³⁸ *Id.* at *16-17.

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