

Texas Court Holds Movie Auditorium Costs Included in COGS Subtraction

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Overview

The Court of Appeals, 3rd District of Texas (“Court of Appeals”), recently held that American Multi-Cinema Inc. (the “Taxpayer”) was entitled to include certain facility-related exhibition costs, such as rent and depreciation associated with the square footage of movie theater auditoriums, as direct costs of producing its product (*i.e.*, film exhibition) for purposes of calculating the Texas franchise tax cost of goods sold (“COGS”) subtraction.¹

The case, *American Multi-Cinema, Inc. v. Hegar*, involved Texas Tax Code (“TTC”) § 171.1012, which defines “goods” for purposes of the COGS deduction as “tangible personal property sold in the ordinary course of business,”² and defines “tangible personal property” to include “personal property that can be seen, weighed, measured, felt, or touched or that is perceptible to the senses in any other manner.”³ The Texas Comptroller (“Comptroller”) argued the Taxpayer’s product of film exhibition did not constitute a “good” but rather an intangible or a film watching service, and therefore Taxpayer’s related exhibition costs are not includable in the COGS calculation.⁴ The Court of Appeals disagreed, siding with Taxpayer, and concluded Taxpayer was entitled to include its exhibition costs in its COGS subtraction.⁵

On May 11, 2015, the Court of Appeals granted the Comptroller’s request for extension of time to file a motion for rehearing and/or reconsideration *en banc*, thus extending the deadline for filing such motion to May 29, 2015.⁶ Accordingly, the case remains pending.

In this Tax Alert we summarize the proceedings and arguments in this case and offer some taxpayer considerations.

Background

For report years 2008 and 2009, Taxpayer determined its taxable margin for purposes of the Texas franchise tax by subtracting COGS from its total revenue. During such years, Taxpayer included exhibition costs in its COGS calculation.⁷ The Comptroller audited Taxpayer’s 2008 and 2009 reports and rejected Taxpayer’s filing position, concluding that exhibiting films does not constitute a “good” because Taxpayer does not sell “tangible personal property,” but instead sells intangible property or a film-watching service under TTC § 171.1012(a). Accordingly, the Comptroller assessed an additional tax liability.⁸ Taxpayer paid the related tax assessment and filed suit for refund in the 200th Travis County District Court (“District Court”), asserting its exhibition costs were properly included in the COGS subtraction.

Lower Court Rulings

At the District Court level, the parties agreed to a bifurcated trial. In phase one of the trial, the dispute centered on whether Taxpayer’s product, film exhibition, was considered a “good” as defined under TTC § 171.1012.⁹ The District Court ruled in favor of the Taxpayer on this issue, thus permitting Taxpayer to include some portion of its exhibition costs (as determined in phase two) in its COGS subtraction.¹⁰

In phase two of the trial, the parties disputed the percentage of auditorium space that should be considered for determining direct costs of “production” for purposes of the COGS subtraction. Taxpayer argued the costs

¹ *Am. Multi-Cinema, Inc. v. Hegar*, No. 03-14-00397-CV (Tex. App.—Austin, Apr. 30, 2015, no pet. h.), available at <http://www.search.txcourts.gov/SearchMedia.aspx?MediaVersionID=578628dd-a08f-4730-8f88-beeeffe29203&coa=coa03&DT=Opinion&MedialD=d5191986-9862-425a-b6ac-420aeb90c01d>. For the procedural status of the case, see, <http://www.search.txcourts.gov/Case.aspx?cn=03-14-00397-CV&coa=coa03>.

² Tex. Tax. Code § 171.1012(a)(1).

³ *Id.* § 171.1012(a)(3)(A)(i).

⁴ *Am. Multi-Cinema, Inc. v. Hegar*, No. 03-14-00397-CV, at *3.

⁵ *Id.* at *12.

⁶ See, <http://www.search.txcourts.gov/Case.aspx?cn=03-14-00397-CV&coa=coa03>.

⁷ *Am. Multi-Cinema, Inc. v. Hegar*, No. 03-14-00397-CV, at *2.

⁸ *Id.*

⁹ *Id.*

¹⁰ *Id.* at *2-4.

associated with the entire square footage of its auditoriums should be included in the COGS calculation. The Comptroller countered that only costs associated with the square footage occupied by the speakers and the screens in the auditorium should be included. Ultimately, the District Court agreed with the Comptroller's interpretation.¹¹

On June 25, 2014, Taxpayer filed a notice of appeal with the Court of Appeals, disputing the District Court's ruling in phase two related to the percentage of the auditorium space that should be considered when determining COGS. On August 7, 2014, the Comptroller filed a notice of appeal with the Court of Appeals, disputing the District Court's ruling in phase one, which held that Taxpayer was permitted to include the exhibition costs within COGS.¹²

Texas Court of Appeals Rulings

The Court of Appeals found that the language of TTC § 171.1012 is unambiguous and, thus, should be construed according to its "plain and common meaning."¹³ The Comptroller argued that Taxpayer's product does not fall within the meaning of "tangible personal property" as defined in the statute because the product is either "intangible property" or a "movie-viewing service."¹⁴ Because the TTC does not define "intangible property" or "services," the Court of Appeals applied the common and ordinary meaning of the words.

The Comptroller contended that Taxpayer does not sell films but only sells the right to watch a film at a certain time and place. In rejecting this argument, the Court of Appeals explained the definition of "tangible personal property" in TTC § 171.1012 does not include a take-home requirement. Further, the Court of Appeals stated the Comptroller's characterization of Taxpayer's film exhibition as "intangible property" and "services" conflicted with TTC § 171.1012(a)(3)(A)(ii), which provides "tangible personal property" also includes:

Films, sound recordings, videotapes, live and prerecorded television and radio programs, books, and other similar property embodying words, ideas, concepts, images, or sound, without regard to the mean or methods of distribution or the medium in which the property is embodied, for which, as costs are incurred in producing the property, it is intended or is reasonably likely that any medium in which the property is embodied will be mass-distributed by the creator or any one or more third parties in a form that is not substantially altered.

According to the Court of Appeals, this subsection clarifies that for purposes of the COGS calculation, "tangible personal property" includes films "without regard to the means or methods of distribution or the medium in which the property is embodied." Applying the plain meaning of the statutory language at issue, the Court of Appeals held the evidence was legally sufficient to support the District Court's finding that Taxpayer was entitled to include its exhibition costs in COGS.¹⁵

In regard to the percentage of auditorium space that should be considered for determining direct costs of production, the Court of Appeals also sided with Taxpayer. TTC § 171.1012(a)(2) broadly defines "production" to include "construction, installation, manufacture, development, mining, extraction, improvement, creation, raising, or growth." Taxpayer presented evidence demonstrating its "improvement" and "creation" of its film exhibition product in its auditorium space.¹⁶ As explained by the Court of Appeals, Taxpayer's evidence established that its costs associated with the square footage of its auditoriums were direct costs of producing its product, and the Comptroller failed to present contradicting evidence. Consequently, the Court of Appeals held the entire square footage of Taxpayer's auditoriums should be included in the COGS calculation and ordered a corresponding tax refund.¹⁷

On May 11, 2015, the Court of Appeals granted the Comptroller's request for extension of time to file a motion for rehearing and/or reconsideration *en banc*, thus extending the deadline for filing such motion to May 29, 2015.¹⁸ Accordingly, the case is not yet final.

¹¹ *Id.* at *4.

¹² For more information regarding the procedural status of this case, see: <http://www.search.txcourts.gov/Case.aspx?cn=03-14-00397-CV&coa=coa03>.

¹³ *Am. Multi-Cinema, Inc. v. Hegar*, No. 03-14-00397-CV, at *8 (citing *Presidio Indep. Sch. Dist. v. Scott*, 309 S.W.3d 927, 930 (Tex. 2010)).

¹⁴ See, Tex. Tax. Code § 171.1012(a)(3)(B) (excluding "intangible property" and "services" from the definition of "tangible personal property").

¹⁵ *Am. Multi-Cinema, Inc. v. Hegar*, No. 03-14-00397-CV, at *11-2.

¹⁶ *Id.* at *15-7.

¹⁷ *Id.* at *18-9.

¹⁸ See, <http://www.search.txcourts.gov/Case.aspx?cn=03-14-00397-CV&coa=coa03>.

Considerations

Taxable entities that have not included production costs in the COGS calculation may wish to consider whether a claim for refund should be filed while *American Multi-Cinema Inc.* remains pending. In deciding whether to file a refund claim, taxable entities should also consider that: 1) the Comptroller is not required to hold the claim in abeyance while the case remains pending; thus, a taxpayer may be required to further pursue its claim before an administrative law judge or in trial court in order to preserve the claim; 2) the filing of a refund claim will extend the regular statute of limitations for assessments and may trigger a general audit of open tax years;¹⁹ and 3) the success or failure of the claim will depend in part on a taxpayer's particular facts and circumstances.

According to a statement by the Comptroller, this pending decision also potentially raises a Texas sales tax issue for service providers and sellers of intangibles who are not otherwise subject to the sales tax.²⁰ Because the sales tax definition of "tangible personal property" resembles the franchise tax definition,²¹ a question arises whether a service provider or seller of intangibles, seeking to argue qualification for the COGS subtraction as a seller of tangible personal property, could inadvertently undermine its position that it is not a seller of tangible personal property for Texas sales tax purposes.

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¹⁹ Tex. Tax Code § 111.2051.

²⁰ See TexasTribune.org, *Texas Court Ruling Could Undermine Major State Taxes*, <https://www.texastribune.org/2015/05/06/texas-court-ruling-could-undermine-major-state-tax/> (last visited May 14, 2015).

²¹ Compare the sales tax definition of "tangible personal property" ("personal property that can be seen, weighed, measured, felt, or touched or that is perceptible to the senses in any other manner . . .") under Tex. Tax Code § 151.009 with that applicable to the franchise tax (defined to include "personal property that can be seen, weighed, measured, felt, or touched or that is perceptible to the senses in any other manner . . .") under Tex. Tax Code § 171.1012(a)(3)(A).