

Texas Supreme Court Reverses Appellate Court Ruling Involving COGS Eligibility

Overview

On April 3, 2020, the Texas Supreme Court (Supreme Court) reversed the ruling previously issued by the Third District, Court of Appeals (Court of Appeals) and rendered judgement in favor of the Texas Comptroller (Comptroller), holding American Multi-Cinema Inc. (AMC) was not entitled to include certain facility-related exhibition costs 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 based on the conclusion its film exhibitions were not “goods” under Texas Tax Code (TTC) § 171.1012(a)(1).¹

In this Tax Alert, we summarize the Supreme Court’s ruling. For a more thorough overview of the case’s procedural history, including both appellate court decisions, please refer to our previously issued Deloitte Alerts.²

Texas Supreme Court Decision

For purposes of the Texas franchise tax, a cost may be included in COGS when: (1) the cost relates to “goods”, which means (a) real or tangible personal property that is (b) “sold” in the ordinary course of a taxable entity’s business; and (2) the taxable entity “owns” the goods it is selling.³ AMC, which operated as movie theatre chain, elected to use COGS in calculating its franchise tax liability for 2008 and 2009.⁴ The Comptroller argued the costs of film exhibition did not qualify as COGS under TTC § 171.1012 (as the statute existed during 2008 and 2009) because AMC was not selling tangible personal property when showing films to customers.⁵ In response, AMC asserted its business was the distribution of films’ creative content to customers, so its cost of film exhibition qualified as COGS.⁶ AMC also argued the 2013 amendment adding subsection (t) to TTC § 171.1012 (hereinafter referred to as “subsection (t)”) was applicable as it was considered a “clarification” of existing law.⁷ Subsection (t) expressly allows movie theatres to subtract exhibition costs as COGS.⁸

The Supreme Court’s opinion centered around TTC § 171.1012, which defines “goods” for purposes of the COGS deduction as “tangible personal property sold in the ordinary course of business.”⁹ TTC § 171.1012 thereafter defines “tangible personal property” as (i) personal property that is “perceptible to the senses,” and (ii) films and similar creative content embodied in a medium that “is intended or is reasonable likely” to be mass-distributed.¹⁰ The TTC does not define the term “sold” for purposes of TTC § 171.1012.¹¹ Relying on the term’s ordinary meaning, the Supreme Court held the term “sold” for purposes of TTC § 171.1012(a)(1) requires a transfer.¹²

Ultimately, the Supreme Court held AMC was not entitled to subtract its film exhibition costs as COGS in 2008 and 2009 because no transfer occurred and “exhibitions are not tangible personal property that is sold” under TTC §

¹ *Am. Multi-Cinema, Inc. v. Hegar*, 63 Tex. Sup. J. 722, No. 17-0464 (Tex. Apr. 3, 2020), available [here](#).

² See Deloitte External Tax Alert, *Texas Court Holds Movie Auditorium Costs Included in COGS Subtraction* (May 14, 2015), available [here](#), and Deloitte External Tax Alert, *Texas Appellate Court Issues New Opinion in Franchise Tax Case Involving Film Exhibition Costs* (Jan. 23, 2017), available [here](#); see further *Am. Multi-Cinema, Inc. v. Hegar*, No. 03-14-00397-CV, Comptroller’s Motion for Rehearing and Reconsideration En Banc (June 5, 2015), available [here](#); see also *Am. Multi-Cinema, Inc. v. Hegar*, 580 S.W.3d 663 (Tex. App.—Austin 2017), available [here](#).

³ *Am. Multi-Cinema, Inc.*, No. 17-0464, at *10-11.

⁴ *Id.* at *4.

⁵ *Id.* at *8-9.

⁶ *Id.*

⁷ *Id.*

⁸ See Tex. Tax Code § 171.1012(t) (stating: “If a taxable entity that is a movie theater elects to subtract cost of goods sold, the cost of goods sold for the taxable entity shall be the costs described by this section in relation to the acquisition, production, exhibition, or use of a film or motion picture, including expenses for the right to use the film or motion picture”).

⁹ Tex. Tax Code § 171.1012(a)(a).

¹⁰ Tex. Tax Code § 171.1012(a)(3)(A).

¹¹ *Am. Multi-Cinema, Inc.*, No. 17-0464, *11.

¹² *Id.* at *12.

171.1012(a)(1).¹³ The Supreme Court also held subsection (t) was not retroactive, and therefore, AMC was unable to rely on subsection (t) to subtract its costs of acquisition, exhibition, or use for the tax years in question.¹⁴

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¹³ *Id.* at *21-22. In addition to finding AMC was not entitled to subtract its film exhibition costs as COGS under TTC 171.1012(a)(1), the Supreme Court also found AMC did not qualify for such treatment under TTC 171.1012(o), which states: If a taxable entity...whose principal business activity is film or television production or broadcasting or the distribution of tangible personal property...elects to subtract cost of goods sold, the cost of goods sold for the taxable entity shall be the costs described in this section in relation to the property and include depreciation, amortization, and other expenses directly related to the acquisition, production, or use of the property, including expenses for the right to broadcast or use the property only applies to taxable entities." Ultimately, the Supreme Court found AMC was unable to rely on this provision because AMC's principal business was not production or distribution as understood in the film industry. *Id.* at *13.

¹⁴ *Id.* at *20.