Texas Appellate Court Issues New Opinion in Franchise Tax Case Involving Film Exhibition Costs

Overview

On April 30, 2015, the Court of Appeals, 3rd District of Texas (Court of Appeals) had held that American Multi-Cinema Inc. (AMC or Taxpayer) was entitled to include certain facility-related exhibition costs, such as rent and depreciation associated with the square footage of movie theatre 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]

On January 6, 2017, the Court of Appeals withdrew its April 30, 2015, decision and issued a new opinion.[2] Although the Court of Appeals' holding is unchanged relative to ruling in the favor of the Taxpayer, the Court limited its analysis to the narrower definition of tangible personal property found under Texas Tax Code (TTC) § 171.1012(a)(3)(A)(ii).

In this Tax Alert, we summarize the appellate history, the Court of Appeals' new opinion, and offer some taxpayer considerations.

Previous Appellate Decision

As discussed in a previous Deloitte external alert,[3] the case involved TTC § 171.1012, which defines "goods" for purposes of the COGS subtraction as "tangible personal property sold in the ordinary course of business."[4] The Texas Comptroller (Comptroller) contended that Taxpayer's film exhibition did not constitute a "good" but rather an intangible or a film watching service, and, therefore, Taxpayer's related exhibition costs were not includable in the COGS subtraction.[5] The Court of Appeals disagreed, and concluded that Taxpayer was entitled to include its exhibition costs in its COGS subtraction.[6]

In making its determination, the Court of Appeals explained that Taxpayer's film exhibitions qualified as tangible personal property under both subsection (i) and (ii) of TTC § 171.1012(a)(3)(A), which provides:

> Tangible personal property means:
>
> (i) personal property that can be seen, weighed, measured, felt, or touched or that is perceptible to the senses in any other manner;
>
> (ii) 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 means 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…[7]

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[1] *Am. Multi-Cinema, Inc. v. Hegar*, No. 03-14-00397-CV, 2015 Tex. App. LEXIS 4388 (Tex. App.—Austin, Apr. 30, 2015, *withdrawn*, substituted opinion at *Am. Multi-Cinema, Inc. v. Hegar*, No. 03-14-00397-CV, 2017 Tex. App. LEXIS 85 (Tex. App.—Austin, Jan. 6, 2017, no pet. h.)), original appellate decision from April 30, 2015, available here.
[2] *Am. Multi-Cinema, Inc. v. Hegar*, No. 03-14-00397-CV, 2017 Tex. App. LEXIS 85 (Tex. App.—Austin, Jan. 6, 2017, no pet. h.), available here.
[3] *See* Deloitte External Tax Alert, *Texas Court Holds Movie Auditorium Costs Included in COGS Subtraction* (May 14, 2015), available here.
[4] Tex. Tax. Code § 171.1012(a)(1).
[5] *Am. Multi-Cinema, Inc. v. Hegar*, No. 03-14-00397-CV (Apr. 30, 2015), at *3-4.
[6] *Id*. at *12.
[7] Tex. Tax. Code § 171.1012(a)(3)(A).

On June 5, 2015, the Comptroller filed a motion for rehearing, stating that the ruling "could cost the State [of Texas] up to $6 billion from tax refunds and reduce the State's annual revenue by $1.5 billion."[8] As articulated in the motion for rehearing, concern existed that if tangible personal property was interpreted so broadly under both subsection (i) and subsection (ii) of TTC § 171.1012(a)(3)(A), then potentially any service could qualify as tangible personal property, and, thus be eligible for the COGS subtraction. The Comptroller contended that the interpretation under subsection (i) would "effectively result in writing the exclusion for services out of [the COGS subtraction] and likely result in traditional service providers claiming cost of goods sold for the cost of providing services (e.g., examination rooms, legal offices, professional sports facilities), so long as their services are perceptible to the senses."[9] The Comptroller argued the distinction between the sale of tangible personal property and the sale of services would be erased if the Court of Appeals' previous opinion were upheld.[10]

The potential uncertainty of the Court of Appeals' 2015 decision upon sales and use tax was also highlighted by the Comptroller in the motion for rehearing.[11] The Comptroller expressed his concern that if the costs at issue qualified under subsection (i), then a similar interpretation would apply for sales and use tax purposes because the tangible personal property definition under subsection (i) of TTC § 171.1012(a)(3)(A) derives from a largely identical definition in the sales and use tax statute.[12] As stated in the Comptroller's motion for rehearing, a substantial amount of legislative guidance on the definition of tangible personal property in the context of sales and use tax would arguably be nullified if the Court of Appeals' previous opinion was upheld.[13]

Appellate Court's New Opinion

On January 6, 2017, the Court of Appeals withdrew its previous opinion, reinstated the case, and issued a new opinion.

The ruling in favor of the Taxpayer remained unchanged in the new opinion. However, instead of holding Taxpayer's exhibition costs qualified as tangible personal property under both subsection (i) and subsection (ii) of TTC § 171.1012(a)(3)(A), the Comptroller limited the basis of its finding to the narrower definition of tangible personal property found under subsection **(ii)** of TTC § 171.1012(a)(3)(A) *specific to film distribution* versus the broader definition of tangible personal property under subsection **(i)** of TTC § 171.1012(a)(3)(A). The Court of Appeals explained: "Because [subsection (ii)] is dispositive, we limit our review of the evidence to AMC's theory under section 171.1012(a)(3)(A)(ii) and expressly do not resolve whether the evidence also supports the trial court's finding that AMC's product falls within the definition of "tangible personal property" in section 171.1012(a)(3)(A)(i)."[14] The new Court of Appeals' opinion appears to limit the potential scope of the decision (relative to non-film production taxpayers) in the manner sought by the Comptroller.

The Comptroller has the ability to file a new motion for rehearing within 15 days of the Court of Appeals' new opinion.[15] In addition, the Comptroller may file a petition for review with the Texas Supreme Court within 45 days of the last ruling of the Court of Appeals on all timely filed motions for rehearing.[16] Thus, the case is not yet final.

Considerations

Taxpayers that have not included production costs in the COGS subtraction 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; and 3) the success or failure of the claim will depend in part on a taxpayer's particular facts and circumstances.

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[8] *Am. Multi-Cinema, Inc. v. Hegar*, No. 03-14-00397-CV, Comptroller's Motion for Rehearing and Reconsideration En Banc (June 5, 2015), at *11, available here.
[9] *Id*. at *10.
[10] *Id*.
[11] *Id*. at *2-3.
[12] *Id*. at *2; *see also* Tex. Tax Code § 151.009 (definition of "tangible personal property" for Texas sales and use tax purposes). Because the sales tax definition of "tangible personal property" closely mirrors the franchise tax definition, the potential may have existed under the now withdrawn 2015 decision for a service provider or seller of intangibles, seeking to qualify for the COGS subtraction as a seller of tangible personal property, to inadvertently undermine its position that it was not a seller of tangible personal property for Texas sales tax purposes.
[13] *Am. Multi-Cinema, Inc. v. Hegar*, No. 03-14-00397-CV, Comptroller's Motion for Rehearing and Reconsideration En Banc (June 5, 2015), at *17.
[14] *Am. Multi-Cinema, Inc. v. Hegar*, No. 03-14-00397-CV, 2017 Tex. App. LEXIS 85 (Tex. App.—Austin, Jan. 6, 2017, no pet. h.), at *10.
[15] Tex. R. App. P. 49.5
[16] Tex. R. App. P. 53.7(a).

Contacts:

If you have questions regarding the *American Multi-Cinema Inc.* case or other Texas tax matters, please contact any of the following Deloitte Tax professionals:

Russell Brown
Partner
Deloitte Tax LLP, Dallas
+1 214 840 7533
rubrown@deloitte.com

Andrew Robinson
Partner
Deloitte Tax LLP, Houston
+1 713 982 2960
arobinson@deloitte.com

Pamela Downs
Partner
Deloitte Tax LLP, Dallas
+1 214 840 7572
pdowns@deloitte.com

Robert Topp
Managing Director
Deloitte Tax LLP, Houston
+1 713 982 3185
rtopp@deloitte.com

Brad Brookner
Managing Director
Deloitte Tax LLP, Houston
+1 713 982 4897
bbrookner@deloitte.com

Jacob Aguero
Senior Manager
Deloitte Tax LLP, Houston
+1 713 982 4246
jaguero@deloitte.com

The authors of this alert would like to acknowledge the contributions of Grace Taylor to the drafting process. Grace is a Senior working in the Houston Multistate Tax Practice of Deloitte Tax LLP.

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