



SALT Alert!



SALT Alert! 2017-01: Texas Appeals Court Issues a Substitute Opinion in the AMC Case

On January 6, 2017, the Texas Court of Appeals, Third District issued a substituted decision (replacing its April 30, 2015 decision) in a case addressing whether a taxpayer, American Multi-Cinema, Inc. (AMC), could include costs associated with exhibiting films in calculating its Costs of Goods Sold (COGS) deduction for the franchise (margin) tax years at issue (2008 and 2009).^[1] Although the decision represents a win for the taxpayer (and other movie theaters), the revised decision arguably narrows the original holding. Shortly after the court's original April 30, 2015 opinion was released, the Comptroller's Office suggested it could lead to billions of dollars in franchise tax refund claims.

Background

Under Texas law in effect for the tax years at issue, taxable "margin" was the lesser of (1) 70 percent of total revenue, or (2) total revenue minus either (a) COGS or (b) compensation and benefits. The COGS statute allows a company to deduct "all direct costs of acquiring or producing goods," and up to four percent of other "indirect or administrative overhead costs." Generally, only entities that own and sell real or tangible personal property can elect to deduct COGS.

AMC, a multistate movie theater company, included its costs of exhibiting films and other content (exhibition costs) in its COGS deduction for the tax years at issue. The Comptroller adjusted AMC's COGS deduction on the basis that it was not selling tangible personal property when it sold tickets to movies and was, therefore, not entitled to deduct its exhibition costs as COGS. AMC paid the additional franchise taxes under protest and appealed. At trial, in support of its position that its products were "goods," AMC called witnesses who explained the extensive production steps that AMC takes from the time it receives a film from a movie studio to the time the movie is shown to theater patrons. The Comptroller, in turn, argued that AMC's customers do not purchase "goods" when they buy the right to see a movie in the theater. In a two-phase case, the trial court concluded that AMC was entitled to deduct a portion of its exhibition costs as COGS. Both AMC and the Comptroller subsequently appealed. The Comptroller appealed the trial court's ruling that the exhibition costs could be deducted as COGS. AMC, on the

other hand, disagreed with the trial court's ruling that only 13.42 percent of its disputed costs could be deducted.

Relevant Law and Appeals Court Decision

As mentioned above, Texas franchise taxpayers may elect to deduct COGS or compensation in determining taxable margin. COGS includes "all direct costs of acquiring or producing the goods." "Goods" is defined as "real or tangible personal property sold in the ordinary course of business of a taxable entity."

Under Tex. Tax Code §171.1012(a)(3)(A), "tangible personal property" is defined as:

- (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.

Tangible personal property does not include intangible property or services.

COGS Conclusion

Before the appeals court, the Comptroller argued that exhibiting films does not constitute a "good" because AMC does not sell tangible personal property, but sells intangible property or a movie-viewing service. The appeals court, in both the April 30, 2015 and January 6, 2017 opinions, ultimately rejected the Comptroller's assertions. However, the original opinion focused on the first prong of the definition of tangible personal property, i.e., personal property that can be seen, weighed, measured, felt, or touched or that is perceptible to the senses in any other manner. The court, in the 2015 opinion, reviewed witness testimony and concluded that AMC's film products fell within this section of the definition of "tangible personal property." Notably, AMC's witnesses described the films as a "tangible product visible to the sight and sound – perceptible to sound," and as "creative content that is consumed."

In its revised January 6, 2017 opinion, the court limited its review of the evidence presented at trial to whether AMC's product fell within the definition of tangible personal property under Tex. Tax Code § 171.1012(a)(3)(A)(ii), which address films and similar property. Numerous trial witnesses presented evidence that AMC distributed "films" and that its products were "films" as contemplated in the relevant prong of the definition of tangible personal property. The Comptroller focused its arguments on the fact that AMC did not sell "films," but sold a ticket to view a film. However, the court noted that the definition of tangible personal property did not include a "take-home requirement." The court concluded that, under the plain meaning of "tangible personal property" and viewing the evidence under the applicable standard of review, the trial court did not err in concluding that AMC was entitled to include its exhibition costs in its COGS subtraction.

Square Footage Determination

Having determined that AMC was eligible for the COGS deduction, the court next addressed the taxpayer's appeal from the trial court finding that only its costs associated with the square footage housing the speakers and screens in AMC's auditoriums, rather

than the costs associated with the square footage of the auditorium as a whole, qualified as COGS. In this regard, the revised opinion was not substantially changed from the original opinion. AMC argued that the trial court erred when it gave deference to the Comptroller's interpretation of the relevant statute and that the evidence showed the costs associated with the entire auditorium—not just the speakers and screens—were direct costs of producing the films AMC sells to its customers. After agreeing with AMC that the Comptroller's interpretation was not entitled to deference, the court concluded that AMC had established that its costs associated with the square footage of the entirety of its auditoriums were the direct costs of producing its product. It should be noted that the Comptroller had not called witnesses to rebut the evidence presented by AMC.

Next steps

By focusing on the second prong of the definition of tangible personal property, which addresses films and similar property, the court arguably narrowed its prior holding that tangible personal property is that which is perceptible to the senses. However, the arguments presented by AMC with respect to the first prong may be applicable to other taxpayers. Notably, there may be other types of taxpayers who, like AMC, have products that do not fit squarely into common definitions of intangible property or services, but are nonetheless products that are perceptible to the senses and could therefore be considered tangible personal property for franchise tax purposes.

By allowing AMC to deduct costs associated with its entire auditorium, rather than just the square footage housing the speakers, sound equipment and screen, the court appeared to take a broad view of the expenses associated with producing goods that can be included in COGS. It remains to be seen whether the Comptroller will seek review by the Texas Supreme Court.

Please contact [Doug Maziur](#) or [Lori Wiseman](#) with questions.

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^[1] The 2013 Texas legislature adopted legislation providing that for franchise tax reports due on or after January 1, 2014, movie theaters that elect to deduct COGS may deduct certain costs associated with the acquisition, production, exhibition or use of a film or motion picture, including expenses for the right to use the film or motion picture.