

## The Texas Supreme Court Denies a Cost of Goods Sold Deduction to a Movie Theater Company in a Texas Franchise Tax Case

By [David E. Colmenero](#) and [Alex J. Pilawski](#) on April 13, 2020



In the recent case of *American Multi-Cinema, Inc. v. Hegar*, Cause No. 17-0464 (Tex. Apr. 3, 2020), the Texas Supreme Court held that a taxpayer engaged in exhibiting movies in movie theaters could not claim a cost of goods sold for the costs it incurred in exhibiting its movies. This case, which has been closely monitored by taxpayers and practitioners alike, addresses important questions regarding the definition of “tangible personal property” for cost of goods sold purposes. The Court ultimately concluded that American Multi-Cinema, Inc. (“AMC”) did not qualify for the cost of goods sold deduction because it did not sell tangible personal property.

AMC argued that the cost of exhibiting movies could be included in cost of goods sold citing the broad definition of tangible personal property, which includes personal property that is “perceptible to the senses” (referred to by the Court as the “perceptibility prong”) and “films ... intended or reasonably likely [to be] mass distributed ....” (referred to by the Court as the “film prong”). The Court rejected AMC’s argument for several reasons. First, the Court held that the word “sold” for cost of goods sold purposes requires the transfer of property. Citing 19th Century case law, the Texas Business and Commerce Code and black letter law, the Court held, “Indeed, every sale must transfer property, and where no transfer occurs, nothing is sold.” In connection with this initial holding, the Court also held that subsection (o) of Section 171.1012 did not override this requirement as to AMC. The Court stated subsection (o) applies to taxpayers engaged in the “production” or “distribution” of certain film products, and AMC was not involved in either of these activities under these terms’ meaning within the film industry.

Second, the Court held that AMC was not involved in selling tangible personal property as contemplated by the statute. The Court stated, “We ... hold that property with a physical or demonstrable — that is, tangible — presence must be transferred.” The Court held that “[t]ransferring a film’s creative content alone” did not satisfy this requirement. The Court stated that, while the Tax Code’s definition of tangible personal property does not contemplate a particular medium, it does require that the “medium in which the property is embedded” be intended to or likely to be mass-distributed. In this case, the medium embodying exhibited films, which consisted of the auditoriums’ speakers and screens according to AMC, were not mass-distributed or transferred.

Third, with respect to the “perceptibility prong”, the Court similarly held that it requires a transfer of property with some physical or demonstrable presence, which did not occur in this case. The Court noted that the cost of goods sold provisions require that “personal property” be transferred, which is generally defined as “everything that is subject to ownership’ that is not real property.” Stated the Court, “the ‘sights and sounds’ embodied in AMC’s theaters are certainly perceptible to the senses, but are not ‘subjected to ownership’ and thus cannot be personal property.”

In a footnote, the Court expressly disclaimed deciding whether the film exhibitions sold by AMC constituted the sale of a service or an intangible. The Court held that given its holding, it “need not decide whether film exhibition is a service.”

The significance of the Court’s holding to movie theaters may be significantly diminished by the fact that, in 2013, the Legislature amended the Tax Code to specifically permit movie theaters a cost of goods sold deduction for “costs ... 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.” Tex. Tax. Code sec. 171.1012(t). Nevertheless, the Court’s holding is potentially relevant in other contexts, particularly as it relates to the “perceptibility prong” within the definition of tangible personal property.

This decision is not yet final as the parties could still file a motion for rehearing. But, unless overruled or modified, this decision will soon reflect the law of the land in Texas. To the extent taxpayers have filed refund claims or taken reporting positions on prior franchise tax reports based on the potential outcome of this case, they may want to revisit those claims or reporting positions in light of this decision. Taxpayers and practitioners should be aware that the Comptroller may very well consider targeting for audit taxpayers and industries the Comptroller believes may have claimed a cost of goods sold deduction based on a definition of tangible personal property that is contrary to the Court’s decision. Any questions regarding this case can be directed to either David Colmenero at [dcolmenero@meadowscollier.com](mailto:dcolmenero@meadowscollier.com) or Alex Pilawski at [apilawski@meadowscollier.com](mailto:apilawski@meadowscollier.com). You can also reach both attorneys at (214)744-3700.