



TaxNewsFlash

United States

No. 2017-012
January 9, 2017

Texas: “Tangible personal property” for franchise (margin) tax purposes

A Texas state appeals court on January 6, 2017, issued a “substituted decision” in a case concerning whether the taxpayer 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).

The case is: *American Multi-Cinema, Inc. v. Hegar*

KPMG observation

Although the decision is favorable for the taxpayer (and other taxpayers owning movie theaters), the revised decision arguably narrows the original holding. Shortly after the court’s original April 2015 opinion was released, the Comptroller’s Office suggested the decision could lead to billions of dollars in franchise tax refund claims.

Summary

Under Texas law (as in effect for the tax years at issue), taxable “margin” is the lesser of:

- 70% of total revenue, or
- Total revenue minus either (1) COGS, or (2) compensation and benefits

The COGS statute allows a company to deduct “all direct costs of acquiring or producing goods,” and up to 4% of other “indirect or administrative overhead costs.” Generally, only entities that own and sell real or tangible personal property can elect to deduct COGS.

The taxpayer, a multistate movie theater company, included its costs of exhibiting films and other content (exhibition costs) in its COGS deduction for the tax years. The Comptroller adjusted the COGS deduction on the basis that the taxpayer was not

selling tangible personal property when it sold tickets to movies and was, therefore, not entitled to deduct its exhibition costs as COGS.

The taxpayer paid the additional franchise taxes under protest and appealed. In a two-phase case, the state trial court concluded that the taxpayer was entitled to deduct a portion of its exhibition costs as COGS. On appeal, the state appellate court in a 2015 decision, concluded that the taxpayer's film products fell within the definition of "tangible personal property." The taxpayer'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 2017 opinion, the appeals court limited its review of the evidence presented at trial to whether the taxpayer's product fell within the definition of "tangible personal property" under Tex. Tax Code § 171.1012(a)(3)(A)(ii)—the provision that addresses films and similar property. The state appeals 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 the taxpayer was entitled to include its exhibition costs in its COGS subtraction.

Having determined that the taxpayer was eligible for the COGS deduction, the court next addressed the taxpayer's appeal from the trial court's finding that only its costs associated with the square footage housing the speakers and screens in its auditoriums—rather than the costs associated with the square footage of the auditorium as a whole—qualified as COGS. The appeals court agreed with the taxpayer that the costs associated with the square footage of the entirety of the auditoriums were the direct costs of producing its product.

KPMG observation

By focusing on the second prong of the definition of tangible personal property, which addresses films and similar property, the appeals court arguably narrowed its prior holding that tangible personal property is that which is perceptible to the senses. However, the arguments presented by the taxpayer with respect to the first prong may be applicable to other taxpayers. There may be other types of taxpayers that, like the taxpayer in this case, 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.

The appellate court—by allowing the taxpayer to deduct costs associated with its entire auditorium, rather than just the square footage housing the speakers, sound equipment and screen—also appears to have taken a broad view of 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.

Read a [January 2017 report](#) [PDF 49 KB] prepared by the KPMG LLP

The information contained in TaxNewsFlash is not intended to be "written advice concerning one or more Federal tax matters" subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230, as the content of this document is issued for general informational purposes only, is intended to enhance the reader's knowledge on the matters addressed therein, and is not intended to be applied to any specific reader's particular set of facts. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. Applicability of the information to specific situations should be determined through consultation with your tax adviser.

KPMG International is a Swiss cooperative that serves as a coordinating entity for a network of independent member firms. KPMG International provides no audit or other client services. Such services are provided solely by member firms in their respective geographic areas. KPMG International and its member firms are legally distinct and separate entities. They are not and nothing contained herein shall be construed to place these entities in the relationship of parents, subsidiaries, agents, partners, or joint venturers. No member firm has any authority (actual, apparent, implied or otherwise) to obligate or bind KPMG International or any member firm in any manner whatsoever.

Direct comments, including requests for subscriptions, to [Washington National Tax](#). For more information, contact KPMG's Federal Tax Legislative and Regulatory Services Group at + 1 202.533.4366, 1801 K Street NW, Washington, DC 20006-1301.

To unsubscribe from TaxNewsFlash-United States, reply to [Washington National Tax](#).

[Privacy](#) | [Legal](#)