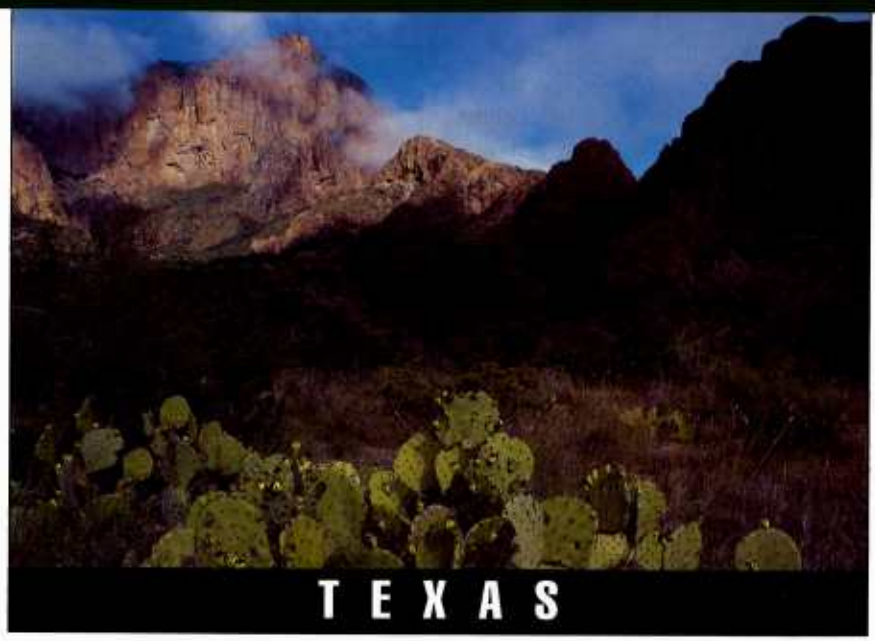

AMC's Movie Showings Are Sale of TPP for COGS Deduction

Courts continue to grapple with determining whether or not a company's business activities can be considered the sale of "tangible personal property"—particularly as technology evolves and many items are no longer physically transferred. Typically, these issues arise in the sales tax context of determining whether a hybrid transaction is the taxable sale of tangible personal property or the non-taxable sale of intangibles or services.

However, in *American Multi-Cinema, Inc. v. Hegar*, 2015 WL 1967877 (Tex. App. Apr. 30, 2015), the Texas Court of Appeals addressed this issue in a more unusual context—the cost-of-goods-sold deduction from revenue subject to Texas franchise tax. Specifically, the court addressed whether the sale of movie theater tickets could be considered the sale of "tangible personal property" and therefore qualify for Texas' cost-of-goods-sold deduction. Answering in the affirmative, the court allowed AMC to deduct all costs associated with its movie exhibitions from AMC's taxable revenue.

Although the decision provides legal support for taxpayers defining tangible personal property more broadly in calculating costs of goods sold, it is unclear how persuasive the opinion will be outside of Texas. The Texas statute at issue broadly defines "tangible personal property" to include any personal property that can be "seen" or that is "perceptible to the senses," and it specifically includes "films . . . without regard to the means or methods of distribution or the medium in which the property is embodied." In addition, practitioners would be wise to avoid defining tangible personal property too broadly in the cost-of-goods-sold context, if taking such a broad stance could be used against the taxpayer by the taxing authority in determining whether those same transactions are the taxable sale of tangible personal property for sales and use tax purposes.

This case illustrates the importance of presenting persuasive evidence in fact-based tax cases, such as whether the sale of an item can be viewed as tangible personal property or the sale of services. Here, the court repeatedly noted that AMC presented testimony from various persuasive witnesses, while the Comptroller relied almost exclusively on the "common knowledge" of going to the movie theater. In fact, the only Comptroller witness referenced by the court actually helped AMC by admitting that showing movies at the theater was the sale of tangible personal property.

Background. AMC operates movie theaters by showing films and other similar content to customers. For 2008-09, AMC deducted its costs of exhibiting films as "costs of goods sold" from its taxable revenue under Texas' franchise tax. In its calculation of costs, AMC included all costs associated with its movie theater facilities, including rent and depreciation of the full buildings. Texas disagreed and disallowed the deduction. AMC appealed to the district court.

The trial court held that AMC was allowed to deduct its movie exhibition costs as costs of goods sold because those movie exhibitions are the sale of tangible personal property. However, the trial court held that AMC's deductible costs were limited to costs associated with the area of AMC's facilities devoted only to the movie speakers and screens. The state and AMC cross-appealed to the Court of Appeals.

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Movie exhibitions are tangible personal property under cost-of-goods-sold deduction. Under Texas law, the cost of goods sold is deductible from a taxpayer's gross receipts subject to franchise tax. Tex. Tax Code § 171.1012. The term "goods" is statutorily defined as "tangible personal property," which in turn is statutorily defined to include "personal property that can be seen, weighed, measured, felt, or touched or that is perceptible to the senses in any other manner." Tex. Tax Code § 171.1012(a)(3)(A)(i). That same statute also defines "tangible personal property"

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to include "films . . . without regard to the means or methods of distribution or the medium in which the property is embodied."

The Court of Appeals began its analysis by examining the plain meaning of the statutory language based on definitions from *Webster's Third New International Dictionary*. The court noted that the term "personal property" is defined broadly as all property "other than real property" that consists of "things temporary or moveable," while the term "seen" in the statute means "perceived by the eye."

Applying those broad dictionary definitions, the court concluded that AMC's movie exhibitions were the sale of tangible personal property. The court relied on AMC witness testimony that movies arrived from multiple locations, and AMC had to "construct" and "assemble" the films, including adding advertisements, trailers, and cues for lights. The court also relied on testimony from a Texas Comptroller representative who admitted that "a movie on the big-big screen would meet the definition" of tangible personal property under the statute, and therefore be deductible.

The court rejected the Comptroller's argument that AMC's movie exhibitions were actually the sale of "intangible personal property" or a movie-viewing "service." Again looking to *Webster's*, the court noted that "intangible personal property" means "property having no physical substance apparent to the senses" and "no intrinsic value." The term "service" is defined as "useful labor that does not produce a tangible commodity." In essence, the Comptroller argued that AMC sells the right to watch a film, emphasizing the fact that movie-goers do not "take a copy" of the film home with them.

In rejecting the Comptroller's arguments, the court first pointed out that there is no "take-home" requirement in the statutory definition of tangible personal property. The court then noted that the definition of tangible personal property expressly and specifically includes "films," regardless of the means of distribution.

Based on this analysis of the applicable legal authorities and evidence, the appellate court upheld the district court's threshold finding regarding the scope of deductible "tangible personal property." The appellate court reasoned that the evidence considered by the district court was "legally sufficient" to support its factual conclusions, and that the district court "did not err" in reaching its legal conclusions.

Costs associated with movie exhibition include entire movie theater building. After holding that AMC's movie exhibitions were tangible personal property, the Texas Court of Appeals then considered which costs associated with that tangible personal property were actually deductible. The Comptroller argued that the trial court correctly limited AMC's deductible costs to only those costs associated with the movie theater speakers and screen.

The Texas Court of Appeals disagreed, noting that the statute includes a wide variety of items deductible as "costs," including the "cost of materials that are consumed in the ordinary course of performing production activities." Tex. Tax Code § 171.1012(c)(3). In turn, the term "production" is broadly defined under the statute to include "construction" and "creation." Again resorting to *Webster's*, the court defined "create" as "to bring into existence," and "improve" as "to enhance in value or quality."

Relying again on testimony from AMC witnesses, the appellate court concluded that the "sight, sound, and lighting in the auditorium" both "improved" and "created" the movie exhibition. For instance, the witness explained that through the auditorium's specific sound equalization system, sound pressure levels, acoustics, type of screen, and type of projector, AMC was engaged in "production" by "changing what comes out of the projection booth" and thereby engaging in "creation" in "near real time."

The appellate court then pointed out that the Comptroller failed to produce any evidence to contradict AMC's testimony, instead relying on the "common knowledge" of "anyone who watches movies in movie theaters." Based on this lack of evidence, the court held that the evidence was "legally and factually insufficient to support the trial court's" conclusions regarding the scope of deductible costs.

As a result, the court ordered a refund of more than $1 million in tax for 2008-2009, plus penalties and interest.

Indiana Tax Court Upholds Use Tax on Cars That Never Entered Indiana

Generally, tax imposition statutes must be construed in favor of taxpayers and against the taxing authority. In practice, however, courts are sometimes reluctant to apply this principle, particularly where the result appears unjust or inequitable—such as when a large corporation would escape taxation altogether, especially on large transactions.

For instance, in *Asplundh Tre Expert Co. v. Indiana Department of State Revenue*, 2015 WL 3968274 (Ind. Tax Ct. June 30, 2015), the Indiana Tax Court held that the taxpayer owed Indiana use tax on vehicles that never entered Indiana. Although the vehicles were licensed, titled, and registered in Indiana, the court's conclusory analysis failed to fully explain how a tax based on the "storage, use, or consumption of tangible personal property in Indiana" could be imposed on tangible personal property that never actually entered the state. The court also held that imposing Indiana's use tax statute in this context did not violate the Commerce Clause of the U.S. Constitution.

Digging deeper into the opinion, it appears the court may have been troubled that Asplundh could not establish payment of sales tax when purchasing those vehicles outside Indiana. The court seemed reluctant to grant a $2.6 million use tax refund and allow Asplundh to potentially avoid taxation altogether on its vehicle sales. This case serves as a helpful reminder that explaining why a taxpayer's position is equitable and just can go a long way in persuading the court to grant the relief requested.

Background. Asplundh Tree Expert Company is a Pennsylvania company providing specialized vegetation management and emergency storm services

throughout the United States. In order to provide its specialized services, Asplundh garages vehicles in various states, including Indiana.

From 2007-09, Asplundh purchased more than 500 custom-built service vehicles outside Indiana from non-Indiana retailers, intending to use the vehicles outside Indiana. Consistent with Asplundh's intent, the vehicles never entered Indiana—the vehicles were not delivered to Indiana, and Asplundh never drove or garaged the vehicles in Indiana. In short, Asplundh never physically "used" the vehicles in Indiana, based on the common usage of that term.

Nonetheless, Asplundh registered, licensed, and titled the vehicles in Indiana as part of Indiana's "International Registration Plan," a registration reciprocity agreement among various states (plus the District of Columbia and Canada). As part of that Indiana registration process, Asplundh paid $2.6 million in use tax to Indiana from January 2007 through May 2009.

Asplundh filed refund claims for the use tax it paid based on the position that Asplundh never actually "used" the vehicles in Indiana. The Indiana Department of State Revenue denied those claims, and Asplundh appealed to the Indiana Tax Court.

Indiana use tax statute applies to vehicle registration. Indiana imposes use tax on the "storage, use, or consumption of tangible personal property in Indiana." Ind. Code § 6-2.5-3-2(a). A taxable "use" is defined as "the exercise of any right or power of ownership over tangible personal property." Ind. Code § 6-2.5-3-1(a).

With minimal analysis, the court simply held that by electing to register, license, and title the vehicles in Indiana, Asplundh "exercised its right as an owner over those vehicles" in Indiana. The court acknowledged that cases in many other states have rejected this approach and held that use tax only applies if the tangible personal property is actually physically present in the taxing state.

However, the court rejected reliance on those cases on the ground that they each interpreted their own "state-specific imposition statutes" and legal principles—notwithstanding virtually identical language in those statutes. For instance, in *In re Culverhouse, Inc.*, 386 B.R. 806 (M.D. Ala. 2006), the court addressed Alabama use tax imposed on the "storage, use or other consumption in this state" of any automobile. Ala. Code § 40-23-61(c). The Alabama statute also defined "use" as the "exercise of any right or power over tangible personal property incident to ownership of that property." Ala. Code § 40-23-60(8). Applying those statutes, the *Culverhouse* court construed the phrase "in this state" to "mandate the physical presence of the vehicles in Alabama."

The Indiana court failed to address these similarities between tax statutes. Instead, the court merely stated that Indiana's statutory definition of a taxable "use" is "broad and leads to a very low threshold of taxability."

This aspect of the court's holding is troubling for at least two reasons. First, Indiana law does not specifically provide that registering, titling, or licensing a vehicle in Indiana is a taxable "use." As the *Culverhouse* court held regarding the same statutory language in Alabama, use of the vehicle "in this state" could mean the physical presence of the vehicles "in Indiana." At best, the issue of whether merely licensing a vehicle constitutes "use" of the vehicle in Indiana is ambiguous. Second, the court's holding violates the rule that any ambiguities in a tax-imposition statute must generally be construed in favor of the taxpayer and against the taxing authority. Here, the court applied the opposite presumption, construing any potential ambiguity in favor of the Department.

Use tax on vehicles never present in Indiana does not violate the Commerce Clause. The court also rejected the argument that application of Indiana's use tax to Asplundh's vehicles violated the Commerce Clause. The court briefly addressed all four prongs of the *Complete Auto* test: (i) substantial nexus; (ii) fair apportionment; (iii) discrimination against interstate commerce; and (iv) fair relation to state services. *See Complete Auto Transit v. Brady*, 430 U.S. 274 (1977).

First, the court held that Asplundh had substantial nexus with Indiana based on its physical presence of maintaining vehicles in Indiana—even though the Indiana vehicles were not at issue.

Second, the court held that the tax was fairly apportioned because Asplundh failed to introduce any evidence that it "has been subject to multiple taxation" or that it is "subject to the risk of multiple taxation." As a practical matter, Indiana's use tax statute provided a credit for any sales or use tax paid to any other state. Ind. Code § 6-2.5-3-5. As the court pointed out, Asplundh's tax manager testified that Asplundh failed to pay sales tax on several vehicle purchases at issue.

Third, the court also held that Asplundh failed to demonstrate how the tax statute provided a commercial advantage to in-state businesses versus out-of-state businesses.

Fourth, the court held that the tax was fairly related to state services because Indiana's licensing department provided a "One Stop Shop" multistate registration program, as well as access to Indiana's judicial system. ■