Glenn Hegar Texas Comptroller of Public Accounts

June 3, 2015

The Honorable Greg Abbott, Governor
The Honorable Dan Patrick, Lieutenant Governor
The Honorable Joseph R. Straus, III, Speaker of the House

Re: American Multi-Cinema Inc. v. Hegar, et al., 2015 Tex. App. LEXIS 4388
(Tex. App. – Austin, April 30, 2015)

Gentlemen:

This letter serves as my official communication of the potential fiscal impact of the recent Third Court of Appeals decision impacting the Texas franchise tax that we previously discussed.

On April 30, 2015, the Third Court of Appeals issued an opinion ruling that American Multi-Cinema (AMC) produces a "good" when it exhibits a movie and can include costs of the auditorium as "production costs" in determining its cost of goods sold (COGS) deduction from revenue to lower the amount of franchise tax owed. The decision holds that anything perceptible to the senses is "tangible personal property" (TPP), regardless of whether the purchaser takes possession or title to the item and regardless of whether the item was historically considered a service and not a good. If the AMC decision is upheld by the Texas courts, the definition of TPP could potentially allow service providers to qualify for the COGS deduction if any aspects of the service are perceptible to the senses.

Although the tax years in contention in the AMC case were 2008 and 2009, it was not until 2013 that the Legislature was considering granting a COGS deduction for the motion picture exhibition industry. As the Chairman of the Subcommittee on Fiscal Matters in 2013 and as the Senate sponsor of HB 500 during the 83rd Legislative Session, I assure you that prior to September 1, 2013, the Legislature did not understand the motion picture exhibition industry to qualify for the COGS deduction. In preparing HB 500, the Legislature drafted the carefully tailored language to grant the COGS deduction to the motion picture exhibition industry. Such a sweeping re-interpretation of preexisting law, if applied to services perceptible to the senses generally, was never foreseen, discussed or contemplated by the members of the Legislature, as demonstrated by the HB 500 fiscal analysis, which attributed only $3 million in revenue loss per year in the cost of the bill.

As a practical matter, the court's holding could potentially treat a business exhibiting a movie as producing TPP in much the same way that a carpenter produces a chair or desk. This statutory interpretation, if upheld on appeal, could potentially enable persons previously classified as service providers (and that were previously limited to compensation deductions or the 70 percent of revenue calculation) to now claim COGS deductions and potentially reduce their total revenue by an additional 29-55 percent.

If this court decision were to stand and become final, we estimate the potential loss of franchise tax revenue due to the AMC holding at $1.5 billion annually,[1] with refunds for open periods, up to four years back, potentially reaching up to $6 billion. The enclosed *Preliminary Assessment* sets out the fiscal implications of this decision in greater detail.

[1] The annual potential decrease in franchise tax revenue will be reduced by 25 percent if the Governor signs HB 32 reducing the tax rates by 25 percent. This change in law will not impact the estimated costs of the refunds.

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Furthermore, the franchise tax definition of TPP in the Tax Code is identical to the definition of TPP adopted by the Legislature over 50 years ago when the sales and use tax was first adopted. Although this agency has consistently interpreted the definition of TPP to exclude services, the AMC holding could bring long-settled treatment of certain types of services into question. Namely, services that are not specifically identified as taxable in Tax Code Chapter 151 (sales and use taxes) could possibly meet the definition of TPP because the activity engaged in by the seller is "perceptible to the senses." For example, under the AMC holding, architects who draw blueprints, barbers who cut hair, and lawyers who draft contracts could be selling TPP, although historically and currently such activities are considered nontaxable services.

In addition, based on this court decision, businesses that sell what we now classify as taxable and nontaxable services might argue that they qualify for manufacturing exemptions that are available to businesses that produce TPP for ultimate sale. This means that movie theaters might potentially seek a sales and use tax manufacturing exemption for the movie projectors, speakers, screens and any other tangible personal property used to exhibit the movie, if the decision is upheld on appeal. Lawyers might claim an exemption for computers used to prepare briefs. Architects might claim an exemption for equipment and materials used to produce architectural drawings or blueprints.

We have not estimated the potential additional sales and use tax revenues that might be gained or lost from taxing services that are not currently taxable under the court's ruling, because of the potential for additional claims of sales and use tax exemptions that could offset or exceed, to an unknown extent, incremental revenue.

These potential tax revenue implications are based on information available to the Comptroller as of the date of this letter, and actual tax revenue results could differ depending upon a final court ruling upon appeal, as well as business, or other economic circumstances. The forecast of potential revenue loss could also be affected by any legislative action taken to reverse or limit the consequences of the Third Court of Appeal's decision.

Our agency's current preliminary assessment of the potential far-reaching impact of this decision has been publicly discussed by many of the leading accounting, legal, and taxpayer representative entities in Texas.[2] Clearly, this potential change in the tax law was not intended, discussed or contemplated by the Legislature, and has never been used in any of the Comptroller's biennial estimates of revenue available for expenditure.

We also note that 35 states, in addition to Texas, include the phrase "personal property that can be seen, weighed, measured, felt, or touched or that is perceptible to the senses in any other manner" or one substantially similar to it, as part of, or as the entirety of, a statutory definition of tangible personal property. However, we are not aware of such a broad interpretation in those other jurisdictions, as the Texas court has offered in AMC.

We are seeking rehearing of the AMC decision with the Third Court of Appeals and, if necessary, we intend to seek review by the Texas Supreme Court. However, I wanted to bring this significant matter to your attention now because the ultimate outcome of this case could reduce the future revenue available to sustain the programs that are vital for this state, as well as create ongoing uncertainty in tax administration on a going-forward basis, should the ruling not be altered or overturned.

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[2] *See, e.g.*, PWC, "Texas Court of Appeals holding that film exhibition involves tangible personal property could have broad franchise and sales tax implications," *Tax Insights from State and Local Tax Services* (May 21, 2015); Deloitte, "Texas Court Holds Movie Auditorium Costs Included in COGS Subtraction," *State Tax Matters* (May 22, 2015); KPMG, "Texas – Expanded definition of "goods" for COGS; possible refund opportunities," *TaxNewsFlash-United States* (May 2015); Baker Botts, "Texas Appellate Court Decision Reads Definition of Tangible Personal Property Expansively for Texas Tax Purposes," *http://www.bakerbotts.com/ideas/publications/2015/4/taxupdate* (site last visited: May 29, 2015).

We are available for any question you might have and look forward to working with your offices on this important issue.

Sincerely,

Glenn Hegar

Enclosure

cc: Legislative Budget Board

Preliminary Assessment

Franchise tax fiscal implications resulting from the expanded definition of tangible personal property in *American Multi-Cinema, Inc. v. Hegar et al*, Case No. 3-14-00397-CV (Tex. App. – Austin, 2015): Section 171.1012(a)(3)(B) excludes "intangible property" and "services" from what is considered to be "tangible personal property." The decision in *AMC v. Comptroller* would overrule that section and expand the definition of tangible personal property to include anything that can be seen, weighed, measured, felt, or touched or that is perceptible to the senses in any manner, regardless of whether the item has been historically viewed as a service or intangible property. This judicially expanded definition would greatly increase the availability of the cost of goods sold deduction to taxable entities currently not allowed the deduction. It would also increase the cost of goods sold deduction for taxable entities currently using that deduction, by allowing them to deduct costs for services and intangible property as "goods" when calculating franchise tax, resulting in substantially less franchise tax collected. Based on a review of franchise taxes paid by companies in the service industry, the estimated state revenue consequences are as follows, unless the decision in this case is reversed or modified on appeal:

	Gain/(Loss)
Fiscal Year	Property Tax Relief Fund 0304
2016	($1,500,000,000)
2017	(1,500,000,000)
2018	(1,500,000,000)
2019	(1,500,000,000)
2020	(1,500,000,000)

Similar effects would persist after 2020.

Additionally, if the judicially expanded definition of tangible personal property were to apply for tax years prior to fiscal 2016, the potential refund liability for the standard four-year statute of limitations period, plus other periods opened due to audit activity, could be $6,000,000,000 plus interest. The revenue loss attributable to the Third Court of Appeals' holding in *AMC v. Comptroller*, unless reversed or modified, greatly exceeds the entire direct revenue loss projected for HB 500 in the 2013 Legislative Session. Please note that Section 10 (Tax Code § 171.1012(t)) is only a minor factor in the cost analysis for the Bill. See Legislative Budget Board Fiscal Note, IN RE: HB500, 83rd Legislative Regular Session, dated May 25, 2013.

These estimates are preliminary and based on historical data. These potential tax revenue implications are estimates and actual tax revenue results could differ depending upon a final court ruling upon appeal, as well as business or other economic conditions and circumstances. The annual potential loss will be reduced by 25 percent if the Governor signs HB 32 reducing the tax rates by 25 percent. This change in law will not impact the estimated costs of the refunds. The forecast of potential revenue loss could also be affected by any legislative action taken to reverse or limit the consequences of the Third Court of Appeal's decision.