Understanding How State Tax Credits Work For Productions

By David Albert Pierce, Esq.

"*Tax loopholes are like parking spaces. As soon as you get there, they aren't there*."
--Legendary comedian and television icon Milton Berle.

You've landed the rights to produce an amazing script about the life of a famous outlandish X-games skateboard competitor. The story has intrigue, sex, practical jokes and a lot of non-stop skateboard action. California has several skate-parks, but who shoots in that state any more? California does not offer tax credits. Kansas has just the skate park you need for your film and is in fact the very place where this particular X-game competitor grew up. There is also a skate park in Michigan which is all right, but would require some money to perfect. But what if you were to learn that Michigan offers a 40% tax rebate for production expenses, whereas Kansas only offers a non-transferable, non-refundable 30% tax credit? You may find it cheaper to spend more on set redesign in Michigan than to film in Kansas, because you'd be spending less money on your production in the end. Likewise, the overall tax benefits will actually reduce the overall hard dollars needed for your budget compared to filming at home in California and using the perfect parks it has to offer. Hence, one thing to consider in choosing location for all phases of your production is states' tax incentive programs.

Many states view film production as an invigorating shot in their economy's arm. Savvy production companies closely scrutinize and compare the incentives different states offer in choosing where to film. States are competing to provide the most alluring incentive packages, while California passively watches productions flee to these new venues. Head East young man and stake your tax credit fortune!

Just as two skate parks will be functionally similar but differ in noticeable ways, states' tax incentive programs operate similarly, but differ in terms of how the incentives are procured, and when the money will be available to you during your production. This article maps out the general terrain of state tax credits and rebates, and highlights some key interstate differences. (In the months ahead, check out our regular MovieMaker.com online column for details on specific states' incentive programs.)

A state may offer tax incentives as either rebates or credits. While both reduce the final amount of taxes you end up paying, tax rebates are optimal as they are cash refunds paid directly to your company. Tax credits, on the other hand, are processed through tax returns and work as a dollar-for-dollar reduction on your company's income tax liability. Since your out-of-state production company will typically generate little or no taxable income in the specific state offering the credits you seek, credits typically translate to less money saved than rebates.

A SIMPLE LESSON IN TAX CREDITS FOR THOSE OF US WITH LIBERAL ARTS DEGREES INSTEAD OF MBAs:

There are three types of tax credits; from most favorable to least favorable, they are:

Refundable. Refundable tax credits first reduce your company's tax liability to a state; if this amount is reduced to zero, any surplus credit is refunded as cash directly into your company's bank account! Hawaii and Michigan offers a refundable tax credit.

Transferable. Transferable credits first reduce your company's tax liability to a state; however, any surplus credit can be sold as a fungible commodity to local taxpayers at a fraction of their face value. In other words, if you have $50,000 in surplus tax credits in a state that you don't normally conduct business in, some wealthy citizen of that state will give you $25,000 to buy your $50,000 worth of credits (allowing him to save $25K on his own tax bill). Pennsylvania and Arizona are examples of states offering transferable tax credits.

Non-transferable. Non-transferable credits can only reduce a company's own tax liability, as they are the least liquid and cannot be sold. If they are also non-refundable, a company can't avail of any surplus credits. Non-transferable credits do little to benefit you or their states (unless you regularly reside, work and pay large amount of taxes in those states). Kansas and West Virginia are examples of states offering non-transferable, non-refundable tax credits.

To determine whether your production qualifies for tax rebates or credits in a given state, you must meet the state's criteria for *qualified production* and *qualified spend*, while keeping in mind filing requirements and monetization issues (i.e., the ability to convert the "credit" into "cold hard cash for your film").

THE SMART GUYS KNOW HOW TO TAKE ADVANTAGE OF THESE CREDITS AND SO CAN YOU:

How Productions Become "Qualified": Each state has unique requirements for productions to qualify for tax rebates or credits. First and foremost, the filmmaker must ensure that the type of project qualifies for the credit. Pennsylvania includes the following as eligible projects: "qualifying feature films, television films, TV talk or game show series, TV commercials, TV pilots or each episode of a TV series intended as programming for a national audience." Some states will not provide a tax incentive to productions that will reflect poorly on the state as determined by the State's Qualifying Committee, items such as pornography or glamorizing illegal or harmful activities might present a barrier to qualification depending on the state. Filmmakers should be aware of any script content prohibitions, such as Texas which will not award tax incentives to productions which have inappropriate content or content that portrays Texas or Texans in a negative fashion. In other words, don't mess with Texas!

Commonly, states will require your company to spend a minimum amount—either a fixed dollar amount, or a percentage of your production budget or a combination of both—in state. Pennsylvania, for example, requires production companies to spend at least sixty percent of their budgets in state to receive the tax credit. In addition, there may also be minimum filming day requirements in the state. For instance, Rhode Island requires that 51% of the motion picture principal photography days must be filmed in Rhode Island. Some states don't require any principal photography to be done in state—post-production expenses incurred in New Mexico, for example, will qualify for the state's tax rebate.

Finally, many states require that a certain percentage of a company's crew be state residents. For example, Arizona has a minimum local hire of 35% of the total number of paid crew must be Arizona residents. Some states may have no minimum local hire requirement such as New Mexico which simply disqualifies out of state crew members from applying towards the tax credit and only considers New Mexico resident crew member salaries in determining the tax credit. Some states like, Michigan, are union states that require that all crew members by union members in order for a production to qualify.

How Much Of The Budget Can Be Applied To Tax Credit (Defining The "Qualified Spend"): Once you've determined your production is qualified for tax rebates or credits within a state, you need to determine how much of your budget will be deemed as "Qualified Spend"— i.e., how much will be eligible for credits or rebates in the state. Even more so than with qualified production criteria; "the devil is in the details" when it comes to Qualified Spend criteria. States will allow a tax credit only for a Qualified Spend, i.e. expenses that are incurred in state and subject to the state's general excise or state income tax.

Basically, the standard costs incurred during production, such as cast and crew wages, camera, grip, and lighting equipment rentals, lodging, transportation, location fees, airfare, etc.—will qualify as a Qualified Spend so long as the costs are incurred in state and are subject to state tax. For example, travel tickets to and from the state will count towards a qualified spend if purchased through an in state travel agency. Production and Errors & Omissions insurance will qualify if purchased through a local insurance broker. Therefore, smart pre-planning and analysis as to how to maximize the "Qualified Spend" is essential for any filmmaker looking to maximize tax credits.

Particular attention should be directed towards talent compensation as a Qualified Spend. In some states, whether your talents' compensation will count as Qualified Spend depends on whether the talent's Loan Out Corporation has registered to do business in the state. If that is the case, your production company should contractually require talent to register their Loan-Outs to do business in any state where they will work, if you wish to take advantage of tax incentives in states requiring registration. Some talent may demand the production company pay the cost of registering the talent's Loan-Out to do business in that state. Some talent might resist the idea entirely, if cooperation from talent cannot be obtained, you may try to insist that the talent be paid directly through the regular pay-roll (subject to the specific state's tax) rather than via their out-of-state Loan-Out. Hawaii requires the registration of each talent/crew Loan-Out. The state of New Mexico has alleviated the cost burden of this requirement by the registration of one corporation - a "Super Loan Out Corporation" - which the production company pays all non-resident talent/crew compensation and fees to, which the Super Loan Out Corporation in turn pays out all non-resident talent/crew compensation and fees. Pennsylvania's Loan-Out requirements are much simpler and do not require the registration to do business of Loan-Outs so long as the compensation and fees are subject to Pennsylvania tax.

The Importance Of TheTiming of Applying With The State ("Availability of Funds"): State legislators allocate a certain number of funds available for disbursement for the state tax incentive program based upon the state budget. Depending on when a filmmaker applies for the film tax incentives, the state may or may not have funds available for fulfillment of the tax incentive. For example, for the July 1, 2007 – June 30, 2008 fiscal year, Pennsylvania capped the amount of funds available for tax incentives at $75 million. Whereas, Missouri has a cap of $4.5 million allocated for its tax incentive program. The demand for a tax incentive program may be so strong that funds available for disbursement will be consumed up by the time the production company applies for the tax incentive. It is advised to speak to film commission offices in advance about the availability of funds for disbursement, lest the production company reschedules principal photography to coincide with the disbursement of funds.

We Qualify, Now How Do We Get The Money ("Monetization of Credit"): If the tax incentive is in the form of a transferable tax credit rather then a rebate, filmmakers should understand how to monetize the tax credit. Of importance to filmmakers is the timing of the tax credit – when will you get the monetary benefit of the credit? This is essential for the cash flow of your Picture (particularly post-production). Generally, tax credits are available at the end of principle photography after a lengthy process of the submission of an audited qualified expense report and/or the filing of a final state tax return, the approval of the applicable state authorities (State Department of Revenue or State Film Commission), the issuance of a tax credit certificate and the sale of the tax credit through a broker who knows exactly what wealthy state residents are eagerly willing to buy such credits. Filmmakers may not receive the benefit of the tax credit until a year after principle photography. To help filmmakers receive the benefit of the tax credit up front, some states provide loans to filmmakers based on the expected tax credit to free up funds for principle photography. Other filmmakers obtain private loans using future tax credit money as collateral.

Before choosing a state, a filmmaker should inquire as to how large of a market exists for the tax credits, tax broker fees and the typical discount value of the tax credit. These factors will largely affect the actual monies realized from the tax credit. If a buyer market for tax credits does not exist in the state, you may be left with an unusable tax credit. Additionally, broker fees and discount values will reduce the amount realized. For example, Pennsylvania state taxpayers are willing to pay up to ninety percent (90%) face value for the tax credit and brokers will charge anywhere between 1% to 5% of the face value, thereby reducing your tax credit by 15%.

Additional Benefits Offered By States To Lure Filmmakers: In addition, or as an alternative, to tax rebates or credits, several states offer other incentives that can reduce your costs, including sales and use tax reductions on production related expenses (including lodging and equipment), tax credits for film investors, and free use of state property for filming. New York City even provides discounted advertising for films primarily produced in the city, and free use of city police officers during filming to ensure it goes smoothly. Michigan provides fifty percent of the cost of on-the-job training of resident crew you hire.

Be mindful of each state's existing and developing infrastructure for film productions. For instance, while you may be hard pressed to find a studio or other industry resources to support your work in Texas, Louisiana's film infrastructure has been growing exponentially. For instance, the experience and competence of the local crew base is another factor to consider. Although Michigan has 21 sound stages and a local film lab, its' crew base is largely inexperienced with two to three features under its belt. Michigan has trained laid off Reddi-whip factory workers in the belief that their manufacturing skills will translate well into working as crew—whether this will prove true or not has yet to be seen.

TO SUM IT ALL UP

Researching states' incentives programs and existing infrastructure in light of your project's needs will not only save you money, but could also uncover surprising creative possibilities. While you might find yourself engaged in Byzantine calculations to assess which states' tax incentive programs provide you the greatest benefits, keep in mind that the final aim of the programs is to simultaneously benefit you and the states. Simply being aware of the existence and basic nature of incentives programs puts you at a great advantage in your next production. Don't forget to visit our online column for detailed information on incentive programs in specific states. Until next time, happy filming.