BY David Albert Pierce, Esq

Riding High on the Government's Dime

UNDERSTANDING HOW STATE TAX CREDITS WORK

YOU'VE LANDED THE RIGHTS TO PRODUCE AN amazing script about the life of a famously outlandish X Games skateboarder. The story has it all: Intrigue, sex, practical jokes and a lot of nonstop skateboard action. California has several skate parks, but the state doesn't offer any tax credits.

There's a skate park in Michigan that could work, but would require some money to make it perfect. Kansas has just the skate park you need for your film and is in fact the very place where this particular X Games competitor grew up.

But what if you found out that Michigan offers a 40 percent tax rebate for production expenses, whereas Kansas only offers a non-transferable, non-refundable 30 percent tax credit? You may find it cheaper to spend more money to 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 a location for all phases of your production is state tax incentive programs.

Many state officials view film production as an invigorating shot in their economy's arm. In choosing where to film, savvy production companies closely scrutinize and compare the incentives that different states offer. This has led to a competition among states to provide the most alluring incentive packages.

Just as two skate parks will be functionally similar but differ in noticeable ways, state tax incentive programs operate similarly, but differ in terms of how the incentives are procured and when the money becomes available to the moviemaker.

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.

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. Both Hawaii and Michigan offer 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 $25,000 on his or her own tax bill). Pennsylvania and Arizona offer transferable tax credits.
- **NON-TRANSFERABLE:** Non-transferable credits can only reduce a company's own tax liability, as they are the least liquid option 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 a large amount of taxes in those states). Kansas and West Virginia offer 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 a 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).

HOW PRODUCTIONS BECOME "QUALIFIED" Each state has unique requirements for productions to qualify for tax rebates or credits. First and foremost, the moviemaker must ensure that the type of project qualifies for the credit. Some states will not provide a tax incentive to productions that reflect poorly on the state, as determined by the state's Qualifying Committee. Items such as pornography or those glamorizing illegal or harmful activities might present a barrier to qualification, depending on the state. Moviemakers should be aware of any script content which will prohibit the awarding of tax incentives from states such as Texas, where inappropriate content includes any that portrays Texas or Texans in a negative fashion.

Commonly, states will require your company to spend a minimum amount—either a fixed dollar amount, a percentage of your production budget or a combination of the two—within the state. Pennsylvania, for example, requires production companies to spend at least 60 percent of their budgets in-state to receive the tax credit. There may also be minimum filming day requirements in the state. Rhode Island requires that 51 percent of a motion picture's principal photography days must be in the state. 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 tax rebate.

Finally, many states require that a certain percentage of a company's crew be state residents. Arizona requires that a minimum of 35 percent of the total number of paid crew members must be Arizona residents. Some states, such as New Mexico, have no minimum local hire requirements but simply disqualify out-of-state crew members from counting toward the tax credit. Other states are union states that require the entire crew be union members in order for a production to qualify.

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DEFINING THE "QUALIFIED SPEND" Once you've determined whether your production is qualified for 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 chosen state). Even more so than with qualified production criteria, the devil is in the details when it comes to qualified spend criteria.

Basically, the standard costs incurred during production—cast and crew wages, camera and lighting equipment rentals, lodging, transportation, location fees, airfare, etc.—will qualify as 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 toward a production's qualified spend if purchased through an in-state travel agency. Production and errors and omissions insurance will qualify if purchased through a local insurance broker. Therefore, smart pre-planning and analysis of how to maximize the qualified spend is essential for any moviemaker looking to maximize tax credits.

Particular attention should be directed toward talent compensation as a qualified spend. In some states, whether your talent's 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 and you wish to take advantage of tax incentives in states requiring registration, your production company should contractually require talent to register their loan-outs to do business in any state where they will work.

Some talent may demand the production company pay the cost of registering the loan-out to do business in that state; some might resist the idea entirely. If cooperation from talent cannot be obtained, you should try to insist that the talent be paid directly through the regular payroll (subject to the specific state's tax) rather than via their out-of-state loan-out. Hawaii requires the registration of each talent or crew loan-out while New Mexico has alleviated the cost burden of this requirement by the registration of one corporation—a super loan-out—to which the production company pays all non-resident talent and crew compensation and fees. The super loan out corporation in turn pays out all non-resident talent and crew compensation and fees. Pennsylvania's loan-out requirements are much simpler and do not require registration to do business with loan-outs, so long as the compensation and fees are subject to Pennsylvania tax.

AVAILABILITY OF FUNDS Based upon the state budget, state legislators allocate a certain amount of funds to disburse for the tax incentive program. Depending on when a moviemaker applies for the incentives, the state may or may not have funds available for fulfillment. 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 had a cap of $4.5 million. The demand for a tax incentive program may be so strong that funds available for disbursement will already be consumed by the time the production company applies for the tax incentive. It is advised to speak to a state's film commission as far in advance as possible about the availability of funds for disbursement so principal photography can be rescheduled if necessary to coincide with that disbursement.

MONETIZATION OF CREDIT If the tax incentive is in the form of a transferable tax credit rather then a rebate, moviemakers should understand how to monetize the credit. Of importance to moviemakers is the timing of the credit—when will you get the monetary benefit? This is essential for the cash flow of your picture (particularly during post-production). Generally, tax credits are available at the end of principal photography, after a lengthy process including the submission of an audited qualified expense report and/or the filing of a final state tax return, approval from the applicable state authorities (State Department of Revenue or State Film Commission), issuance of a tax credit certificate and the sale of the tax credit through a broker who knows exactly which wealthy state residents are eagerly willing to buy such credits. (*See sidebar.*)

Moviemakers may not receive the benefit of the tax credit until a year after principal photography. To help them receive the benefit of the tax credit up front and free up funds for principal photography, some states provide loans to moviemakers based on the expected credit. Other moviemakers obtain private loans using future tax credit money as collateral.

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

ADDITIONAL BENEFITS OFFERED TO LURE MOVIEMAKERS 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 produced in the city and free use of city police officers during filming to ensure it goes smoothly through its Made in NY program. Michigan provides 50 percent of the cost for state residents trained on the job for crew positions.

Researching state incentive 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 will provide you with the greatest benefits, keep in mind that the final aim of the programs is to simultaneously benefit you *and* the state. Simply being aware of the existence and basic nature of these incentive programs puts you at a great advantage with your next production. MM