BEYOND THE BASICS

The inside scoop on production incentives. **By Matthew Savare, Esq., Michael Hansen, and Mark Flippen**

Any producer who has shot a movie in the U.S. in the last 10 years is familiar with production rebates and tax credits. However in the midst of the worst economic crisis since the silent movie era, producers must do more than simply know about or use these incentives; they must squeeze every last dollar they can out of them. In some cases, properly monetizing these rebates and credits can be the difference between green-lighting and postponing a film.

Although much has been written on production incentives, practical, specific information on how to maximize their value is scarce. Providing that type of information is our goal here.

1 OVERVIEW OF THE INCENTIVES

Before you can make the most of any incen-tive, it's important to understand the different types and how they work.

There are two types of production incentives: tax credits and rebates. Tax credits come in three basic types: refundable, transferable, or non-refundable and non-transferable. A refundable tax credit is a refund the production company receives from the state after paying its income taxes in that state. Producers are eligible to receive these refundable credits even if they have no state income tax liability, which is often the case for production companies making one-off films. States offering refundable credits include Hawaii, Michigan, New Mexico, New York (and New York City) and North Carolina, which recently increased its credit.

Transferable tax credits are not refundable. The production company must use the tax credit to offset its state income tax liability. If it has no such liability, it must sell or assign the tax credit to local taxpayers. Such a sale can be done directly by the production company or indirectly through a broker, but always at a discount. A number of states offer transferable tax credits including Connecticut, Illinois, Iowa, New Jersey and Pennsylvania.

A non-refundable and non-transferable tax credit requires the production company to use the tax credit to offset its own taxes. Although production companies cannot sell or transfer such credits, they can carry the credits forward and reduce their tax burden in subsequent years. California employs such a program, although tax credits issued to "independent films" may be transferred or sold to an unrelated party. All other qualified taxpayers may carry over their tax credits for five years and/or transfer tax credits to an affiliate.

Rebates are funds that the state pays directly to the production company for qualifying expenditures. Unlike tax credits, which can be claimed only after filing a tax return in the state providing the incentive, rebates do not require the producers to file a return. States offering rebates include Colorado, Florida, Oregon, South Carolina, Texas and Virginia. In some of these states, producers can receive their rebate check within 60 to 90 days of completion of principal photography.

2 INDUSTRY PLAYERS

Assuming you're like most producers and you need money now, your best option is to approach a bank or an asset backed lender (ABL) and borrow against the expected resale value of the incentive. Who are these lenders? What do producers need to do before contacting them? When is the best time to approach them? What do these lenders consider when deciding whether or not to lend money to a producer? Let's examine each question.

Active ABLs for motion pictures include Bayberry Capital Group, Winchester Capital Management and Tax Credit Finance. (Editor's Note: One of the authors, Michael Hansen, is a Managing Director at Bayberry Capital Group, LLC.) Although some banks are still wary about financing production incentives, more banks are now starting to enter this space. Bank Leumi and the National Bank of California have been very active in loaning against these incentives.

Before reaching out to any of these companies, you should have, at a minimum, a shooting script, proposed locations, a budget, a cash flow statement and a production schedule. The lender will typically work with you to evaluate and select the best states in which to shoot the film based on a number of variables, including the film's budget and shooting schedule.

The timing of when you should approach these lenders depends on your circumstances. Some producers, such as Robbie Bryan (iMurders, The Man from Earth, The Stand-In), seek a letter of intent (LOI) from the lender as early as nine months before the start of principal photography. As Bryan notes: "On my latest film, The Mighty Misfit Kids, we got a letter of intent very early in the process in order to approach potential investors. It's been very helpful in our financing efforts, because investors appreciate that we plan on using these credits to the maximum extent possible."

Even in this economy, lenders are continuing to lend for the "right" projects. Although these factors may vary, lenders frequently consider the following elements: (1) a detailed budget and top sheet, (2) a financing plan, (3) producer and director bios, (4) cash flow schedule, (5) production and shooting schedule, (6) the producer's ability to obtain a completion guaranty from an acceptable guarantor, (7) confirmation of the estimated incentive and (8) a copy of the initial certification from the state's film commission, evidencing the commission's approval of the initial application.

Lenders typically issue a LOI, which outlines the most basic terms of the loan. After issuing the LOI, if the parties agree to move forward, the lender will issue a term sheet, which outlines the majority of the transaction's terms. If the parties then elect to enter into a deal, the lender will prepare the long form documentation, after which the funds will be released to the production company. Although it varies among lenders, it typically takes two to three weeks to close on the long form agreements.

In addition to the banks and ABLs, the other main industry players are the brokers that buy and sell tax credits. One of the more prominent national brokers is Tax Credits, LLC, which brokers credits in most states with saleable credit programs. Regional brokers also focus on individual states, such as Witter Consulting Group, which has traded the majority of the Iowa credits, and FBT Investments, which specializes in the purchase and sale of film credits in Louisiana.

3 PICKING THE STATE(S) TO SHOOT IN

When deciding where to shoot their films, producers consider a number of factors, including where they can get the best production incentives. Some producers are tempted to select the state or states with the largest incentives, such as Michigan, which offers a 42 percent tax credit. However many other variables must also be carefully considered.

For example, although the "biz" is often just as (if not more) important than the "show," producers still need to shoot in locations that match the locations called for in the script. In addition, although some states offer generous incentives, the costs of bringing in crew from out of state, travel, per diem, and hotels quickly eat into the incentive, and an out-of-state crew typically qualifies the production company for a smaller incentive than an in-state-crew. Equally important, producers need to understand the state's incentive program before committing to shoot there. Because some states have annual funding caps, it's important to know if there will be money to fund the incentive when it becomes due. Similarly some states have sunset provisions, which establish end dates for the program. Producers need to make sure their production qualifies for the incentive before the program expires. Most important, every state has eligibility criteria not only for the individual project, but also for each expenditure made in connection with the project. For example, most states require a minimum percentage of shooting days to occur in the state, a minimum budget, a minimum percentage of the production budget be spent in the state (with some states differentiating between above-the-line and below-the-line costs), or some combination of all three. Given this complexity, producers should engage experienced accountants and auditors to monitor such issues.

Experienced producers such as Joe Seldner (*Redemption*, *61**, *Ripley's Believe It or Not!*) understand the need to analyze all of these issues before deciding on where to shoot. Seldner notes: "The bottom line in selecting locations is not to be penny-wise and pound-foolish. You need to closely look at all the costs of production, and the tax incentive is an important piece of the puzzle. Tax incentive programs are always changing. I wish it were as easy as picking the state with the highest incentive. Unfortunately, it's not."

4 THE ECONOMICS OF THE TRANSACTION

The economics of these deals depend on many factors, including the following:

a. ABLs Versus Banks

ABLs structure and price their loans differently than traditional banks. ABLs price these loans at a discounted rate, typically between 80 to 90 percent of the incentive, while banks typically charge interest and upfront fees, which are deducted from the loan amount at the time of funding. When all costs are considered, banks and ABLs are typically very competitive with each other.

Both kinds of lenders will pass through their legal and due diligence expenses. Legal expenses can range from $10,000 to $75,000 depending on the size, complexity and timing of the transaction. Diligence fees, which cover audits of the budget, cash flow schedule and production schedule for state eligible expenses, are generally around $25,000 per project.

ABLs usually lend against any type of production incentive and often sell or assist the production company in selling the tax certificate. Banks, on the other hand, prefer to lend against either states that offer rebates or states with a legislated floor for their tax credit, such as Massachusetts at 90 percent or Louisiana at 85 percent.

Another important difference is that banks rarely lend solely against the incentive, preferring to own a number of loans associated with the project, such as senior loans, pre-sale/gap and the production incentive. ABLs, however, prefer to loan against just the incentive and possibly some gap, but rarely will loan against distribution contracts.

b. Rebate/Refundable Tax Credit Versus Transferable Tax Credit

The amount of money a producer will actually receive from a lender depends, in large part, on the state and the type of the incentive. In all the states with a significant number of productions, such as Louisiana, California, New York, New Jersey, Connecticut and Michigan, producers typically get 80 to 90 cents on the dollar. Although such pricing is negotiable, lenders frequently put their best foot forward knowing that producers often shop these incentives around.

The economics of the transaction are more favorable for producers shooting in states with a rebate or a refundable tax credit program. For example, if the production company expects to earn a $1,000,000 credit in a refundable state like New York, the lender will loan against the entire $1,000,000 credit. If the same project is going to be shot in Connecticut, which offers a transferable tax certificate, the certificate will have to be sold, and the production company will ultimately receive approximately 80 to 90 percent of the face value of the certificate, which is the amount the lender will loan against.

If we assume that the lender will loan 90 percent of the proceeds from the incentive, we can see how the difference in the incentive program affects the producer's bottom line. In the refundable state, the production company will receive $900,000 (90 percent x $1,000,000), whereas in the transferable state it will receive only $765,000 (90 percent x $850,000). This is a fairly significant difference and obviously an important issue for a production company to consider when choosing a state for its project.

In instances where a production company

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owns a saleable tax credit and the lender (if any) is not in a position to sell the credit, the production company typically engages an intermediary such as Tax Credits, LLC to broker the transaction. For example, assume a California production company with no tax liability outside that state owns a $1,000,000 tax certificate from New Jersey. The production company will likely engage a broker to sell the tax credit to a company with a New Jersey tax liability. Because New Jersey's tax credits are fairly liquid, the purchasing company will typically buy the credit for approximately 85 to 90 percent of its face value. The broker's commissions, which are generally negotiable, can be anywhere from 1 to 6 percent of the credit's face value, depending on the size of the credit, the timing of the transaction, the state, and the broker selling the credit. If we assume this broker's commission is 3 percent and can sell the credit at 89 percent of its face value, the production company will receive $860,000.

c. Timing of the Incentive

The timing of when the state pays out the incentive also affects the economics of the transaction. For example, if the producer is to receive a tax credit between $1,000,000 and $5,000,000 from the state of New York, the credit would be paid out over two years. In states where payments are divided or delayed, ABLs tend to discount the loans more, and banks require a larger interest reserve. As another example, some states base their programs around the calendar year. So, if a project starts in February and the tax return is not expected until the following April, the discount (or interest reserve) will be higher than it would be for a production starting in August.

5 BONDING AND/OR INSURING THE CREDIT

Given the increased reliance on tax incentives to help fund films, many have expressed concerns over potential liabilities specific to these incentives. For example, to qualify for most tax incentives, production companies must complete a certain percentage of their production work in the state offering the incentive and spend their budget according to the state's specific guidelines. What happens if something prevents the producers from meeting their spend requirements? A standard completion bond should cover this, right? Wrong. A standard production insurance policy should provide coverage, right? Nope.

Producers, financiers, investors and lenders at all levels are beginning to ask what assurances they have to cover such unforeseen events that could jeopardize the tax incentive and negatively impact the production company's ability to repay any loan on the incentive. One of the hot topics at film panels and symposia across the country is whether insurance and/or bond coverage is available to protect producers from such risks. As described below, the answer is yes.

a. Bonding the Incentive

With the shuttering of cineFinance earlier this year, there are now only two major completion bond companies: International Film Guarantors (IFG) and Film Finances, Inc. (FFI). These companies will, in certain cases, extend their oversight of a film's completion to ensure that the production company spends its money in a way that will qualify it for the incentive. Termed "bonding the credit" or "bonding the incentive," this arrangement contractually guarantees the production company's eligibility to receive the tax incentive.

IFG bonds the incentive through an additional beneficiary addendum to its bond contract, and FFI adds additional language to its bond agreement. The additional coverage extends the typical bonding oversight to ensure that the production company will be eligible for the state tax incentive. Eligible is the key word, as neither company provides coverage in the event the state doesn't issue the incentive (e.g., if the state's program runs out of money).

Although this coverage is relatively new and has only been used on a handful of productions, the process is straightforward. At the beginning of the underwriting process, filmmakers should let IFG or FFI know that they wish to include the addendum. The bond company will use a third party, such as the Incentives Office in Los Angeles or Hadity and Associates in New York City, to vet the production budget. To bond the incentive, there is an additional premium of approximately 2 percent of the face value of the incentive.

With these marginal charges for coverage, banks extending loans on tax incentives may start requiring their borrowers to add such coverage to the bond contract. Currently ABLs will assess the risk of each individual project and the production team to determine if such additional coverage is necessary.

b. Insuring the Tax Credit

Unfortunately even with the additional completion bond coverage, the tax incentive is still exposed to numerous risks. Some insurance carriers are now offering coverage for a loss (or a portion of a loss) of the incentive triggered by a "covered insurance claim." Here are some broad examples of events that could be a covered claim under a properly structured production insurance policy: (1) significant property damage causes the production to be moved to an out-of-state location, resulting in the producer's failing to satisfy the state's qualified expenditure requirement; (2) an act of terrorism (if terrorism coverage is elected) causes a change in location or a complete stoppage of production; and (3) in states that include talent costs as qualified expenses, a loss triggered by a key actor or talent results in a loss of the incentive. And, unlike the additional completion bond coverage, these enhanced insurance policies can provide key coverage for changes in legislation, insolvency of the state and, in certain cases, repudiation of the state's obligation.

It is important to stress that such coverage is not standard. If you are interested in insuring your incentive, be sure to request such coverage from your broker or agent before the policy is drafted. Insurance companies offering this coverage will typically charge an additional premium equal to 2 to 3 percent of the face value of the incentive.

Houston Casualty and Lloyds of London are regarded as the leading insurance companies that offer these types of coverage for the incentive and have underwritten the majority of these policies. Other carriers such as Chubb, Fireman's Fund, Travelers, EBI/One Beacon and Hiscox are starting to discuss offering basic tax-incentive coverage to their standard production policies. Insurance brokers with entertainment specialty practice groups, such as Wells Fargo Insurance Services, Arthur J. Gallagher, and Aon/Albert G. Ruben, are well versed in the world of tax incentives. (Editor's Note: One of the authors, Mark Flippen, is an Assistant Vice President with Wells Fargo Insurance Services, Inc.)

Producers shooting virtually any size film can take advantage of these tax incentives, which have become an indispensable financing tool for filmmakers. In today's market, the key is to maximize these incentives by understanding the state's program and staying on top of the process. ▼