LIGHTS, CAMERA, TAXES!

How to Use State and City Tax Credits to Help Fund Your Motion Picture

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Contributors

In the midst of the worst economic crisis since the Great Depression, financing an independent motion picture has become even more challenging. Although reports of their demise were premature, presales are on the decline, both in number and in dollars. Even though banks are still lending and private equity continues to flow into the entertainment space, obtaining these loans and private capital is more competitive than ever and often can only be obtained on fairly lopsided terms.

Given this difficult economic environment, it is not surprising that financing – particularly for individual projects – has become increasingly complex to locate and obtain. On any given film, a producer may use private equity, bank debt, privately-placed gap/mezzanine loans, foreign presales, government and private grants, and funds from product integration and partnership marketing deals. In the last several years, the monetization of state tax incentives[1] has emerged as one of the most important new funding sources for independent filmmakers.

This article provides practical guidance on how to locate, apply for, secure, monetize, and protect these tax incentives.

LOCATION, LOCATION, LOCATION

Producers analyze many factors when scouting locations. Such considerations include matching actual physical locations with the locations required by the script; and shooting in states that either have or are in close proximity to states that have an adequate supply of equipment suppliers, talent, and crew. Increasingly, producers are also evaluating the tax incentives offered by the various states in determining where to shoot.

Virtually every state, the District of Columbia, Puerto Rico, and several cities, such as New York City and San Francisco, offer tax incentives for film production. These incentives vary widely from state to state both in terms of the rate of the incentive, the specific elements of the program, and eligibility requirements. Some of the key considerations that producers must evaluate include:

• Type of Incentive – There are two types of tax incentives: rebates/grants and tax credits. Rebates are funds that the state film commission pays directly to the production company. In many of the states that offer a rebate program, such as South Carolina, Oregon, Utah, and Washington, the production company usually receives its rebate check within 60-90 days of completion of principal photography.

Tax credits come in three types: refundable, transferable, or non-refundable and non-transferable. A refundable tax credit is a refund the production company receives in an amount equal to the excess production credit it is entitled to receive under the state's program after paying all of its applicable state and/or city income taxes. Production companies are eligible to receive these refundable tax credits even if they have no state income tax liability.[2]

Transferable tax credits, on the other hand, are not refundable, which means the production company must use the tax credit to offset its state and/or city income tax liability. If the production company has no income tax liability in the state from which it is receiving the tax credit or if it wishes to monetize the credit sooner, it may elect to sell the tax credit, at a discount, to local taxpayers or indirectly through brokers.

As the name implies, a non-refundable and non-transferable tax credit requires the production company to use the tax credit to offset its own taxes, and does not permit the sale or transfer of the credit.

• Eligibility Requirements – Each state has its own eligibility requirements. For example, most states require a minimum budget, a minimum percentage of shooting days to occur in the state, a minimum percentage of the production budget be spent in the state (with some states differentiating between above-the-line "ATL" and below-the-line "BTL" costs), or some combination thereof. Complying with a state's eligibility requirements is critical to ensure that a production company qualifies for the tax incentive. Given the complexity and importance of these compliance requirements, production companies are well advised to engage accountants and auditors who are experienced in monitoring such issues. In addition, production companies should consider tailoring their production insurance policies and completion bond so they are reimbursed for the value of the anticipated tax incentive (or a portion thereof) if an unforeseen event (e.g., loss of key actor or director, significant property damage, or an act of terrorism) prevents them from meeting their eligibility requirements. Such insurance is becoming more widely available to production companies of all sizes within the global insurance marketplace.

• Compensation Caps – Many states put a cap on the tax incentives individual productions can receive. In addition, numerous states – even ones with no caps on individual productions – have budget caps that they cannot exceed. Therefore, producers seeking certainty that the rebate or tax credit upon which they are relying will be available when it becomes due and payable should confirm that the state has sufficient funds remaining in its incentive program before committing to shooting in that state.

MONETIZING THE TAX INCENTIVE

Tax incentives are no longer an option when assembling funding for a film; they are an imperative. Knowledgeable investors expect (and insist) that their producers understand and utilize these incentives to the maximum extent possible.

There are several ways for a producer to monetize these incentives. First, although some banks are still wary about financing tax incentives, a secondary capital market has developed in which companies lend money to

production companies against the expected resale value of the tax incentive. Known as "asset backed lending," this type of arrangement typically yields a producer between $.75 and $.90 for each incentive dollar at the beginning of production. It has the distinct advantage of putting a significant portion of the film's budget into the production company's hands very early in the process, allowing it to advance the project.

Second, in instances where the production company receives a transferable tax credit, it can use such a credit to lower or eliminate its tax liability in that state. If it has no such liability, as is typically the case for production companies making individual independent projects, it will can the tax credit, either directly or through a tax credit placement specialist, typically at a discount of 10-15% of the credit's face value.
Finally, in the case of rebates, the production company may elect to wait for the rebate check and apply it to post production expenses, prints and advertising, or some other expenses.

HYPOTHETICAL

To illustrate this process, consider this hypothetical scenario: Deconstruction Productions has obtained the option to shoot a feature titled, "The Moment of Untruth." The producers have already attached a well-known director and two B-list actors to star in the film, which is a character-driven piece, set in a contemporary city. The producers have estimated a production budget of $3.8 million dollars, and plan to film in New York, which offers a refundable tax credit. The example assumes that, first all expenses are "qualified expenses" (i.e., count towards the production's eligibility requirements); second, that production is set to commence on May 1, 2010 and finish by October 31, 2010; and, third, that the production budget is $3.8 million, with $1.5 million in projected ATL expenses and $2.3 million in projected BTL expenses.

THE CREDIT

The State of New York offers a refundable tax credit equal to 30 percent of qualifying production spends. In addition, New York City offers a similar 5 percent refundable tax credit for films shot within the five boroughs of Bronx, Queens, Brooklyn, Staten Island, and Manhattan.[3] Under both the state and city programs, qualified expenses are generally limited to BTL expenses, such as costs for crew, facilities, props, makeup, wardrobe, and set construction, and generally exclude costs for stories and scripts, and compensation to writers, directors, producers, and performers (other than extras without spoken lines).

THE PROCESS

Assuming Deconstruction Productions elects to borrow funds against the anticipated tax credits, it will approach an asset-backed lender. The lender, after performing due diligence on the project, will typically issue a letter of intent, describing the terms of the loan. The loan will generally be subject to the producer's

- obtaining a completion guaranty with a guarantor acceptable to the lender;
- demonstrating an ability to raise sufficient funds to finance the budget;
- confirmation of the estimated tax credits; and
- production of additional documents satisfactory to the lender with respect to the project. Those documents could include a copy of the initial certification from the state's film commission, evidencing the commission's approval of the initial application; a copy of the budget, financing structure, and cash flow statement; production schedule; shooting script; distribution agreements, if any; and the film's chain of title.

THE APPLICATION

Concurrent with the loan process, Deconstruction Productions will need to initiate the formal application process for the state and city tax credits. For the New York programs, applicants must submit their initial applications at least 10 business days, but not more than 180 days (90 days for New York City), prior to the start of principal photography. Although the process varies from state to state, most programs require the following: an initial application; submission of supporting documentation; and registration with the state.

The state incentive program is administered by the New York State Governor's Office for Motion Picture and Television Development ("MPTD"): www.NYLovesfilm.com. The New York City program is administered by the city of New York Mayor's Office of Film, Theatre and Broadcasting ("OFTB"): ***www.nyc.gov/film***.

In applying for the New York credits, Deconstruction Productions may use the same forms for both the state and city application, provided it submits separate copies with original signature pages to both offices. After submitting the initial application, Deconstruction Productions must schedule a time to meet with the MPTD to discuss its project, "The Moment of Untruth." A producer and either the line producer, unit production manager, or production accountant must attend this meeting. If the initial application is approved, the MPTD and/or the OFTB will issue to Deconstruction Productions a certificate of conditional eligibility, which the producer should promptly provide to the lender financing the tax credits.

THE NUMBERS

In our hypothetical, the production company plans to incur $2.3 million in qualified BTL expenses in New York City. Applying the state's 30 percent tax credit and the city's 5 percent credit, the production company will have a refundable tax credit of $805,000, or 21.2 percent of the picture's total production budget. The lender will likely lend Deconstruction Productions approximately 87% of that amount or $700,350, or 18.4 percent of the film's budget.

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NORTH CAROLINA UPS FILM TAX CREDIT

Production companies doing business in North Carolina next year will be eligible for an increased tax credit, up to 25 percent from 15.

"This legislation will help grow our $91 million motion picture industry, preserve and create thousands of jobs and increase investments in yet another emerging economic cluster," said North Carolina Governor Bev Perdue. "Providing a strong foundation for North Carolina's film industry is essential as we work to build a strong and sustainable economy through increased diversification."

Companies must spend a minimum of $250,000 on production costs in the state to be eligible for the tax credit. The bill also requires companies to meet hiring requirements for North Carolinians and other criteria to qualify for the incentive.

"This incentive will help keep film production in North Carolina," said N.C. Commerce Secretary Keith Crisco. "It will be a major boost for the film industry and allow us to compete on a level playing field in a vital and growing global market."

The incentive is the state's attempt to remain competitive in the quest for film production dollars, which totaled $91 million in direct spending in 2008. The industry employs more than 2,500 in North Carolina. Recent major motion pictures filmed in the state include "Nights in Rodanthe," "Leatherheads" and "The Secret Life of Bees."

The North Carolina film industry is also home to the CW Network's "One Tree Hill" TV series as well as hundreds of commercial and industrial productions each year throughout the state.

More than 800 movies have been filmed in North Carolina. Wilmington, NC's EUE Screen Gems, home of the largest studio lot east of California, recently opened the largest film and television production soundstage on the East Coast.

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If Deconstruction Films elects to apply the credits to its New York State and New York City tax returns, instead of borrowing against the anticipated tax credits, the credits will be applied as follows:

- Under the state program, the tax credit will be applied to Deconstruction Productions' state tax return for the year in which the production was completed. Because the credit is less than $1 million, if it exceeds any state tax owed by Deconstruction Films, the state will refund the full value of the overage for the tax year that the production was completed. If the credit were between $1 million and $5 million, Deconstruction Productions would receive half of the credit for the tax year that the production is completed and half of the credit the next tax year. If the credit were over $5 million, Deconstruction Productions would receive the credit in three equal installments.

- Under the city program, the credit is also applied to Deconstruction Productions' city tax return for the year in which the production was completed. If the credit exceeds any city tax owed by Deconstruction Productions, half of the overage will be refunded to the production company in the year it is earned, and the balance will be carried over to the next year's tax return.

EPILOGUE

State and city tax incentives represent a win-win scenario. For production companies, such incentives provide additional capital to fund their projects. Unlike loans that carry high interest rates or equity financing that mortgages profits in the film, tax incentives are free money, with virtually no strings attached. Although reasonable minds may differ, various Ernst & Young economic impact studies demonstrate that for each dollar a state or city spends for tax incentive programs, they get some return on their investment. For example, a recent study found that for every dollar New York State invests in tax credits, it gets back $1.90.

Although these programs present substantial opportunities, producers must be mindful that navigating the tax incentive terrain can be time-consuming and complex. In addition, as a result of the severe recession that has gripped the world economy, many states are simply running out of money, jeopardizing the continued viability of their tax incentive programs. Notwithstanding these challenges, if production companies surround themselves with knowledgeable legal and business advisors, such programs can be the difference between greenlighting or abandoning their next project.

[1]This article does not address Section 181 of the Internal Revenue Code, which is an important federal tax incentive that allows owners of a qualified film to deduct from their passive U.S. income production costs in the year they are paid or incurred.

[2]Although it is beyond the scope of this article to address corporate structure, it should be noted that production companies making individual films, or "one-offs," often form a separate entity to produce each individual project and these entities are frequently organized under the laws of the state in which they are to receive the tax credit.

[3]As of July 2009, all funds for the New York City tax incentive were exhausted for 2009. In addition, there are a number of competing bills pending before the city legislature, which, if passed, could reduce the credit to 4%, increase the credit to 15%, and/or add new incentives to the program.

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