BEZDEK LAW

Screen International's "Financing Films in America" Conference

MEMORANDUM

TO:	Screen International's "Financing Films in America" Conference
FROM:	Bianca Bezdek, Esquire bianca@bezdeklaw.com +1-917-699-8026
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SUBJECT:	**US State Level Tax Incentives- Macro Overview**

I. Introduction

BIG BUSINESS

To illustrate just how strongly the US film industry continues to perform, please take note of the following statistics:

1.) There were 699 MPAA rated feature films produced in 2005, reflecting a growth trajectory of 7%.

2.) MPAA estimates industry employment in the United States to be around 400,000; and

3.) Film production workers collectively have been estimated to have earned 22 Billion dollars nationwide.

This clearly illustrates that the film production industry in the United States maintains its strength with a vengeance. This is in spite of a number of **recent changes to the nature of the industry over the past several years.**

CHANGES TO THE FILM BUSINESS

1.) Namely, the fact that **development, production and marketing costs have increased dramatically**, which has affected the ability of Studio Distributors to

earn attractive returns on their capital and has increased their risk on investment.

1A.) As a result, studios began placing the onus on **filmmakers to raise their own production funding, thus allowing the studios to focus on distribution** as opposed to being in the financing business, with the **exception of tentpole** franchise films (such as this years Spider Man 3, **Shrek 3**, Pirates of the Carribean 3, Oceans Thirteen, etc.)

1B.) Additionally, **Studios began moving away from shooting productions at home**, in favor of Canada (which captured 81% of all US runaways by 1998), as well as the UK, and Australia **due to their tax incentives schemes,** or the Czech Republic, Romania and Bulgaria **due to their cheap labor.**

According to a survey conducted by Monitor Company commissioned by the Screen Actor Guild and Directors Guild of America, the investigation found that from 1990 to 1998, the **rate of US developed film and tv productions produced abroad almost doubled from 14 to 27 percent.**

When these productions moved abroad, a $10.3 Billion dollar **economic loss resulted** for the US.

This amount is **five times** the 2 Billion dollar runaway loss in 1990.

Because of the outsourcing of financing by studios to indie producers, and indie producers' relocation of productions to tax favorable locations, two significant side effects have occurred as a result:

1.) The first was a rethinking by the US state and federal authorities of the value of film production. Resulting in the **creation of domestic and federal tax incentive programs** dedicated to audiovisual production.

Today, a majority of the states have some sort of incentive in place for audiovisual productions, the most aggressive being Connecticut, Louisiana, Massachussets, New Jersey, Pennsylvania, Rhode Island, New Mexico, Hawaii, Mississippi, North and South Carolina, Florida, Texas, and Arizon. And even states like Wisconsin and Idaho that do not yet have any significant tax incentives are currently crafting them.

I will discuss some of these in greater detail shortly, but before I do, I would like to say a few words about the federal incentive, known as **Section 181** of the US Jobs Creation Act of 2004.

Section 181 of the US Jobs Creation act was implemented to **combat and repatriate runaway production** (namely to Canada and Australia)

How Section 181 works specifically is that is enables qualifying investors to take 100% deductions of their investments into qualifying audiovisual productions.

Qualifying investors are high net worth individuals with passive income (which is rental revenue or royalties) against which they can off set the investment as a deduction.

C corporations also qualify.

Qualifying productions are productions budgeted up to 15M (or in some cases 20M if the productions are shot in the depressed Delta region- including Mississippi and Louisiana).

Also, the productions must expend at least 75% of their budgets for services rendered in the US.

On its face, Section 181 is an interesting risk mitigator for investors.

For example, if a qualifying investor wishes to invest 1M into a qualifying production, then the investor should actually invest 1.54M assuming that they are to be taxed at the standard federal tax rate of 35%.

Because 35% of 1M, is 350K, then with the Section 181 deduction, investors of 1M will actually only be investing 650K.

Therefore, **producers should factor this in** when negotiating what the valuation of this investment has on their profit participation offer to the investor, and give away less of their back end.

Alternatively, producer's should have investors who wish to invest 1M invest 1.54M, which nets out to a total investment of 1M after applying the federal tax deductions.

Moreover, there are companies that will **buy the rights to the Section 181** deduction in advance of production **at a discount.** Just like monetizing qualifying state credits at a discount.

For state credits, expect to receive **circa 70 cents on the dollar as an advance** when monetizing them through a broker like Fallbrook Credits.

For the Section 181 credit, expect to receive **circa 10% of your budget** for allocating all of your 181 credits to a buyer, like Fallbrook Credits.

While you can take the 181 credits for yourselves, or your production companies, you will have to w**ait to get some taxable income i**n against which to take the deduction. That could take a few years.

Therefore, it may be more practical for you to **pre-sell the 181 credit** for a value you can apply toward raising your budget.

Please note as well, that Section 181 and the state credits **do not require any kind of distribution deal to be in place** as a condition precedent to qualification (except for New Mexico and Maryland).

When **combining Section 181 credits** with, for example, the Rhode Island incentive, producers can get **over a third of their budgets covered thru soft funding in the United States.**

This is significant because it can amount to **a competitive value when compared with Canadian incentives**, and you don't have to move your production to a place talent may not wish to go. *(which offer regional tax credits on labor expenditures ranging from 17 % to 45 %, and federal tax credits of 16%).*

Besides the development and implementation of US production credits,

2.) The **second significant side effect** resulting from the tightening of studio coffers is the **cultivation of a crop of trailblazing independent producers** who have learned how to:
a.) master the indie financing system by **using foreign sales agents**,
b.) maintain strong **relationships** with **commercial talent** on which to **base strong sales estimates**,
c.) negotiate competitively priced **gap financing** based on those strong estimates (assuming the sale of a few foreign territories as required by gap lenders), while proposing a risk mitigated investment to their equity investors, and

d.) filling any short fall in their budgets through state and federal tax credits.

!!! The Bottom Line is:
This model allows filmmakers today to **hold back the pre-sale of the domestic territory to studio**, by getting their budgets covered from non-studio sources, and this

allows them greater leverage to negotiate stronger studio deals for domestic distribution, while retaining significant upside.

What this also means is that for an indie budget (of for example 10M,) producers do not need to raise more than development money through private equity (which is less than 10% in any case).

Later in the presentation, I will run through an example of **how to** close your production budget, using specific numbers (without equity), based on a 10M budget.

First I would like to address the phenomenon of smaller budget films.

SMALLER BUDGTED FILMS

The last few years have seen a strategic shift in the industry on another level, as studios have begun to realize that, while their heritage lies in big budget films, their profits and returns on capital are **increasingly driven by smaller budgeted indie films**.

The successes of a number of high profile low-budget films (like 1999's *The Blair Witch Project*, 2002's *My Big Fat Greek Wedding*, "*Crash*" "*The Illusionist*" and "*Little Miss Sunshine" among others*) has revolutionized how distributors look at the production and marketing of films.

Analysis of the historical results of studio-released films shows **profits to be concentrated on the ends of the budget spectrum,** such that films budgeted over $100 million dollars, and films that are low-budget genre films (costing $15 million dollars and less) are, on balance, considerably more profitable than those in between.

Assume for the purposes of this **example** that: (1) the budget of a film is $10Million dollars, (2) that 35% or 3.5 Million dollars of the budget is used to hire residents of the state; (3) that 20% or $2 Million dollars of the budget is used for purchases and leases that qualify for state sales/ use tax; and that (4) the sales tax in each state equals 6% (common state sales tax).

Under that scenario, producers in Massachusetts, Rhode Island, Arizona, Connecticut, Hawaii, New Mexico, New Jersey, and Pennsylvania, would save over $2,000,000 in production costs!

Due to such incentives, not only are films coming back to the states, they are staying in tax incentive heavy states, as reflected in a 2004 study by the California Film Commission, that of all of the productions shot in the US that year, **48% where shot outside of California**.

I would be pleased to discuss the differences and value chain of production tax credit incentives on a state by state basis with you separately, as that involves a much longer presentation than we have time for today.

So, Let's continue talking about how to raise 100% of a 10M budget with little or no equity.

We have established that 2M can come from state credits, and 1M can come from the federal Section 181 credit (if monetized as an advance).

So we now have 3M in the pot.

We need to understand the value of our talent to justify the amount of our budget.
How do we do this?

First, you assess the below the line costs with a line producer by breaking down the script. That is your base line budget, and what amount you **add** to that must be justified by the domestic and foreign sales estimates your package can get you.

By package, I mean your **lead actors and your director.**

Let's presume that your below the line cost is 6M, and your above the line is 4M between the talent package and the producers, then your sales estimates **must be** around 11M for international to **justify that budget**.

Assuming 11M for international sales estimates of your film, this 'worst case scenario' shows a profit amounting to at least 1M from theatrical distribution.

From that **11M for international,** we assume **8M in sales estimates out of foreign** as your Take (not your Ask price) and at least **3M for your domestic**.

If your estimates are lower than that, then your above the line budget **must be reduced** or **your talent must be replaced** for more commercial talent garnering you higher estimates.

From these 11M estimates, you will want to pre-sell enough territories to cover at least **30% of your budget**.

You do not want to pre-sell any more than that until you have your domestic deal in place, **bc with domestic studio distribution you get a strong P&A commitment** (prints and advertising commitment) , then that commitment will **spike your foreign numbers by around 20% for each open territory**.

Effectively, that means that a studio has blessed the film with their approval and they expect it to perform well.

The way **pre-sales** work is that the **foreign buyers will not give you the money directly**. You will have to collateralize the pre-sales agreement and get a bank loan for the pre-sold territories.

Once you finish the film and **deliver it to the foreign buyers**, **then** the foreign buyers will pay back those loans to the bank, for the money the bank advanced you.

Depending on who the buyers are, you may get the loan on a **dollar for dollar basis**, assuming your foreign buyer is a studio affiliate, or a strong buyer like Canal Plus in France or ProSieben in Germany.

The reason also you will want to sell at least 30% of your budget out of foreign **or the equivalent of two major foreign territories** is because that is what a **gap financer and super gap financier will require before they provide you with a gap loan.**

They do this to make sure that there is an appetite in the market place and that the film will sell and can pay back their loan.

Also, it is integral that you choose a **top tier sales agency**, like Mandate, Summit, Myriad, Dream Machine, Kathy Morgan, Voltage, Hyde Park and arguably Arclight.

These are the sales agents that the **gap financiers** (such as Imperial Capital Bank, Comerica, Blue Ryder, New Bridge, Israeli Discount Bank and Bank of Ireland) **accept estimates from** due to their reliability in reading the market and meeting their estimates in terms of sales.

If a gap provider gets estimates from a second tier sales agency, they will not lend against the estimates.

Once you have estimates, as I said of around 11M, and you pre-sell say 3M, you are left with 8M in open territories. (11 minus 3 is 8).

You also have now 3M from state and federal credits, 3M from pre-sales and need 4M to complete your budget.

A gap provider will offer you enough in loans to allow them a cover of 2:1, meaning, if you have 8M in open territories, the gap provider will lend you up to half or 4M because

you have 8M in open territories (to achieve that 2:1 lending ration, or 4M in loans collateralized by 8M of open territories from which they may get their loan back.

A**nd now you have 100% of your budget in place** without having to give away any of your back end to private equity investors.

If let's say that the gap provider lends you **less based on weaker estimates,** and you still have a shortfall of say 1M, th**en you can get that money from a private equity investor.**

Under the scenario we have been discussing, this investment is a solid investment for the investor, because according to the estimates, **if** the banks get paid back in first position from cash-flowing the presales, state credits and gap loans amounting to 9M, **then** there is **still** an immediate return to investor (of his 1M investment) **plus** 1M to share between the producer and investor based on estimates of 11M. **This set up makes it a low risk private equity investment.**

The s**tandard rule of thumb** for such an investment is: if an investor gives you 100% of a budget, they are entitled to a 120% to 125% **return on their initial investment** and then 50% of the back end pari passu with you.

Therefore, if an investor gives you 1M (or 10% of the 10M budget) as in our previous scenario, you can expect to give then 120 or 125% ROI and 5% back end.

This is of course only a base line to begin negotiations and the end offer will be **what the market can bear**. If your investor agrees to less, that's great. If the investor wants more for his money, then depending on how much you need the money, you will give up more.

Every film is a case by case assessment.

Please note however, when accepting private equity investment of over 1M, producers **will need to incorporate** their special purpose vehicles as LLCs in which the investors shall be making their investments.

You will also need to have an **operating agreement** setting out how the production company will be run (namely, how **active** you will be as **producers**, and how **passive** they will be as **investors**).

You will **also** need for the investors to complete an **investor questionnaire,** and execute a s**ubscription agreement** allowing them to **actually subscribe** to purchasing economic interest units in the LLC that is the production company.

Remember, investors are not buying a piece of the copyright, but they are buying shares in the company entitled to revenues from the distribution of the copyright.

Finally, you will need to have a PPM to market the investment. This is a **Private Placement Memorandum** setting out the risks of the investment.

It is integral that you understand that selling shares in a company is the **sale of securities** and you will **need** to be in compliance of state and federal securities laws when accepting investment.

Therefore, you will have to make some Regulation D and blue sky filings within 15 days of accepting any money from investors.

I highly urge you to utilize the services of a lawyer and do not try this at home.

Q&A:

Let's talk about tax incentive schemes in particular states.

NORTH CAROLINA

The experience of **North Carolina** provides a useful example of how important tax incentives are for states.

For nearly two decades, North Carolina has ranked third among all states with respect to production revenue, only New York and California ranked higher.

Historically, North Carolina has relied on its attractive scenery, experienced crew base, and developed production infrastructure to attract production business into the state.

Despite all these assets, the state had experienced major declines in production revenue because of economically driven runaway production, specifically a fall from $504 Million dollars in 1993 to less than $235 Million dollars in 2004.

Until recently, the only incentive North Carolina offered was a reduction of its sales and use tax from 7% to 1% for items purchased or rented in the making of a film.

As of January 1, 2007, North Carolina passed NEW tax incentive legislation to lure film production back into the state.

The Bottom Line today is that a **production company spending at least $250,000 in North Carolina on a motion picture or television production is eligible to receive a tax credit of 15% on in-state spending for goods, services and labor.**

The **maximum tax credit** for a production **is $7.5 million**.

Here is the Caveat:
On goods with a purchase price of $25,000 or more, the amount included as a qualifying expense is the purchase price LESS the fair market value of the goods at the time the production is completed.

Spending for services is eligible for the tax credit regardless of whether paid to residents or non-residents, as long as the services are performed in North Carolina.

Amounts paid to an individual who receives compensation in excess of $1 million are excluded and ineligible.

There is also a reduction of the sales/use tax from 4% to 1%.

SOUTH CAROLINA

Using North Carolina as a cautionary tale, **South Carolina's tax incentive** scheme is even more aggressive.

BUT IT IS A REBATE, WHICH IS MORE DIFFICULT TO TRANSFER AND MONETIZE, AND THEREBY USE TOWARD BUDGETS PRIOR TO PRODUCTION.

Productions that film in South Carolina can now receive up to a 20**% cash rebate on employee wages that are less than $1,000,000;** and

A 30% **cash rebate on supplier expenditures if they spend at least $1,000,000 in the state.** This increase positions South Carolina as one of the country's leading incentive states.

In addition, all productions spending over $250,000 in SC are **exempt from sales and accommodations taxes (ranging between 5 – 7%)**.

MARYLAND

Maryland has had a similar experience with tax credits and the film production industry.

The state was **spurred to action** recently when production of the Disney film "Annapolis" was moved from Annapolis, Maryland to Pennsylvania on the very day that Pennsylvania adopted aggressive new tax incentive legislation, which Maryland lacked.

According to the Maryland Film Commission**, in 2003 filmmaking in Maryland had an economic impact of $126 million, but in 2004 it fell to $75 million.**

Since passing aggressive tax incentives for film producers, several feature films have been produced in Maryland:

* "Wedding Crashers"

* "Syriana" "

* "Failure to Launch"

* the soon to be released "Invasion" (starring Nicole Kidman),

* and the fourth season of the HBO show "The Wire."

Maryland's newly enacted tax incentives ARE ALSO REBATES of 50% on wages paid for salaries up to $25,000 per person for employees working in Maryland earning less than 1 Million dollars (they need not be Maryland residents).

The incentive also includes an **exemption from the state's 5% sales tax;** and

Rebates may not exceed $2 million per project.

To qualify, the **production must incur at least $500,000 in total direct costs in the State** and at least **50% of the production's filming must occur in Maryland**.

THE CAVEAT: The production must have national distribution in place when applying for the rebate.

PENNSYLVANIA

There are CAVEATS related to the Pennsylvania production incentive:

1. **it is a rebate; and**

2. **the total amount of money allocated by the state annually to this incentive is $10 Million dollars, so it is tapped out almost immediately.**

The rebate provides up to **20 percent for production expenses** incurred in the State.

In order to qualify, **60 percent of the total production expenses must be incurred in Pennsylvania.**

There is also a Sales Tax Exemption

LOUISIANA

I WON'T SPEAK IN SPECIFICS ABOUT LOUISIANA SINCE THERE ARE OTHER SPEAKERS WHO WILL EXPLAIN IT IN DETAIL, BUT I WILL NOTE THE STATE'S INCENTIVE IMPACT SINCE IT BECAME ENACTED IN 2002:

Film production expenditures between 1992 and 2000 totaled just $44 million, or $5.5 million per year on average.

Since enacting the incentives it has today, Louisiana has experienced an *eleven-fold increase* in average annual production expenditures as compared to its production expenditures in 1998. (according to the Austin Film Study of 2006.)

ILLINOIS

Production spending in **Illinois** increased from 25 Million in 2003 (prior to the adoption of its current incentives) to over 75 Million in 2004.

Illinois currently offers:

- a 20% tax credit on the Illinois production spend; and
- a 20% tax credit on Illinois salaries **up to $100,000** per worker

CAVEAT: Each production's credits are transferable only once, though.

The tax credits can now be **carried forward 5 years**.

Additional Incentive

- The state offers an **additional 15% tax credit** of the Illinois labor expenditures generated by the employment of residents who make more than $1,000 and live in geographic areas of high poverty or high unemployment (but still capped at $100,000 per worker)

CONNECTICUT (Best in Country)

MY LOBBYING EFFORTS of the State Legislature on behalf of Utopia Studios (22,000 new jobs) were successful, and lead to the implementation of this particular incentive.

It is a fully transferable tax credit equal to **30% of qualified digital media and motion picture production, preproduction and postproduction expenses** incurred in the state that exceed $50,000.

The UNIQUELY APPEALING ASPECT OF CONNECTICUT'S INCENTIVE IS:

That it **includes development costs** incurred in Connecticut

There is a **carry forward** for the **three years**.

There is also a **HOTEL TAX EXEMPTION** which **excludes productions from paying** the 12% hotel occupancy tax after thirty consecutive days of paying it.

RHODE ISLAND (is in my opinion the second best incentive in US at present)

It provides for a **25% fully TRANSFERABLE TAX CREDIT** for all Rhode Island spending.

There are **no caps**.

UNIQUE ASPECT: is that it **applies to video game** production as well.

The production must be filmed **primarily** in the state of Rhode Island and have a **minimum budget of $300,000.**

The credit can be **carried forward 3 years.**

MISSISSIPPI (ties for third place)

Mississippi has a NEW tax incentive passed just last week. It is a REBATE of

20% of the first $1 million of the local spend (goods and services);
25% of the next $4 million of the local spend; and
30% of the local spend over $5 million.

There is no minimum spend, but there is a $5 million cap per project (which translates to an approximate local spend of $17.67 million).

There is an ADDITIONAL 10% rebate for the payroll paid to out of state cast and crew whose wages are subject to Mississippi Income Tax Withholding and whose salary is less than $1 million.

There is ALSO an exemption from the 7% sales and use tax.

MASSACHUSETTS, (ties in third place)

- **It has a 20% credit** off the total payroll for Massachusetts source income**, when production costs exceed 250K,** that excludes salaries over 1 Million dollars
- **There is also a 25% credit** for all in state production expenses**, but 50% of the budget or shooting days must be in the state.**
- **Carry forward for 5 years**
- **Fully transferable credit**
- **Credit cannot exceed a total of 7 Million per production.**
- **There is also a sales tax exemption.**

STOP THE SPEECH! (30 MINTES ARE UP)

ARIZONA,

Fully transferable income tax credits of

Credit **Qualifying Production Costs**

10%	**$250,000 - $1,000,000**
15%	**$1,000,001 - $3,000,000**
20%	**More than $3,000,000**

There is a cap of **$5 million** in tax credits per production.

Further, Commerce cannot pre-approve a total amount of tax credits that exceeds:

Calendar Year	Maximum Tax Credit Amount
2007	$40 million
2008	$50 million
2009	$60 million
2010 and after	$70 million

unused tax credit amounts may be **carried forward for up to five years**.

To qualify,

- **In 2007, at least 35% of the full-time employees working on the production must be Arizona residents,**
- **In 2008 thru 2010, at least 50% of the full-time employees working on the production must be Arizona residents.**

NEW JERSEY

New Jersey offers a tax credit in an amount of **20% of qualified production expenses**.

To qualify,
(1) At least **60% of the total expenses of a project, <u>exclusive of post-production costs (Unique)</u>, will be incurred for services performed and goods used or consumed in New Jersey**

Can be **carried forward 7 years**

Unique: *FULLY TRANSFERAL CREDIT BUT* ***CANNOT BE DISCOUNTED*** *BY LAW FOR* ***LESS THAN 75%*** *(VERY GOOD FOR FILMMAKERS)*

Unique: Does not include commercials

BAD: Annually, the total **coffers are limited to 10 Million for all productions (quickly tapped**)

NEW YORK, (it is tapped out by tv shows, and you must use specific expensive sound stages)

Empire State Credit (10%), and the Made in New York City Credit (5%)

The two programs (State and City) are similar and have similar qualifying thresholds.

To qualify for the New York State credit, the production must:

1) shoot on a set, on a stage, at a **qualified** production facility in New York State; and

2) complete at least **75% of the total facility related expenses at a qualified facility**.

These productions will qualify for up a **10% state tax credit for the work done at the facility**.

If the **facility is within New York City,** these productions will also qualify for the additional 5% tax credit from the New York City program.

For location work, post-production, and costs of other work done in New York **outside the facility to be eligible**, either:

1) **at least 75% of the location shooting days must be in New York State,** or

2) the production must **spend at least $3 million on work incurred at the qualified facility.**

If the facility is in New York City and 75% of location days are done within New York City, the production will also qualify for the **additional 5% tax credit from the New York City** program.

Qualified costs exclude costs of stories and scripts, and wages for writers, directors, producers and performers (other than extras without spoken lines).

(there are 8 qualified state sound stage companies, and a few more city sound stage companies) * They are *EXPENSIVE SO MAY EAT UP YOUR CREDIT IN THE END.*

The State of New York has allocated $60 million in aggregate credits per calendar year, and the City of New York has allocated $30 million per year.

There is also a sales tax exemption (between 4 and 9%)