



MEMORANDUM

**TO:** Screen International's "Financing Films in America" Conference  
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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

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 and later entering into negative pick-up deals once the films were in the can, unless they had tent-pole franchise prospects.

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, Massachusetts, New Jersey, Pennsylvania, Rhode Island, New Mexico, Hawaii, Mississippi, North and South Carolina, Florida and Arizona. And even states like Wisconsin and Idaho that do not yet have any significant tax incentives are currently crafting them. A federal level incentive has also been implemented, and is known as Section 181 of the US Jobs Creation Act of 2004.

How Section 181 specifically works is that it enables qualifying investors to take 100% deductions of their investments into qualifying audiovisual productions, as detailed below:

## SECTION 181

In the United States, the 2004 enactment of Section 181 of the Internal Revenue Code of 1986 (the "Code") marked an unprecedented change in U.S. policy toward the phenomenon known as "Runaway Production". Runaway Production refers to a film or television production that leaves one state or country to be filmed in another purely for economic reasons. This movement occurs because producers tend to film in the location where they can minimize production costs through tax incentives, cheaper labor.... Over the years, Canada has been the greatest beneficiary of U.S. runaway productions (according to some reports, Canada has claimed up to 80% of the U.S. runaways, generating an economic impact of \$10.3 billion in production output in 1998 alone). Section 181 represents the first time that the U.S. federal government has recognized this impact by passing tax legislation to actively combat the flight of film and television programming.

Section 181 permits a 100% write-off for the cost of certain audio-visual works, regardless of what media they are destined for (e.g., theatrical, television, DVD, etc.). Section 181 is in lieu of the income forecast method that would otherwise be required. The requirements for the audio-visual work to be a qualified film include:

- (i) **Limitation on Aggregate Cost.** The aggregate cost of the audio-visual work cannot exceed \$15 million (or \$20 million in certain cases).
- (ii) **U.S. Costs.** 75% of the total compensation relating to the production of the audiovisual work must be paid for services performed in the United States by actors, directors, producers, and production personnel.
- (iii) **Commencement of Principal Photography.** Principal photography must commence after October 22, 2004 and prior to January 1, 2009.
- (iv) **Content of Work.** The audio-visual work cannot include a "depiction of actual sexually explicit conduct."





Meaning, an individual who makes an investment into Section 181 qualified productions can take a 100% deduction of their investment against their passive income in the year their investment was made. The deduction can be made against active income should the investment be made by or through a widely held C corporation. The law is in effect until December 31, 2008, therefore investments must be made before that date and the money invested into qualifying productions must be spent by then by the productions. As an un-leveraged example of its use, should an individual who is taxed at a 35% tax rate have passive income to take a deduction against, then should that individual make a 1M\$ investment into a qualified production, the actual net investment will be \$650,000 since they can take a deduction against that full 1M\$ against their passive income, and 35% of 1M\$ is \$350,000, which is the value of the deduction they can make in the year they make their investment. Therefore, 1M minus \$350,000 is \$650,000 which is the net amount of their investment into the qualified production.

On its face, it is interesting as a risk mitigator for investors, however, once it is leveraged sufficiently, it can significantly reduce risk so that the risk to qualified investors for Section 181 content becomes diminimus.

The bottom line is that producers can get up to 35% of their budgets covered using the federal incentive. When combined with, for example, the Connecticut incentive, producers can get over half of their budgets covered thru soft funding in the United States. This is significant because it can amount to more value than the current Canadian incentives. (*which offer regional tax credits on labor expenditures ranging from 17 % to 45 %, and federal tax credits of 16%*).

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.) negotiating 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 domestic, by getting their budgets covered from non-studio sources, and allows them greater leverage to negotiate stronger studio deals, while retaining significant upside.

#### **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*, and last year's "*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.

US SOFT FUNDING IS OPEN TO FOREIGN FILMMAKERS TOO, as they do not require domicile.

Even if a foreign filmmaker cannot take certain deductions to which they may be entitled (since you have no US taxable income as of yet), there are a number of companies in the US that will purchase the credits from them at a discount and monetize them as an advance toward their budget, assuming the state credit is transferable (which some are not, but most are). Also, most credits can be carried forward if not used immediately.

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

Assume for the purposes of this **example** that: (1) the budget of a film is \$10 Million 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% were shot outside of California.

