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SWEET SPOTS

Alicia Van Couvering breaks down the complex state tax incentives and learns how producers find the best deals for their films.



PRODUCER MIKE S. RYAN. PHOTO BY KENT EANES

Not so long ago, it looked like the Canadians had seduced film production away from the United States, beguiling studios and producers with sexy tax credits and friendly union agreements. But we weren't going to let our \$10 billion industry get away that easily. The unions and vendors cried out. "Defense Against Canada" acts were passed. Rolling from Colorado, through Louisiana, North Carolina and then across the Northeast, states entered a cutthroat battle to attract production. They empowered their film commissions, organized location databases, printed glossy production guides, handed out permits and free policemen, hosted lavish sightseeing tours for producers and, most critically, created tax incentives.

They also created competition among each other. "People used to call and say, 'Gee, do you have a small New England town, a race track and an aquarium?'" remembers New Jersey film Commissioner Steve Gorelick. "Now that's not enough. Now you have to have the incentives or people go to a different state."

Imagine producers as tourists in this new landscape, trying to keep their cool as city commissioners bark enticements like back-alley Turkish watch merchants. But buyer beware — you might not know your Rolex is a Rolax until you arrive an hour late to the airport. In other words, making the credits, grants, refunds and rebates work for an independent film demands a very close inspection of a state's tax incentive program and, just as important, the specific needs of one's production.

"It's completely different for studios than it is for independents," says New York-based producer Mike S. Ryan, whose credits include *Junebug* (North Carolina), *Fay Grim* (New York and Europe), *Forty Shades of Blue* (Tennessee) and *Palindromes* (New York). Ryan is an experienced veteran when it comes to knowing where to shoot a movie. He began his career as a location manager on films shot across the country like *Ride With the Devil* (Missouri), *Meet Joe Black* (Rhode Island) and *The Laramie Project* (Wyoming). His most recent films shot in Florida, New Jersey and New Mexico, and all were dependent on the tax incentives in those states to make their budgets work.

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A BRIEF GUIDE TO TAX INCENTIVE TERMINOLOGY

TAX CREDITS Issued by the state to the production company, they can be used to offset corporate, individual and premium taxes, among others. When they are transferable (as in Connecticut, Massachusetts, New Jersey, Illinois and Louisiana, among others), film companies (who usually have zero tax liability in that state) can sell them at a discount to another taxpayer. Some tax credits are refundable or "redeemable" by the state, but may often require a waiting period. A production company's ability to monetize their earned tax credit in any given state is referred to as that state's "capacity." If a state has a small tax base or is giving out too many tax credits among too many programs, it will surely face a "capacity" problem, and might be stuck holding the paper.

TAX DEDUCTIONS An amount that reduces a taxpayer's "taxable income," versus a tax credit, which reduces the taxpayer's liability to the state. In most cases, dollar for dollar, tax credits are more valuable than deductions.

GRANTS When a state offers a grant, the production company receives money from a finite incentive fund based upon a percentage of their in-state spending. Currently in Pennsylvania there is a \$10 million annual fund which pays qualified

In May, Ryan began prepping a \$4 million independent film that had to start shooting in July. It has scenes in a big hospital, a zoo and at a Colonial Williamsburg-type park. Half a dozen Northeastern states could provide those locations. New York, New Jersey, Connecticut, Maine, Rhode Island, Pennsylvania and Vermont all have film incentive programs. Where to film?

Connecticut seemed an obvious choice; this year it unleashed a huge, instantly popular 30 percent tax credit. While most states allow just the money spent in-state to apply toward your credit, Connecticut allows almost everything — movie star salaries, editing in Los Angeles, airline tickets. “To an accountant or a financier, it seems obvious that 30 percent is better than the 15 percent offered in New York, for example,” said Ryan. Peter Jackson’s epic *The Lovely Bones* and the Leonardo DiCaprio–Kate Winslet–Sam Mendes Oscar bait *Revolutionary Road* were heading there for the summer, along with many more.

However, those big movies are different than the ones Ryan is producing. “They have so much going to salaries and above-the-line that the 30 percent is like a cash cow,” he explains. “But in Connecticut there is no local crew, so you’re filling everyone’s gas tanks for the drive in from New York. You have to put everyone up at hotels that are charging top dollar. [The state] is filled with millionaires, so location owners bleed you dry. In a state like this, \$4 million will finally get you 21 shoot days versus 25 days in a state with a big local crew base.”

So Ryan and his fellow producers kept looking. Rhode Island? “Providence is great, but it has just enough crew to support about two features at a time,” he says. “Edward Burns’s new movie and a Showtime series were monopolizing the whole town until August.” New York? “Didn’t quite have the locations we needed, and less tax back.” New Jersey? “They had the locations we needed, we can shoot inside the production zone [cast and crew can live in New York and not be paid extra for their travel], strong crew base, the film commission and county officials found us an affordable county-owned office and a 20 percent rebate.” So New Jersey it was.

Ryan was assured that the state still had money left in its coffers for the year, and prep began in the office located by the commission. But just the day before filing their project application with the state, some other movie submitted their application and presumptively capped the film tax credit allotment for the 2007-08 fiscal year. If no projects drop out before them, Ryan’s production might have to wait in line for a year to get their credit certificate.

Still, despite the hassles and uncertainties, for independent filmmakers, often working with budgets under \$5 million cobbled together with bridge loans and a half-dozen investors, a healthy tax incentive can make the difference between making a film or not.

Many states’ incentives take the form of transferable tax credits. There are also wage reimbursement, training incentives, grants, refunds on hotel taxes and cash loan programs, but tax credits are hands-down the most popular. Say a state offers a 15 percent tax credit on money spent in-state. That means that the state issues a certificate to your production of tax credits worth 15 percent of the money you spent on local labor, local gas, local vendors, etc. To qualify for any incentive, you (usually) need to spend a majority of your money in the state (and sometimes also spend a minimum amount, like \$200,000).

What does a movie production company do with tax credits? While a studio, with its permanent offices and long-term spending, might have some use for them, indie films are usually single-purpose companies with almost no income or tax liability. If the credits are transferable, however, they can be sold by the production company to a big business with lots of taxes to pay. They are sort of like the now-fashionable carbon credits promoting clean energy which a filthy polluter might buy from a virtuous recycler to meet EPA standards.

In some states, like New York, the credits are not transferable except up and down the ownership ladder of the company. (In other words, a credit might be issued to a production company and then be claimed by the private investor who has invested the money into the company.) When these recipients have no tax liability in the production state, they can often opt to take their credits as cash. Gretchen McGowan, head of production at HDNet Films, has shepherded five films through New York in the last three years (including *Broken English*, *Diggers* and *The Architect*), all budgeted under \$2 million. She says HDNet expects to see credit

companies 20 percent of their Pennsylvania production spend. When the project wraps, the production company submits a final accounting, receives a grant voucher and then redeems it in the state’s next fiscal year.

TAX-FREE INCENTIVES In some states production companies enjoy sales tax exemptions on all purchases.

WAGE REIMBURSEMENTS Usually a refund for salary paid to local crew. Many states (New York, New Mexico, for example) have training incentives which reward the hiring of residents to do their jobs for the first time (making a prop master a production designer, for example), qualifying a production for 50 percent of that employees’ salary. New York even has a boot-camp-style production-assistant training program.

INVESTMENT CREDITS Tax credits that encourage private investment in the films or the film industry.

LOAN PROGRAMS In place mainly on the West Coast, with loan programs states actually loan productions cash. New Mexico, notably, which has just built two fancy new stages and offers a 25 percent tax rebate, now offers loans up to \$15 million that can equal an entire film’s budget. The loan is interest-free, but the state gets a back-end percentage of the film’s profits. And in New Jersey, for example, the Economic Development Authority may provide a 30 percent loan guarantee to qualified productions.

RECAPTURE If companies get stuck with credits that end up worthless, or end up worthless, or end up buying too many, will the state still honor them? States must have a recapture plan in place to ensure that transferable credits are “clean” and marketable. Massachusetts just this month solved their recapture problem in addition to lowering their minimum spend to \$50,000 and raising their cap, opening up what many think is the greatest buying power in the country.

- edited by *Christine Peluso, Tax Credits LLC*

money from the first four of those films during this fiscal year; it will total about \$700,000 spread over 18 months.

Meeting the demands for an incentive isn't always easy. For the 10 percent New York credit, you must shoot a day on a qualified soundstage, which means that you have to budget for the construction of at least one set. Also, 75 percent of your shooting days must be in the state. (By shooting these days within the five boroughs of New York City, you can qualify for an additional 5 percent New York City credit.) It can take a bit of finessing for a low-budget picture to qualify for the New York credit, but, says McGowan, "you can make it work if you're careful to select creative art and locations departments." For *Diggers*, HDNet shot Staten Island for Long Island to gather more days inside city limits and thus combine the state and city incentives for the 15 percent credit on the applicable budget categories.

In states with transferable credits, brokers and consulting firms will find buyers for the credits and sell them at a discount so that films can turn them into cash.

"States can lure production in with an attractive credit, but they have to make sure the film company isn't left holding a worthless piece of paper," says Christine Peluso of Tax Credits LLC, one of the top companies in the field. Peluso admits to having spent more time lately advising states how to make sure their programs work than actually selling credits. In Connecticut, several such consultants opened shop the day the state's new incentive was announced.

As noted, many of the states' credit programs don't pay back to the producers until months or even years after the film is finished. But for producers with money needs up front, it is sometimes possible to get a bank or company to loan money based on the credits you expect to get. Independent Film Financing, an offshoot of the entertainment payroll and software company Axiom, is one such company. But vice president Len Pendergast says that for films budgeted under \$5 million, it's not quite feasible to set up a tax credit-based loan. "If you're expecting less than \$500,000 back from credits, the legal fees and financing fees make it not really worth it," Pendergast says. Furthermore, IFF will only set up these loans for films shooting in states that have refundable credits, like New York, South Carolina and New Mexico. "Programs that depend on other companies and investors buying the credit certificates result in negotiable credit prices, which aren't clean enough for us to work with," he says.

Transferable credits such as the ones offered by Connecticut create a buyers' market, so to make them marketable, they have to be what Pendergast refers to as "clean." Steven C. Beer of Greenberg, Traurig advises his clients that "there are good states and bad states with regard to tax credits." He continues, "We're not just focusing on how high the percentage they're offering is, but whether or not the state tax program allows for a secondary market so that banks and brokers or consultants can come in and match people with tax liability to films trying to sell their credits." Beer, who had eight films in Sundance and Slamdance this year, cites New Jersey and Illinois as being among the "cleanest" tax credit programs. He also likes New York for its helpful and efficient film commission and mature, dependable incentive.

"Most states have 'spend-to-get' programs, which don't make it easy for low budgets," admits producer Ted Kroeber, whose credits include *American Gun* and the Sundance Competition entry *Four Sheets to the Wind*. A few years ago Kroeber and his business partner Chad Burris found themselves frustrated after years of chasing after what seemed like ever-elusive tax credit pay offs. "People talk about it like there's a bag of money on the state line, but we saw a lot of friends get burned by incentives that didn't deliver." Kroeber and Burris knew that what they and other indie films needed was cash — during or right after shooting, not 18 months later, after lengthy audits and bureaucratic reviews. But with the exception of New Mexico, which has begun a loan program, almost no states give films money upfront.

So Burris and Kroeber joined forces in Burris's home state of Oklahoma and started their own creative solution to the cash-flow problem: Indion Film LLC, which finds local investors to bankroll 15 percent of your film (utilizing non-film tax credits). After the shoot you can combine the money they found you with Oklahoma's state-issued tax credits, worth 15 percent of your in-state spend. They set it up specifically for low budgets — up to \$27 million, but as low as \$200,000 — with the

intention of making Oklahoma a truly viable possibility in an ever-crowded field.

"Every state is completely different," states Tim Williams of GreeneStreet Films, who has shot recently in Missouri (*Bill*) and New York (*Awake, Tenderness*). "You never know what the rules are until you get there. The great thing is, though, you can play one state off the other. The problem is it's all so complex that, 9 times out of 10, no one person can understand it."

To keep track of the changing tax credit environment, the entertainment payroll and software development firm Axiom began a quarterly guide to state tax incentives organized by independent producer Jeff Begun (*Hardbodies, Vendetta*). The laws change so fast that the publication has to be thoroughly revised every few months (especially in June, when the state legislators finish their session). "First the states copied Canada's legislation, and now the states will copy each other's legislation — you see the same language over and over," says Begun. "But they do it without knowing that the first state is already changing their laws to adapt to a problem they uncovered."

After Connecticut, for example, rolled out their flashy 30 percent-of-the-entire-budget tax credit refund, dozens of projects poured into the state. But it soon became clear that only a tiny fraction of the companies in the state were eligible to buy the credits. And the state is already awash in other credits — historical building credits, relocation credits, etc. There was clearly too little tax liability to go around. Some said that banks and brokers were reporting the price of a credit at only 70 cents to the dollar. And the worth of the credits wasn't just low, it was also unstable.

Connecticut has been quick to correct this problem, passing legislation in June that vastly expanded the pool of buyers. 2929 Productions' *In Bloom*, starring Uma Thurman, was the first to film in Connecticut under the credit in September 2006 and will be the first film to actually get its credits back. At press time, 2929 senior VP of production Mike Upton estimated that they were two or three weeks away from getting their certificate in the mail. The production will be able to take that certificate to a broker, who, thanks to the fresh laws, will have many more buyers at her fingertips. Or 2929 can try to use those credits to sweeten a production deal for another film, or try to sell the credits themselves without giving any money to a broker.

Connecticut's commissioner, Heidi Hamilton, insists that the rumors of falling credit buy-back rates were baseless, pointing out that Disney, Universal and others have all recently brought films into the state. "These are huge companies with very sophisticated financiers," she says. "Do you think they would risk tens of millions of dollars if they didn't have buyers for their credits?"

However, giant corporations are not dependent on the credits to stay in business. They can wait to sell them over the allowed three years. Most small projects are hanging their budgets on that money. They either need to use brokers or bank loans to get cash for the credits ahead of time or assure their investors that credit funds will be returned to them at a specific time and for a specific amount.

Unlike most states, Connecticut doesn't have an annual cap limiting credits in place. As Ryan discovered when he set up shop in New Jersey, a cap can restrict a production's ability to receive its credit in a timely fashion, but, on the positive side, a cap keeps the price of the credit stable. New Jersey, with a \$30 million credit, keeps its credit at 88 cents to the dollar. By May of this year, Connecticut had already preapproved \$87 million of tax credits that will all be seeking buyers on the open market. (Of course, some of these preapproved productions may wind up not shooting or shooting elsewhere.)

"It's not Connecticut's responsibility to guarantee the credits," says commissioner Heidi Hamilton. "The market will dictate the cap. We put the credit out there. We say, Look, this is what you will get — 30 percent in tax credits — and you can sell them to companies who need them if you don't. [Producers] can look on the Web site; they can see how many other films are in the state and calculate their own risk."

"My feeling is there's going to be a saturation point," warns Williams about the whole U.S. film tax credit frenzy. "It could just implode. That happened in London — there were several movies shooting, all dependent on the 20 percent tax credit

in place. While they were moving forward, the government repealed it. This could all just go belly-up.”

While the majority of states continue to raise their caps to attract even more production, others seem to be sifting their way through big-money expectations down to realistic goals for their in-state film industries and thus scaling back to more modest incentives. After trying to catch up to its northern neighbor for a few years, South Carolina is considering a reduction of its out-of-state rebate by 50 percent.

For some states, this reduction in incentives may have been part of the long-term plan. Everyone agrees that for a film incentive program to really work for both producers and a state, a permanent infrastructure of local crew and vendors needs to grow. To do this, some states make their initial incentive outrageously attractive. They might make the entire budget — not just the in-state spend— eligible for credits. This is how Louisiana, for example, one of the most successful incentive programs and now a major production hub, attracted enough films to set up a permanent crew and vendor infrastructure. “Try looking for crew by calling down the union roster in Florida and Texas — they’ve all moved to Shreveport,” notes Ryan.

Louisiana was smart, explains Begun. The first incentive they passed was 15 percent of the entire budget. If you spent a week in the state and three weeks elsewhere, you still got the entire 15 percent back. Tons of movies went to Louisiana. Two years ago they changed it, and now you only get money back on the in-state spend, but the bayou is still crawling with movies. The state brought enough projects to build up a solid infrastructure and permanent crew before downsizing the size of the incentive. (Missouri just accomplished a similar bait-and-switch, if on a smaller scale.)

Leave it to the IRS and the FBI to ruin the Mardi Gras festivities. On June 1 those agencies raided LIFT Productions, a credit brokerage company, which is the largest such firm in the state. Reported in the Times-Picayune by Robert Travis Scott, it seems that LIFT and the Louisiana Film Commission may have been working together to double-count eligible expenses in film budgets and hugely inflate the number of credits, providing a windfall for LIFT and some nice kickbacks to an official at the film commission. A former LIFT employee blew the whistle, and independent auditors uncovered, for instance, that in the case of the recently released Kevin Costner vehicle *Mr. Brooks*, \$34.1 million in tax credits was approved despite only \$18.5 million in production costs. The controversy — and the freezing of LIFT’s credits, likely to shut the company down — could severely impact the Bayou’s production scene.

The layered, unpredictable and immensely complicated world of tax incentives requires a skillful producer to balance the physical needs of a production with the benefits offered by shooting in a particular state. At Tax Credits, LLC, Peluso says, “Sometimes people come into the office saying, I have a \$10,000,000 — where should I go? And when we lay it out for them, all the variables...” — she pauses, laughing — “...usually they have a seizure.” Still, despite the complexities and occasional headaches, the state-tax incentive programs are working. Production is up, and investors are grateful for a revenue source other than distribution overages.

In order to stay afloat in the competitive independent film world, a working knowledge of the various state incentive programs is essential. But attaining this knowledge isn’t always easy. For a producer navigating his or her way through the maze, says Begun, “it can feel like there’s a mechanic changing your tire while you’re driving down the freeway.” But for now, at least, the film commissioners can be happy that the car the producers are driving is an American one.

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