Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author:	Nunez	Analyst:	John Pavalasky	Bill Number:	AB 777
Related Bills:	See Legislative History	Telephone:	845-4335	Amended Date:	August 17, 2005
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT:	Qualified Motion Picture And Qualified Commercial Production Refundable Credit/Claim For Sales & Use Tax Refund Or Credit In Lieu Of Credit

SUMMARY

This bill would create refundable tax credits based on certain wages paid or amounts paid to purchase or lease certain property used to produce motion pictures or commercials in California.

SUMMARY OF AMENDMENTS

The August 17, 2005, amendments deleted the requirement for a report by the California Film Commission of the impact of runaway production on the California film industry and replaced it with the two refundable credits discussed in this analysis. This is the department's first analysis of this bill.

PURPOSE OF THE BILL

According to the author's staff, the purpose of this bill is to stem run-away film production by providing a subsidy by way of a tax incentive to produce motion pictures and commercials in California.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would become effective immediately upon enactment. The bill specifies that the credits would be operative for taxable years beginning on or after January 1, 2005, and would be repealed on January 1, 2016. The bill also specifies, however, that the amounts upon which the motion picture credit is based does not include any qualified wages paid or incurred for services performed or any qualified property purchased or leased before January 1, 2006. The bill also specifies that qualified production costs for a qualified commercial do not include qualified wages paid or incurred before January 1, 2006.

POSITION

Pending

Summary of Suggested Amendments

Technical amendments are provided to correct incorrect phrases.

Board Position:			Department Director	Date
________ S	________ NA	________ NP	Will C. Bush	08/30/2005
________ SA	________ O	________ NAR		
________ N	________ OUA	___X___ PENDING		

ANALYSIS

FEDERAL/STATE LAW

Current state and federal laws generally allow taxpayers engaged in a trade or business to deduct all expenses that are considered ordinary and necessary in conducting that trade or business (e.g., employee wages and benefits). However, when a taxpayer produces or creates a product (e.g., video, film, etc.) the taxpayer will generally incur a great portion of the expenses before the product is ready to produce income. When this happens, the taxpayer is usually required to capitalize those expenses and amortize—recover or deduct—them over the period that the product produces income using a specialized cost recovery method called the "income forecast" method. Amortized expenses include costs of researching, preparing, producing, recording, and other direct production costs. It also includes an allocation of indirect costs such as utilities, tools, clerical, and equipment rental.

The federal American Jobs Creation Act (AJCA) of 2004 contains provisions that impact the income tax treatment of motion picture productions. Effective for productions commencing after October 22, 2004, and before January 1, 2009, the AJCA permits qualifying film and television productions to elect to deduct certain production expenditures in the year the expenditure is incurred in lieu of capitalizing the cost and recovering it through depreciation allowances under the income forecast method discussed above. This provision only applies to qualified productions the aggregate cost of which does not exceed $15 million. For this purpose, a qualified film or television production is defined as any production of a motion picture, miniseries, scripted, dramatic television episode, or movie of the week if at least 75% of the total compensation expended on the production is for services performed in the United States. For an episodic television series, only the first 44 episodes qualify under the provision. The AJCA modifies the income forecast method to include certain participations and residuals in the adjusted basis of the property. The AJCA also allows a deduction equal to a portion of the taxpayer's qualified domestic production activities, including any disposition, lease, rental, or license of qualified film produced by the taxpayer. California has not conformed to these provisions.

Current state and federal laws do not provide any tax credits relating to production of commercials or motion pictures.

THIS BILL

This bill would create two refundable credits. Each credit will be discussed separately.

1. Qualified Motion Picture Credit

This bill would create a refundable franchise tax or income tax credit for a percentage of the wages paid or amounts paid to purchase or lease tangible personal property used in the production of a qualified motion picture, as defined, in California that is allocated and certified by the California Film Commission. The bill would also allow the refundable motion picture credit to be claimed against sales or use tax liability in lieu of the franchise or income tax liability.

Qualified Motion Picture Credit

Initial Allocation
Taxpayer's apply to Commission for initial allocation on first-come-first-served basis under Commission regs.

Filming Starts
Taxpayer uses initial allocation for financing and begins filming within 180 days of initial allocation.

Picture Complete
Motion picture completed; taxpayer submits independent audit to Commission; and makes irrevocable election to claim credit

Final Certification – Commission makes final certification of **qualified taxpayer**; **amount of credit** allowed to each; and **notifies** qualified taxpayer, FTB, and BOE.

Taxpayer Claims Refundable Credit on franchise tax, income tax, or sales tax return

Credit Amount – In general. 12% of the "qualified amount" of wages and property during the production period of a "qualified motion picture." **Additional 3% for movie of the week and miniseries.** **Maximum Credit The lesser of** – The amount of initial credit allocation; the amount of credit based on actual allowable expenditures on completion; or $3 million per qualified motion picture.

Qualified Wages – Wages and certain fringe benefits paid or incurred by the production company with respect to a qualified individual for services performed on a qualified motion picture in this state.

Qualified Property – Tangible personal property purchased or leased in California that is used primarily in the production of a qualified motion picture.

Qualified Motion Picture In general. A motion picture produced for exploitation in theaters, TV, videotapes, videodiscs, DVDs, or any other digital format or on commercial carriers and at least 75% of the total days spent in principal photography occur wholly in California. **Budget requirements. A feature film, movie of the week or miniseries** qualifies if it has a minimum budget of $500,000 and a maximum budget of $75 million. **TV Episode.** Also qualifying is a single episode in a single season (not exceeding 22 episodes) of a TV series that is new to California with a minimum budget of $500,000 and a maximum budget of $1.8 million per episode.

Maximum Allocation – An amount equal to an unspecified amount for the 2006 calendar year, plus unused credit allocations.

"Qualified amount" does not include any of the following:

- o Wages paid or incurred for services performed before January 1, 2006.
- o Qualified property purchased or leased before January 1, 2006.

"Qualified motion picture" does not include any of the following:

- o Motion picture produced:
  - for private noncommercial use, such as weddings or graduations,
  - by students made as part of any educational course, or
  - for industrial purposes.
- o News program, current events or public events program, talk show, game show, sporting event, or awards show.
- o Telethon or other production that solicits funds.
- o Reality television program.
- o A feature where 80% or more of the content consists of computer-generated images.
- o Clip-based programming if more than 50% of the content is comprised of licensed footage.
- o Documentary.
- o Variety program.
- o Daytime drama.
- o Strip show.
- o One-half-hour (air time) episodic television show.
- o Any production that falls within the recordkeeping requirements of Section 2257 of Title 18 of the U.S. Code.

"Qualified wages" does not include any of the following:

- o Expenses, including wages, in excess of the first $25,000 paid per person per qualified motion picture for writers, directors, music directors, music composers, music supervisors, producers, and performers, other than background actors with no scripted lines.
- o Expenses, including wages, for legal or accounting services except production accountants.
- o Expenses, including wages, related to new use, reuse, clip use, licensing, secondary markets, or residual compensation, or the creation of any ancillary product, including, but not limited to, a soundtrack album, toy, game, trailer, or teaser.
- o Expenses, including wages, paid or incurred with respect to acquisition, development, turnaround, or any rights thereto.
- o Expenses, including wages, related to financing, overhead, marketing, promotion, or distribution of a qualified motion picture.

"Qualified property" does not include any of the following:

- o A story, script, or scenario to be used for a qualified motion picture.
- o The literary, dramatic, or musical material upon which the qualified motion picture is based or may be adapted.
- o Any rights relating to the two preceding items.

2. Commercial Production Credit

This bill would also create a refundable franchise tax or income tax credit for a percentage of the incremental production costs of producing a qualified commercial in California that is allocated and certified by the California Film Commission

Commercial Production Credit

Credit amount – 12% of the incremental qualified production costs.

Maximum credit –

The lesser of –$500,000 per qualified production company per calendar year, or the credit allocated by the Commission to the qualified commercial production company.

Incremental qualified production costs – Qualified production costs for the taxable year greater than the qualified production costs for the base year.

Qualified production costs – Costs for tangible property used and services directly and predominantly in the production of a qualified commercial. Costs for qualified wages, technical and crew production costs, certain depreciation, and other specified expenses.

Qualified commercial production company applies to Commission for credit allocation.

Application must contain qualified production costs for the base year and the taxable year.

If limit exceeded, Commission aggregates all applications within 120 days of due date and makes pro rata allocation.

Certification – Commission makes certification of **qualified taxpayer**; **amount of credit** allowed to each; and **notifies** qualified taxpayer and FTB.

Taxpayer Claims Refundable Credit on franchise tax or income tax return

Qualified commercial
A commercial or advertisement composed of moving images and sounds that is recorded on film, videotape, or other digital medium, created for display on a network, regional channel, or cable where 75% of the total production days occur wholly in California.

Maximum allocation – An amount equal to an unspecified amount for the 2006 calendar year, plus unused credit allocations.

Pro rata allocation – If the amount allocable to commercial production companies exceeds maximum amount allowed to be allocated in any year, the Commission is required to make a pro rata allocation of that maximum amount.

"Qualified commercial" does not include any of the following:

- Program length production with an advertising component including a documentary length commercial.
- An infomercial.
- A news or current affairs program.
- Interview or talk program.
- Network promotion (short form content intended to promote other programming).
- Game show, sporting event, or award ceremony.
- Daytime drama.
- Reality entertainment programming.
- Program intended primarily for industrial, corporate, or institutional end users.
- Fundraising or political commercial.
- A program consisting primarily of stock footage.
- A program produced by an organization organized under Section 527 of the Internal Revenue Code, relating to political organization.
- Any production that falls within the recordkeeping requirements of Section 2257 of Title 18 of the U.S. Code.

"Qualified production costs" do not include costs for any of the following:

- A story, script, or scenario to be used for a qualified commercial.
- Qualified wages paid or incurred before January 1, 2006.

"Qualified wages" do not include wages, salaries, or other compensation for any of the following:

- writers,
- directors,
- music directors,
- producers, and
- performers (other than background actors with no scripted lines who are employed by a qualified commercial production company).

This bill contains special rules for both credits that specifically provide that the amount of the credit is to be treated as a separate item of income of the qualified taxpayer that is sourced to California. Additionally, in the case of an S corporation, the credit is required to be claimed and refunded to the shareholders and not the S corporation.

IMPLEMENTATION CONSIDERATIONS

Implementation of these refundable credits would result in significant changes to tax forms, processing systems, and computer systems. Added lines on each return could result in an additional page for each return, in turn requiring additional storage space. Verifying certification for the credits when processing returns would result in a new manual workload. The department has never administered a refundable corporation credit or a credit relating to the motion picture industry; however, administering this bill would be relatively simple as FTB's administrative activities would be limited to matching the taxpayer claiming the credits against a list of those qualified taxpayers that were allocated credits by the California Film Commission.

TECHNICAL CONSIDERATIONS

1. On page 8, line 40, and on page 28, line 36, strikeout “percent of” and insert “percent or” in lieu thereof.
2. On page 14, line 30, strikeout “and”.
3. On page 21, line 16, and on page 41, line 27, strikeout “qualified motion pictures” and insert “qualified commercials” in lieu thereof.
4. On page 36, line 37, strikeout “fall” and insert “falls” in lieu thereof.

LEGISLATIVE HISTORY

SB 58 (Murray, 2005/2006) would provide a refundable franchise and income tax credit for certain wages paid or amounts paid to purchase or lease certain property used to produce a motion picture in California. This bill is currently in the Senate Appropriations Committee.

AB 1830 (Cohn, 2003/2004) and AB 2747 (Wesson, et. al., 2001/2002) would have provided a refundable income tax credit for wages paid in connection with the production of a motion picture in California. AB 1830 did not pass out of the Assembly policy committee. AB 2747 did not pass out of the Senate Appropriations Committee.

AB 484 (Kuehl, 1999/2000), as amended July 14, 1999, would have provided a refundable income tax credit for wages paid in connection with the production of or musical scoring for certain television programs or motion pictures. As enacted, AB 484 (Stats. 1999, Ch. 699), created the Film California First Program within the Technology, Trade, and Commerce Agency to assist in the underwriting of actual costs incurred by production companies filming in California.

AB 358 (Wildman, 1999/2000) would have provided a refundable income tax credit for wages paid in connection with television programs or motion pictures similar to AB 484. AB 358 did not pass out of the Senate Appropriations Committee.

OTHER STATES’ INFORMATION

Numerous states and foreign jurisdictions provide incentives to the motion picture industry. Attached as appendices to this analysis are charts compiled by the California Film Commission summarizing the most significant of these incentives.

Recently enacted Oregon legislature established two film production incentives:

- The Greenlight Oregon Labor Rebate Fund, which will offer productions a rebate of approximately 6.2% on qualified wages. The program sets up a special withholding arrangement where income taxes withheld from wages on a qualified production will be put into a suspense account at the Oregon Department of Revenue, and rebated back to the production when filming in Oregon is completed. Productions must spend at least $1 million on production-related expenses in Oregon to qualify. This rebate also applies to commercial productions, if a company spends at least $1 million on production expenses in the state in a single year. The new program takes effect 90 days after the legislature adjourns, so exact start-up time is not yet known, but is expected to be this fall.

- A credit is allowed for contributions to the Oregon Production Investment Fund that is certified by the Oregon Film and Video Office. The credit applies to tax years beginning on or after January 1, 2005, for tax credit certifications issued on or after July 1, 2005.

FISCAL IMPACT

The estimated cost to implement this proposal would be approximately $450,000 for modification of the individual and corporate tax systems to accommodate the refundable credits and other automated and manual return processing functions. Estimated annual costs to process returns claiming the credit would be approximately $120,000. It is assumed that FTB's activities to administer this bill would be limited to verifying that the taxpayer claiming the credit or refund is in fact the qualified taxpayer allocated credits by the Commission, and then making or denying the credit or refund as applicable. The bill should include an appropriation for the department's costs to implement and administer the credit.

ECONOMIC IMPACT

This bill would result in a loss of state income tax revenue in the amount of the total aggregate amount of credits subject to allocation in any calendar year. The bill has left the amount that may be allocated blank, and therefore, the estimated amount of revenue loss cannot be determined at this time.

LEGAL IMPACT

This bill would provide incentives for motion picture production in California.

The U.S. Court of Appeals for the 6th Circuit ruled in *Cuno v. DaimlerChrysler, Inc.* (2004) 386 F. 3d 738 that Ohio's Investment Tax Credit is unconstitutional because it gives improper preferential treatment to companies to locate or expand in Ohio rather than in other states and, therefore, violates the Commerce Clause of the U.S. Constitution. Ohio is seeking review by the U.S. Supreme Court. Although the outcome of this decision and its affects on the income tax credits of other states, including California, is unknown, targeted tax incentives that are conditioned on activities in California may be subject to constitutional challenge.

Recently introduced federal legislation titled, the "Economic Development Act of 2005," S. 1066 and H. R. 2471, would authorize state tax incentives for economic development purposes that may otherwise be subject to constitutional challenge as discriminatory.

ARGUMENTS/POLICY CONCERNS

This bill provides that the Commission would allocate credits to a qualified taxpayer based on information required to be included with the taxpayer's application, and certify the allowed credits upon completion of the motion picture or commercial in accordance with rules and regulations promulgated by the Commission. Since the bill would require the Commission to certify the allowed credit prior to being claimed on a franchise or income tax return, FTB administration of the credit would be limited to verifying that the taxpayer claiming the credit or refund is in fact the qualified taxpayer allocated credits by the Commission, and then making or denying the credit or refund as applicable. In this regard, administration of the credit would be relatively simple. FTB currently administers the low-income housing credit and the natural heritage preservation credit, both of which are allocated by a designated agency, in this manner. However, if the allocation certification feature were eliminated or if the bill is amended to require FTB to examine returns subsequent to the taxpayer claiming the credit or refund, such examinations would be lengthy, complex, and costly.

Unlike other allocated tax credits such as the low-income housing credit and the natural heritage preservation credit, this credit does not specifically restrict the taxpayer able to claim the credit for the expenses of producing the motion picture or commercial to the owner (or owners) of the motion picture or commercial.

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APPENDIX
SUMMARY OF CURRENT MOTION PICTURE PRODUCTION INCENTIVES OF OTHER STATES

STATE	INCENTIVE	DESCRIPTION
FLORIDA	FILM INDUSTRY REBATE PROGRAM	• **15%** reimbursement of qualified expenditures • Funded at $10 million per year
GEORGIA	INCOME TAX CREDIT	• **9%** transferable income tax credits on all costs spent in Georgia, plus: • **3%** credit on wages paid to GA residents, plus: • **2%** credit for TV productions that spend more than $20 million annually, plus: • **2%** credit for tier 1 & tier 2 areas
ILLINOIS	WAGE TAX CREDIT	• **25%** credit on first $25,000 of wages paid to Illinois residents
LOUISIANA	INVESTOR TAX CREDIT EMPLOYMENT/LABOR TAX CREDIT SALES & USE TAX EXCLUSION	• **15%** transferable credit of entire spend including post production costs not done in Louisiana (if spending exceeds $ 8million, otherwise 10% credit) plus: • **20%** credit on total aggregate payroll of Louisiana residents (if payroll exceeds $1 million) plus: • **4%** sales and use tax exclusion
MARYLAND	FILM PRODUCTION ACTIVITY	• **50%** rebate on wages (up to $25,000 per employee) with funding at $4 million per year.
NEW MEXICO	PRODUCTION TAX CREDIT INTEREST-FREE LOAN	• **15%** refundable tax credit for eligible production costs (additional **5%** credit for targeted TV series productions) with 80% of refund given in advance of spending plus: • Interest free loan up to $15 million • Job training funds
NEW YORK	FILM PRODUCTION TAX CREDIT	• **10%** refundable tax credit of qualified expenditures, capped at $100 million over 4 years • City of New York offers the same incentive with a refundable tax credit equal to **5%** of qualified expenditures capped at $37.5 million for 3 years

Source: California Film Commission (5-12-05)

APPENDIX
SUMMARY OF CURRENT MOTION PICTURE PRODUCTION INCENTIVES OF OTHER STATES

STATE	INCENTIVE	DESCRIPTION
PENNSYLVANIA	INCOME TAX CREDIT	• **20%** transferable tax credit of qualified Pennsylvania costs when production spends 60% of production costs in state ($10 million annual cap)
PUERTO RICO	PRODUCTION PROJECT TAX CREDIT	• **40%** transferable labor tax credit (paid to Puerto Rican residents). At least 50% of the shooting must take place in Puerto Rico
SOUTH CAROLINA	TRANSFERABLE TAX REBATES	• Increases the existing incentive rebate from 5% to **15%** of total aggregate payroll for employees who are subject to South Carolina withholding, if in-state spending is at least $1 million. Plus: • Existing **7%** sales tax exemption for purchases/rentals of in-state goods and services. Plus: • **15%** supplier rebate program for in-state production expenditures • Capped at $10 million annually

Source: California Film Commission (5-12-05)

APPENDIX – SAMPLE OF PENDING PRODUCTION INCENTIVES OF OTHER STATES

STATE	INCENTIVE	DESCRIPTION
ARIZONA	INCOME TAX CREDITS	• **20%** transferable income tax credit on production expenditures or sales tax exemption on purchases • To qualify, a production must hire a minimum of AZ residents
MASSACHUSETTS	EMPLOYMENT TAX CREDIT SALES TAX EXEMPTION	• **20%** tax credit on aggregate payroll for residents when in-state spending exceeds $1 million (10% credit on payroll when spending is less than $1 million.) • **25%** transferable tax credit on production expenditures, capped at $5 million per production. • **5%** Sales and Use tax exemption
NORTH CAROLINA	REFUNDABLE TAX CREDIT	• **15%** refundable tax credit on expenditures and wages
RHODE ISLAND	INVESTOR TAX CREDIT EMPLOYMENT TAX CREDIT	• **25%** tax credit for qualified productions when spending is over $10 million; **15%** credit when spending is between $300,000 and $10 million • **20%** employment tax credit when spending is over $1 million; **10%** employment credit when spending is between $300,000 and $1 million
TEXAS	WAGE BASED PRODUCTION REBATE	• Grants equal to **20%** of wages paid to Texans up to $750,000 per production

Source: California Film Commission (5/12/05)

APPENDIX
SUMMARY OF CANADIAN PRODUCTION INCENTIVES

PROVINCE	INCENTIVE	DESCRIPTION
CANADA (FEDERAL)	CANADIAN PRODUCTION TAX CREDIT (Federal incentive is **in addition** to provincial incentives below)	• **16%** federal tax credit on Canadian labor expenditures • No limitation on the amount of any Canadian refund
BRITISH COLUMBIA	FILM INCENTIVE TAX CREDIT DIGITAL ANIMATION OR VISUAL EFFECTS TAX CREDITS	• **18%** tax credit on BC labor expenditures • **6%** additional tax credit on labor expenditures outside of Vancouver • **15%** digital animation or visual effects credit for BC labor costs
ONTARIO	FILM INCENTIVE TAX CREDIT	• **18%** refundable tax credit on Ontario labor expenditures • **10%** additional tax credit for productions outside of the Toronto area • **20%** Ontario computer animation credit
MANITOBA	FILM INCENTIVE TAX CREDIT	• **45%** refundable tax credit on Manitoba labor expenditures • **5%** frequent film bonus additional tax credit for 3 or more projects
NOVA SCOTIA	FILM INCENTIVE TAX CREDIT	• **35%** tax credit on Nova Scotia labor expenditures • **5%** frequent film bonus, additional tax credit for 3 or more projects
QUEBEC	FILM INCENTIVE TAX CREDIT	• **20%** refundable tax credit on Quebec labor expenditures
SASKATCHEWAN	FILM INCENTIVE TAX CREDIT	• **17.5%** refundable tax credit of the total production cost • **22.5%** refundable tax credit if outside of the province's two major cities

Source: California Film Commission (5-12-05)

APPENDIX – SUMMARY of INTERNATIONAL PRODUCTION INCENTIVES*

*** This a sample of incentives offered internationally**

COUNTRY	INCENTIVE	DESCRIPTION
AUSTRALIA	REFUNDABLE TAX OFFSET	• **12.5%** rebate for qualifying Australian production expenditures on films and TV series that spend a minimum of A$15 million
FIJI	REFUNDABLE TAX OFFSET	• **15%** refundable tax offset for productions that spend a minimum of F$50,000
IRELAND	PRODUCTION TAX RELIEF	• **12%** of Irish production expenditures capped at $2.9 million per project
NEW ZEALAND	FILM GRANTS	• **12.5%** large budget film grant on films that spend a minimum of NZ$15 million
SOUTH AFRICA	SOUTH AFRICAN PRODUCTION EXPENDITURE	• **15%** of the gross amount spent in South Africa for foreign production. At least 50% of the production must be shot in South Africa with a minimum budget of $3,800,000
UNITED KINGDOM	TAX DEDUCTION	• A production company can enter into a "sale and lease back" of its film with a UK investor and receive approximately **15%** of its negative cost

Source: California Film Commission (5/12/05)