There's No Place Like Home

Bringing Film & Television Production Back to California

February 2012

THE HEADWAY PROJECT

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Bringing Film & Television Production Home to California

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in association with

The Institute for Research on Labor and Employment

University of California, Los Angeles

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About the Headway Project

The Headway Project is a nonprofit, nonpartisan think tank and issues-advocacy firm based in Los Angeles and devoted to promoting progressive public policy issues in California and throughout the nation. The five pillars of the project are promotion of small business, fiscal responsibility in government, protection and promotion of civil rights, protection and promotion of consumer rights and the development of long-term, sustainable clean energy.

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Executive Summary

In September 2011, The Headway Project undertook a study of the 2009 California Film & Television Tax Credit Program. Our purpose at The Headway Project is to explore initiatives and ideas that seem likely to create middle class jobs, and in this respect we were interested in determining whether this relatively new tax credit has been effective in reversing film and TV production flight out of the state and returning it to its natural and long-standing home in California.

As of the date of this report, the only full-scale economic impact study of the tax credit was produced and released in June 2011 by the Los Angeles Economic Development Corporation (LAEDC) and commissioned and paid for by the Motion Picture Association of America (MPAA). It found that the tax credit is creating jobs as well as an immediate economic benefit to state and local governments by generating $1.13 in new tax revenues for every $1 of tax credits allocated. But because the MPAA represents Hollywood studios, many dismissed the findings as biased.[1]

We hired a group of researchers from UCLA's Institute for Research on Labor and Employment (UCLA-IRLE) to analyze the LAEDC study. In addition, we conducted an original survey of film and television producers who have applied to California's tax credit program and we interviewed dozens of filmmakers, TV producers and other industry participants.

1. Michael Hiltzik, "Upon review, shine comes off glowing report on film tax credit," *Los Angeles Times*, July 20, 2011, http://articles.latimes.com/2011/jul/20/business/la-fi-hiltzik-20110720 (accessed January 19, 2012).

Key Findings

1. There remains a very strong correlation between tax credits and where film and TV producers go to shoot their projects.

2. While tax credits are not the only factor in deciding where a project should be shot, they appear to be the most powerful.

3. Although the UCLA-IRLE researchers found that the LAEDC study was reasonably well-conducted, they determined that the economic impact was overstated due to the LAEDC assumption that none of the projects that received tax credits from California would have filmed in California without one. Our examination of 14 projects that were produced despite having been placed on the 2010/11 wait list revealed that 8.4% of the subsidy was given to films and TV shows that would have shot in California anyway. Accordingly, the UCLA-IRLE researchers reduced the net positive impact of $1.13 found by the LAEDC to as much as $1.04 per $1 of tax credit allocated.

4. The uncertainty created by the limited size of California's tax credit program, which is able to provide credits by lottery to only one in every five applicants, causes many film and TV producers to pursue credits from other states.

5. Nontransferability restrictions on California's tax credits create serious problems and many unintended consequences that make California's program uncompetitive with other states.

In the following report, we explore these and other issues and provide recommendations to state lawmakers and program administrators to help make California's tax credit program more effective and competitive. Neither The Headway Project nor UCLA's Institute for Research on Labor and Employment has received any funding from any person or company affiliated with the entertainment industry.

A Note on the Economics Research

The economic analysis of the California Film & Television Tax Credit, as well as the analysis of the LAEDC study contained in this report, were performed by UCLA's Institute for Research on Labor and Employment (UCLA-IRLE) and are published under a separate version entitled "Economic and Production Impacts of the 2009 California Film and Television Tax Credit," by Lauren Appelbaum and Chris Tilly. It can be found on their website at www.irle.ucla.edu. The Headway Project contracted with UCLA-IRLE to conduct the economic analysis for this study, and to provide its specific expertise in the area of measuring employment subsidy programs such as this tax credit. Thus, for this report, UCLA-IRLE provided the economic analysis piece and The Headway Project provided the public policy piece.

Although published in two editions, the economic findings in the two reports were both produced by UCLA-IRLE. The version on the UCLA-IRLE website is more academically exhaustive (containing a lengthy literature review of studies produced on other states, for instance). This version is shorter and more accessible to the general reader, and contains recommendations for program administrators and state lawmakers. In order to maintain its academic objectivity and political neutrality, UCLA-IRLE did not wish to be a part of any of the policy recommendations contained in this report, and thus published its own version containing only the economic analysis.

It is important to note that all of the economic findings, as well as the analysis of the LAEDC study, were produced by UCLA-IRLE and are identical in both reports. UCLA-IRLE approved all of the economics findings published in this report, and The Headway Project approved the publication of the UCLA-IRLE report.

Introduction

In 2010, Columbia Pictures made a film entitled *Battle: Los Angeles,* a medium-budget movie about an alien invasion of the Earth and the valiant efforts of a division of Marines to prevent them from taking over the city of Los Angeles. Columbia Pictures (a division of Sony Pictures) and its executives are based in Culver City, California. The producer, director and principal actors are based in Los Angeles. The story line of the movie is actually *set* in Los Angeles, as the name *Battle: Los Angeles* implies. Yet the film was shot in Louisiana because of that state's generous 30% tax credit. As Doug Belgrad, President of Columbia Pictures, explains, "despite the fact that we're all based here and the movie's story is set in Los Angeles, we went to Louisiana and re-created scenes to look like Santa Monica because, among other reasons, we got a financial incentive from Louisiana."[2] This was good news for Louisiana – over the course of 13 weeks of live-action shooting, Columbia Pictures hired 2,095 people on location in Louisiana (bringing in just 199 from California),[3] poured $46 million into the local economy, and earned a $15 million tax credit.[4]

There are now more than 100 productions that, like *Battle: Los Angeles*, are shot outside of California every year, as other states and countries continue to aggressively lure film and television production out of its traditional home in California. As of the writing of this report, Marvel is preparing to shoot *Iron Man 3* (approx. $200 million) in a sound stage in North Carolina; New Line/Warner Bros. is shooting *Oz* ($200 million) in Michigan; Jerry Bruckheimer is preparing to shoot *The Lone Ranger* ($215 million) in New Mexico; MGM is shooting *G.I. Joe* in Louisiana ($155 million), which is also where Summit will shoot *Ender's Game* ($100 million) and where Universal and Tom Cruise are preparing to shoot *Horizons* ($100+ million); Overbrook Entertainment and Will Smith are preparing to shoot *After Earth* ($100 million) in Pennsylvania; Universal is shooting *R.I.P.D.* in Boston ($150 million); and the list goes on. All of these productions are receiving tax credits that they cannot get in California.[5]

Tax credits remain a powerful determinant of production location. Louisiana, which today is one of California's strongest competitors, had essentially no film or television production business before it introduced its tax credit for this industry in 2002. In that year, one film was shot in Louisiana.

2 Doug Belgrad, phone interview, August 4, 2011
3 Gary Martin, via email on October 20, 2011
4 Adrian Glick Kudler, "Just Add Palm Trees: 'Battle: Los Angeles' Shoots Louisiana For LA," March 1, 2011, http://la.curbed.com/archives/2011/03/just_add_palm_trees_battle_los_angeles_shoots_louisiana_for_la.php. (accessed January 21, 2012). Richard Verrier, "On Location — 'Battle: Los Angeles' takes the Bayou by storm," *Los Angeles Times*, March 1, 2011, http://latimesblogs.latimes.com/entertainmentnewsbuzz/2011/03/on-location-battle-los-angeles-takes-the-bayou-by-storm-.html. (accessed January 18, 2012).
5 Phone interviews with studios and filmmakers, January 5, 2012. IMBD Pro Database, www.imdb.com. (accessed January 5, 2012)

In 2007, by contrast, 54 films were shot in Louisiana, and in 2010 Louisiana was home to 69 feature films and 18 television productions.[6] There are few "natural reasons" for the film and TV business to be shooting in Louisiana – in fact, producers must overcome many obstacles and incur relocation and other logistical costs to be able to shoot there. The 30% Louisiana tax credit (plus an additional 5% on local labor), now a decade old, is the only compelling reason. This is why 40 states in America (plus Puerto Rico and many foreign countries) now offer film and TV tax credits as well.[7]

Why are tax credits so effective at influencing location decisions in the entertainment business? There are three reasons. First, film and television production is uniquely mobile. Unlike manufacturing, tourism, agriculture, biotech, high tech or other industries that naturally "stick" to the state they are in or require more established infrastructure and are harder to move, locations for films and television shows are determined on a case-by-case basis, and the question of where to shoot is at issue with every production. Moreover, in the last decade, as film has been replaced with digital photography, and editing and post-production has become an entirely digital process as well, the need for filmmakers to remain proximate to editorial, post production and special effects labs has become much weaker, which means that the industry is getting even *more* mobile each year. Second, the dollars are big and fast – a large motion picture can spend $200 million and create 3,000 jobs for a small, local community in a matter of six months of live-action filming. It's hard to imagine any other industry that can deliver such a large economic impact so quickly. "That's why," says one senior studio executive, "the Secretaries of State of Louisiana, New York, Texas and many other states can regularly be found in every big studio in California, pitching their Film Commission's abilities and cutting deals to bring film and TV production to their states." The third reason that film and TV tax credits have worked so well is that, as other states and countries have offered aggressive tax credits to lure production away from California, legislators in Sacramento have reacted very slowly and cautiously, believing that film and television producers would stay in California because it's the traditional heart of the industry, offering the best facilities, the deepest bench of talent and the essential cluster of support companies that studios need to build sets, edit footage, create special effects and provide other specialized services.

This phenomenon is quickly approaching a tipping point – a point at which California will forever lose any true competitive advantage as the heart of the entertainment industry.

6 Motion Picture Association of America, "State-by-State Statistics," *MPAA website*, http://www.mpaa.org/policy/state-by-state. (accessed January 17, 2012)
7 Entertainment Partners, *The Essential Guide to U.S. & International Production Incentives, 2011 1st edition*

Twenty years ago, this may have been the case. But after two decades of steady subsidy and focused dedication to building production infrastructure, many states and countries (especially Canada) now offer first-rate facilities, larger skilled labor pools and the support of state agencies that are nearly equal to those of California. This phenomenon is quickly approaching a tipping point – a point at which California will forever lose any true competitive advantage as the heart of the entertainment industry. "Even five years ago," says Doug Belgrad, "we would not have been able to make a movie as big as *Battle: Los Angeles* in Louisiana because it just didn't have the labor or facilities. For this film, we hired more than 85% of the crew right in Louisiana. That's how far Louisiana has come. Today, you can make a film of almost any size and scope in Louisiana, New York or Vancouver, and many other locations are not far behind."

The studios may still be largely based in California because it's where the actors live, where the agents are, where the creative talent is located and where the deals are made. But the production goes where the incentives are.

Today, the great majority of California-based film and television producers claim that securing a tax credit is one of the first and most important decisions that they make in the production process.[8] Some producers we interviewed said that, in certain circumstances, subsidies can even trump talent and script concerns: if an actor refuses to shoot in a state that offers the best tax credit, the producers find another actor; if the script needs to be modified to reflect the scenery offered in the state with the best tax credit, the script gets modified. The studios may still be largely based in California because it's where the actors live, where the agents are, where the creative talent is located and where the deals are made. But the production goes where the incentives are.

Indie film producer Peter Safran – who makes two to three films per year, favors Louisiana and has made only one film in California despite the fact that he lives in Los Angeles – says that his investors would consider him to be in "breach of his fiduciary responsibilities over their money" if he were to make a film in a state without a tax credit.[9]

But while the math may be fairly simple for film and TV producers, the issue for state legislators is considerably more difficult. In the current environment, almost every state in the nation has a budget deficit. Unemployment is high – as of December 2011, California's unemployment is at 11.1%, or approximately 30% higher than the

8 Lauren Appelbaum and Chris Tilly, "Economic and Production Impacts of the 2009 California Film and Television Tax Credit," *UCLA Institute for Research on Labor and Employment*, November 14, 2011, www.irle.ucla.edu.
9 Peter Safran, via email on January 23, 2012

national average of 8.5%[10] – tax revenues are down, and states can scarcely afford to divert already limited resources away from education, law enforcement, healthcare, infrastructure and other essential services. Many states engaged in offering film and TV tax incentives have tried to justify these subsidies by pointing to increased employment and tax revenues brought in by the entertainment industry through these programs. While there is undoubtedly increased employment and local spending when a film brings its production to one of these states, the majority of studies on film and TV tax credits conclude that most states suffer serious losses in this effort, paying out far more in incentives and rebates than they collect in tax revenues from increased employment or other economic activity related to this effort.[11]

In California, lawmakers are uncertain of the effectiveness of California's film and TV tax credit program, largely because there is very little performance data available yet, and they don't know how many jobs and how much revenue California's $100 million annual tax credit may be creating. The most extreme opponents of this tax credit claim that the program is a total waste of money, nothing more than a giveaway to rich studios who are planning to shoot their films and TV shows in California anyway and are thus the lucky recipients of windfall subsidies at the taxpayer's expense. They dismiss the June 2011 report by the LAEDC as biased because it was sponsored by the MPAA. Lacking any California study of their own, they point to studies from other states that report film and TV tax credits generating weak returns in locations such as Michigan, New Mexico or Massachusetts, but such comparisons only confuse the issue for California because many states offer incentives that are often twice as rich as those offered by California.[12]

The most extreme supporters, relying mainly on the LAEDC study, claim that *every* film and TV show shot in California is a result of the tax credit program and that without such support, none would be filmed in California.

Hoping to further a productive discussion on the value of this tax credit and perhaps gather some consensus around early performance data, The Headway Project hired a group of economists at UCLA's Institute for Research on Labor and Employment (UCLA-IRLE) to examine the LAEDC report

10 U.S. Department of Labor, Bureau of Labor Statistics, "Regional and State Unemployment-December 2011," *BLS website*, January 24, 2012, http://www.bls.gov/news.release/laus.nr0.htm (accessed January 24, 2012)
11 Robert Tannenwald, "State Film Subsidies: Not Much Bang For Too Many Bucks," *Center on Budget and Policy Priorities* website, December 9, 2010, http://www.cbpp.org/cms/index.cfm?fa=view&id=3326. (accessed January 18, 2012)
12 In this report, we have largely ignored studies conducted on the economic impact of film and television tax credits in other states and countries because the incentives and terms offered differ widely from location to location. Many studies on other states have concluded that such subsidies lose the state money and do not recapture tax revenues sufficient to offset the original incentive. While contextually interesting, such studies cloud and confuse the issue in California because California's program is far less generous, both in terms of level of subsidy and terms of use, than almost any other similar subsidy in the world. The UCLA-IRLE report contains a comprehensive literature review of studies on film and television tax credits across the nation and internationally. Lauren Appelbaum and Chris Tilly, "Economic and Production Impacts of the 2009 California Film and Television Tax Credit," *UCLA Institute for Research on Labor and Employment*, November 14, 2011, www.irle.ucla.edu

and evaluate its findings.[13] The UCLA-IRLE study was managed by Research Director Lauren Appelbaum, Ph.D., under the supervision of UCLA-IRLE Director Chris Tilly, Ph.D. Christine Cooper, Ph.D., who had written and directed the LAEDC report, agreed to work with the UCLA-IRLE researchers to share her source data and explain her methodology and conclusions. Amy Lemisch, Director of the California Film Commission, and her office were also very cooperative with the UCLA-IRLE researchers since they had provided much of the original source data to Christine Cooper at LAEDC for her earlier report. Our analysis of the claims and findings of the LAEDC report are discussed below. The urgent need for bipartisan cooperation in producing a new, disinterested, comprehensive study of this tax credit program is something that we address in the Recommendations portion of this report.

Indie film producer Peter Safran – who makes two to three films per year, favors Louisiana and has made only one film in California – says that his investors would consider him to be in "breach of his fiduciary responsibilities over their money" if he were to make a film in a state without a tax credit.

The purpose of our report therefore is to provide some objective and disinterested analysis of the LAEDC economic impact study and provide recommendations and ideas to help state legislators understand how they may be able to refine and even expand the program to stem the continuing flight of film and TV production out of California, increase production spending within the state, and do so at the least possible expense to the state's cash-strapped budget. To that end, we ask, and attempt to answer, the following questions:

First, given that California offers many key advantages for film and television production beyond just tax incentives, what is the least amount that California can offer in tax incentives in order to keep production in-state without giving away more rebates than necessary?

Second, how large should the annual program (pool of allocations) be in order to accommodate the maximum number of projects that wish to produce a film or television show in California?

Third, how can California's program be structured to make sure that maximum benefit is focused on creating quality jobs for the hard-working middle class Californians who form the backbone of this industry, without being a tax giveaway to millionaire celebrity actors, producers and studio chiefs?

13 Lauren Appelbaum and Chris Tilly, "Economic and Production Impacts of the 2009 California Film and Television Tax Credit," *UCLA Institute for Research on Labor and Employment*, November 14, 2011, www.irle.ucla.edu

Fourth, how can we determine which projects opt to film in California as a result of receiving a tax credit, and which would have filmed here anyway, even without a subsidy?

Fifth and lastly, where should the incentives be focused within the industry to generate the greatest overall economic activity and, consequently, deliver the best tax revenues to the state's coffers?

In this report, we propose answers to all of these questions and more, and then offer specific recommendations to legislators to help them make California's film and TV tax credit into the least expensive and most effective program it can be, both for the 11.1% of California's citizenry that is currently unemployed, and for legislators trying to balance the state's budget and manage its other pressing priorities.

California's Film & Television Tax Credit Program

In 2009, the California Legislature enacted the California Film & Television Tax Credit Program, which is a 5-year, $100 million per year tax credit against qualifying expenses in film and television production. In order to be eligible for consideration, film and television producers must shoot 75% of their live action production days inside the state of California or spend 75% of their total production budget in California. Since there are more applicants than credits available, recipients are selected by lottery, and the amount of credits allocated is based on "qualifying expenditures," which include wages and benefits for production workers, independent contractors, background actors without scripted lines, and purchases or leases of tangible property or other items used in production.[14] The recipients of these "below the line" expenditures are often unionized laborers and small businesses. California's tax credit is far less generous than programs being offered by other states and countries, as well as more carefully and intelligently designed – an accomplishment for which California legislators and the California Film Commission (CFC) deserve considerable credit.

The program made its first round of tax credit allocations on July 1, 2009 (the beginning of the state's 2009/10 fiscal year). In the first year of the program, the CFC was allowed to make a one-time double allocation of $200 million, effectively distributing two years' worth of the program's $500 million of credits in the first fiscal year of the program. On July 1, 2010, another $100 million in tax credits were allocated, and the same amount was allocated on July 1, 2011. Thus, as of the writing of this report, $400 million of the program's $500 million in original available tax credits has been allocated.[15]

Aside from requiring that producers spend 75% of their production days in-state, California's film and TV tax credit also largely excludes credits for the types of productions that are likely to be produced in California anyway. Additionally, it is administratively demanding on recipients, requiring them to submit to rigorous auditing by the CFC before being granted an actual Tax Credit Letter. There are many technical requirements for applicants, as well as compliance conditions for those lucky enough to receive a tax credit allocation, all of which can be found at the California Film Commission's website at: http://www.film.ca.gov/res/docs/CFCGuidelines_May_2011.pdf.

14 California Revenue and Taxation Code, 17053.85 (b)(16) and (18), http://www.leginfo.ca.gov. (accessed January 18, 2012)

15 According to CFC Director Amy Lemisch (via email on January 20, 2012), "the credits in excess of $100 million in any fiscal year's allocation are the result of unused credits from the previous fiscal year rolling over into the new fiscal year. (The statute specifically allows for this rollover.) Credits may be unused for a variety of reasons such as projects not moving into production and withdrawing from the program or projects spending less than originally estimated thereby reducing their tax credit amount."

For our purposes, however, the five key considerations of the program are as follows:

1. California's Film & TV Tax Credit is Small

Capped at $100 million per year, California's Film & Television Tax Credit Program is relatively small for a state as important as California in the entertainment industry. By comparison, the New York State Legislature currently allows its film commission to allocate $420 million per year in tax credits for the same industry. And many states, such as Louisiana, have no cap on this incentive at all, offering tax credits to any and all who would like to come to their state to shoot a film, a television show or even a pilot.[16]

Notably, because California's program is capped at a total of $100 million per year, any film with a production budget larger than $75 million is categorically excluded from the program because one big blockbuster would deplete practically the entire annual allocation. That is why all of the large productions listed on the first page of this report, such as *Iron Man 3*, are filming out of state at the moment. This is ironic, because the largest Hollywood productions generate by far the most employment, production spending and tax revenues for the state, but they are excluded from the state's tax incentive program. But even with all productions larger than $75 million excluded from the program, the CFC is still only able to make tax credit allocations to approximately one in every five applicants, and these it allocates by lottery. In its first year (2009/10), the CFC was able to fund 100% of projects, allocating tax credits to all 77 applicants. In part, this was because the program was new, and also because the Film Commissioner was allowed to make a double allocation of $200 million in the first year. But at the start of the program's second year (2010/11), only 32 projects were allocated credits, while 38 were placed on the waiting list. And at the beginning of this year (2011/12), 38 were allocated credits and more than 150 were placed on the waiting list.[17] Because the number of applicants so far exceeds the capacity of the $100 million pool, the tax credit allocation letters are awarded randomly by lottery, and the entire annual allocation is completely gone on the first day of the new fiscal year on July 1. After the credits are allocated on July 1, California effectively has no film and TV tax credit program at all, which means that filmmakers spend the rest of the year shopping for tax credits elsewhere and taking their productions out of state. The insufficient size of California's $100 million tax credit allocation, compared to states' programs offering four to five times as much subsidy, plus the arbitrariness of the annual June 1 application deadline, are problems addressed in the Recommendations section at the end of this report.

16 Entertainment Partners, *The Essential Guide to U.S. & International Production Incentives, 2011 1st edition*

17 The July 2011 Progress Report published by the California Film Commission cites tax credit allocations to 69 projects for the 2009/10 fiscal year, 52 projects for the 2010/11 fiscal year and 29 projects for the 2011/12 fiscal year. This discrepancy is explained by CFC Director Lemisch (via email on January 21, 2012): "these numbers are constantly changing as projects move out of state, lose funding or move off the list when credits become available."

2. The Right Segments Benefit

Unlike many other states' programs, California's tax credit specifically excludes all "above the line" expenses: namely, wages paid to actors, directors, producers, writers, music directors and composers. This is not a "rich man's tax credit." Under California's plan, a studio may decide to pay a $20 million fee to a celebrity actor such as Will Smith or a director such as Steven Spielberg, but these expenses will not qualify for a tax credit in California (although they do qualify in many other states). California's tax credit also excludes acquisition and development costs, as well as expenses related to financing, overhead, marketing, publicity and distribution. Also excluded are expenses related to residuals, as well as expenses related to the creation of ancillary products such as soundtrack albums, video games and toys. Even accounting services needed to conform to the CFC's compliance audits are excluded from tax credit eligibility.[18]

On the other hand, we feel that all of the right expenses *do* qualify: "below the line" expenses include salaries, wages and benefits for the filming crew and staff, most production and equipment costs (including studio and soundstage expenses), camera and equipment rentals, lodging and lab processing. In a typical film, approximately 50-75% of the crew and staff are below the line, working in set construction, set dressing, wardrobing, props, art direction, special effects, sound, lighting, hair and makeup, unit operations, transportation, security, tests and preshoots, and other functions. In addition, almost all fees paid to support companies such as caterers, trailer rentals, private security and transportation also qualify for tax credits under California's plan. California's film & TV tax credit program is admirable in that it clearly focuses the thrust of the incentive on creating and maintaining the hundreds of thousands of unionized, middle class production jobs that form the backbone of the entertainment industry.

After the credits are allocated on July 1 of each year, California effectively has no film and TV tax credit program at all, which means that filmmakers spend the rest of the year shopping for tax credits elsewhere and taking their productions out of state.

Notably, California's tax credit is endorsed by the California Labor Federation (CLF), which typically does not support tax credits for private corporations. According to Angie Wei, Legislative Director of the CLF, the CLF endorses California's film and TV tax credit because of its focus on middle class jobs and its effectiveness in keeping entertainment jobs in California. Says Wei, "This is the only corporate tax credit that the CLF has endorsed in recent history."[19] One senior entertainment union representative

18 California Revenue and Taxation Code, 17053.85 (b) (18), http://www.leginfo.ca.gov. (accessed January 18, 2012)
19 Angie Wei, phone interview, October 14, 2011

adds: "These are also very high quality jobs - exactly the kind of jobs that California should want to hold on to. They pay well above the national average, are fully benefitted and fully pensioned, and are environmentally clean."

3. California's Tax Credit Focuses on Productions With the Highest Flight Risks

The only types of film and television shows that qualify under California's tax credit program are feature films with production budgets between $1 million and $75 million, miniseries and movies of the week (MOW), new television series for basic cable, television series relocating to California and Independent films (non-studio films with qualifying expenses between $1 million and $10 million). The types of productions eligible for California's tax credit are the most mobile and are subject to the greatest flight risk due to other state and national incentives being offered. The rest of the entertainment industry is actually excluded from this tax credit. Commercials, television pilots, news programs, music videos, talk shows, reality shows, award shows, daytime dramas, animated shows, variety shows and other productions are all *excluded* from this tax credit program.

4. California's Tax Credit Offers a Lower Percentage Than Other States

Despite the allure of tax credits, many filmmakers and television producers want to film in California because of its natural advantages and superior infrastructure in the industry. Recognizing these advantages, California offers considerably lower subsidies. Films and television series receive tax credits worth 20% of qualified expenditures, while Independent films and existing television series that relocate to California receive a credit of 25% of qualified expenditures.[20] By contrast, California's chief rival states offer larger subsidies, and offer them against a wider range of expenses. The table on the following page demonstrates the comparative subsidies that a producer with $75 million in local production spending would receive from California, New York, Louisiana and Vancouver respectively.

20 California Revenue and Taxation Code, 17053.85 (a)(4), http://www.leginfo.ca.gov/, (accessed January 18, 2012). California Film Commission, "California Film & Television Tax Credit Program Guidelines," May 2011, http://www.film.ca.gov/res/docs/CFCGuidelines_May_2011.pdf, (accessed January 18, 2012)

Comparative Value of Tax Incentives

($millions)	California	New York	Louisiana	Vancouver
Film Budget Local Spend	$75	$75	$75	$75
Below-the-Line Local Portion of Budget	$50	$50	$50	$50
Local Labor Expenditure	$45	$45	$45	$45
Above-the-Line Credit Available			30%	
Below-the-Line Credit Available	20%	30%	30%	
Local Labor Benefit				56%
Credit Earned	$10	$15	$23	$25
Cash Refund %		100%	85%	100%
Cash Refunded to Filmmaker	$0	$15	$19	$25

(Source: Entertainment Partners, *The Essential Guide to U.S. & International Production Incentives*, 2011 1st edition)

By locating the production outside of California in any of the three locations shown above, this producer would receive a credit of anywhere between $15 million and $25 million – a very significant percentage against a total production budget of $75 million, and much greater than the $10 million offered by California. Moreover, all three of the other locations allow the producer to either sell that credit back to the state for cash or to another taxpayer in a private transaction, thereby allowing the producer to immediately liquidate the subsidy and return home with a check in his or her pocket. California's tax credit is nonrefundable and nontransferable for all except Independent films and television productions (a problem we address below).

Despite the overwhelming financial incentives offered by California's most aggressive competitor states and Canada, more than 180 filmmakers and television producers applied for California's tax credit program in 2011/12. These producers were hoping to be able to shoot in California even with the smaller incentives, indicating that California legislators correctly surmised that they could capitalize on California's depth of talent and facilities and offer a lesser credit. But with such a modest total pool of allocations each year, most of the projects that receive no allocation in the lottery will leave California in exchange for a tax credit from another state.

5. The Compliance Requirements Are High

In order to turn a Tax Credit Allocation Letter into an actual Tax Credit Certificate, participants in California's program must conform to a rigorous set of auditing requirements laid down by the

CFC. First, a primary producer and an accountant are required to attend an orientation meeting at least four weeks prior to the commencement of principal photography. Thereafter, productions must submit a first day's call sheet as well as production reports for *every day of shooting* thereafter, among other requirements. When shooting is finished, the production must hire a third-party Certified Public Accountant to perform the required audit process, test for eligibility and prove that qualified expenditures are in accordance with the CFC guidelines. Many other states do not require an independent CPA. The cost of auditing must be borne by the production, and even these costs are not considered to be expenses that qualify for the tax credit.[21]

Compared to programs and incentives offered by other states and countries, we give California's program high marks and find that the California Film Commission manages the public's money well.

In conclusion, the California Film & Television Tax Credit Program is thrifty and well-designed. It offers filmmakers and television producers a far smaller subsidy than is offered in New York, Louisiana, Canada or other locations. It specifically excludes credits for the actors, producers, directors, screenwriters and others in Hollywood's "rich man's club," focusing its incentives instead on the hundreds of thousands of middle class, unionized laborers and small companies who support the entertainment industry. Unlike New York and Louisiana, California will not write a check and buy the tax credit back for cash. The California Film Commission imposes a high standard of compliance and auditing in return for the tax credit allocation, and it performs its audits well with modest staff and resources. Compared to programs and incentives offered by other states and countries, we give California's program high marks and find that the California Film Commission manages the public's money well.

21 California Film Commission, "California Film & Television Tax Credit Program Guidelines," May 2011, http://www.film.ca.gov/res/docs/CFCGuidelines_May_2011.pdf (accessed January 18, 2012)

Analysis of the LAEDC Economic Impact Study

Despite the many admirable qualities of California's film & TV tax credit program, the question remains: does this credit "work" for the state? Does it create jobs and, if so, how many? How much economic activity does it generate and how much tax revenue for California does it produce in return for the $100 million in tax credits that it allocates each year? The LAEDC attempted to answer these questions in its June 2011 report entitled *California Film and Television Tax Credit Program: An Economic Impact Study,* directed by Christine Cooper, Ph.D.[22] The Headway Project retained researchers from UCLA's Institute for Research on Labor and Employment (UCLA-IRLE) to examine the LAEDC report and issue an opinion on its source data, methodology and findings.

It is important to note that UCLA-IRLE researchers did not conduct a complete, original economic impact study for this report, but rather only examined the LAEDC report. In general, they found the LAEDC report to be reasonable, but differed with Cooper's findings regarding how many productions the tax credit is responsible for bringing to, or keeping in, California, which caused them to reduce the total economic benefit claimed in the LAEDC report.[23] This discrepancy is discussed below.

Sample Set, Size and Array

In conducting its study, the LAEDC examined the first set of grantees to receive tax credits under California's newly enacted Film & Television Tax Credit Program. These first allocations were made on July 1, 2009 for the state's 2009/10 fiscal year.[24] The LAEDC was granted access to the full, itemized budgets of nine productions from this set; it then extrapolated from these productions to estimate the revenues and expenditures of the full set of 77 productions that received credits during the 2009/10 fiscal year.

The researchers at UCLA-IRLE reviewed the sample set for the LAEDC study and found the types and sizes of productions to be representative of the larger group, as the chart on the following page demonstrates:

22 Christine Cooper, Gregory Freeman, Shannon Sedgwick and Myasnik "Nik" Poghosyan, "California Film and Television Tax Credit Program: An Economic Impact Study," *Los Angeles Economic Development Corporation*, June 2011, http://laedc.org/reports/CAFilm.pdf (accessed January 18, 2012).
23 Lauren Appelbaum and Chris Tilly, "Economic and Production Impacts of the 2009 California Film and Television Tax Credit," *UCLA Institute for Research on Labor and Employment*, November 14, 2011, www.irle.ucla.edu
24 Under this program, the CFC was allowed to allocate a double amount in its first year of funding, so for fiscal year 2009/10, the CFC allocated $198.8 million rather than $100 million. When the LAEDC refers to "the first two years of credits," they are referring to two years' *worth* of credits allocated during this one fiscal year. All of the 77 productions granted tax allocations in 2009/10, including the subset of nine productions studied by LAEDC, were allocated their credits in fiscal year 2009/10.

Nine Budgets Studied by LAEDC

Project	Type	Indie?	Budget ($ millions)
1	Movie of the Week	Y	$2.5
2	Feature Film	Y	$6.7
3	Television Series	N	$28.2
4	Feature Film	N	$22.8
5	Feature Film	N	$32.8
6	Feature Film	N	$35.2
7	Feature Film	N	$60.4
8	Feature Film	N	$72.5
9	Feature Film	N	$75.1

(Source: California Film Commission)

Total Productions	**77**
Sample Proportion	**12%**
Credit Allocation Proportion	**22%**

Together, these nine projects represented 9/77ths, or about 12%, of the numerical group, but they represented 22% of the total allocations in terms of tax credit dollars, which is why Cooper multiplied all of her findings by 4.5 to estimate the total economic impact (22% x 4.5 equals approximately 100%). As the UCLA-IRLE critique of the LAEDC analysis notes, the LAEDC extrapolation included adjustments for the fact that the nine projects in the sample set were underweighted in Independent films and TV shows, which tend to have larger percentages of qualifying expenditures and also receive a 25% tax credit, as opposed to 20%, making the economic impact of the nine projects in the sample set somewhat greater than the full 77 projects would be. In addition, LAEDC accounted for the "temporal mismatch" between when the projects are produced (creating the economic benefit to the state) and when the Tax Credit Letters were allocated and then applied to actual tax returns. The UCLA-IRLE researchers felt that this adjustment was reasonable.

Modeling Program

The LAEDC used Minnesota IMPLAN as the input/output program to generate its economic impact model and conduct many of its analyses. Minnesota IMPLAN is a respected modeling program that has been used by more than 1,000 public and private organizations, including federal government agencies, state agencies and prominent universities. Like all proprietary "black box" economic modeling programs, Minnesota IMPLAN contains thousands of tables of data (mostly government supplied), which it uses to generate economic multipliers and estimates of indirect and induced economic activity. The UCLA-IRLE researchers did not have access to any of the data and assumptions used by Minnesota IMPLAN (nor did LAEDC), but this is typical of such modeling programs. The UCLA-IRLE researchers feel that the modeling program used by LAEDC is a respected and widely used one, and there is no reason to doubt its integrity.

Direct, Indirect and Induced Economic Impacts

The LAEDC added up the budgets of the 77 projects and determined that these film and television productions had generated $3.8 billion in total economic activity for the state of California. This figure was produced by the Minnesota IMPLAN model and includes the "direct" impact, "indirect" impact and the "induced" impact. The direct impact is simply the sum of the production budgets in the program. If a given film has a total production budget of $50 million, and that $50 million is spent in California on labor and materials, the LAEDC considers this to be $50 million worth of "direct impact." The indirect impact is the impact of spending related to the production, but not actually in the budget. For example, a movie's budget calls for $10 million to be spent on the set, and the producers hire a set design and contracting firm to provide these services. The contractor then hires other subcontractors, as well as his own direct labor, and also purchases materials to create the set as ordered. Economic activity such as this is defined as the "indirect impact." Finally, the LAEDC adds in the economic benefit of the induced impact, which is the impact of personal spending by everyone associated with the production, plus their households. In other words, a carpenter is hired by the set contractor and receives wages for several months' worth of work on the movie's set. When he spends his wages on his family, lifestyle and other personal household expenses, this economic activity is called the "induced impact." Calculating the direct, indirect and induced impact is a generally accepted practice among researchers measuring the overall economic activity created by an economic event such as the production of a film or television series.

Using the Minnesota IMPLAN model, the LAEDC determined that the economic impact multiplier for this program is 2.5 times the direct spending of the films' budgets. These figures imply a household savings rate of one third, which is much higher than the national average,[25] which led the UCLA-IRLE researchers to conclude that a multiplier of 2.5 is very reasonable.

Ancillary Production

In addition to the direct, indirect and induced impact created by these 77 productions filming in California, the LAEDC estimated that "ancillary production" generates an additional seven cents in tax revenues to the state for every $1 of tax credit allocated. Ancillary production is additional production that is "piggy-backed" onto an original production because crew on the first production is already assembled. Christine Cooper at LAEDC referred to it as the "critical mass factor" that California once uniquely possessed in this industry and is in danger of losing as other states build up significant infrastructure. In researching this beneficial effect with filmmakers and television producers, the LAEDC estimated ancillary production of $1 million for every $15 million in direct production spending. According to Cooper, "we spoke to many industry participants on this issue. It was quite clear that each film generated ancillary activity including not only promotional shoots but also productions that were piggy-backed just because the crew was already assembled. Quantifying this activity is difficult, but an estimate of $1 million for each $15 million in production spending did not seem excessive."[26] We spoke to Doug Mankoff, President of Echo Lake Productions, who confirmed this phenomenon and described one occasion in which he had shot additional footage for *The Joneses* using a crew that had been assembled for a John Carpenter film called *The Ward*. The two films were otherwise unrelated.[27] The UCLA-IRLE researchers did not find evidence that the LAEDC estimate for ancillary production was unreasonable, but they were also not able to measure it specifically.

Fiscal Impact to California

The LAEDC report concluded that the two years of approved productions produced an economic impact of $3.8 billion in total economic activity, which generated $1.13 in state and local taxes to California for every $1 in tax credits allocated, implying a $26 million profit for the state. As explained above, the UCLA-IRLE researchers felt that the analysis conducted by Christine Cooper and her team did, for the most part, result in a reasonable estimate of the economic impact of the tax credit. However, the UCLA-IRLE researchers reduced their estimate of the economic

25 Personal savings rate last measured at 3.5% on November 1, 2011. US Dept. of Commerce, Bureau of Economic Analysis as cited in http://research.stlouisfed.org/fred2/data/PSAVERT.txt
26 Christine Cooper, via email on December 13, 2011
27 Doug Mankoff, via email on January 24, 2012

impact of the tax credit by nine cents from $1.13 to as much as $1.04 in benefit to state coffers because of a problem they identified as “the 100% assumption” – the LAEDC report assumes that 100% of the 77 films that received tax allocations in 2009/10 were made in California only because of the tax credit program, and that without such subsidy, none of them would have been shot in California. This seems unreasonable given that some films and television shows were made in California prior to 2009 (when there was no film and TV tax credit offered in California), and some productions that did not receive a tax credit subsidy continued to be shot in California even after the program came into existence.

The Problem with the 100% Assumption

The very heart of the economic debate over this tax credit is centered around the issue of trying to determine whether a tax credit issued to a film or television production was the *decisive factor* that kept that production in California – creating employment, in-state production spending and tax revenues – or whether it was a free money subsidy given to a production that would have filmed in California anyway.

This question is difficult to answer because production location decisions, while heavily influenced by tax credits, are also subject to other considerations. As previously discussed, there are many reasons that film and TV producers prefer to stay in California. California has the greatest bench of industry talent, the best production facilities, the largest cluster of industry support companies and a rich variety of locations and scenery. In addition to these reasons, a filmmaker may decide to shoot in California because the movie’s story is set in California, as was the case with *Sideways*, or because an influential actor such as Will Smith or Tom Cruise refuses to shoot outside of California, or because a producer or director needs to work with a specific set of specialists based in California who cannot be relocated out of state affordably. Allocating a tax credit to a filmmaker who has already made the decision to shoot in California for any one of the reasons above would result in a subsidy that creates no return for the tax credit. The problem is distinguishing between such projects and ones that are kept in California (or brought to California) as the result of an attractive financial subsidy.

With a more recent entrant into the film and TV production business, such as Louisiana, the correlation between tax credits and film and TV production is easier to see because it effectively had no such industry before it initiated its tax credit program. Louisiana, which started essentially at zero 10 years ago, was home in 2010 to 69 feature films and 18 television series. We can chart a fairly direct correlation between the last decade of generous subsidy and the number of film and TV shows now being shot in that state.

Even with a state such as New York, which has long been the second hub of the film and television production business after California, the effectiveness of the tax credit is fairly clear. In 2009, New York state conducted a "natural experiment" when its legislature failed to approve the continuation of its previous film and television tax credit and, for part of the year, New York was unable to offer this subsidy. The result was a dramatic decrease in new television pilots shot in New York for the 2009/10 season, declining from 20 the previous year to just 4 in 2009/10. However, once credits were instituted again, according to a news report in *The Guardian*, pilots shot in New York City jumped dramatically back up from 4 to 22 for the 2010/11 season.[28]

With California, because of the long history of film and television production, there are many "confounding factors" that make it difficult to distinguish between projects that filmed in California as a result of receiving a tax credit, and those that were going to film in California anyway. Data from recently *wait-listed* applicants to California's program, however, sheds some light on this problem and suggests that among all of the projects receiving a subsidy, as much as 91.6% of the total budgeted expenses may have occurred outside of California, if not for the tax credit.

In the first fiscal year of the program (2009/10), all 77 applicants received some tax allocation because the CFC was allowed to allocate a double amount ($200 million) that year. There were, therefore, no projects on the wait list to analyze. In the second year (2010/11), however, 32 projects were allocated a tax credit, while 38 were placed on the wait list. Of these 38, a total of 24 either withdrew from the wait list or were removed because they did not get financing, could not find talent or for some other reason were not greenlit. The 14 projects that remained on the wait list were produced: five were shot in California and nine were shot out of state. Of the nine that were shot outside of California, two were shot in Michigan, three in Louisiana, three in Georgia and one in Texas. All of these nine received a tax subsidy from the state in which they were produced.[29]

Moreover, the five films that ended up shooting in California without receiving a subsidy were all *small Independents* with budgets of less than $10 million in qualifying expenditures – three were so

28 Lauren Appelbaum and Chris Tilly, "Economic and Production Impacts of the 2009 California Film and Television Tax Credit," *UCLA Institute for Research on Labor and Employment*, November 14, 2011, www.irle.ucla.edu. Matea Gold, "N.Y. tax-credit program that lured film and TV shoots runs out of funds: Studios weigh options after the state reveals that $515 million allocated through 2013 is already exhausted," *Los Angeles Times*, February 6, 2009, http://articles.latimes.com/2009/feb/06/business/fi-nyproduction6 (accessed January 18, 2012). Joanna Walters, "New York steals the shows as TV networks look east: Tax breaks are luring an increasing number of producers to shoot on the east coast," *The Observer*, June 18, 2011, http://www.guardian.co.uk/media/2011/jun/19/new-york-more-tv-shows/print. (accessed January 18, 2012)
29 Nancy Stone, California Film Commission, via email on December 9, 2011

small ($1.1 million, $1.2 million and $1.8 million respectively) that they were barely large enough to qualify for the program. For very low budget Indies, the cost to relocate to another state or, in some cases, to even scout locations in another state is prohibitively expensive because the cost to relocate will likely exceed the value of the tax credit. Thus, Indies (especially very low budget ones) may make up a special category of productions that are more willing to shoot in-state, even without a subsidy.[30]

When considered as a sum of production spending, these 14 wait-listed films represented a total of $240.2 million in direct expenditures. The five Indies that were shot in California despite receiving

The very heart of the economic debate over this tax credit is centered around the issue of trying to determine whether a tax credit issued to a film or television production was the <u>decisive factor</u> that kept that production in California or whether it was a free money subsidy given to a production that would have filmed in California anyway.

no tax credit represented $20.2 million, while the nine non-Indies that went out of state to pursue other tax credits represented $220 million. Since 91.6% of the wait-listed projects (by budget) that were made ended up leaving to pursue tax credits in other states when they were unsuccessful in getting a credit from California, the UCLA-IRLE researchers extrapolated the same percentage to the entire group of 77 productions and concluded that the state will likely realize about 91.6% of the economic benefit calculated by the LAEDC, while approximately 8.4% of the subsidy will end up being given to films and TV shows that would have shot in California anyway. Applying these figures to the LAEDC data, we believe the return to the state is therefore $1.04 for every tax dollar allocated, not $1.13.[31]

Admittedly, this is a very small study sample because we only have data from one wait list so far (the 2010/11 set), and only 14 films from that wait list ended up being produced. There was no wait list in the previous 2009/10 group to study, and the 2011/12 group is still too recently formed to analyze. Nonetheless, the data from the 2010/11 wait list is telling. If low budget Indies were to be removed from this tax credit program because they are often financially unable to relocate to another state anyway, it is likely that 100% of produced wait-listed projects would leave the

30 Although we did not study differences in behavior among relatively smaller versus larger Independent films and television shows, it is clear that there is a threshold – probably around $3 million in budget size – that determines whether or not a California-based Indie project is likely to stay in California regardless of subsidy, or seek one from another state. Of the five Indies from the 2010/11 wait list that shot in California with no subsidy, two required California-specific scenery and three were under $1.8 million in budget size and, we believe, were too low budget to be able to afford to scout other locations. Many Indies with larger budgets between $3 million and $10 million do leave California and film elsewhere if they are unable to secure a tax credit from California.

31 Lauren Appelbaum and Chris Tilly, "Economic and Production Impacts of the 2009 California Film and Television Tax Credit," *UCLA Institute for Research on Labor and Employment*, November 14, 2011, www.irle.ucla.edu

state and shoot their film where they can get a tax credit.[32] If small Indies were excluded from this analysis, the benefit to the state could be as much as the $1.13 per $1 of tax credit allocated that the LAEDC found.

...the state will likely realize about 91.6% of the economic benefit calculated by the LAEDC, while approximately 8.4% of the subsidy will end up being given to films and TV shows that would have shot in California anyway.

Job Creation

The LAEDC determined that when the labor and employment data culled from the nine sample budgets was extrapolated out to the entire group, the first $200 million allocation of tax credits created 20,040 jobs with a 95% conversion to full-time equivalent, or 19,038 full time equivalent jobs. The researchers at UCLA-IRLE found that the method for determining the employment created was reasonable and agreed with the LAEDC that the program created these 19,038 full time equivalent jobs. Even if only half of the benefit found by the LAEDC is recovered by the state in tax receipts, the cost per job created is a very reasonable $4,989.

Cost per Job Created by CA Film & Television Tax Credit Program

Economic Benefit Recovered by State	0%	50%	100%
Economic Benefit per $ of Tax Credit	$-	$0.57	$1.13
Jobs Created	20,040	20,040	20,040
Full-Time Conversion Factor	95%	95%	95%
Full-Time Equvalent Jobs Created	19,038	19,038	19,038
Production Kept in CA by Tax Credit	91.6%	91.6%	91.6%
Tax Credit-Related Jobs	17,439	17,439	17,439
Credit Not Recovered by State	$200,000,000	$87,000,000	$(26,000,000)
Cost Per Full-Time Job Created	**$11,469**	**$4,989**	**$(1,491)**

The full amount of $1.13 per $1 spent calculated by the LAEDC generates tax revenues of $226 million on $200 million spent, a net gain of $26 million, and a negative cost of $1,491 per job. If only 50%, or $0.57 per dollar were recaptured, the cost per job created would still only come out to $4,989. Compared with a number of job-creation programs around the country, this employment comes cheaply. The President's Council of Economic Advisers estimated the cost per job for different

32 Despite their relatively low return on investment, and the likelihood that many small independent films that apply for a tax credit from California are planning to shoot in California anyway because of the prohibitive costs of sourcing locations out of state, we do NOT recommend that Indies be removed from this program. Many of the producers, directors and actors we interviewed stressed the importance of the Indie market because of the experience and mentorship it provides. It is essential that Indies continue to be produced in California because they represent the farm of new talent coming up in the industry each year.

types of fiscal stimulus in the American Recovery and Reinvestment Act of 2009 and found that direct government spending created jobs at a cost of $92,000 per job-year created or saved.[33] Similarly, in a February 2011 report by David Neumark at the Public Policy Institute of California,[34] programs such as "hiring credits" paid as subsidies to employers can cost anywhere between $9,100 and $75,000 per job, and "worker subsidies" can cost between $50,000 and $117,000. Like the film-related job costs analyzed above, both of these ranges are gross costs per job and do not account for the resulting tax receipts and reduction in other government spending resulting from the decrease in unemployment. Based on this comparison, we are confident in stating that the California Film & Television Tax Credit Program is highly cost-effective even when solely viewed as a job creation program.

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In conclusion, the UCLA-IRLE researchers found the LAEDC study to be reasonable. They were generally satisfied with the source data, methodology and analysis. The UCLA-IRLE researchers believe that the return on investment of the tax credit found by the LAEDC is likely about nine cents too high, but agreed that the 2009/10 tax credit allocation created approximately 19,038 full time equivalent jobs and likely generated a positive return of as much as $1.04 per every $1 in tax credits allocated.

33 Executive Office of the President Council of Economic Advisers, "Estimates of Job Creation from the American Recovery and Reinvestment Act of 2009," May 2009, http://www.whitehouse.gov/administration/eop/cea/Estimate-of-Job-Creation. (accessed January 18, 2012)
34 David Neumark, "How Can California Spur Job Creation?", *Public Policy Institute of California*, February 2011, http://www.ppic.org/content/pubs/report/R_211DNR.pdf. (accessed January 18, 2012)

Challenges with the Current Program

We found that the two greatest problems faced by film and TV producers who wish to locate their production in California are 1) restrictions on tax credits that forbid sales or transfers to third parties, and 2) the uncertainty caused by the $100 million cap on California's annual subsidy and the lottery system that allocates it. Both of these problems can and should be reformed.

Restricted Tax Credits

Under California's program, tax credits to film and television producers are nonrefundable (meaning that the state does not offer an option to buy them for cash) as well as nontransferable (meaning that private sales or transfers between parties are also not allowed). Indies, the exception to this rule, are allowed to sell their tax credits under the California program. This is critical because film and television projects with very small budgets commonly include tax credits as an important piece of their financing package, putting them up as collateral for the bank or sponsor providing the cash flow to shoot the film. According to CFC Director Lemisch, "if Indies weren't able to monetize their credits, many of them wouldn't be able to get made at all."[35] Recognizing this issue, California legislators made an exception for low budget Indies, allowing them to sell their credits to third parties. Under the current program, $10 million of the annual $100 million tax credit allocation in California is set aside for Indies. For everyone else in this program – making projects in the $10 million to $75 million budget range ($75 million being the maximum size that qualifies under California's program) – the tax credits are nontransferable, and this creates serious problems for mid-size filmmakers and even for some large studios. Among the 40 states offering film and TV tax credits, all of them (except California and Kansas) either offer a refundable tax credit or transferability, or both. Refundability and/or transferability is essential because a California-based filmmaker who shoots his film in a state such as North Carolina is very unlikely to have enough North Carolina state income tax liability (if any at all) to be able to monetize this incentive if he can't sell it for cash to someone who does.

California neither offers a refundable credit nor allows private transfers (except in the case of Indies) and this is a major problem for filmmakers and television producers. First of all, many small to medium-sized, privately owned filmmakers claim that they aren't profitable enough – and consequently don't have enough California state tax liability – to be able to even use the credit.

35 Amy Lemisch, via email on January 22, 2012

Secondly, many private production companies are set up as Limited Liability Companies, or LLCs, which pay no tax at the corporate level but rather "flow through" profits and losses to individual members. Apportioning such a tax credit among members is very difficult because some members may have California state tax liabilities while others may not. For example, with a typical mid-size film with a budget of $50 million, commonly $35 million would be below the line expenses. Such a film would qualify for a $7 million (20%) tax credit under California's program. According to one executive at a private, medium-size production company, such a credit would be "very difficult to use" because that $50 million film would have to make $150 million in profits (about half of which would be paid to the distributor), leaving approximately $75 million in profits for the studio, in order to generate $7 million in California state tax liabilities.[36] Such profits are extremely rare.

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Moreover, members who are unable to apply the full value of their portion of the credit towards their taxes will feel that they are being unfairly treated in comparison with other members who are able to use theirs immediately. "The big studios use this credit the best," said the CFO of a film production company organized as an LLC. "Big studios typically have lots of profits every year, plus they have affiliated companies which can use the credit" (the California program allows internal transfers between affiliated entities). "Disney, for instance, owns television and sports networks, distribution companies, theme parks, retail stores and lots of other properties. It can typically use up a credit like this, no problem. And, since it's a C-corporation which does pay tax, there isn't the problem with individual members that a smaller, private LLC has to contend with."

For many privately owned, medium-size filmmakers, the nonrefundability and nontransferability of California's tax credit makes it very uncompetitive with states that allow refunds or private sales. The nonrefundability and nontransferability of the California tax credit therefore creates an unintended disincentive to apply to the program at all, and it adversely affects up to 90% of those who apply (excluding the other 10% of credits set aside for Indies, which are transferable). How many producers disqualify California as a potential location for filming based on this issue alone is hard to know, but the number may be significant.

Why does California restrict transferability? One reason is that unused credits may stimulate further in-state production. Since many filmmakers may not have enough California state tax

36 For 2011, corporations were taxed at 8.84%, and the top individual marginal rate was 9.3%, with an extra 1% taxed to incomes above $1 million at 10.3%, according to the Franchise Tax Board's "2011 California Tax Rates and Exemptions" https://www.ftb.ca.gov/forms/2011_California_Tax_Rates_and_Exemptions.htm

liabilities to be able to apply the full value of a film's tax credit in one tax year, that filmmaker could be incentivized to make *more* films in California in the hope of generating more profits to eat up the unused portion of earlier credits. Furthermore, since only about one fifth of applicants are lucky enough to receive a credit by lottery each year under California's small program, that additional production would probably be unsubsidized. In this manner, the original nontransferable tax credit could be the impetus for a second or third film being shot in-state at no additional cost to the state's tax incentive program, making the return on the original credit much more productive.

Bad political optics is the other reason. Allocating a tax credit to the film industry, which then might end up being sold to Chevron or AIG, creates the impression that the credit is inadvertently going to subsidize a different industry than was intended. To a small degree, this would be true: if a filmmaker sells a $10 million credit at a 10% discount to Chevron, the filmmaker liquidates his credit for $9 million and Chevron realizes a $1 million tax discount. Restricting transferability protects state politicians from such negative perception.

The big studios seem to be the best equipped to monetize this tax credit because they generally have enough profits coming in from their affiliates to be able to apply it. But big studios mainly make big pictures – and big pictures are excluded from this program entirely.

On the whole, however, the nontransferability restriction creates far more problems than benefits. Currently, the tax credit works best for Indies which are allowed to sell or transfer it, but Indies provide a very small number of jobs and create a miniscule economic impact compared with larger filmmakers and big studios. Medium-size studios, which appear to have been the category originally most intended to benefit from this subsidy, have the most trouble using it because they aren't profitable enough and are often set up as LLCs or other flow-through entities with multiple members, making apportionment an administrative nightmare. For them, it's much easier just to select a state that offers a cash option. And lastly, the big studios seem to be the best equipped to monetize this tax credit because they generally have enough profits coming in from their affiliates to be able to apply it. But big studios mainly make big pictures – and big pictures are excluded from this program entirely.

Why create an incentive to encourage economic activity, and then put it in the form of a financial instrument that is difficult for the recipient to use? A more liquid market is always a better market, and this liquidity can be achieved by simply allowing inter-industry transfers between entertainment companies that qualify for this program. An approach to revising this restriction is discussed in the Recommendations section below.

Production Uncertainty

The other big problem with California's current program, as identified by most filmmakers and TV producers, is the uncertainty caused by the lottery selection process and the arbitrariness of the June 1 application deadline. Because the CFC has only $100 million in tax credit allocations but garners between $400 million and $500 million in applicants each year, it requires that all applications be completed and submitted by June 1, one month before the start of the state's new fiscal year on July 1. On July 1, the CFC conducts a random selection of applicants until the $100 million is completely allocated. In the current 2011/12 fiscal year, 38 projects were originally allocated tax credits, and approximately 150 were placed on the wait list, which meant that applicants had approximately a one in five chance of getting a tax credit to film in California. This uncertainty creates problems across the spectrum of producers. For Independent filmmakers such as Peter Safran, it costs too much money and is simply too risky to scout locations and prepare a film for a possible shoot in California, and then wait around for July 1 to find out if he's going to win the lottery. "We just go to Louisiana where we know we will get our tax credit regardless of when we are ready to shoot."[37] Andy Fraser, Vice-President of Physical and Post Production at Morgan Creek, says that it's a problem even for bigger producers. "The actors and directors want to know where the production is happening, and if you can't tell them, they get skittish. First you tell your Crew and Creatives that you've applied to California and it's your first choice, and people start thinking that you're going to be filming here and they make plans. Then you tell them, 'sorry, we didn't win the lottery so we're going to Georgia or Louisiana,' and it's a potential problem. In California, you have to put off that conversation and put everything on hold waiting for the results of the lottery on July 1. Everyone needs certainty, because everyone needs to make plans."[38]

Additionally, the single July 1 allocation date is unfair to any potential applicant whose project isn't fully developed by this point in the year. If a project is not developed enough to be able to meet all of the CFC's requirements by June 1, it cannot apply. If a project is sufficiently developed two months *after* July 1, the producers would have to put everything on hold for 10 months and wait until the following July for California's next round of allocations, which is impossible. "Right now we are only able to accept about one in five applicants to the program, but the real number of filmmakers and TV producers who want to film in California is actually many times higher," says CFC Director Amy Lemisch. "Everyone knows that we are completely out of tax credits on the first day of the fiscal year, and there is a huge waiting list, so many don't bother to apply after that."[39]

37 Peter Safran, via email on January 23, 2012
38 Andy Fraser, phone interview on December 14, 2011
39 Amy Lemisch, phone interview on September 14, 2011

The pool of applicants to California's program is therefore made up of projects that just *happen* to be far enough along in development one to two months before the June 1 application deadline. These projects will typically lob in an application to California's program, cross their fingers, and hope to win the lottery. But producers who don't hit this timing window just right – or need certainty and aren't willing to put their plans on hold in the hopes that they might be one of this year's lucky one in five – take their productions elsewhere.

Recommendations

The Headway Project recommends the following modifications to the current California Film & Television Tax Credit Program:

Increase the Size of the Annual Allocation from $100 million to $200 Million

At $100 million per year, California's program is uncompetitive with locations such as New York, Louisiana and Canada that offer $400 million to $500 million per year in subsidies, have no caps and/or offer much higher percentages. While the immediate financial benefit to California may only be $1.04 on each dollar of tax credit allocated, the program does not currently appear to be costing the state any money, nor is it creating a cash flow squeeze since the film and television producers must make their projects in California – thereby creating jobs and tax revenues – well before they are allowed to monetize their credits. In addition, the credit is creating approximately 9,500 high-quality jobs per year.[40] The credit program should allocate $100 million as it does under the current guidelines, with 10% set aside for Independent films and television shows, and an additional $100 million to productions with budgets larger than $75 million, but at a lower percentage credit. Furthermore, half of each credit should be allocated on July 1 at the beginning of the new fiscal year, and the other half should be allocated on January 1, making the program available to those film and TV producers whose projects were not sufficiently developed to make the July 1 allocation.

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Allow Films and TV Shows with Budgets in Excess of $75 Million to Participate at a 12% Credit

Currently, because the annual tax allocations are capped at $100 million, all productions with qualifying expenses in excess of $75 million are excluded from applying. These are the largest and most beneficial projects, often spending $100 million to $200 million per film and employing thousands of workers per project. Today, the majority of these "tent pole" productions leave California for states that, like Louisiana, have no cap on their subsidies. In our interviews, almost all filmmakers (Independents, mid-size and large studios) expressed a preference for filming in California and also admitted that the value of tax credits offered by states such as Louisiana is often significantly reduced by the

40 The 19,038 FTEs cited above represents the onetime double allocation of $200 million for the 2009/10 fiscal year.

cost of relocation. Says Indie Producer Peter Safran, “Louisiana’s 30% really ends up being 20% after relocation and broker costs.”[41] According to Charles Newirth, currently producing *Iron Man 3* in North Carolina, he will have to import “a significant amount” of the crew required to make this film, which will considerably diminish the value of the 25% credit he is getting from North Carolina.[42] The opportunity to stay and work in California; the convenience for actors, directors and producers; the access to California’s superior industry infrastructure; and the time saved by not relocating could well encourage many large productions to stay in state, even at a 12% credit level.

In its report, the LAEDC considered the hypothetical economic impact that a $175 million film would have if such a film were allowed to participate in the California program, but with a $75 million cap on qualifying expenditures. In examining an actual $175 million film budget, the LAEDC found only 51% of the expenditures to be qualifying, below the line expenses. Assuming a 20% credit and a cap at $75 million of qualifying expenditures, the LAEDC found a whopping $1.78 in tax revenues for every $1 of tax credit allocation. The high return to the state is mainly because of the large percentage of above the line expenditures the state would benefit from with no subsidy,

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as well as the benefit of any below the line expenditures beyond the $75 million cap. We did not personally examine this budget, but we agree that the economic return on investment to the state from allowing large productions to participate in the program – either at a reduced credit rate of 12% or by establishing a credit cap as modeled by the LAEDC – would significantly boost the return on investment currently being generated by California’s program.

Allow Credits to be Transferrable Within the Entertainment Industry

As discussed above, the current nontransferability restriction creates unintended negative consequences for private production companies, especially LLCs. Legislators should amend the current program to allow tax credits to be sold or transferred privately only to California-based film and television producers. This keeps the tax credits entirely within the intended industry and removes the incentive for filmmakers to go out of state in pursuit of a cash option that California doesn’t offer. Recipients of the tax credit will benefit from the flexibility, and the unnecessary

41 Peter Safran, via email on January 23, 2012
42 Charles Newirth, phone interview on November 29, 2011

accounting burden will be removed. The guidelines for a "permitted transfer" of a tax credit can easily be defined by the California Film Commission, and any transfer should be subject to the approval of the Film Commissioner. Additionally, California legislators may consider offering a refundable tax credit option at a significant discount, perhaps 80 cents on the dollar, which would not be redeemable until March 15 of the first year in which the tax credit could be applied. In this way, a cash option would not create a cash flow imbalance for the state and, if redeemed at only 80%, would also significantly enhance the current economic return to the state.

Allow the Film Commissioner Discretion Over "Anti-California" Projects

It is clear that when movies such as *Sideways* and television series such as *Entourage* portray California as an attractive place to visit, there is an increase in tourism revenues. Despite that, we do not recommend that the California Film Commissioner be given any discretion to allocate credits based upon content that she may deem supportive of the California tourism business. We *do* recommend, however, that the Commissioner be given discretion to deny or withdraw a credit from a film or television project which specifically portrays California as an unattractive location. Such guidelines are not uncommon in other states. Texas's program contains such jeopardy,[43] and New Jersey Governor Chris Christie recently pulled his state's tax credit from the reality TV show *Jersey Shore* because of its unflattering portrayal of his state.[44] We do not believe that the California Film Commissioner should get involved in content in general, but we do believe that any project which, in the Commissioner's discretion, heavily denigrates California's image and damages its tourism economy ought not to be subsidized by its taxpayers.

Commission a New, Bipartisan Study

It is unlikely that there will be any extension or significant expansion of this program until both opponents and supporters can agree on the performance data. Currently, supporters can rely only upon the LAEDC report, which was commissioned by the MPAA. On the other side, opponents fall back on other states' negative performance data, which are not applicable to California. With supporters claiming enhanced employment at no cost to the state and opponents claiming that the program is a "total waste" – and no set of data that both parties can agree on – this debate is stalled. The Headway Project recommends the creation of a bipartisan panel of seven individuals composed of legislators who both support and oppose the program, as well as industry experts and public policy analysts, which might be constituted as follows: one supportive and one opposed state legislator, one representative from the MPAA, one small Independent filmmaker, one representative from

43 Entertainment Partners, *The Essential Guide to U.S. & International Production Incentives, 2011 1st edition*
44 Jarrett Renshaw, "Gov. Christie vetoes 'Jersey Shore' tax credit," September 26, 2011, http://www.nj.com/news/index.ssf/2011/09/gov_christie_vetoes_jersey_sho.html. (accessed January 22, 2012)

the California Budget Project, one representative from the Legislative Analyst's Office, plus the California Film Commissioner. Together, this panel should hire a reputable, objective public policy research organization and meet together to discuss their goals and concerns. After that, the researchers would proceed with their study and both supporters and opponents would agree to live with the results of the study.

We spoke to several economics think tanks and estimate that such a study would likely take six months and cost approximately $250,000 – a pittance in comparison to the $100 million per year that the state is currently allocating in tax credits. We do not feel that there is likely to be much progress on this issue until there is some set of performance data upon which both supporters and opponents can agree.

Report Conclusion

The film and television business is as native and important to California as energy is to Texas or citrus is to Florida. It is a precious, local industry that, over the course of the last century, was invented and largely developed in California, and is an industry of which all Californians should be justifiably proud. It is, furthermore, a powerful driver of tourism to the state, and it is one of the few remaining important American industries that adds positively to our international trade balance, since we export far more entertainment to other countries than we import. In short, the Hollywood industry is one that legislators and policymakers in California should zealously protect.

But for the last 20 years, much of the production spend – more than half of the revenue that this industry represents – has happened outside of California as the result of tax credits and other incentives. In 2009, the California Legislature finally responded to film flight and enacted its own small program, but this program now needs to be expanded as well as refined to make it effective enough to bring that production work back in-state.

Admittedly, this topic is a "net zero" issue regarding the high unemployment problem in America writ large; this study does not focus on increasing employment generally, but rather only considers the phenomenon of jobs being transferred from one state to another as a result of interstate competition using tax credits. It is also a "race to the bottom," as many think tanks and public policy firms critical of such subsidies have pointed out. States desperate for employment have engaged in a war of attrition with each other, offering ever more aggressive incentives that only enrich the Hollywood studios. The problem with this criticism is that, while it may be true, it doesn't change anything. California cannot simply throw up its arms and allow an important local industry to leave the state completely. And these other states and countries are not likely to reverse their strategies or give up on their programs anytime soon. In 2002, five states in America offered film and television tax incentives. Today, there are 40 states (plus Puerto Rico) offering them, plus many foreign countries. There remains a *very strong* correlation between tax incentives and where producers locate production. California must continue with its own tax subsidy program, and it must become more aggressive about recapturing the disproportionate amount of production business that is still fleeing the state.

Having interviewed dozens of legislators, filmmakers, television producers, labor leaders, tax credit attorneys, accountants and tax credit program administrators, we have found that the issue is less partisan and political than it sometimes seems to stakeholders. The most extreme opponents of this tax credit describe it as a scheme to enhance the fortunes of rich studio heads and celebrities at the expense of the state's educational system and other key priorities. This is not true. California's program is designed to subsidize only below the line spending – where most of the unionized jobs and small businesses are – and specifically excludes credits for producers, directors, screenwriters and actors. The most extreme supporters claim that opponents are out to kill this program because it represents more jobs to Southern California than it does to their Central and Northern districts. This is also not true. Even though the entertainment business is largely clustered in and around Los Angeles, every legislator we spoke to appreciates the importance of the entertainment industry and seems determined to keep it in California, if a way can be found to do so at a reasonable expense and without sacrifice to the state's education program or other essential services. We feel that a new study of California's Film & Television Tax Credit Program – commissioned by a bipartisan panel that includes the supervision of the Legislative Analyst's Office – is necessary to provide the data that will bring lawmakers together and allow them to amend the current subsidy into the most effective and productive program that it can be.

Furthermore, since California's program will be one year older than it was when the LAEDC conducted its study in 2010/11, researchers will have the benefit of the 2011/12 wait list results. Analyzing where applicants to California's program ended up going to make their films or television shows – when they were unable to get a credit from California – is probably the most objective and valuable data to consider on this topic.

The question of the tipping point – the point at which filmmakers and television producers will no longer consider California as having any real advantages over other locations – is hard to forecast scientifically, but clearly it is not far away. Most large films are now already being produced outside of California. And the problem is even worse for medium-budget filmmakers and larger Indies, for whom shooting outside of California is more the norm than the exception. "For Hollywood's biggest producers today," says one longtime industry executive, "most of them are old enough to remember when shooting outside of California was unusual. Now that's completely changed. For the young filmmakers coming up in the industry right now, as far as they are concerned, you develop your project here but you take your production outside of California and shoot it somewhere else. It's all they've ever known."