

ARIZONA MOTION PICTURE TAX INCENTIVE PROGRAM
RESEARCH & RECOMMENDATIONS FOR 2009 LEGISLATION

A SYNOPSIS

By

Lorna Soroko

&

Tucson Film Office

a division of the Metro Tucson Convention & Visitors Bureau

Date: October 27, 2008

CONTENTS

- I. Introduction
- II. Recommendations
- III. Conclusion
- IV. List of Interviews

I. INTRODUCTION

The 2009 Legislative session will be a critical time for the Arizona Motion Picture Production Tax Incentive Program. We know that the program as currently drafted has certain flaws, and those flaws have rendered the program less effective than expected or intended. Those who oppose the program might point to these problems and argue that the program should be cut entirely. This would be a real mistake and would result in a significant economic loss to the state, because, in fact, the AZMOPIC program is very close to becoming the successful and competitive motion picture and television incentive program that it was meant to be.

The key lies in pinpointing the most important changes that should be fought for in this upcoming 2009 legislative session, the changes that will make the Arizona incentive truly competitive with several other states like Louisiana, New York and New Mexico, all of which are all experiencing tremendous success with their motion picture incentive programs.

This synopsis summarizes the results of research that investigated the AZMOPIC program from a number of points of view. Interviews were done with several film industry executives in Los Angeles, a number of Arizona stakeholders and with administrators of the program at the Arizona Department of Commerce. Their names, titles and affiliations are attached. Most readily told us what they thought needed to be changed and/or improved. The film industry executives were particularly clear about why they are currently not choosing Arizona as the location for their motion picture or television production.

Following are the recommendations for the AZMOPIC program that came out of the interview feedback. Some improvements are more critical than others in terms of increasing Arizona's potential to become more competitive, so we attempted to place the recommendations that might make the most difference ahead of others. The challenge now is to determine which areas to address at the 2009 legislative session and which ones do we address at a later date. All of the recommendations are intended to make the Arizona Motion Picture Production Tax Incentive Program one of the most competitive, successful and sustainable programs in the country.

II. RECOMMENDATIONS

1. Remove 50% Full-time Employee Residency Qualification: The strong perception from film industry executives is that Arizona does not have enough of an experienced crew base to satisfy this requirement. This perception in itself is enough to stop them from bringing their production here; hence, the 50% qualification is functioning as a strong disincentive for filming here.

It is important to note that there is a strong incentive for production companies to hire as many locals as possible already built into the AZMOPIC program. *Local crew wages count toward the production company's Arizona production spend.* Also, production companies would rather hire local crew whenever possible in order to avoid paying costly travel and per diem expenses.

Once there is more production going on in the state and more locals gain experience, Arizona's crew base will naturally deepen. It will deepen even further when there is steady work here because former Arizona crew who have moved to New Mexico to work in recent years will return. And if the industry booms here, many out of state crew persons will begin to establish residency here as has happened in other states with successful incentive programs.

The industry consensus is that it would be optimal to remove any residency requirement for the next three years. If it looks like the legislature will insist on some kind of residency threshold, the state could go to a 25% residency requirement for the next two years, increasing by 5% each year after that, up to a limit of 50%. Another idea is that the state could offer a bonus incentive to the production companies if they do hire 50% Full time Employee residents.

While considering this provision, it was noted by a number of interviewees that the current DOC computation of the percentage of residents needs to be more easily applied, probably using days of production rather than hours per day for the computation.

Also, a provision should be added to allow the DOC to waive the residency threshold in certain special circumstances, e.g., if there are several films in production in the state and the crew base is depleted, or if a film needs crew trained for a very specific type of shoot, etc.

Also, if a production falls below the residency requirement in the final computation by a minimal amount, the entire incentive should not be disallowed; there could be some kind of penalty. At present, it is a significant deterrent to filming in Arizona if a dip below the residency percentage results in completely disqualifying the production from receiving the tax credits.

- a) Non-resident salaries for expenditure calculation: *The salaries of non-resident crew who are paying Arizona taxes are not currently included in either the qualification percentage or in the total expenditures of the production for purposes of calculating the tax*

credit amount. It was suggested by the industry that salaries of nonresident crew who are paying Arizona taxes should be considered to be Arizona expenditures for calculation of monies spent in the state. Local loan-out companies can be used as the employer. (See Georgia)

- b) On-the-job training subsidies and workforce development: To develop a sustainable industry, Arizona could develop and implement an apprentice on-the-job training program state wide to deepen their crew base. Some states, like New Mexico, pay a portion (up to 50%) of the salary of people training in certain crew positions.
2. Sunset clause: The first two years of the AZ MOPIC tax credit program were not representative of the intention of the program. Problems in the bill resulted in credit hoarding and projects not starting production etc. Because of this, the AZ MOPIC program has really only begun functioning in a manner closer to its intent in 2008. If the current sunset clause of 2010 is left in place, the legislative review will be premature, and such a review would not supply accurate information about the potential economic impact of the incentives. Accordingly, the sunset date needs to be extended out. For example, extending it to 2015 would give the program more time to actually demonstrate what its impact can and will be prior to a review.

Also, in terms of infrastructure, an extension of the sunset clause is critical because of the time necessary to develop and complete a major construction project. Investment in infrastructure will freeze if investors believe that tax incentives will be disappearing within a couple of years.

Finally, the review process for the sunset should be clearly delineated ahead of time, with the criteria fully described, so that the process is more of a review than a sunset. Perhaps other tax incentive plans with sunset clauses have already formulated ways to structure reviews so that preparation and predictability are possible. It would be advisable to study the state's review process in other similar provisions, and then to research the possibility of legislating the parameters of the review that will determine the bill's chance of renewal.

3. Application Rollover provision/Annual Cap: While it would be clearly advantageous to remove the annual cap, this will not be possible legislatively in the current financial climate. However, a way to keep a cap and rectify the array of resulting problems is to have a rollover system similar to the state of New York's Film Tax Credit Program where any application in a year with no remaining fund money is rolled into the next year that still has available funds, without a need to wait until that year for actual funding of the project. The projects are rolled into future years until theoretically the sunset year has been reached. A rollover system would be an advantageous change for Arizona, especially if the sunset is extended.

The rollover provision allows production companies access to the incentives in the future with the ability to produce in a year when the AZMOPIC program cap has already been fully allocated. It offers them predictability and certainty in preparing budgets. It also removes stumbling blocks that Television Series have with the current AZMOPIC program (See paragraph 5 below).

The rollover provision would allow Arizona to increase production volume dramatically without disturbing the current budget, and it would lessen DOC administrative issues around having to aggressively monitor and police the cap (i.e. the 90 Days for Pre-approval periods, Applicant Readiness, etc). *(However, we would need to discuss the risk of repercussions in the legislature)*. If we were to propose this change, we would need to do quite a bit of research to back up its effectiveness in other states where the rollover is done. New York, New Jersey and Pennsylvania are all states with rollover provisions.

4. Television Series: There are some significant stumbling blocks in the Arizona legislation in connection with television series.

The first issue is that if a pilot or initial season of a series is shot in Arizona, the production company has no idea if they will continue to receive the tax credit for future seasons of the series that are shot in Arizona, a situation that is completely unacceptable to most production entities. Choosing Arizona is just too risky for most series producers.

To help rectify this problem, every production entity that a) shoots a pilot or a season of a television series in Arizona and b) receives tax credits, needs to know that they will continue to receive the Arizona tax credits in subsequent seasons if the series is renewed.

To accommodate the structure of the Arizona program, a recommendation is that continuing series productions should be automatically put at the head of the applicant line in terms of the capped tax credit fund in subsequent years of the series. A provision should be added to the bill allowing a continuing series to do this in order to continue receiving the credit incentive on each season of shooting.

The other approach to this is to have a rollover plan that rolls applicants into future years when an existing year's fund has been allocated, such as New York. See paragraph 3 above.

5. Post-approval process and limited managed audit:

a) Every industry representative interviewed said that the tax credit funds must be available within a reasonable amount of time after completion of photography and the submission of post-approval documentation. The time periods varied between six months and one year.

There need to be regulated and limited time periods for the government agencies who review the completion material - to review the post docs, do the audit and issue the final certificates.

b) Limited Managed Audit: The Arizona bill was improved by the legislative addition of a limited managed audit so that tax credits can be deemed to be not subject to recapture. However, in practice, the limited managed audit has not been working efficiently for applicants or for the state. In many cases, there is a DOC audit, then the applicant finances an audit by an independent auditor, and then DOR does another audit. All of this is time-consuming, expensive, and clearly gives the impression that the state has a high level of distrust in the applicant, even to the extent of distrusting its independent CPA.

These problems can be resolved by various approaches that should be discussed with, and analyzed by, accounting experts before selecting an approach to take with the legislature. One possible method would be to institute a uniform agreed-upon audit procedure that must be accepted by all concerned (possibly with some opportunity for appeal) to condense the process; another would be to change the process so that there are only two audits, possibly at the same time, conducted within specified time limits. In any event, the applicants need to know exactly how long the DOR has to issue audit approval or to challenge the audit.

6. Obscenity Provision: The Arizona obscenity statute is quite restrictive and most industry producers cite this as a significant concern – in some cases an absolute deal-breaker -- unless they produce network television (which already has Standards and Practices restrictions), or Disney (non-Miramax) movies. However, whether to raise this issue at this time is a big question. If it is decided that the obscenity provision for the purposes of eligibility in this program needs to be amended in the current session, we might suggest use of the Federal definition of obscenity. This definition would make the provision less broad in its reach. (The Federal obscenity definition seems to be the one most used by other programs, *but we should check on that.*)

The other issue is when the obscenity determination is made. In the past, the determination apparently was made by the DOC during both the pre-approval and post-approval process. This procedure was changed and now the obscenity determination is made by the DOC only during the post-approval process. Several industry people said that they need to know one way or the other at the very beginning of the process, because they clearly would not elect to shoot in Arizona if there was any chance that their project might be deemed to be obscene and thus ineligible for the tax credit. Also the way that the definition of obscenity is currently written, it is not possible for a filmmaker to know with any certainty whether certain scenes would be considered obscene or not under the Arizona law.

Finally, there needs to be an appeal process for the DOC's obscenity determination. Currently (as I understand it), two DOC employees review the

project for eligibility under the obscenity statute, with a secondary review committee of higher-up DOC employees if there is an internal concern. That determination appears to be final. An appeal process should be created that would bring in a non-governmental entity, possibly a private attorney who is familiar with the language of the obscenity law and the related case law, to make a final determination in the event of a determination of ineligibility due to obscenity and a subsequent appeal by the applicant (*But again, we need to consider whether we want to open this subject in this session*).

7. Applicant Readiness: Some applicants are using the tax credit as seed money and a springboard to raise their project's financing, which is not in any way the intent of the program. Discussion should be had about including in the pre-approval application a requirement for applicants to demonstrate that at least a specified percentage, e.g., 75%, of the project's financing is in place, (without requiring financial details that an applicant might consider to be private.) This would weed out many of the less serious projects and would likely free up DOC time as there would be fewer projects falling out of line (and immediately reapplying) due to an inability to commence production.

If there were a rollover plan that rolls applicants into future years when an existing year's fund has been allocated, such as New York, this would not be as big an issue. See paragraph 3 above.

8. Infrastructure: This study has not gone deeply into the challenges of implementing the infrastructure provisions. However, it does seem apparent that early credit release needs to be added to the law due to the timing and financing demands of construction. Also, if the bill is being interpreted as being available to only one possible applicant to the exclusion of all others, then modifications must be made in the language in this session to address that problem. Of course, there needs to be a way to keep a cap on the percentage of the fund that can be used for infrastructure tax credits.
9. Overages: Again, this might be one we want to put on the backburner, but several industry people felt that they should not be held to the original estimate of expenses if they spend more money in Arizona than originally planned and if there is non-allocated money in the tax credit fund. Supporters of a change in approach to real expenses, not estimated expenses, say that that higher final amount of expenses should be used for determining the credit. The related issue is if a company needs to do some re-shoots, there should be a way that those expenses can be added on if there is money in the fund.

The study came up with other issues that may be considered down the line. Here are a few of those:

10. List of applicants, status, and fund availability available and current: In the last session, the DOC agreed to publish applicant information once annually. Stakeholders said that they have not seen this list and it was often mentioned that it would be helpful to know who is in line, who has been awarded credits,

etc. This isn't an issue to tackle in this session, however, DOC should be encouraged to post on-line at least a completed annual listing in a timely way.

11. Add reality show: Reality shows are not specifically excluded from the bill, but any show with an awarded prize is excluded. It might be worth carving out reality shows as an allowable production even though there is usually a prize awarded.

III. CONCLUSION

CERTAINTY EASE TIMELINESS

Our goal in this legislative session needs to focus on those words. The film industry has to somehow turn around one hundred and eighty degrees in its perception that the Arizona incentive is none of those things – they believe that it’s not certain, it’s not easy, and it’s not timely. And they are pretty much right.

So, any changes we try to get passed need to keep those goals in mind.

It’s going to be a delicate balancing act to convey the urgency of the changes we propose and to communicate that the incentive appears to be nearly worthless to most industry players without those changes. On the other hand, we certainly don’t want the legislature to think about doing away with the bill since it’s not working well. Instead, we need to convey how just a few tweaks will make the program significantly more effective.

As part of this process, it’s imperative that we have an economic impact study done. Only when we are armed with multipliers showing the dramatic economic impact of production will this group of lawmakers really take the program (and the necessary changes) seriously.

Somehow, during this legislative season, we need to forge more sympathetic bonds with the administering agencies, to help create an overall shift in the state’s approach to production applicants. The current prevailing perception in Los Angeles is that the state of Arizona is adversarial to tax credit applicants, and that agency interactions are designed to deny them the credits, not to attract and facilitate production. (Part of this problem may be the result of overworked staff who have lots of other duties, little direct experience in the film business and the fact that the program itself is only 3 years old.)

As we select the issues to fight for, and as we devise strategies, it is most important that we all try to keep the ultimate goal in mind -- which is, to attract more film and television production to Arizona. If we work together in an intelligent and focused way, the goal is clearly within our reach.

IV. INTERVIEWS

Arizona Interviews:

- a. Patty Duff - Director, Business, Finance and Development Division, Arizona Department of Commerce & Vanessa Gonzalez, Arizona Department of Commerce Director of Legislative Affairs
- b. Harry Tate - Director, Arizona Film Office - Arizona Department of Commerce
- c. Philip Bradstock - Program Manager, Phoenix Film Office
- d. Noel Paynter – President, Arizona Production Capital & current AFMC President
- e. Randy Murray - Arizona Filmmaker, Randy Murray Productions
- f. Theresa Murray - Arizona Filmmaker/Bookkeeper, Randy Murray Productions
- g. Mike McGinn - Infrastructure Development, Arizona Location Scout, previous AFMC President
- h. Brad Yonover - DDB Ventures, LLC, Principal

California Interviews:

- i. HBO: Jay Roewe, Senior Vice President of Production, and Ginny Nugent, Vice President of Production
- j. Twentieth Century Fox Television: Jim Sharp, Executive Vice President of Production, Craig Hill, Senior Vice President of Production, and Nissa Diedrich, Vice President of Production
- k. Disney/ABC: Mary Ann Hughes, Vice President of Film Production Planning
- l. NBC/Universal: Mark Binke, Senior Vice President of Production
- m. Warner Bros: Michael Walbrecht, Vice President of Studio and Production Affairs, and Robert Fisher, Executive Vice President of Financial Investments
- n. Lionsgate: Gary Goodman, Executive Vice President of Production
- o. Allan Kassirer, Entertainment lawyer in Los Angeles and a principal of International Studio Group
- p. Ronnie Clemmer, Independent Producer