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BILL ANALYSIS

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Senate Bill 1168 (Substitute S-1 as reported)
Sponsor: Senator Roger Kahn, M.D.
Committee: Commerce and Tourism

CONTENT

The bill would amend the Michigan Business Tax (MBT) Act to do the following:

-- Allow the Michigan Film Office, with the State Treasurer's concurrence, to enter into an agreement with an eligible production company granting it an MBT or income tax credit.
-- Require the production company to meet certain criteria, including the investment of at least $50,000 in Michigan for development and production costs, in order to qualify for the credit.
-- Provide for the credit to equal 42% of direct production expenditures for a State-certified qualified production in a core community, and 40% of expenditures elsewhere, and 30% for qualified personnel expenditures, excluding expenditures for which the taxpayer claimed an MBT credit for job training expenditures.
-- If a credit exceeded the taxpayer's tax liability, require the excess to be refunded.
-- Require a production company to apply to the Film Office and pay an application fee.
-- Specify provisions that an agreement between the Film Office and a production company would have to contain.
-- Require the Film Office and the State Treasurer to consider various factors in deciding whether to enter into an agreement.
-- If a production company had complied with its agreement, require the Film Office to issue a postproduction certificate, which the company would have to submit to the Department of Treasury.
-- Require the credit to be reduced by an application and redemption fee equal to 0.5% of the credit.
-- Provide that a taxpayer that knowingly and willfully submitted false or fraudulent information would be liable for a civil penalty equal to the amount of the credit.
-- Require fee revenue and penalties to be deposited into a proposed Michigan Film Production Fund.
-- Require the Film Office to report annually to the Governor, the president of the Michigan Strategic Fund, and legislative committees on the operation and effectiveness of the credit.

(The income tax credit could be claimed under Section 367 of the Income Tax Act, which is proposed by Senate Bill 1171.)

Proposed MCL 208.1455 Legislative Analyst: Patrick Affholter

FISCAL IMPACT

Senate Bills 1168 (S-1) and 1171 would decrease State revenue, mostly to the General Fund, by an unknown and potentially significant amount, depending on the expenses

affected and the number of agreements the State entered into. While not tie-barred to other bills affecting similar taxpayers or to each other, the bills would exclude certain expenditures eligible for credits under the other bills. Generally, taxpayers would be assumed to pursue the combination of credits and expenditures that would minimize their total tax liability. The circumstances affecting that combination are likely to vary from taxpayer to taxpayer. However, the effective credit rate for affected expenditures would be 40%-100% under Senate Bills 1168 (S-1) and 1171, suggesting that for such expenditures, the bills' provisions would be used over those in some of the other related bills, where the effective credit rate is generally less. However, in some cases, the other credits would be refundable while, at least in the case of Senate Bill (SB) 1171, credits would not be refundable. Thus, a taxpayer could choose to pursue a refundable credit even if it faced a lower effective rate.

The bills would increase the responsibilities of the Michigan Film Office by requiring that the Office administer the proposed Michigan Business Tax Act credit for film production and to produce an annual report concerning the operation and effectiveness of the credit. The additional expenses would be offset partially by the application fee required by the bills.

The appropriation for FY 2007-08 for the Film Office is $180,300 GF/GP to support the 1.0 FTE and one part–time student on staff. In addition, the legislation creating the 21st Century Jobs Trust Fund package that was enacted in 2005, contained a $2.0 million earmark for the Office. These funds were placed into a work project account and are available to be carried forward until FY 2009-10. The balance of this account as of January 31, 2008, was $1.9 million.

A detailed analysis of the bills' impact on tax revenue follows.

Senate Bill 1168 (S-1) proposes a credit for production expenses. The bill would not allow the same expenses to qualify for credits under SB 1171, as well as under several other related bills. The expenses used to generate credits under SB 1168 (S-1) and SB 1171 also could generate credits under the existing MBT provisions, such as the compensation credit and the investment tax credit. The credit under Senate Bill 1168 (S-1) would be refundable, and would be applied after all other credits. In addition, the bill does not distinguish between funding sources. Other bills would allow the Michigan Film Promotion Fund to loan up to two-thirds of a film's predicted expenses (subject to a limit of 80% of the value of any predicted credits). Expenses funded by the loans also could generate credits under SB 1168 (S-1).

According to data from the Michigan Film Office, eight movies have been filmed in Michigan in the last two years. If all eight films had applied for the credit proposed in the bill in the same year, the bill would have increased revenue by $800. The State also would have received 0.5% of credits claimed as a "credit redemption fee". Revenue from both the credit application fee and the credit redemption fee would be deposited in the Michigan Film Promotion Fund.

Expenditures that would qualify for the credit would reflect only activity related to Michigan, although all compensation expenditures (subject to a limit of $2.0 million per employee) would qualify if any of an employee's activity occurred in the State. (Thus, a full $2.0 million would be eligible to count for the credit for an employee who received $2.0 million but performed only 1% of his or her services in Michigan.) Compensation costs often average approximately 50% of a film's production costs. The production costs of recent films filmed at least in part in Michigan varied significantly, ranging from $125 million for *The Island* and $150 million for *Transformers* to $4 million for *Bowling for Columbine* and $6.5 million for *Narc*. Smaller films also are produced in the State. Under the assumption that 100% of a movie's expenses occurred in Michigan, and based on the income generated to date from the movie, if the bill had been effective during these films' production, it would

have reduced General Fund revenue from the MBT by at least $47.0 million for *Transformers* and $41.6 million for *The Island*, but only $0.3 million for *Bowling for Columbine* and $2.1 million for *Narc*. These impacts reflect additional income and sales tax revenue resulting from the expenditures related to the film. To the extent that any expenses claimed for credits were funded by loans provided under the other bills, the net revenue loss would be reduced.

A significant factor in evaluating the impact on the MBT depends on whether the taxpayer retains nexus with Michigan after the production phase of the movie is finished. Films generally incur expenses during production, while net income and gross receipts that would be taxable under the MBT Act are received later. The bill would allow a taxpayer to generate refundable credits for production expenses, when the taxpayer would have nexus in Michigan. However, in later tax years if the taxpayer no longer had nexus with Michigan, any income or gross receipts generated by the film would not be taxable under the MBT Act. As a result, particularly for high-budget films that generate significant profits, losses from the credits would not necessarily be offset by MBT revenue in later years. For example, the revenue loss from *Transformers* would increase $3.2 million and the loss from *Bowling for Columbine* would increase $1.1 million if the companies were not liable for MBT revenue in subsequent income-earning years.

Many of the expenditures also would generate tax revenue outside of the MBT. Compensation would generate income tax revenue, although to the extent that the withholding accurately reflected the ultimate income tax liabilities of employees, the credit essentially would equal any increased liability. It is unknown what portion of both the wages and any noncompensation costs would be spent on items subject to the sales tax, but under the assumption that 40% of the wages would be spent on taxable items and that 100% of the noncompensation costs were subject to either sales or use taxes, the expenditures would generate additional revenue to offset the costs of the MBT credit. However, generally, it is not likely that the costs would fully offset any credits. Using the examples for the four movies and assumptions previously described, *Transformers* would have generated $6.3 million in sales and use tax revenue, compared with $5.3 million for *The Island*, $0.3 million for *Narc*, and $0.2 million for *Bowling for Columbine*. As a result, the net impact on State tax revenue still would be negative.

<u>Senate Bill 1171</u> likely would not have a significant impact on State revenue if both bills were enacted, given the provisions of SB 1168 (S-1). Senate Bill 1171 would allow a refundable 40% credit on 100% of wages compared to a 100% nonrefundable credit on at most 4.35% of wages. Taxpayers subject to the individual income tax with their business activity also would be subject to the MBT, so there would likely be no circumstances of a firm being unable to use the credit under SB 1168 (S-1). Unlike the credit in SB 1168 (S-1), the income tax credit would not be refundable, could not be carried forward, and would not be transferable. As a result, the credit in SB 1168 (S-1) would be preferable to the credit in the bill.

If SB 1171 were enacted and SB 1168 (S-1) were not, SB 1171 would be expected to reduce State revenue only to the extent that the production company faced taxation under the individual income tax, which essentially would require taxpayers to be organized as a pass-through entity such as a partnership, sole proprietorship, or S-corporation. Assuming taxpayers were so organized, using the four examples cited above, the bill would reduce individual income tax revenue by approximately $3.3 million in the case of *Transformers*, $2.7 million for *The Island*, $0.1 million for both *Narc* and *Bowling for Columbine*.

<u>Combined Impacts and Incentives</u>: The provisions of both bills interact with each other and with several other proposed bills affecting the film industry. As a result, when combined with the other related bills, SB 1168 (S-1) and SB 1171 have the capacity to offset the costs of a film production substantially. Without accounting for the effects of any proposed

Michigan Economic Growth Authority credits or job training credits, infrastructure investment credits, reduced production costs associated with the free use of public facilities for filming, expenditures funded by loans from the State, or tax preferences for reinvestment of gains, the credits under the bills generally would lower costs for film production during the tax year production occurred by approximately 36%. In future years a portion of those costs could be offset by additional tax revenue, assuming the taxpayer maintained nexus with Michigan and the film was ultimately profitable. Films with lower-production costs that were financially successful would reduce the offset the most. For example, under the assumptions listed earlier, for movies like *Bowling for Columbine* and *American Pie 2,* the reduction in costs attributable to the bills would be lowered to about 29%, compared with large-budget movies that were not particularly successful, such as *The Island* and *Dreamgirls*, where virtually no offset would occur. The timing of any future revenue associated with the package is also unknown, aside from the issue regarding nexus: Some films take years to generate profits while others may generate them in a relatively short period of time.

An important caveat on the example figures shown above relates to the multistate nature of film production. Many movies are filmed in multiple locations and thus only a portion of the activity would be apportioned to Michigan. The examples above assumed the films' production occurred entirely within Michigan. If only 1% of the production costs occurred in Michigan, then the figures would be much smaller—generally 1% of the impacts listed in the examples. In the case of some of the listed films, it is unclear if Michigan activity represented even 1% of the film's production costs, while for a film such as *8 Mile*, a majority of the $40 million of production costs would have been incurred in Michigan.

Films that have a greater presence in Michigan will generate more activity in the State economy than films with less of a presence. The offset to a film's production costs that would be created under the bills would likely provide a significant incentive for films to increase the amount of activity within Michigan. A large budget film such as *Transformers* would generate substantial activity were it entirely produced in Michigan. However, while the economic activity generated would be substantial, the fiscal impact of the bills is such that the tax revenue generated from the additional activity would be unlikely to offset completely, or in some cases, even offset significantly, the cost of the proposed credits and deductions, even over the long run.

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