




Senate Fiscal Agency  
P. O. Box 30036  
Lansing, Michigan 48909-7536


 BILL ANALYSIS

Telephone: (517) 373-5383  
Fax: (517) 373-1986  
TDD: (517) 373-0543

House Bill 5841 (Substitute H-1 as passed by the House)

*(as enacted)*

House Bill 5844 (as passed by the House)

*(as enacted)*

Sponsor: Representative Andy Meisner (H.B. 5841)

Representative Bert Johnson (H.B. 5844)

House Committee: Commerce

Senate Committee: Commerce and Tourism

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### **CONTENT**

**House Bills 5841 (H-1) and 5844 would amend the Michigan Business Tax (MBT) Act and the Income Tax Act, respectively, to allow an eligible production company to claim a credit against the tax imposed by either Act.**

**House Bill 5841 (H-1) would 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, 40% of those 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 Michigan 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 (MSF), and legislative committees on the operation and effectiveness of the credit.

**House Bill 5844 would allow an eligible production company to claim an income tax credit equal to the amount of the MBT credit the company was eligible to claim for a State-certified qualified**

**production, unless the company claimed the MBT credit; and require the income tax credit to be reduced by an application and redemption fee equal to 0.5% of the credit, which would have to be deposited in the Michigan Film Promotion Fund.**

The bills are described in detail below.

### **House Bill 5841 (H-1)**

#### State-Certified Qualified Production

The bill would define "state certified qualified production" or "qualified production" as single media or multimedia entertainment content created in whole or in part in this State for distribution or exhibition to the general public in two or more states by any means and media in any digital media format, film, or video tape, including a motion picture, a documentary, a television series, a television miniseries, a television special, interstitial television programming, long-form television, interactive television, music videos, interactive games, video games, commercials, internet programming, an internet video, a sound recording, a video, digital animation, or an interactive website.

The term also would include the development, preproduction, production, postproduction, and distribution of a trailer, pilot, video teaser, or demo created primarily to stimulate the sale, marketing, promotion, or exploitation of future investment in a film or digital media production.

The term would not include the production of any of the following:

- A production for which records must be maintained with respect to any performer in the production under 18 USC 2257 (which concerns sexually explicit visual depictions).
- A production that includes obscene matter or an obscene performance, as described in Public Act 343 of 1984 (which prohibits the dissemination of obscene material).
- A production that primarily consists of televised news or current events, a live sporting event, or political advertising.
- A radio program.

- A weather show, talk show, or game show.
- A financial market report.
- A production that primarily markets a product or service.
- An awards show or other gala event production.
- A production with the primary purpose of fund-raising.
- A production that primarily is for employee training or in-house corporate advertising or other similar production.

The bill also would define "state certified qualified production" as a qualified production for which a postproduction certificate had been issued by the Michigan Film Office under the bill.

"Qualified personnel expenditure" would mean an expenditure made in Michigan directly attributable to the production or distribution of a qualified production that is a transaction subject to taxation in Michigan and is a payment or compensation payable to "below the line crew" members who were not Michigan residents for at least 60 days before approval of the tax credit agreement under the bill, not to exceed \$2.0 million for any one employee or contractual or salaried employee who performed services in Michigan for the production of a qualified production. This would include payment of wages, benefits, or fees, and payment to a personal service corporation or professional employer organization for the services of a performing artist or crew member if the corporation or organization were subject to the MBT on the portion of the payment qualifying for the tax credit under the bill and the payments received by the performing artist or crew member that were subject to the income tax and were withheld and paid to the State as provided under the Income Tax Act.

#### Credit Criteria

The bill would allow the Michigan Film Office, with the concurrence of the State Treasurer, to enter into an agreement with an eligible production company providing it with a credit against the MBT or against the income tax, as provided in the bill and in Section 367 of the Income Tax Act (which House Bill 5844 would add).

To qualify for the credit, the company would have to spend at least \$50,000 in Michigan

for the development, preproduction, production, and postproduction costs of a State-certified qualified production. The company also would have to enter into an agreement with the Michigan Film Office; receive a postproduction certificate of completion from the Office; and submit the certificate to the Department of Treasury.

The company could not be delinquent in a tax or other obligation owed to the State or be owned or under common control of an entity that was delinquent in a tax or other obligation owed to the State.

"Eligible production company" would mean an entity in the business of producing qualified productions. It would not include an entity that is more than 30% owned, affiliated, or controlled by an entity or individual who is in default on a loan made or guaranteed by this State or by any other state.

#### Credit Amount

For direct production expenditures or qualified personnel expenditures made after February 29, 2008, an agreement under the bill could provide for an eligible production company to claim a tax credit equal to 42% of direct production expenditures for a State-certified qualified production in a core community, 40% of direct production expenditures for a production in part of this State other than a core community, and 30% for qualified personnel expenditures.

A taxpayer could not claim a credit under the bill for any of the following:

- A direct expenditure or qualified personnel expenditure for which the company claimed a credit under Section 479 of the MBT Act (which is proposed by House Bill 5844 and would allow an MBT credit for an eligible production company's job training expenditures).
- A direct expenditure or qualified personnel expenditure for which the company claimed a credit under Section 367 of the Income Tax Act (the section proposed by House Bill 5844).
- A direct expenditure or qualified personnel expenditure for which another taxpayer claimed a credit under the bill, Section 459 of the MBT Act, or Section 367 of the Income Tax Act.

"Core community" would mean a qualified local governmental unit as defined under the Obsolete Property Rehabilitation Act (MCL 125.2782).

"Direct production expenditure" would mean a development, preproduction, production, or postproduction expenditure made in this State that is not a qualified personnel expenditure directly attributable to the production or distribution of a qualified production that is a transaction subject to taxation in Michigan. The term would include payments to vendors doing business in Michigan to purchase or use tangible personal property in producing or distributing the qualified production or to purchase services relating to its production or distribution, including all of the following:

- Expenditures for optioning or purchasing intellectual property, including books, scripts, music, or trademarks relating to the development or purchase of a script, story, scenario, screenplay, or format, including all expenditures generally associated with the optioning or purchase or intellectual property, but not including deferrals, deferments, royalties, profit participation, or recourse or nonrecourse loans negotiated by the eligible production company to obtain rights to the intellectual property.
- Production work, equipment, and software; development work; postproduction work, equipment, and software; set design, construction, and operations; props; lighting; wardrobe; makeup; makeup accessories; photography; sound synchronization; special effects; visual effects; audio effects; film processing; music; sound mixing; editing; and related services and materials.
- Use of facilities or equipment, use of soundstages or studios, location fees, and related services and materials.
- Catering, food, lodging, and related services and materials.
- Use of vehicles, including chartered aircraft based in Michigan used for transportation in this State directly attributable to production of a qualified production, but excluding the chartering of aircraft for transportation outside of Michigan.
- Commercial airfare if purchased through a travel agency or travel company based in Michigan for travel to and from, or

within, this State directly attributable to production or distribution of a qualified production.

- Expenditures for distribution, including costs related to the creation of trailers, marketing videos, commercials, point-of-purchase videos, and content created on film or digital media, and purchase of equipment relating to the duplication or market distribution of any content created or produced in Michigan.
- Other expenditures for production of a qualified production in accordance with generally accepted entertainment industry practices.

"Direct production expenditure" also would include payments and compensation, not to exceed \$2.0 million for any one employee or contractual or salaried employee who performed services in Michigan for the production or distribution of a qualified production, including payment of wages, benefits, or fees for talent, management, or labor; and payment to a personal services corporation or professional employer organization for the services of a performing artist or crew member if the corporation or organization were subject to the tax levied under the MBT Act on the portion of the payment qualifying for the credit under the bill, and the payments received by the performing artist or crew member were subject to taxation under the Income Tax Act and were withheld and paid to the State as provided under that Act.

#### Application & Agreement

An eligible production company that intended to produce a qualified production in Michigan, or that initiated production of a qualified production after February 29, 2008, and before the bill's effective date, could submit to the Michigan Film Office an application to enter into an agreement under the bill. The request would have to be accompanied by a \$100 application fee and all of the information and records requested by the Film Office. The fee would have to be deposited in the Michigan Film Promotion Fund (which House Bill 5850 would create).

The Office could not process the application until it was complete. As part of the application, the company would have to estimate direct production expenditures and qualified personnel expenditures for an identified qualified production. If the Office,

with the State Treasurer's concurrence, determined to enter into an agreement, it would have to provide for all of the following:

- A requirement that the company begin work in Michigan on the production within 90 days of the date of the agreement, or it would expire, although the Office could extend the period for an additional 90 days, if the company made a request based on good cause.
- A statement identifying the company and the qualified production that it intended to produce in whole or in part in Michigan.
- A unique number assigned to the production by the Office.
- A requirement that the production not depict obscene matter or an obscene performance.
- If the production were a long-form narrative film production, a requirement that it include an acknowledgement that the production was filmed in Michigan.
- A requirement that the company provide the Office with the information and independent certification the Office and the Department of Treasury considered necessary to verify direct production expenditures and eligibility for the tax credit.
- If determined necessary by the Office and the State Treasurer, a provision for addressing expenditures in excess of those identified in the agreement.

In determining whether to enter into an agreement, the Film Office and the State Treasurer would have to consider all of the following:

- The potential that, absent the credit, the qualified production would be produced in a location other than Michigan.
- The extent to which the production could have the effect of promoting this State as a tourist destination.
- The extent to which the production could have the effect of promoting economic development or job creation in the State.
- The extent to which the credit would attract private investment for the production of qualified productions in the State.
- The company's record in completing commitments to engage in a qualified production.

### Postproduction Certificate

If the Michigan Film Office determined that an eligible production company had complied with the terms of an agreement entered into under the bill, the Office would have to issue a postproduction certificate to the company. The company would have to submit to the Office a request for a certificate, along with any information or independent certification the Office or the Department considered necessary.

The Office would have to process each request within 60 days after it was complete, but could request additional information or independent certification before issuing a certificate. The Office would not have to issue a certificate until it was satisfied that direct production expenditures, qualified personnel expenditures, and eligibility were adequately established. The additional information requested could include a report of direct production expenditures and qualified personnel expenditures for the qualified production audited and certified by an independent certified public accountant.

Each postproduction certificate of completion would have to be signed by the Michigan Film Commissioner and include the following information:

- The name of the eligible production company.
- The name of the certified production produced entirely or partly in Michigan.
- The company's direct production expenditures and qualified personnel expenditures for the qualified production.
- The date of completion for the production in the State.
- The unique number assigned to the production project by the Office.
- The company's Federal employer ID number or Michigan Treasury number.
- Any independent certification required by the Office or the Department.

An eligible production company would have to submit a postproduction certificate of completion to the Department.

### Credit Refund; Assignment; Reduction

If the credit allowed under the bill exceeded the tax liability of the eligible production company for the tax year, or if the company

did not have an MBT liability for the tax year, the Department would have to refund the excess or pay the amount of the credit to the company. The credit would have to be claimed after all other credits under the MBT Act.

An eligible production company could assign all or part of its credit to any assignee, which could subsequently assign all of part of the credit to one or more assignees. A company could claim part of a credit and assign the remainder. A credit assignment would be irrevocable. An assignment would have to be made on a form prescribed by the Department. The qualified taxpayer would have to send a copy of the form to the Department in the tax year in which the assignment was made, and attach a copy of the form to the return on which the credit was claimed.

The amount of a credit would have to be reduced by a credit application and redemption fee equal to 0.5% of the credit claimed. The fee would have to be deducted from the credit otherwise payable to the taxpayer claiming the credit and be deposited in the Michigan Film Promotion Fund.

### Penalty

A taxpayer that willfully submitted information under the bill that the taxpayer knew to be fraudulent or false would be liable for a civil penalty equal to the amount of the taxpayer's credit, in addition to any other penalties provided by law. The penalty would have to be deposited in the Michigan Film Promotion Fund.

### Film Office Report

By March 1 of each year after 2008, the Michigan Film Office would have to submit to the Governor, the MSF president, the chairperson of the Senate Finance Committee, and the House Tax Policy Committee an annual report concerning the operation and effectiveness of the credit. The report would have to include all of the following information for the immediately preceding calendar year:

- A brief assessment of the overall effectiveness of the credit at attracting qualified productions to the State.

- The number of qualified productions for which an eligible production company applied for a tax credit during the preceding year, the names of the qualified productions produced in the State for which credits were begun or completed in the preceding year, and the locations in Michigan that were used in the production of qualified productions.
- The amount of money spent by each eligible production company identified above to produce each qualified production in Michigan and a breakdown of all production spending by all companies classified as goods, services, or salaries and wages.
- An estimate of the number of people employed in Michigan by eligible production companies that qualified for the credit.
- The value of all tax credit certificates of completion issued.

The disclosure of tax information required by these provisions would not be subject to requirements of the revenue Act that prohibit employees of the Department of Treasury from disclosing information obtained in connection with the administration of a tax.

#### Confidentiality

Information, records, or other data received, prepared, used, or retained by the Film Office that were submitted by an eligible production company and considered by the taxpayer, and acknowledged by the Film Office, as confidential would not be subject to the disclosure requirements of the Freedom of Information Act. Information, records, or other data could be considered confidential only to the extent that they described the company's commercial and financial operations or intellectual property, the information or records had not been publicly disseminated at any time, and disclosure of the information or records could put the company at a competitive disadvantage.

#### **House Bill 5844**

The bill would allow an eligible production company to claim a credit for a State-certified qualified production against the income tax equal to the amount of the credit the company was eligible to claim for the production under Section 455 of the MBT Act

(the section that House Bill 5841 (H-1) would add).

An eligible production company could not claim a credit for either of the following:

- A credit or portion of a credit the company claimed under Section 455 of the MBT Act.
- A credit or portion of a credit that another taxpayer claimed under the bill or under Section 455 of the MBT Act.

The income tax credit could not exceed the company's income tax liability for the tax year, and would have to be claimed after all other credits under the Income Tax Act.

The amount of the income tax credit would have to be reduced by a credit application and redemption fee equal to 0.5% of the credit claimed. The fee would have to be paid by the taxpayer and deposited in the Michigan Film Promotion Fund.

"Eligible production company" and "state certified qualified production" would mean those terms as defined under Section 455 of the MBT Act.

To the extent not withheld by a professional services corporation or professional employer organization, payments to the corporation or organization for the services of a performing artist or a crew member that qualified for the income tax credit or the MBT credit under House Bill 5841 (H-1) would be subject to withholding by the eligible production company.

Proposed MCL 208.1455 (H.B. 5841)  
Proposed MCL 206.367 (H.B. 5844)

Legislative Analyst: Patrick Affholter

#### **FISCAL IMPACT**

The bills 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 House Bills 5841 (H-1) and 5844, 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 House Bill (HB) 5844, 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 21<sup>st</sup> 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.

#### **House Bill 5841 (H-1)**

The bill proposes a credit for production expenses. The bill would not allow the same expenses to qualify for credits under HB 5844, or under several other related bills. The expenses used to generate credits under HB 5841 (H-1) and HB 5844 also could generate credits under the existing MBT provisions, such as the compensation credit and the investment tax credit. The credit under House Bill 5841 (H-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 HB 5841 (H-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. Generally, however, 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.

#### **House Bill 5844**

The bill likely would not have a significant impact on State revenue if both bills were enacted, given the provisions of HB 5841 (H-1). House Bill 5844 would allow a refundable 40% credit on 100% of wages compared with 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 under which a firm would be unable to use the credit under HB 5841 (H-1). Unlike the credit in HB 5841 (H-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 HB 5841 (H-1) would be preferable to the credit in HB 5844.

If HB 5844 were enacted and HB 5841 (H-1) were not, HB 5844 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*.

#### **Combined Impacts and Incentives**

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, House Bills 5841 (H-1) and 5844 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.

Fiscal Analyst: Elizabeth Pratt  
Maria Tyszkiewicz  
David Zin

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