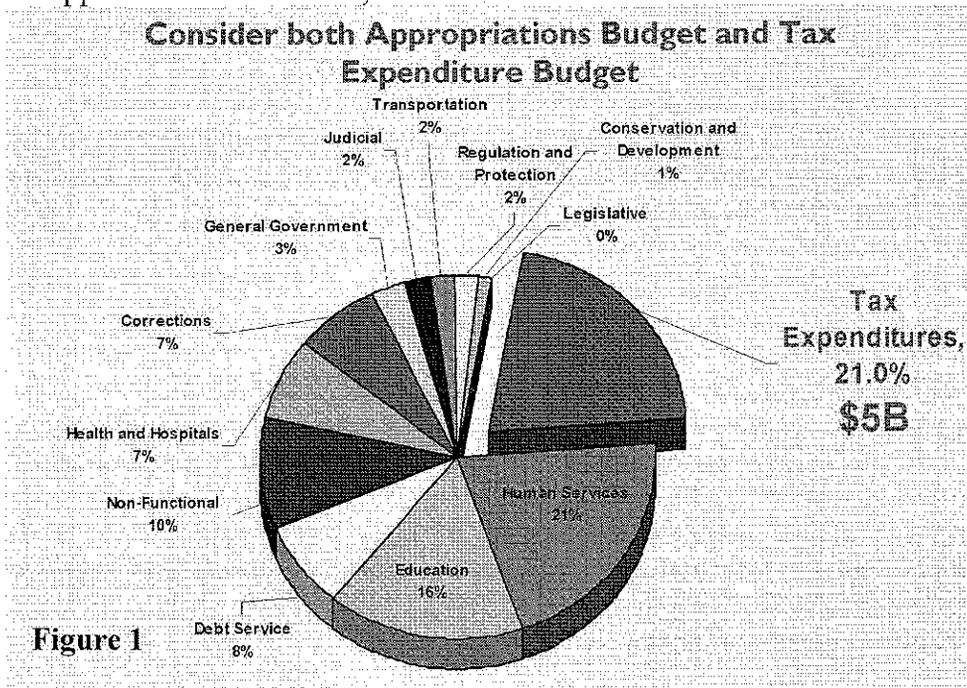


Testimony Supporting
S.B. No. 249, An Act Concerning The Film Production Tax Credit
Testimony of Dr. Douglas Hall
To the Commerce Committee
February 10, 2009

Senator LeBeau, Representative Berger, and distinguished Members of the Commerce Committee,

I submit testimony today on behalf of Connecticut Voices for Children, a statewide research and advocacy organization that works to promote the well-being of Connecticut’s children, youth, and families. As child advocates, we have a particular responsibility to ensure that Connecticut’s revenue system is sound. Currently, tax expenditures – including film tax credits – take a bite estimated at almost \$5 billion/year out of Connecticut’s revenues (see Figure 1 below). According to the Office of Fiscal Analysis’ *2008 Tax Expenditure Report*, \$556 million was projected to be lost to tax expenditures through the corporation income tax in FY09 including \$115 million for the three tax credits in support of the film industry.¹



Connecticut Voices for Children is very concerned about the state’s economic viability. We annually prepare a report, *The State of Working Connecticut*, which looks at the state’s economy, including wage trends, shifts in employment by sector, productivity and gross state product.² We also follow best practices in state economic development policies, and keep abreast of studies that examine the effectiveness of various state policies at stimulating economic growth. While there is some evidence

to show that tax credits such as the film production tax credit show modest return on investment, there are other areas in which the state could better invest its economic development funds to support economic growth and ongoing high quality of life. The best known of these studies was undertaken by Art Rolnick, from the Federal Reserve Bank of Minneapolis. His study shows that investments in early care and education reap a return on investment of 16 percent, inflation-adjusted (including a 12 percent (inflation-adjusted) public return on investment). Subsequent studies reiterate the argument that “race to the bottom” policies – policies which try to lure corporate activity from one state to another through bidding wars – are in fact detrimental to the economy and waste resources that could be better utilized in other ways. Rolnick writes:

Around the country, billions of public dollars are spent each year to subsidize private companies so that they will either locate or expand their businesses in hometown markets. Recent studies of this approach to economic development, however, make clear that the so-called economic bidding war among state and local governments is actually counterproductive. The bidding war is at best a zero-sum game that distorts market outcomes and diverts public funds from more productive investments in economic development.³

Connecticut’s film production tax credits are illustrative of this approach to economic development, with Connecticut, Rhode Island, and Massachusetts using ever more generous film tax credits to lure production away from New York in hopes of becoming the so-called “Hollywood East”. Even if it can be shown that by some measure Connecticut’s film production tax credit “pays for itself”, that does not mean that such an investment is the best possible use of Connecticut’s very limited fiscal resources. Independent analysis might show that the Connecticut economy would benefit more through further investments in nanotechnology, biotechnology, green energy and other emerging industries. Because we don’t know, we need to step back and find answers before proceeding.

In this respect, the film and production tax credit is typical of many of Connecticut’s tax credits. The General Assembly needs access to better information in order to determine: a) whether tax credits are achieving the promised results, and b) whether tax credits are the best mechanism available to achieve objectives of long-term, sustainable economic growth. We strongly believe that expenditures made on the tax side should be subject to regular scrutiny just as are appropriated expenditures.

Provisions of SB 249

Senate Bill 249 has two components, each of which we would like to comment on. The first component attempts to ensure that firms receiving the film production tax credits “conduct at least fifty-percent of the total production in studios located in Connecticut.” This is an important provision. There has been considerable excitement in Connecticut over some of the films that have been produced here in part since the enactment of the three film tax credits. New Haven was understandably abuzz with excitement during the filming of the Indiana Jones sequel, yet the prevalence of catering trucks and other support vehicles with New York state plates cast doubt on the extent of new Connecticut employment created.

The second component of SB249 proposes “plac[ing] a cap on the total annual amount of film production tax credits available.” We strongly support this provision. The Governor’s budget proposal puts a cap of \$30 million on the film and digital media production tax credit. Given the state’s current fiscal situation, placing a cap on the film production credit is necessary to prevent the further erosion of state revenues.

Some Background on Connecticut's Film Production Tax Credit⁴

A transferable tax credit for producing films, digital media and virtually any other type of entertainment content was enacted in 2006 and expanded in 2007.⁵ The credit, administered by the Connecticut Commission on Culture and Tourism ("CCT"), is equal to 30% of all "qualified production expenses or costs," so long as they exceed \$50,000.

What is eligible for the 30% credit? The term "production expenses or costs" is defined very broadly as "all expenditures clearly and demonstrably incurred *in the state* [in the] development, pre-production, production or post-production costs of a qualified production"⁶ (emphasis added). The only ceiling placed on an otherwise qualifying expenditure pertains to compensation for services provided in a qualified production. On or after January 1, 2008, compensation of *more than \$15 million that is paid to any individual* (or entity representing an individual) for services provided in a qualified production cannot be claimed.

"Qualified production," in turn, also is defined very broadly⁷ as "entertainment content created in whole in part within the state" including:

- a) Motion pictures;
- b) Documentaries;
- c) Long-form, specials, mini-series, series, sound-recordings,⁸ videos, and music videos and interstitials television programming;
- d) Interactive television;
- e) Interactive games;
- f) Videogames;
- g) Commercials;
- h) Infomercials;
- i) Any format of digital media, including an interactive website,⁹ created for distribution or exhibition to the general public;
- j) "Any trailer, pilot, video teaser or demo created primarily to stimulate the sale, marketing, promotion, or exploitation of future investment in either a product or qualified production via any means and media in any digital media format, film or videotape, provided such program meets all the underlying criteria of a qualified production."¹⁰

A state-certified qualified production is one produced by a company that: a) the CCT has approved for a production tax credit; b) complies with regulations the CCT adopts for the tax credit program, and c) is authorized to do business in Connecticut.¹¹

Must the production expenses and costs be incurred in Connecticut? A 2007 amendment¹² to the statute authorizing this tax credit appears to allow the credit to be based, in part, on expenses or costs that are incurred *outside* the State of Connecticut, but are "used" in the state, during a specific three-year period, stating:

- a) On and after January 1, 2009, 50% of the expenses or costs can be counted toward the credit when incurred outside the state but used within the state;
- b) On and after January 1, 2012, *no* expenses or costs incurred outside Connecticut can be counted toward the credit even if used in the state.¹³

That is, from January 1, 2009 through December 31, 2011, it would appear that production companies could receive a credit equal to 15% of production expenses or costs that are incurred outside Connecticut if “used” here (i.e., 50% of the 30% credit).

For example, if during this time period, a \$100 million motion picture was entirely filmed in New York, but DVDs of the movie were made in Connecticut (i.e., the motion picture was “used” in Connecticut for purposes of duplication and distribution by DVD), Connecticut arguably would be obligated to provide the production company with \$15 million in transferable tax credits, even though the in-state economic activity was nominal.

This provision, however, seems to conflict with a subsequently-adopted amendment that requires that the 30% credit for qualifying production expenses apply *only* to expenses and costs that are incurred in Connecticut.¹⁴

Against what taxes can the credits be applied? What companies are eligible for the credits?

The credit can be taken against the corporate business tax and the insurance premiums tax.¹⁵ The entity qualifying for the credit, however, need not be a corporation or an insurance company. Rather, the credits can be awarded to any “corporation, partnership, limited liability company, or other business entity engaged in the business of producing qualified productions on a one-time or ongoing basis, and qualified by the Secretary of the State to engage in business in the state.”¹⁶

That is, a business entity can be awarded tax credits to offset corporation business tax or insurance premium tax liability even if the company is subject to *neither* tax. Indeed, as noted below, many of the production companies that have received credits (or that have credits pending) are Limited Liability Companies (LLCs) and so are liable only for Connecticut’s \$250/year business entity tax (imposed on LLCs, S corporations, and partnerships).

For example, a production company that is an LLC is not, per se, liable for the corporation business tax or insurance premiums tax. So when it is awarded tax credits that can only be used to offset tax liability under the two taxes, it can *sell* these credits to any willing corporation or insurance company that *has* such tax liability, even if the companies have nothing at all to do with the entertainment industry. As noted later in the report, Connecticut’s film production tax credits already have been sold to a bank, department store chain, and manufacturer.

This departure from past practice was noted by Connecticut Office of Policy and Management Secretary Robert Genuario in testimony on proposed legislation to establish the credit:

One reason the proposal is so costly is that the bill appears to extend corporation tax credits to non-corporate entities. This would be a major change in state tax policy and would set the precedent to open up all our corporation credits to any business or individual. We must not forget that in 1993 Connecticut passed the Limited Liability Company law permitting the formation of such entities. One of the primary benefits of such an entity is its ability to pass through income to the partner’s individual tax return which is taxed at a lower rate. These lower taxed firms would now generate a corporation tax credit which they could sell to other parties.¹⁷

Transferability of the credits. The credit may be transferred, in whole or in part, to “one or more taxpayers” and can be resold, assigned or otherwise transferred a maximum of three times.¹⁸ The

Commission must be notified of any transfer. There are no requirements concerning the nature of the transferee's business, although the transferee ultimately using the credits necessarily will have some Connecticut corporate tax or insurance premiums tax liability. A February 2008 report to the Secretary of OPM, prepared by the Connecticut Commission on Culture and Tourism, noted that tax credits in support of one television show, one feature film, and two commercials had been transferred to other corporate entities. The two most egregious credit transfers involved a \$6.2 million transfer to Wachovia Bank, and and a \$2.0 million transfer to Kohl's Department Stores, Inc.

Claiming the credits. Credits can only be claimed for the income year in which the expenditures are made. Credits are non-refundable, but unused credits can be carried forward for three years.¹⁹ Importantly, a production company can apply for and receive credits on an annual basis while a production is in progress; it need not wait until a production is finished. State law limits the state's authority to recapture tax credits *even if* there was "material misrepresentation or fraud" in a company's reporting of expenditures and costs.²⁰

Is the credit capped? This credit is *not* capped – either by the individual production (e.g., no more than \$5 million in tax credits per production) or in total (e.g., no more than \$50 million in tax credits in a single state fiscal year).

What is the projected revenue loss from this credit? When the tax credit was adopted in the 2006 Session, the Office of Fiscal Analysis (OFA) estimated a \$10 million FY 08 loss and a \$20 FY 09 million loss from a reduction in corporate business tax revenues. OFA's January 2008 report estimated a \$90.5 million revenue loss in FY 09: a \$90.0 million reduction in corporation business tax revenues and \$0.5 million reduction in insurance premium tax revenues.²¹

Some More Background on Connecticut's Business Tax Credits

Figure 2 shows the dramatic decline in corporation business tax revenues as a share of General Fund revenues over the past two decades. While the initial decline can be accounted for by the more significant role played by the personal income tax after its adoption in 1991, the ongoing erosion of revenues from the corporate business tax is due in part to the dramatic growth in corporate tax expenditures.

In the absence of routine oversight by the Connecticut General Assembly, Connecticut's business tax credits risk becoming blank checks for economic development. While such an approach is highly questionable as

Corporate Tax Revenue as a Share of GF Tax Revenue (FY 1990-2008)

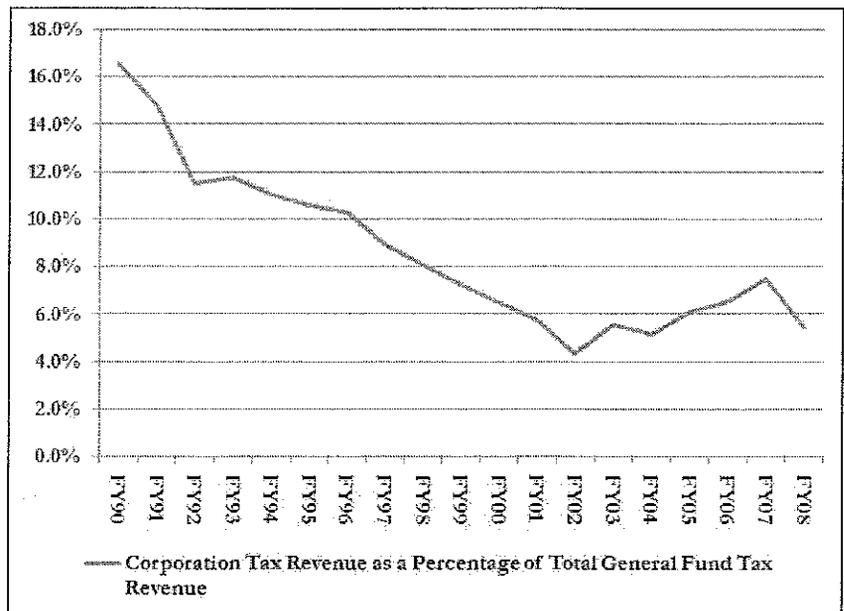


Figure 2

Sources: Historical budget data derived from Office of Fiscal Analysis, *Connecticut Revenue and Budget Facts*, February 27, 2006, pp.6, 38; Governor's Midterm Budget Adjustments (FY2006-2007); Governor's Biennial Budget (FY2008 - FY2009); Governor's Budget Adjustments (FY 2009 Midterm).

economic policy, as fiscal policy it is clearly flawed, and contributes significantly to the deficit situation in which Connecticut currently finds itself.²²

Connecticut’s revenue loss from corporation business tax credits has increased 113-fold since 1987. In 1987, Connecticut had a total of nine credits against the corporation business tax. In that year, 289 corporate tax returns claimed a total of \$2.7 million in tax credits. By 2003, the number of credits had increased to twenty-three, and 7,266 returns claimed a total of \$93.1 million.²³ OFA now projects a \$305.6 million revenue loss in FY 09 from corporate business tax credits.²⁴ This is 113 times greater than the revenue loss from corporate business tax credits 20 years ago and nearly 6 times greater than the total FY 08 budget of Connecticut’s Department of Economic and Community Development (including its bond and carry-forward funds).

The fiscal and economic crisis Connecticut currently faces requires the adoption of new approaches to governance, and prudent oversight of Connecticut’s resources. Business tax credits have been taking a huge (and growing) bite out of state revenues. This crisis presents an opportunity for Connecticut to revisit its approach to economic development, while taking a more responsible approach to oversight of the tax expenditure side of the budget. SB 249 takes appropriate steps in that direction.

We thank the committee for its time, and for considering this testimony.

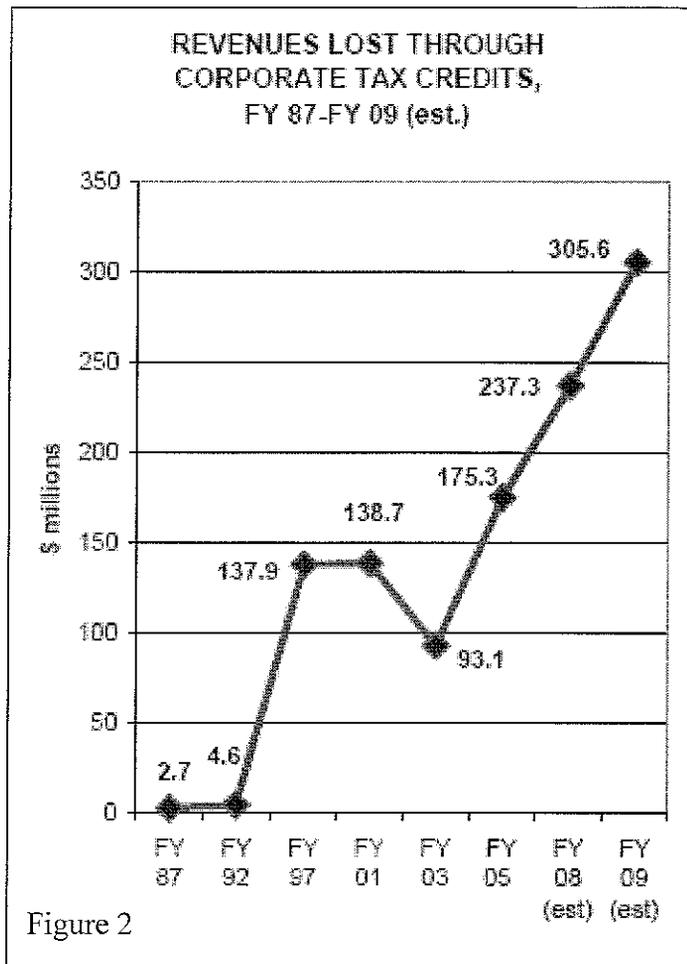


Figure 2

¹ The three credits include the film production tax credit, the digital animation credit, and the motion picture infrastructure credit. OFA estimates that an additional \$1.0m would be lost from insurance premiums taxes due to the film and digital media production credit (\$0.5m) and the digital animation production credit (\$0.5m).

² See Joachim Hero and Douglas Hall, *The State of Working Connecticut, 2008: Job Trends and the Labor Force*, (Connecticut Voices for Children, 2008), and Hero, Hall and Geballe, *The State of Working Connecticut, 2008: Wage Trends*, (Connecticut Voices for Children, 2008).

³ Rob Grunewald and Arthur Rolnick, *A Proposal For Achieving High Returns on Early Childhood Development*, (Federal Reserve Bank of Minneapolis, 2006).

⁴ For a more comprehensive analysis of the film production tax credit and Connecticut’s other two film tax credits, see Shelley Geballe, *Starstruck? Connecticut’s Block-Busting Spending on Entertainment Industry Tax Credits: Part 1: The Credits and Who is Claiming Them*, (Connecticut Voices for Children, 2008).

⁵ Conn. Gen. Stat. §12-217jj. PA 06-83, §20, as amended by PA 06-186, §83; PA 07-236, §1; and PA 07-4 (June Special Session), §§69-71. Note: PA 06-106 enumerated the powers and duties of the CT Commission on Culture and Tourism (CCT) with respect to digital media, motion pictures, and other media related products, including specifically “implementation of the tax credits provided for in section 20 of public act 06-83.” PA 06-172 expanded the charge of the CCT to include promoting film and digital media production and post-production in the state (rather than just film) and expanded its “film” responsibilities to include all types of digital media. It also added six new members to CCT

(appointed by legislative leaders) all of whom must have digital media or film production experience, and also requires that one of the Governor's appointees have direct experience in digital media or film production. It required, also, that the CCT report to the General Assembly every two years (starting January 15, 2008) on its digital media and film production promotion activities, the "estimated direct and indirect economic impact" of all digital media, motion pictures and related production activity in the state, and the impact of each state-assisted production. PA 06-172 also exempted CCT's director for digital media and motion picture activities from the state classified service.

⁶ "Production expenses or costs" also are broadly defined to include: a) expenditures incurred *in the state* (emphasis added) in the form of either "compensation or purchases" related to: i) production and post production work, equipment, and software; ii) expenses related to set and construction; iii) props, lighting, wardrobe, makeup, and makeup accessories; iv) special, video, and audio effects; v) film processing; vi) music, sound mixing, and editing; vii) location fees; viii) soundstages; and ix) "any and all other costs or services directly incurred in connection with state-certified qualified production; and b) expenditures for distribution (including preproduction, production, and postproduction costs of trailers, commercials, and duplication of films, videos, CDs, DVDs) and the purchase of equipment by a Connecticut company related to duplication or mass market distribution of content created or produced in Connecticut. *Excluded* from allowable expenses or costs are: a) on or after January 1, 2008, compensation of more than \$15 million that is paid to any individual (or entity representing an individual) for services provided in a qualified production; b) media buys, promotional events or gifts or public relations associated with promoting or marketing a qualified production; c) certain other deferred, leveraged or profit participation costs for people associated with a production such as producer, director, and writer fees; d) costs related to the transfer of the credit to another company; and e) amounts paid to persons or businesses "as a result of their participation in profits from the exploitation of the qualified production." Conn. Gen. Stat. §12-217jj(a)(5). Also, the credit for 30% of production equipment expenses is available only if these expenses are not eligible for the film infrastructure credit.

⁷ Conn. Gen. Stat. §12-217jj(a)(3)(A).

⁸ "Sound recording" is defined to include "a recording of music, poetry or spoken-word performance," but does *not* include "the audio portions of dialogue or words spoken and recorded as part of a motion picture, video, theatrical production, television news coverage or athletic event." Conn. Gen. Stat. §12-217jj(a)(7).

⁹ "Interactive websites" eligible for the credit must have production costs of more than \$500,000/income year and be "primarily:" a) interactive games or end-user applications; or b) animation, simulation, sound, graphics, story lines or video created or repurposed for distribution over the internet. Websites "primarily used for institutional, private, industrial, retail or wholesale marketing or promotional purposes," or which contain obscene content, are *not* eligible for the credit. Conn. Gen. Stat. §12-217jj(a)(8).

¹⁰ "Qualified production" is defined to *exclude* from the credit any "ongoing television program created primarily as news, weather or financial market reports, a production featuring current events, sporting events, an awards show or other gala event, a production whose sole purpose is fundraising, a long-form production that primarily markets a product or service, a production used for corporate training or in-house corporate advertising or other similar productions" as well as certain productions with "sexually explicit content." Conn. Gen. Stat. §12-217jj(a)(3)(B).

¹¹ Lohman, *Film and Digital Media Production Tax Credit* (Office of Legislative Research, 2006-R-0364, June 2, 2006).

¹² PA 07-236, §1.

¹³ Conn. Gen. Stat. §12-217jj(b)(1).

¹⁴ PA 07-4 (June Special Session), §69, amended the definition of "production expenses or costs" to clarify that they must be incurred "in the state" [Conn. Gen. Stat. §12-217jj(a)(5)] and also clarified that expenditures in the form of either compensation or purchases in connection with a qualified production must be incurred "in the state." Conn. Gen. Stat. §12-217jj(a)(5)(A). The OLR summary of PA 07-4 (JSS) noted that these provisions "appeared to conflict" with the earlier amendment that allowed some out-of-state expenses to be eligible for the credit.

¹⁵ Conn. Gen. Stat. §12-217jj(b)(1).

¹⁶ Conn. Gen. Stat. §12-217jj(a)(4).

¹⁷ Testimony of OPM Secretary Robert Genuario to the Commerce Committee regarding HB 5797 (March 14, 2006).

¹⁸ Conn. Gen. Stat. §12-217jj(b)(2).

¹⁹ Conn. Gen. Stat. §12-217jj(b)(3).

²⁰ Once CCT issues a "tax credit voucher," none of the tax credits stated on it are subject to a "post-certification remedy," defined as "the recapture, disallowance, recovery, reduction, repayment, forfeiture, decertification or any other remedy that would have the effect of reducing or otherwise limiting the use" of the tax credits. Conn. Gen. Stat. §12-217jj(a)(9), (f). If the production company's expense report was fraudulent or materially misrepresented its expenses and costs and, as a result, the specific amount of tax credits awarded would not have been awarded *and* the credits would "otherwise be subject to a post-certification remedy," CCT can only seek collection of the credits from the production company that committed the fraud or misrepresentation and not from any "transferee" of the tax credits. Conn. Gen. Stat. §12-217jj(f). Further, a submission of information to CCT that is willfully fraudulent or false only subjects the

company to a penalty “equal to the amount of such company’s credit entered on the production tax credit certificate” (unless some other penalty applies under other law). Conn. Gen. Stat. §12-217jj(e). CCT *may* require the company applying for a tax credit voucher to provide “independent certification...pertaining to the amount of such company’s production expenses or costs to date.” Conn. Gen. Stat. §12-217jj(c)(2).

²¹ CT Office of Fiscal Analysis, *Connecticut Tax Expenditure Report* (January 2008).

²² For greater detail, see Shelley Geballe, *Business Tax Credits: The Blank Check in Connecticut’s Economic Development Portfolio?*, (Connecticut Voices for Children, 2008).

²³ OFA, *Connecticut Revenue and Budget Data* (February 27, 2006). Note: the plateau in the growth of credits claimed around FY 01 resulted in part from the fact that S corporations no longer were subject to the corporation business tax, so could not claim tax credits against it. The decline in the economy, coupled with a change in the law preventing tax credits from extinguishing a company’s tax liability (see note 14 below) contributed to the dip in credits claimed around FY 03.

²⁴ OFA, *FY 08-FY 12 General Fund and Transportation Fund Budget Projections and Fiscal Information* (November 15, 2007), p. 27.