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A MODEST PROPOSAL TO AMEND HAWAII'S FILM PRODUCTION TAX CREDIT

Submitted to the 2020-2022 Tax Review Commission by Don Rousslang*

PREAMBLE

Trained economists tend to look with a jaundiced eye on tax policies designed to encourage selected businesses. To them, the likelihood that a tax jurisdiction will improve the overall economic welfare of its residents by deliberately distorting the structure of its taxes seems almost as remote as the likelihood that a person will raise himself above the ground by pulling on his shoelaces.¹ Nevertheless, in what follows, I propose only modest changes to Hawaii's film credit that I hope will improve its prospects for helping the local economy.

**Comments are welcomed. The author is an Income Tax Specialist in the Hawaii Department of Taxation, but the views expressed are his own and should not be attributed to the Department of Taxation, nor to any of its officials.*

¹ The standard economic analysis suggests that, absent something called "positive externalities," a tax break for a selected business will prove to have been a good idea only if the business is eventually profitable paying the same taxes as other businesses. That is why economists sometimes refer to such tax breaks as "picking the winners."

THE PROPOSAL

Background

Hawaii's film credit has been in effect, in one form or another, since 1997.² In its current form, the film credit is set at 20% of qualified production costs incurred in the county of Oahu, and 25% of such costs incurred in the counties of Maui, Hawaii and Kauai.³ Costs qualify for the film credit if the money is spent on items subject to Hawaii's general excise tax (GET) or to its use tax on imports, or if the money is income to the recipients and subject to Hawaii's net income tax.⁴ Note that film production costs may be eligible for the film credit, whether they derive from items that are produced in Hawaii, or from items that are imported to Hawaii. The film credit is applied against income tax liabilities of individuals or corporations. It is refundable, so if the film credit exceeds the taxpayer's income tax liability, Hawaii refunds the difference to the

² The film credit was first established in Hawaii by Act 107, Session Laws of Hawaii (SLH) 1997.

³ The current version of the film credit was put in place by Act 275, SLH 2019 and is codified in section 235-17, Hawaii Revised Statutes (HRS). The actual wording of the film credit sets the rate according to the population of the county – the higher rate applies in any county with a population of 700,000 or less and the lower rate applies to any county with a population of more than 700,000.

⁴ The costs subject to GET or use tax must be subject to the tax at the retail rate (4%, plus any applicable county surcharge). See section 18-235-17-10(a), Hawaii Administrative Rules and the guidance provided by Department of Taxation Announcement No, 2019-15.

taxpayer.⁵ The total credit claimed for a single film production cannot exceed \$15 million.

Starting in taxable years beginning after December 31, 2018, the film credit is limited to \$50 million in the aggregate in any year. Claims for the film credit totaled \$61.7 million in tax year 2017 and \$80.2 million in tax year 2018, so the \$50 million aggregate cap is likely to be binding in the future.⁶ Taxpayers who are prevented by the aggregate cap from claiming the full amount of their film credit can carry the remaining credit forward to the next year.

One purpose of the film credit is to help diversify Hawaii's economy,⁷ but as shown in the attached Table, important parts of film production costs involve little in the way of local economic activity. The attached Table shows the budget, by cost category, for a group of feature films that were created in 2000 and later.⁸ A good deal

⁵ The credit is often in the form of a refund, instead of a reduction in tax liability, because persons engaged in the business of motion picture and television film production are exempt from Hawaii income tax on their earnings under section 235-9, HRS.

⁶ See Department of taxation, State of Hawaii, "Tax Credits Claimed by Hawaii Taxpayers: Tax Year 2017" and "Tax Credits Claimed by Hawaii Taxpayers: Tax Year 2018," available at https://tax.hawaii.gov/stats/a5_1annual/a5_4credits/.

⁷ See, for example, the preamble to Act 275, SLH 2019.

⁸ The films in the Table are from an internet search of film budgets. They are not meant to represent films that have benefited from Hawaii's film credit, but rather to show the characteristics of films that may, in the future, benefit from the film credit. You may have noticed that even at 20%, all the films in the Table would exceed the per-production cap of \$15 million, which would be reached with a total budget of \$75 million ($\$75 \text{ million} \times 0.2 = \15 million). This does not mean that they should not be

(from 11% to 55%) of the total production costs of the films consisted of compensation to a few people: the producers, the director and the star actors.⁹ Furthermore, the cost of the story rights, the screenplay and the music, items that are likely to be produced outside of Hawaii, are often substantial. The cost of these items plus the compensation to highly paid individuals accounted for 21% to 65% of the total budgets of the films in the Table.¹⁰

The Proposal and Its Purpose

When calculating the film credit for a production, cap the cost of compensation paid to any individual at \$1 million, and cap the aggregate cost of the story rights, the screenplay and the music at \$5 million.¹¹ The new caps should increase the number of jobs in the local film production industries attributable to the film credit, especially if the aggregate cap is binding.¹²

used for our analysis, however. For example, “Pirates of the Caribbean On Stranger Tides,” which was filmed partly in Hawaii in 2010, had a total budget of \$410 million, of which \$55 million was compensation to the main star (Johnny Depp). See “*Fourth Pirates of the Caribbean Is Most Expensive Movie Ever With Costs of \$410 million,*” at <https://www.forbes.com/sites/csylvt/2014/07/22/fourth-pirates-of-the-caribbean-is-most-expensive-movie-ever-with-costs-of-410-million/?sh=26ea28cb364f>. The film is not included in the Table, because I couldn’t find a break-down of its budget.

⁹ See column C in the Table.

¹⁰ See column D in the Table.

¹¹ The cap amounts are just suggestions.

¹² Even if the film credit creates job opportunities in the film production industries, this does not mean that it creates net jobs in the local economy. To understand why, I refer the interested reader to the timeless article by Frederic Bastiat, “*That Which Is Seen and That Which Is Not Seen*” (available at <https://mises.org/library/which-seen-and-which->

Precedents

Two states already have caps in their film credit like the ones proposed here. Connecticut caps the amount of compensation for the star talent in a production that qualifies for its film credit to \$20 million in the aggregate. Maryland disqualifies salary, wages or other compensation of an individual that is over \$500,000 from the eligible costs for its film credit.¹³

OTHER CONSIDERATIONS

Diversifying Hawaii's economy by increasing local film production is not the only purpose of the film credit. Another purpose is to promote Hawaii as a visitor destination.¹⁴ However, I have discovered no argument to suggest that films with costs concentrated in compensation to a few highly paid individuals, or in high-cost items likely to be produced outside of Hawaii, provide better tourism advertising when compared with films with costs that are less concentrated in these items.

[not-seen](#)). The article was written in the mid-19th century for a nontechnical audience, but the notions are fully consistent with present-day economic theory.

¹³ See National Conference of State Legislatures, *State Film Production Incentives and Programs* (January 30, 2018), available at <https://www.ncsi.org/research/fiscal/fiscal-policy/state-film-production-incentives-and-programs.aspx>.

¹⁴ See the preamble to Act 275, SLH 2019.

ADDENDUM

After writing this paper, I discovered that new legislation (House Bill 1174 and its companion, Senate Bill 921) was introduced this year that would impose a cap of \$2 million per year on “above-the-line costs,” defined as “Development expenditures; Salaries and other compensation of the writers, directors, producers, and lead cast; Travel costs of the writers, directors, producers, and lead cast, of a qualified production, as each of those terms is defined in subsection --, and in each case not determined by how any particular expenditure is categorized with a production’s budget.” The new legislation would also reduce the cap per film production, from \$15 million to an annual cap of \$12 million, and would reduce the overall annual aggregate cap from \$50 million to \$45 million. Owing to the new legislation, my purpose in sending you this paper is changed, from proposing a new idea for amending Hawaii’s film credit, to explaining why the new legislation is a good idea that deserves support.

I would quibble, however, with two new conditions imposed on film producers in the new legislation. The first condition is that in order to qualify for the film credit, the film production costs must be incurred through transactions with a qualified vendor, defined as an entity incorporated or organized in Hawaii for at least five years, all of whose principals are Hawaii income tax payers. The second condition is that if a production claims film credits that exceed certain thresholds, the film producer must agree to pay Hawaii one-fourth of one percent of the film’s worldwide gross receipts.

The problem with the first condition is that it might be an illegal constraint of trade, and it might tend to enrich certain interests at the expense of the film credit beneficiaries and so interfere with the purpose of the film credit. The problem with the second condition is that it might be impractical. Some film producers do not distribute their films, but instead sell them to another entity that distributes them. And ticket sales and royalties for a film can continue for years – would the charge for Hawaii’s share ever cease?

Another condition in the new legislation would require a production that claims the film credit above certain thresholds to provide evidence that at least 75% of the qualified production was filmed in Hawaii. The benefit of this provision is not clear.

TABLE
Film Production Costs - Some Examples

		A	B	C	D
		Amount	Comp. of Top 3 Cast Members	(b+c+C)/g (In %)	(a+e+B)/g (In %)
Unbreakable (2000 film)					
a	Story rights and screenplay	\$6,000,000	29,500,000	55%	65%
b	Producers	\$1,878,260			
c	Director	\$15,081,749			
d	Cast	\$35,068,388			
e	Music	\$2,253,456			
f	Other production costs	\$23,961,253			
g	Total	\$84,243,106			
Lara Craft: Tomb Raider - The Cradle of Life (2003 film)					
a	Story rights and screenplay	\$4,000,000	12,000,000	18%	24%
b	Producers	\$4,000,000			
c	Director	\$5,000,000			
d	Cast	\$17,250,000			
e	Music	\$3,300,000			
f	Other production costs	\$83,000,000			
g	Total	\$116,550,000			
Terminator 3: Rise of the Machines (2003 film)					
a	Story rights and screenplay	\$24,700,000	30,750,000	24%	38%
b	Producers	\$10,000,000			
c	Director	\$5,000,000			
d	Cast	\$35,000,000			
e	Music	\$2,000,000			
f	Other production costs	\$111,600,000			
g	Total	\$188,300,000			
Spider-Man 2 (2004 film)					
a	Story rights and screenplay	\$30,000,000	27,000,000	26%	44%
b	Producers	\$15,000,000			
c	Director	\$10,000,000			
d	Cast	\$30,000,000			
e	Music	\$5,000,000			
f	Other production costs	\$110,000,000			
g	Total	\$200,000,000			
Sahara (2005 film)					
a	Story rights and screenplay	\$14,100,000	11,800,000	11%	21%
b	Producers	\$2,800,000			
c	Director	\$750,000			
d	Cast	\$18,900,000			
e	Music	0			
f	Other production costs	\$105,100,000			
g	Total	\$141,650,000			

Sources:

https://en.wikipedia.org/wiki/Film_budgeting

<https://www.latimes.com/business/la-fi-movie15apr15-story.html>

