ALASKA STATE LEGISLATURE
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SUMMARY OF: A Special Report on the Department of Commerce, Community, and Economic Development (DCCED) and the Department of Revenue (DOR), Alaska Film Production Tax Incentive Program (AFPTIP), Financial Compliance, February 29, 2012

PURPOSE OF THE REPORT

In accordance with Title 24 of the Alaska Statutes and a special request by the Legislative Budget and Audit Committee, we have conducted a financial compliance audit of the AFPTIP. The AFPTIP is administered by DCCED's Alaska Film Office (AFO) in cooperation with DOR's Tax Division. The primary objectives of the audit were to:

1. Identify Alaska Film Production Tax Credits (film tax credits) issued and redeemed by fiscal year, and determine whether the total film tax credits issued have exceeded the statutory cap of $100 million.

2. Determine whether film tax credits were made available to qualified producers and whether the AFO appropriately approved productions after determining the productions were not contrary to the State's best interests.

3. Determine whether film tax credits were correctly calculated in accordance with AS 44.33.235(b)-(c) and (g) and whether producers spent a minimum of $100,000 in qualified expenditures in an agreed upon 24-month period as supported through verification by an independent certified public accountant (CPA).

4. Determine whether film tax credits were used within three years of being issued to exclusively offset corporate income taxes.

REPORT CONCLUSIONS

The AFO and Tax Division generally adhere to film tax credit approval, issuance, and redemption statutes and regulations when administering the AFPTIP. Film tax credits are made available to qualified producers, are properly calculated using qualified expenditures, and are appropriately approved. The approved film tax credits included $100,000 or more of qualified expenditures that were generally incurred within the qualified 24-month expenditure period. Total film tax credits issued have not exceeded $100 million, and all redeemed AFPTIP credits have been used within three years of being issued to offset corporate income taxes. Detailed schedules of prequalified productions and approved film tax credits are included in the report as Appendices A and B respectively.

Although state agencies materially complied with AFPTIP approval, issuance, and redemption statutes and regulations, areas for improvement were identified in the approval and redemption processes.

FINDINGS AND RECOMMENDATIONS

1. DCCED's Division of Economic Development director and AFO development specialist should develop clear and measurable criteria to support best interest determinations.

2. The AFO development specialist should ensure that expenditures reported as reviewed by a CPA are within the 24-month qualifying period.

3. The AFO development specialist should ensure that the names of the director and proposed cast are included in the prequalification application as required by statute.

4. The Tax Division director should improve procedures for tracking and reporting the use of tax credits.

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March 28, 2012

Members of the Legislative Budget
and Audit Committee:

In accordance with the provisions of Title 24 of the Alaska Statutes, the attached report is submitted for your review.

DEPARTMENT OF COMMERCE, COMMUNITY,
AND ECONOMIC DEVELOPMENT
DEPARTMENT OF REVENUE
ALASKA FILM PRODUCTION TAX INCENTIVE PROGRAM
FINANCIAL COMPLIANCE

February 29, 2012

Audit Control Number
08-30065-12

The review of the Alaska Film Production Tax Incentive Program evaluates whether the administration of the program by the Department of Commerce, Community, and Economic Development's Alaska Film Office (AFO) in cooperation with the Department of Revenue's Tax Division, complies with the program's financial requirements. The review evaluates the AFO's approval of the Alaska Film Production Tax Credit (film tax credit) prequalification applications and final credit applications, and the Tax Division's issuance and tracking of film tax credits.

The audit was conducted in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. Fieldwork procedures utilized in the course of developing the findings and recommendations presented in this report are discussed in the Objectives, Scope, and Methodology section.

Kris Curtis CPA, CISA
Legislative Auditor

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OBJECTIVES, SCOPE, AND METHODOLOGY

In accordance with Title 24 of the Alaska Statutes and a special request by the Legislative Budget and Audit Committee, we have conducted a financial compliance audit of the Alaska Film Production Tax Incentive Program (AFPTIP). The objectives, scope, and methodology of our review were as follows.

Objectives

1. Identify Alaska Film Production Tax Credits (film tax credits) issued and redeemed by fiscal year, and determine whether total film tax credits issued have exceeded the statutory cap of $100 million.

2. Determine whether film tax credits were made available to qualified producers and whether the Department of Commerce, Community, and Economic Development's (DCCED) Alaska Film Office (AFO) appropriately approved productions after determining the productions were not contrary to the State's best interests.

3. Determine whether film tax credits were correctly calculated in accordance with AS 44.33.235(b)-(c) and (g) and whether producers spent a minimum of $100,000 in qualified expenditures in an agreed upon 24-month period as supported through verification by an independent certified public accountant (CPA).

4. Determine whether film tax credits were used within three years of being issued to exclusively offset corporate income taxes.

Scope and Methodology

The review of AFPTIP financial compliance activities covers the period of July 2008 through January 2012. To address the objectives of our audit we:

- Obtained from DCCED a schedule of all prequalified productions and a schedule of all film tax credits approved. Examined individual film tax credit files to verify the accuracy and completeness of both schedules.

- Obtained from the Department of Revenue (DOR) a schedule of all tax credits issued and redeemed. Inspected supporting files to verify the accuracy and completeness of the schedule. Examined DOR's methodology used to identify film tax credits redeemed. Evaluated schedules to determine if total film tax credits issued exceeded $100 million.

- Researched statutes, regulations, and policies to identify the AFPTIP tax credits' financial compliance requirements.

- Tested a sample of nine productions receiving film tax credits, and ten prequalified productions to verify:

    1. Credits were made available to qualified producers.
    2. The AFO appropriately approved productions after determining the production was not contrary to the State’s best interests.
    3. Tax credits were properly calculated in accordance with applicable statutes.
    4. Producers spent a minimum of $100,000 in qualified expenditures in an agreed upon 24-month period as supported through verification by an independent CPA.

- Examined Tax Division film tax credit files and individual corporate income tax returns for all film tax credits redeemed to verify film tax credits were used within three years of issuance and were only used to offset corporate income taxes.

- Interviewed staff at DCCED’s Division of Economic Development and DOR’s Tax Division to gain an understanding of AFPTIP prequalification and approval activities and the coordination of administration between the AFO and Tax Division.

- Contacted other states’ film offices to increase our understanding of their use of and approach to best interest determinations.

Additional fieldwork included:

- Researching attorney general and ombudsman online opinions for any issues related to the AFPTIP;

- Researching news articles and reports regarding the AFPTIP and other states’ film incentive programs;

- Analyzing AFPTIP annual reports to the legislature for program specific information and issues; and

- Examining available correspondence between the AFO, the Tax Division, and production companies pertaining to the film tax credits.

ORGANIZATION AND FUNCTION

The Department of Commerce, Community, and Economic Development's (DCCED) Alaska Film Office (AFO) and the Department of Revenue's (DOR) Tax Division administer the Alaska Film Production Tax Incentive Program (AFPTIP). The AFO is responsible for the prequalification and approval of the Alaska Film Production Tax Credit (film tax credit). The Tax Division is responsible for issuing film tax credit certificates and monitoring the redemption of film tax credits by corporate taxpayers.

The Alaska Film Office

DCCED's mission is to promote a healthy economy and strong communities. Within DCCED, the Division of Economic Development (DED) helps businesses and developers navigate the network of programs; it also offers technical assistance and support for start-ups, expansions, and relocations. The AFO is an office within DED.

The AFO was created under AS 44.33.231 to, in part, administer the AFPTIP. The office consists of one development specialist who is supported by one, half-time administrative assistant. Per AS 44.33.231, AFO duties include:

- Cooperating with the private sector to expand and develop the film industry in Alaska;
- Promoting Alaska as a location for film production;
- Assisting productions in connecting with resources in the State for filming;
- Certifying Alaska film production internship training programs and promoting the employment of program interns by eligible production companies; and
- Cooperating with DOR to administer the AFPTIP.

The Tax Division

DOR is responsible for administering, enforcing, and collecting state tax, royalty, and assessment revenues. DOR is also responsible for ensuring the proper custody and investment of funds received by the State.

The Tax Division is one of five divisions within DOR. The Tax Division is charged with collecting state taxes and administering tax laws. It also regulates charitable gaming and provides revenue estimates and economic forecasting. Within the Tax Division, an income tax auditor oversees the administration of the film tax credit.

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BACKGROUND INFORMATION

The Alaska Film Production Tax Incentive Program (AFPTIP) is an economic incentive program created by the legislature in 2008 to encourage film industry growth in Alaska. A production must have at least $100,000 of qualifying expenditures[1] to be eligible for an Alaska Film Production Tax Credit (film tax credit). Film tax credits range from 30 to 44 percent of the qualified expenditures. (Exhibit 1 demonstrates the film tax credit rate structure.) The AFPTIP is set to sunset as of July 1, 2013, or when film tax credits issued reach $100 million.

Exhibit 1

Film Tax Credit Rates

Credit Type	Rate	Requirement:
Base	30%	Production expenditures must be made in Alaska.
Base can be increased by meeting the following:		
Alaska Hire	10%	Wages paid to Alaska residents receive an additional 10 percent credit.
Rural Location	2%	Production expenditures made in a rural area also receive an added 2 percent credit.
Seasonal	2%	Production expenditures made between October 1st and March 30th receive an added 2 percent credit.
	44%	**Maximum Potential Credit**

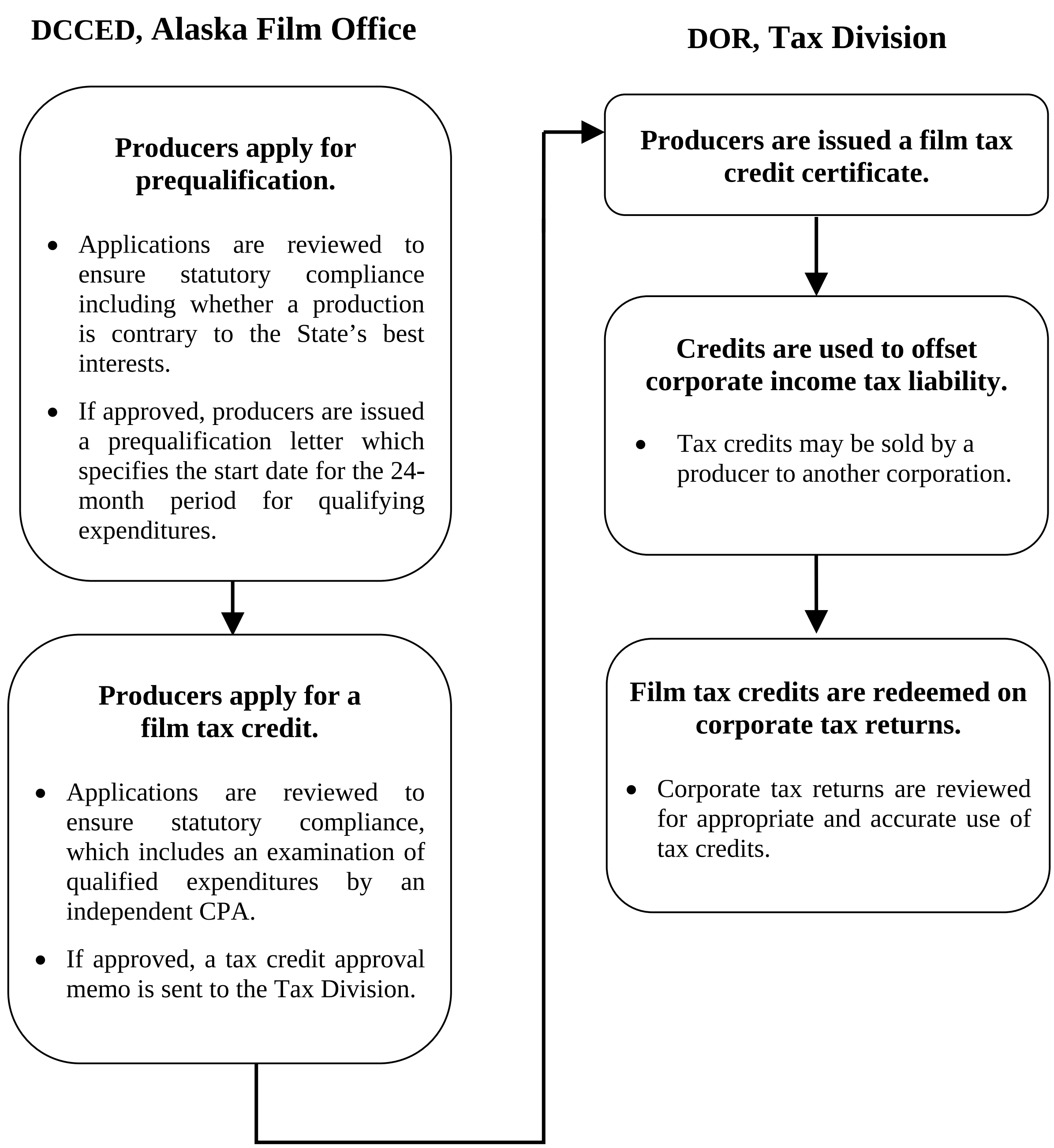
Source: *AS 44.33.235*

As discussed in the Organization and Function section of this report, the AFPTIP is co-administered by the Department of Commerce, Community, and Economic Development's Alaska Film Office (AFO) and the Department of Revenue's (DOR) Tax Division. The AFO prequalifies productions and approves film tax credits. The Tax Division issues film tax credit certificates upon receipt of the AFO's approval and monitors credit redemption.

[1]See AS 44.33.236 for a listing of qualified expenditures.

Exhibit 2

Alaska Film Production Tax Credit
Process for Approval, Issuance, and Redemption



Producers interested in participating in the AFPTIP must prequalify.

A producer interested in participating in the AFPTIP must file an application for prequalification. An application must include:

- A detailed budget clearly identifying expenditures to be made in Alaska, including expenditure dates;
- A distribution plan that outlines where the film will be distributed and its intended audience;
- A script or synopsis of the production;
- The names of the producer, director, and proposed cast;
- The estimated start date and completion date of the production and filming dates; and
- The Alaska business license number or proof of a business license application.

When considering applications, the AFO is required by statute to determine that a production is "***not contrary to the best interests of the State***" (emphasis added). Alaska Statute 44.33.233(a)(2) states that the following general guidance may be considered in making this determination:

> *(1) The effect of the production on both the immediate and long-term prospects for the film industry in Alaska;*
> *(2) The effect of the production on the employment of Alaska residents;*
> (3) *The effect of the production on the economy of the state.*

Current state regulations[2] do not further define what is *"not contrary to the best interests of the State"* nor do proposed regulations.

Upon approval by the AFO, production companies are issued a prequalification letter that estimates the total potential film tax credit based on the production company's submitted production budget. The letter also communicates to the producer that prequalification does not guarantee a film tax credit will be received.

The prequalification approval letter issued by the AFO establishes the 24-month period in which all eligible expenditures must be incurred. Eligible expenditures are those occurring in Alaska[3] and include, in part, wages paid to residents and non-residents, food and lodging, supplies, and transportation.

Only prequalified producers may submit applications for film tax credits.

As discussed above, the production must be prequalified before a film tax credit application may be submitted. Producers are required to submit an application for a film tax credit no

[2] 3 AAC 188.
[3] In-state travel expenditures are fully eligible while expenditures for interstate travel to and from Alaska are only 50 percent eligible.

later than 60 days after the end of the 24-month period for incurring qualifying expenditures. Required support for the film tax credit application includes:

- A detailed identification of the production, including: the name of the production company, related entities, the production title, and a rough assembly of the production as required by state regulation;
- A copy of the Alaska business license valid during production;
- A budget and cost report itemizing Alaska expenditures, including a list of all personnel and cast working in Alaska detailing the dates worked and the salaries earned;
- Lists of names and addresses of entities whose qualified expenditures were included;
- Verification by an independent, Alaska-licensed certified public accountant that the costs claimed in the application are qualified expenditures;
- A list of all Alaska principal photography days including dates and locations;
- A list of any tangible personal property for which costs were included that was not transferred or otherwise disposed of at the end of production; and
- A sworn certification by the producer, that the producer and the production have fully complied with all applicable state laws and regulations during the production.

Applications are reviewed by the AFO for compliance with statutes and regulations. Information requiring further clarification or that was not included with the original submission may be requested. The AFO development specialist was solely responsible for reviewing and approving the prequalification and final credit applications until 2011. Since 2011, a panel of three to four Division of Economic Development (DED) staff have been responsible for reviewing and approving prequalification and final film tax credit applications.[4] The AFO provides a notification memo to the DOR's Tax Division once a film tax credit has been approved and is ready for issuance.

<u>Film tax credits are issued to approved producers</u>.

Upon receipt of the approved film tax credit memo, Tax Division staff prepare a film tax credit certificate. The signed certificate is mailed to the producer or production company.

[4]Potential DED prequalification reviewers may include: the AFO development specialist, the DED division director, and a DED development manager. Potential DED final credit application reviewers may include: the AFO development specialist; an accountant III; a tourism development specialist II; and an economic development advisor.

A film tax credit is available for use by any corporation with an Alaska corporate income tax liability. Film tax credits are fully transferable in whole or in part and may be used for a tax period ending on or after the date the credit certificate was issued.[5] A film tax credit expires three years after its initial issue date.

A producer typically sells the film tax credit at a discount to a corporation with an Alaska corporate tax liability. To transfer the film tax credit to the purchaser, the official certificate must be returned to the Tax Division, and the new, transferred film tax credit certificate is issued to the purchaser. An official tax certificate must be submitted with a corporation's income tax return.

[5]The regulations changed in March 2011 to allow the credit to be used, if transferred, only after the date of transfer. Before March 2011, the tax credit could be used to offset a tax liability incurred on or after the date of the initial certificate's issuance.

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REPORT CONCLUSIONS

The audit of the Alaska Film Production Tax Incentive Program (AFPTIP) evaluates whether the Department of Commerce, Community, and Economic Development's (DCCED) Alaska Film Office (AFO) and the Department of Revenue's (DOR) Tax Division administers the AFPTIP in compliance with the AFPTIP financial requirements. The audit also evaluates the AFO's approval of film tax credit prequalification applications and final credit applications, and the Tax Division's film tax credit issuance and tracking.

Generally, we concluded that the AFO and the Tax Division adhere to film tax credit approval, issuance, and redemption statutes and regulations while administering AFPTIP. However, there are areas for improvement in the film tax credit approval and redemption processes. Recommendations for improvement are discussed in the Findings and Recommendations section of this report.

<u>Total film tax credits prequalified and issued have not exceeded $100 million</u>.

Exhibit 3 (page 12) summarizes the total film tax credits prequalified, issued, and redeemed since the program began in FY 09. Alaska Statute 43.98.030(f) states that the amount of the film tax credits issued may not exceed $100 million. The AFO had $28.6 million of outstanding prequalified film tax credits and $14.6 million of issued film tax credits as of January 31, 2012. The $43.2 million of prequalified and issued credits is 43 percent of the maximum tax credit of $100 million.

In comparing the film tax credits issued to the amount originally estimated as part of the prequalification process, film tax credits issued were 82 percent of the original estimate ($14.6 million divided by $17.8 million). Only $2.4 million (16 percent) of the credits issued have been redeemed. More detailed schedules of prequalified productions and issued tax credits are included in this report as Appendices A and B respectively.

Exhibit 3

Prequalification Applications and Film Credits Issued and Redeemed July 2008 – January 2012

Prequalification Applications

Fiscal Year	Quantity	Estimated Credit
2009	7	$ 345,882
2010	24	16,124,480
2011	33	19,872,154
2012*	19	10,038,507
Total Applications**	**83**	**$ 46,381,023**
Less:		
Finalized & Issued	(34)	$ (17,822,675)
Denied, Expired, or Withdrawn	(12)	-0-
Net Outstanding***	**37**	**$ 28,558,348**

Tax Credits Issued

Fiscal Year	Quantity	Estimated Credit	Actual Credit
2010	4		$ 244,546
2011	17		6,263,266
2012*	13		8,113,907
Total Issued	**34**	**$ 17,822,675**	**$ 14,621,719**
Plus Outstanding Prequalified Estimates			28,558,348
Total Issued & Prequalified			**$ 43,180,067**

Tax Credits Redeemed

Fiscal Year	Redeemed Amount
2011	$ (193,765)
2012*	(2,224,995)
Total Redeemed	**$ (2,418,760)**

*Data from 2012 includes only seven months of activity.

**Total estimated credit amount is net of 12 denied, expired, and withdrawn applications totaling $21,184,958.

***This includes five applications totaling $11,330,098 that are pending final credit approval as of January 31, 2012.

Credits were properly calculated using qualified expenditures, properly approved, and made available to qualified producers.

This audit examined nine of the 34 film tax credits issued representing $9.5 million (65 percent) of the total issued. All nine credits issued were properly calculated in accordance with AS 44.33.235(b)-(c) and (g) using qualifying expenditures as supported through verification by an independent CPA. Additionally, all nine film tax credits were properly approved by the AFO. AFO application forms for prequalification and final film tax credits were consistent with statutory requirements.

This audit also analyzed the nine associated prequalification applications plus one additional prequalification application. All ten of the approved prequalification applications were offered to qualified producers. *Qualified producers* are defined in Alaska Statutes as those individuals who arrange financing for or supervise the production of films, videos, commercials, or television productions or pilots. The prequalification application names the producer and is certified by a representative of the production. In addition to listing the producer, applications are required by statute to list the names of the proposed principal cast and director. As further discussed in Recommendation No. 3, five of ten applications did not list the cast or director.

Best interests determinations were not documented by the AFO.

A production is eligible for a film tax credit if the AFO determines the production is "*not contrary to the best interests of the State*." This best interest determination was not documented for any of the 83 prequalification applications. The AFO does not have regulations or written procedures for determining if a production is not contrary to the State's best interests. The lack of clear and measurable criteria to support best interest determinations is discussed in Recommendation No. 1.

Per DED's division director, the AFO applies the following unwritten guidelines when determining a production is contrary to the State's best interests.

- The production's proposed spending with Alaska vendors would be insignificant and provide little or no incentive for Alaska vendors to invest in legacy infrastructure.

- The production plan anticipates limited employment of Alaskans in comparison to non-Alaskans.

- The production is not dependent on Alaska as the setting for the story; therefore, Alaska would not realize follow-up benefits from the production in promoting tourism or providing a greater understanding of Alaska and Alaskan issues.

DED's division director stated that the above criteria support the determinations; however, this analysis is undocumented.

Inquiries were made of other states' film offices to determine whether the State of Alaska is unique in its best interest requirements. Of the 50 states, 39, excluding Alaska, currently offer a film production incentive. All 39 states were contacted, and 24 (62 percent) responded. As shown in Exhibit 4, states do not follow the same best interest requirements when evaluating potential film productions.

Exhibit 4

Best Interest Determination
Inquiries of Other States

Other States with Film Incentive Programs		**39**
Specific Requirement a Production Be in the State's Best Interest	7	
Unofficial Best Interests Policy	3	
No Best Interests Requirement	14	
Total Respondents		**24**
Non-Respondents		**15**

Exhibit 4 summarizes the results of the inquiry of other states. Of the 24 states that responded, seven (29 percent) make approval determinations using some criteria for the state's best interests in statute, regulations, or policy.[6] Three states (13 percent) stated that, although they do not have requirements in statute or policy, they follow unofficial criteria in weighing whether a production is not in the state's best interests, such as:

- Films that portray the state in a negative light;
- Films that are culturally offensive; and
- Films that are too violent or bordering on sexually explicit.

The other 14 states (58 percent) avoid employing best-interest criteria due to its subjective nature.

Some states have general criteria in statutes, regulations, and/or policies to guide their determination that a production is in the "*state's best interests*" while others have more specific criteria. Texas is a state that uses general and subjective criteria. Texas statute states:

> *The [film] office is not required to act on any grant application and may deny an application because of inappropriate content or content that portrays Texas or Texans in a negative fashion, as determined by the office, in a moving image project. In determining whether to act on or deny a grant application, the office shall consider general standards of decency and respect for diverse beliefs and values of the citizens of Texas.*[7]

[6] The seven states are: Kentucky, Oregon, Michigan, Pennsylvania, South Carolina, Tennessee, and Texas.
[7] Texas Title 4, Subtitle F, Chapter 485, Subchapter B, Sec. 485.022(e).

In contrast, Michigan is a state that determines best interests using more objective criteria. Michigan Film Office policy states:

> *Using the Public Act 291 of 2011 to guide approval decisions, preference is given to projects that best meet the following criteria:*
>
> - *The production is financially viable.*
> - *Utilization of existing infrastructure (studios, post-production facilities, equipment rental, etc.).*
> - *The number and wage levels of direct jobs for Michigan residents created by the production.*
> - *Ability to show Michigan in a positive light and promote the state as a tourist destination.*
> - *Magnitude of estimated expenditures in Michigan.*

The State of Michigan also requires that each application for final film tax credits goes through a three-phase review process: first by an application specialist, then by the finance officer, and finally by a review committee. During this process, an analysis of actual costs is performed to arrive at the "*True Michigan Spend*" which is then compared to the total amount the production is spending to arrive at an economic benefit factor.

<u>Generally, approved film tax credits appropriately included $100,000 or more of qualified expenditures in a 24-month period</u>.

As discussed in the Background Information section of this report, the AFO relies on a review of production expenditures by a certified public accountant (CPA) to ensure expenditures are qualified in accordance with statutes. After review, the CPA generates a letter which specifies the period in which the qualified expenditures were incurred. The period for qualified expenditures stated in the CPA's letter must begin no sooner than the start of the 24-month period established in the prequalification letter, or an alternative agreed upon starting date.

All of the nine issued film tax credits examined as part of this audit had $100,000 or more in qualified expenditures in a 24-month period.[8] However, the CPA letter for three of the nine productions had expenditure start dates that were prior to the documented 24-month starting period. For these three productions, the discrepancies in the start dates ranged between 12 to 97 days. The AFO development specialist did not consistently verify that the expenditure dates in the CPA letter matched the prequalification dates. This finding is further discussed in Recommendation No. 2.

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[8]Per AS 44.33.233(1), qualified expenditures must be incurred in a consecutive 24-month period. When calculating the 24-month qualification period, the period begins on the date on which the AFO issues the notice of prequalification to the producer or on the date agreed upon by the film office and the producer per 3AAC 188.020(b).

Redeemed film tax credits have been used within three years of being issued to offset taxes imposed under Alaska Statute 43.20.

All five redeemed film tax credits were used to offset net corporate income taxes imposed under AS 43.20. The Tax Division uses a query of its Tax Accounting System (TAS) to identify corporations who have used the film tax credit. While the Tax Division's identification of film tax credits redeemed was complete, the TAS query was limited to only credits greater than $10,000, creating the risk of missing the redemption of credits less than $10,000. This finding is further discussed in Recommendation No. 4.

The expiration date for the first film tax credit issued will be September 2012. Therefore, all credits redeemed to date have been used prior to their three-year expiration date.

FINDINGS AND RECOMMENDATIONS

Recommendation No. 1

The Department of Commerce, Community, and Economic Development's (DCCED) Division of Economic Development (DED) director and Alaska Film Office (AFO) development specialist should develop clear and measurable criteria to support best interests determinations.

The AFO does not have regulations or written procedures outlining clear and measureable criteria to determine that a production is "*not contrary to the best interests of the State*." The best interest determination by DED staff was not documented for the 83 approved or denied prequalification applications. Alaska Statute 44.33.233(a)(2) requires the AFO to determine that a production is not contrary to the State's best interests.

Without documenting determinations in accordance with clear and measurable criteria, denials could be seen as arbitrary which increases the risk for appeal and litigation. Approvals may also be questioned in the absence of a documented justification. While the AFO has set up other criteria to administer the Alaska Film Production Tax Incentive Program (AFPTIP), the AFO has not considered it necessary to document or further define what meets the definition of *not contrary to the best interests of the State.*

We recommend the DED director and the AFO development specialist adopt clear and measurable criteria for determining what is not contrary to the State's best interests. We also recommend that the determinations be documented and maintained.

Recommendation No. 2

The AFO development specialist should ensure that expenditures reported as reviewed by a certified public accountant (CPA) fall within the 24-month qualifying period.

In three of the nine credit applications examined, qualifying expenditure dates specified in the CPA's opinion letter were not within the 24-month qualifying period. The AFO either failed to note the date discrepancy or failed to document the change in the agreed upon start date. By not ensuring the dates on the CPA examination letter matched the qualifying period of expenditures, there is a risk that the approved credits were overstated.

State regulation 3 AAC 188.020(b) requires:

> *When calculating the 24-month qualification period of AS 44.33.233(a)(1), the period begins on the date on which the film office issues the notice of*

qualification to the producer or on the date agreed upon by the film office and the producer.

We recommend that the AFO development specialist ensure that the dates specified in the CPA's opinion letter agree with the prequalification letter issued by the AFO or an alternative agreed upon date.

Recommendation No. 3

The AFO development specialist should ensure that the names of the director and proposed cast are included in the prequalification application as required by statute.

Five of the ten prequalification applications examined as part of this audit did not include the names of the director and/or the proposed cast. Alaska Statute 44.33.234(a)(2) states that an application must include "*the names of the producer, director, and proposed cast.*" At the time of application, producers may not know who the director or principal cast will be. However, this information is known before a production begins filming and should be provided to the AFO.

Not consistently requiring that the names of the potential director and cast be included on the prequalification application limits the AFO's ability to evaluate the reasonableness of production expenditures in its prudent administration of the AFPTIP. For example, the salary and fees paid to a lead actor who also serves as producer is an area of potential abuse given that, in this situation, the higher the salary paid to the actor, the higher the tax credit received by the producer.

We recommend that the AFO development specialist ensure that the names of the director and proposed cast are included in the prequalification application as required by statute.

Recommendation No. 4

The Department of Revenue's (DOR) Tax Division director should improve procedures for tracking and reporting the use of tax credits.

The Tax Division uses a query of the Tax Accounting System (TAS) to identify and track the film tax credits redeemed and to ensure the film tax credits were only applied to corporate income taxes as required by statute. Alaska Statute 43.98.030(c) and (f) requires that a film tax credit be used to offset corporate income tax and that total film tax credits not exceed $100 million.

The current TAS query only captures film tax credits that are greater than $10,000. When the query was created, DOR did not anticipate that film tax credits would be redeemed for less than $10,000. However, since credits can be redeemed over a period of three years, a credit could be partially redeemed for less than $10,000.

The TAS query creates a risk that film tax credits redeemed for under $10,000 would not be reported on the Tax Division's film tax credit tracking log. This could lead to overuse of a film tax credit due to error or fraud by a taxpayer, or inaccurate reporting of film tax credit redemptions. The Tax Division's written procedures include a manual review of returns for eligible corporations' use of the film tax credit which would mitigate the identified risk; however, the procedure has not been implemented.

We recommend the Tax Division director improve procedures for tracking the use of tax credits on corporate tax returns. Specifically, we recommend the TAS query be changed to include all film tax credits. Furthermore, performing a manual review of income tax returns for those corporations eligible to use film tax credits, as already required by the division's written procedures, would improve the tracking and reporting of film tax credits redeemed.

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APPENDICES

The appendices included in this report provide detailed information concerning production companies that have applied to participate in the Alaska Film Production Tax Incentive Program.

Appendix A – Provides a complete list of production companies that have applied for Alaska Film Production Tax Credits (film tax credits) by fiscal year from the program's inception through January 2012. Details include identifying those productions that have been prequalified, denied, expired or withdrawn. Amounts for individual productions were not reported due to the proprietary nature of the information.

Appendix B – Presents a complete list of production companies issued film tax credits by fiscal year from the program's inception through January 2012. Details include the production company and production's name as well as the actual amount of film tax credit issued. Prequalification amounts for individual productions were not reported due to the proprietary nature of the information.

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Appendix A

Film Production Tax Incentive Program
Prequalification Applications
July 2008 through January 2012 (Unaudited)

Production Company	Prequalification Date	Estimated Credit
Fiscal Year 2009		
Proposal Productions	9/15/2008	
The Ascending Path	11/3/2008	
Dangerous Passage Productions	Expired	
Moore Huntley Productions	2/3/2009	
Original Productions	3/2/2009	
PSG Motion Pictures	5/6/2009	
Tiger Aspect Productions	Expired	
Total Net Prequalification Applications 2009*	**7**	**$ 345,882**
Fiscal Year 2010		
Kaos Entertainment	7/30/2009	
Diverse Bristol	8/7/2009	
Freemantle Media	Expired	
Affinityfilms	10/13/2009	
KRS Productions	Expired	
Greenwomb Productions	Expired	
Pontecorvo Productions	11/17/2009	
Original Productions	11/30/2009	
Original Productions	12/30/2009	
Anker Productions, Inc. (API)	1/20/2010	
Christmas with a Capital C, LLC	1/26/2010	
On the Ice, LLC	2/4/2010	
Sennet Entertainment, Inc.	Withdrawn	
Rainy Pass Productions	3/1/2010	
Great Projects Media, LLC	3/11/2010	
Rabbit Content	4/1/2010	
Icebreaker Films	5/3/2010	
The Digital Forces, LLC (Brain Farm)	5/3/2010	
Whittier Museum Association	5/17/2010	
Doppelganger Productions	5/26/2010	
Beyond Indigo Productions, LLC	6/15/2010	
Teton Gravity Research	6/15/2010	
Original Productions	6/23/2010	
Godspeed the Movie, LLC	Denied	
Total Net Prequalification Applications 2010*	**24**	**$ 16,124,480**
Fiscal Year 2011		
Jean Worldwide	7/9/2010	
Wildlife HD	7/26/2010	
Bongo, LLC	8/9/2010	

Appendix A

Film Production Tax Incentive Program
Prequalification Applications
July 2008 through January 2012 (Unaudited)
(continued)

Production Company	Prequalification Date	Estimated Credit
Aero Films	8/9/2010	
British Broadcasting Corporation	8/20/2010	
Sun Never Sets Productions, LLC	8/20/2010	
1964 Motion Picture	9/10/2010	
ZONK! Productions, Inc	10/12/2010	
Arctic Film Group, LLC	10/26/2010	
Original Productions	11/19/2010	
PSG Motion Pictures	12/7/2010	
Discovery Studios	12/7/2010	
PSG Motion Pictures	12/16/2010	
Boutique TV	12/28/2010	
Saint Thomas Productions	1/26/2011	
Original Productions	2/1/2011	
Standard Films Distribution	2/10/2011	
Cretaceous Films	2/22/2011	
Kid Play Entertainment, LLC	2/24/2011	
Ten Thirty-one Pictures Holdings	2/28/2011	
Bongo, LLC	3/14/2011	
Kid Play Entertainment, LLC	3/15/2011	
Kid Play Entertainment, LLC	3/18/2011	
Original Productions	3/18/2011	
Iditarod Trail Committee	3/31/2011	
Hyde Productions, LLC	Withdrawn	
Red Machine LLC	4/7/2011	
Teton Gravity Research	4/26/2011	
Authentic Alaskan Productions	4/27/2011	
Al Roker Entertainment	5/23/2011	
Legacy Pictures	Withdrawn	
Screaming Flea Productions	6/16/2011	
Dangerous Waters Productions	6/16/2011	
Total Net Prequalification Applications 2011*	**33**	**$ 19,872,154**
Fiscal Year 2012 through January 2012		
Affinityfilms	7/12/2011	
ZONK! Productions, Inc.	7/13/2011	
Helping Hands, LLC	7/22/2011	
Georgia Film Fund 5	7/28/2011	
Stardust Brands	8/8/2011	
Warm Springs Productions, LLC	8/15/2011	
Original Productions	8/22/2011	

Appendix A

Film Production Tax Incentive Program
Prequalification Applications
July 2008 through January 2012 (Unaudited)
(continued)

Production Company	Prequalification Date		Estimated Credit
Love of Life, LLC	8/22/2011		
Original Productions	9/13/2011		
Experience Media Studios	11/7/2011		
Prospector Productions	12/5/2011		
Original Productions	12/5/2011		
Parthenon Entertainment	12/7/2011		
Epoch Films	12/7/2011		
Alaska Channel	12/8/2011		
Red Rock Films	1/2/2012		
Kid Play Entertainment, LLC	Denied		
Kid Play Entertainment, LLC	Denied		
Kid Play Entertainment, LLC	Withdrawn		
Total Net Prequalification Applications 2012*	**19**	**$**	**10,038,507**
Total Prequalification Applications	**83**	**$**	**46,381,023**
Less:			
Applications with Final Credit Approval (See Appendix B)	**34**	**$**	**(17,822,675)**
Denied, Expired, or Withdrawn	**12**		
Total Outstanding Prequalifications	**37**	**$**	**28,558,348**
Total Denied, Expired, and Withdrawn Prequalifications	**12**	**$**	**(21,184,958)**

* Estimated credit subtotals are the net of denied, expired, and withdrawn applications.

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Appendix B

Film Production Tax Incentive Program
Tax Credits Issued
July 2008 through January 2012

Production Company	Production	Approval Date	Credit Issued
Fiscal Year 2010			
Moore Huntley Productions, Inc	Alaska: Most Extreme	9/11/2009	$ 79,504
KAOS Entertainment, LLC	Grizzly Land	10/21/2009	54,138
The Ascending Path, LLC	Disaster on K2	10/28/2009	46,009
Proposal Productions, Inc	The Proposal	11/25/2009	64,895
Total Tax Credits 2010		**4**	**$ 244,546**
Fiscal Year 2011			
Rabbit Content, LLC	Prilosec - Fairbanks Project	7/9/2010	$ 107,277
Affinityfilms, Inc	Survive and Thrive	8/4/2010	39,693
Original Productions	Ice Road Truckers - Season 3	9/27/2010	393,424
On the Ice, LLC	On the Ice	10/1/2010	171,146
Diverse Bristol LTD	Man vs Wild - "The Last Frontier"	10/11/2010	67,994
Rainy Pass Productions, LLC	R5 Sons - Season 1	11/12/2010	150,442
Original Productions	Deadliest Catch - Season 6	11/22/2010	584,563
PSG Motion Pictures, LLC	Alaska State Troopers - Season 1	12/8/2010	30,709
Original Productions	Ice Road Truckers - Season 4	12/17/2010	898,204
Beyond Indigo Productions, LLC	Beyond (aka Ghost Vision)	12/22/2010	2,140,413
Sun Never Sets Productions, LLC	Top Gear (Alaska Tough Truck)	1/13/2011	81,003
Jean Worldwide	Sarah Palin's Alaska	2/11/2011	1,196,894
Teton Gravity Research	Light the Wick	2/17/2011	51,829
Christmas with a Capital C, LLC	Christmas with a Capital C	3/2/2011	111,690
British Broadcasting Corporation	Frozen Planet	4/13/2011	75,029
Arctic Film Group, LLC	Untitled Arctic Project	4/26/2011	50,493
Pontecorvo Productions	Bears of the Last Frontier	5/2/2011	112,463
Total Tax Credits 2011		**17**	**$ 6,263,266**
Fiscal Year 2012 through January 2012			
ZONK! Productions, Inc.	NAPA's North to Alaska	7/11/2011	$ 91,080
Kid Play Entertainment, LLC*	PlayKids - BG3	7/14/2011	2,053,345
PSG Motion Pictures, LLC	Alaska State Troopers s2	8/8/2011	93,274
Wildlife HD	Alaska BluRay DVD Collection	8/18/2011	217,473
Original Productions	Hillstranded	8/23/2011	53,437
Bongo, LLC	Flying Wild Alaska S1	8/24/2011	398,918
Teton Gravity Research	One for the Road	10/4/2011	48,244
Kid Play Entertainment, LLC	Tiny Detectives - BG4	10/5/2011	1,888,885
Kid Play Entertainment, LLC	Young World Sleuths - BG5	10/31/2011	1,871,718
Stardust Brands Inc	American Eagle Outfitters	11/28/2011	46,752
Original Productions, LLC	Deadliest Catch s7	12/12/2011	786,441
Original Productions, LLC	Ice Road Truckers - S5	12/27/2011	491,772
Iditarod Trail Committee	Iditarod 2011: Year of the Dream…	1/13/2012	72,568
Total Tax Credits 2012		**13**	**$ 8,113,907**
TOTAL		**34**	**$ 14,621,719**
Original Prequalification Estimates for Above Productions			**$ 17,822,675**

* Two tax credits were issued for this production. The first was issued on July 14, 2011 for $250,684 and the second on August 4, 2011 for $1,802,661.

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STATE OF ALASKA
DEPARTMENT OF
COMMERCE
COMMUNITY AND
ECONOMIC DEVELOPMENT
Office of the Commissioner

Sean Parnell, Governor
Susan Bell, Commissioner

April 18, 2012

RECEIVED
APR 18 2012
LEGISLATIVE AUDIT

Ms. Kris Curtis, CPA, CISA
Legislative Auditor
Alaska State Legislature
Legislative Budget and Audit Committee
Division of Legislative Audit
P.O. Box 113300
Juneau, AK 99811-3300

Re: Department of Commerce, Community, and Economic Development, Department of Revenue, Alaska Film Tax Incentive Program Preliminary Audit Report, Audit Control Number 08-30065-12

Dear Ms. Curtis:

Thank you for the opportunity to respond to the three recommendations issued to the Division of Economic Development's (DED) Alaska Film Office (AFO) in the preliminary audit report referenced above.

<u>Recommendation No. 1</u>

<u>The Department of Commerce, Community, and Economic Development's (DCCED) DED director and AFO development specialist should develop clear and measurable criteria to support best interest determinations.</u>

The department concurs with this recommendation. The division has implemented new processes and documentation regarding the qualification process. Ongoing effort will be made to refine and document this process.

<u>Recommendation No. 2</u>

<u>The AFO development specialist should ensure that expenditures reported as reviewed by a certified public accountant (CPA) fall within the 24-month qualifying period.</u>

The department concurs with this recommendation. The division has developed new Agreed Upon Procedures (AUP) that are specifically linked to the final application. Alaska CPAs are required to be trained in using the AUP. A training session was held on January 26, 2012 with more than 30 Alaska CPAs and division staff attending.

P.O. Box 110800, Juneau, Alaska 99811-0800
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Recommendation No. 3

The AFO development specialist should ensure that the names of the director and proposed cast are included in the prequalification application as required by statute.
The department concurs with this recommendation. There are timing and operational considerations regarding when a producer may apply for a production incentive and when key cast and crew contracts are finalized. The division will require the detailed information defined by statute prior to approving a qualified production period. Productions may apply and qualify for the production incentive, but not receive authorization to incur qualified expenses until the cast and crew detail is provided. This process ensures that both the legislative purpose of the program and the statutory detail required can be met.

Again, thank you for an opportunity to respond to the auditor's recommendation. If you have any additional questions please contact me at 465-2500.

Regards,

Susan K. Bell

Susan K. Bell
Commissioner

cc: JoEllen Hanrahan, Director ASD, DCCED
Wanetta Ayers, Director, DED, DCCED

State of Alaska
Department of Revenue

Commissioner Bryan Butcher

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Juneau, AK 99811-3300

April 17, 2012

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APR 17 2012
LEGISLATIVE AUDIT

Dear Ms. Curtis:

Thank you for your agency's review of the Department of Revenue's Tax Division (DOR), as part of the audit of the Alaska Film Production Tax Incentive Program (AFPTIP). We appreciate the opportunity to respond to the preliminary audit report on the Film Production Tax Incentive Program, dated February 29, 2012. The deficiency identified in the report is addressed below for the Tax Division.

<u>Recommendation No. 4</u>
<u>The Tax Division director should improve procedures for tracking and reporting the use of tax credits.</u>

DOR agrees with Legislative Audit's position that it should improve procedures for tracking and reporting the use of tax credits. As stated in your agency's report, the Tax Division runs a report of film credits used in a given tax year, but that report has been limited to film credits that are greater than $10,000. The report showing film credits also includes the use of other tax credits. The current Tax Division accounting system does not allow the Division to run a report showing just the film tax credit. As this report can be voluminous, DOR limited the report query to show all transactions over $10,000, as it has not issued any film credit certificates in an amount less than $10,000. That being said, however, DOR agrees with the recommendation of Legislative Audit, and have changed the report query to capture all credits, regardless of the amount. In addition, DOR has implemented a procedure whereby the tax returns of corporations that have been issued a film production tax credit certificate are manually reviewed to determine if the film credit has been claimed. These two procedures together should ensure that no film credits are improperly claimed.

DOR believes that it has addressed the findings and recommendation presented in your agency's report, and welcome any additional comments or questions from you or your staff.

Sincerely,

Bryan Butcher
Commissioner

cc: Bruce Tangeman, Deputy Commissioner, DOR
Matthew Fonder, Director, Tax Division, DOR
Johanna Bales, Deputy Director, Tax Division, DOR
Jerry Burnett, Director, Administrative Services Division, DOR

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