

**NIELSEN, MERKSAMER,
PARRINELLO, MUELLER & NAYLOR, LLP**
ATTORNEYS AT LAW

1415 L STREET, SUITE 1200
SACRAMENTO, CALIFORNIA 95814

TELEPHONE (916) 446-6752 FAX (916) 446-6106

Testimony of Eric J. Miethke¹ on behalf of
The Motion Picture Association of America (MPAA)
The Effect of a Proposed Business Net Receipts Tax on the Motion Picture Industry

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Commission on the 21st Century Economy
University of California, Los Angeles
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Mr. Chairman and Members of the Commission:

Thank you for the invitation to speak to you today. I am appearing today in my capacity as California outside tax counsel for the MPAA.

The Commission has asked for testimony on the issue of the affect of a proposed Business Net Receipts Tax (BNRT) on the motion picture industry in California. We have also been asked for our views on a proposal which would phase in the BNRT in exchange for a reduction of the sales tax rate and the eventual elimination of the corporate income tax. MPAA has some general observations about the proposal as we understand it, and then some specific observations on how the industry would be affected by the proposal.

General Observations

Our first general point is that we have been unable to fully analyze the proposal because no specific language has been placed before us, and the general parameters of the

¹ B.A (Economics, with Honors) Stanford University; JD (with Distinction) University of the Pacific McGeorge School of Law; LL.M(Taxation) New York University Law School; Partner-Nielsen, Merksamer, Parrinello, Mueller & Naylor, LLP, Sacramento, California; (916) 446-6752; emiethke@nmgovlaw.com.

BNRT have “morphed” since they were first explained to the Commission in June. The “Preliminary Overview” of the BNRT received last week still leaves many if not most major policy decisions unresolved. For example, we have no firm commitment on what the proposed rate of BNRT tax would be. No decision has been made as to whether business capital expenditures will be expensed as originally discussed, or capitalized and depreciated. We do not know the phase-out rates for sales and use taxes and for the corporate and personal income taxes, or indeed what guarantees would ensure that those taxes would be reduced and eliminated as promised. Finally, it is as yet undecided what would happen to accumulated income tax gains, credits and NOLs at the end of the transitional period.

The answers to these questions are essential, because the BNRT is imposed on a unitary basis, and virtually all of the major motion picture studios are part of a much larger unitary family of corporations that are engaged in business around the country and around the world. Therefore, the industry will need to review the specifics of the BNRT proposal in a larger corporate context when those details become finalized before we can finally take a position on a reform proposal.

Even without specifics, we note that there are several incentives built into the BNRT which may not have a positive affect on the motion picture industry. For example, because payments to a studio or production company’s own employees are not deductible from gross receipts, the BNRT as we understand it would have a built-in incentive for both outsourcing and off-shoring. For an industry that has worked closely with our union partners to encourage the expansion of domestic production, and discourage runaway production, we do not view these built-in biases as helpful. We are

unconvinced that there is an easy solution to this problem, because simply limiting deductibility of payments to those made to taxpayers who have registered to pay BNRT would be subject to an immediate constitutional challenge under the Commerce Clause for discrimination. Moreover, even if a court were to find such a requirement legally sound, we would anticipate an international political response similar to that in the 1980's in response to California's use of worldwide combination under the Bank and Corporation Tax.

Furthermore, California is known as the home of start-up companies, and the motion picture industry is a major part of that entrepreneurial spirit. Conceptually, because capital formation and retention is the major bane of start-up companies, a BNRT which will be imposed whether a business entity is profitable or not, does not allow the deduction of interest expense from gross receipts and which eliminates the equivalent of the net operating loss carry back in existing law seems inconsistent with a state's effort to encourage new business creation, including those in the motion picture industry.

Finally, we generally see a BNRT as possibly increasing the price of motion picture production, distribution and exhibition in California. Indeed, as the representative of Ernst & Young testified in June, an estimated 70% of the BNRT would be passed along in the form of higher prices. These higher prices would be imposed on virtually all services and goods that are purchased by the motion picture industry in California. While these expenditures would be deductions from the studios' and production companies' calculations of their own BNRT liability, the industry would still be paying higher prices for goods and services that heretofore had not been taxed under the sales tax regime. To the degree the BNRT increases the cost of production in California, and those cost

increases are not offset by equal or greater decreases in sales tax and corporate income tax liability, we see a conflict with the Administration's and Legislature's stated goals of increasing domestic production through the imposition of the production tax credit implemented this very year.

The MPAA cannot discern whether the NGRT should be viewed as supplanting the sales tax or the corporate income tax. Some MPAA members view the BNRT as close to a sales tax on services, while others view it as the equivalent of an income tax. Without more information on the parameters of the deal as discussed earlier, there is no real way to determine whether this would be a significant new cost on the industry.

B. Income Taxes

Generally, the income taxation of the motion picture industry has been fairly noncontroversial for quite a long time; indeed, the special apportionment regulation that applies to the motion picture industry² is in the process of being updated by the Franchise Tax Board for the first time in 27 years. To the extent the BNRT is deemed to either supplement or supplant the corporate income tax, several issues arise.

First, the issue of whether capital purchases will be immediately expensed in the year placed in service, or capitalized and depreciated or amortized is a significant one for the motion picture industry. The industry makes significant purchases of high-value equipment on an ongoing basis, and also has significant capital investment in films that may be expensed or amortized under the proposal. The answer to this question may significantly affect the industry's analysis of the three tax proposals.

² Regulation 25137-8.

Second, we note that the proposed BNRT retains the same business/nonbusiness income distinction as in the existing Bank and Corporation Tax. This has proven to be an occasional, yet ongoing source of controversy between many corporate taxpayers (not just the motion picture industry) and the Franchise Tax Board, and the prospect of having those disagreements in two tax programs at the same time is a concern.

Third, we note that the formulas depicted on page 4 of the document entitled “Preliminary Overview: Net Receipts Taxes” appear to perpetuate California’s current system of interstate and intrastate apportionment of income between members of a unitary group. While we have not had sufficient time to analyze all of the possibilities and issues associated with this approach, we are concerned that many of the same problems of siloing of income and stranding of tax credits (should tax credits be offered as an offset to BNRT liability for desired activities) formerly found in the Bank and Corporation Tax and eliminated in SB 3x15 of 2009 would be reincarnated.

With regard to transition issues, we have several concerns. First, carried-over tax credits and net operating losses could be used in conjunction with the corporation tax *during the phase-in period*, but what happens to the credits and NOLs remaining at the end of the phase-in period? Although the document does not expressly state, we presume remaining credits and NOLs would be lost completely. We see this as potentially a serious balance sheet issue that is a major stumbling block.

The treatment of deferred expenses, gains and income at the end of the transition period is also far too significant to defer to “future legislative actions.” In the absence of express treatment at the outset, we would expect these deferred items to generate a major tax liability for the corporate community at the termination of the phase-in period.

Finally, if the BNRT is not to be viewed in a vacuum, but as part of a package of rate reductions and eventually elimination of the corporate income tax, the final tax rates and transition rates for all of the taxes in question remain unstated by the Commission, as does the issue of whether the elimination of the corporate tax will be established in the same legislation as that establishing the BNRT, or will be left to “future legislative actions.” Given the state’s fiscal performance in recent years, there is great skepticism as to whether the future tax reduction and eliminations would ever occur, or whether they would be perpetually “delayed for another year” with the BNRT becoming just another layer of state taxation.

Conclusion

On behalf of the MPAA, we appreciate the opportunity to put our views in the record of the Commission, and to appear before you today. I am prepared to answer any questions the Commissioners may have at this time.

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