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AGENCY REVIEW

DEPARTMENT OF COMMERCE
WEST VIRGINIA FILM OFFICE

AUDIT OVERVIEW

The Film Tax Credit Program Has Produced Minimal Economic Benefit to West Virginia; Therefore, the Legislative Auditor Recommends Termination of the Tax Credit and the Film Office

Deficiencies in Business Practices Led to the Collection of Revenue Without Statutory Authority, Incomplete Records, and Misleading, Inflated Reports

WEST VIRGINIA LEGISLATIVE AUDITOR
PERFORMANCE EVALUATION & RESEARCH DIVISION

JOINT COMMITTEE ON GOVERNMENT OPERATIONS

JOINT COMMITTEE ON GOVERNMENT ORGANIZATION

WEST VIRGINIA LEGISLATIVE AUDITOR

PERFORMANCE EVALUATION & RESEARCH DIVISION

Building 1, Room W-314
State Capitol Complex
Charleston, West Virginia 25305
(304) 347-4890

Aaron Allred
Legislative Auditor

John Sylvia
Director

Noah Browning
Acting Research Manager

Trent Anderson
Research Analyst

Samantha Holiskey
Research Analyst

Justin Chapman
Referencer

Note: On Monday, February 6, 2017, the Legislative Manager/Legislative Auditor's wife, Elizabeth Summit, began employment as the Governor's Deputy Chief Counsel. Most or all the actions discussed and work performed in this report occurred after this date. However, the Governor's Deputy Chief Counsel was not involved in the subject matter of this report, nor did the audit team have any communications with her regarding the report. As Deputy Chief Counsel, the Legislative Auditor's wife is not in a policy making position within the Executive Branch. Therefore, the Performance Evaluation and Research Division does not believe there are any threats to independence with regard to this report as defined in A3.06.a and A3. 06.b of the Generally Accepted Government Auditing Standards. Furthermore, the Legislative Auditor has instructed the Director of Performance Evaluation and Research Division to document and discuss any issues he believes are a threat to the division's independence with the President of the Senate and the Speaker of the House due to Ms. Summit's position.

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EXECUTIVE SUMMARY

The Legislative Auditor conducted an Agency Review of the Department of Commerce pursuant to *W. Va. Code §4-10-8(b)(5)*. As part of this review, a performance audit was conducted on the West Virginia Film Office within the Tourism Office, which is a division of the Department of Commerce. The Film Office supports commerce by recruiting motion picture, television, and related media productions to select West Virginia as a place to conduct business. The objectives of this audit were to answer the following questions:

- Is there a continued need for the Film Industry Investment Tax Credit?
- Is there a continued need for the West Virginia Film Office?

The highlights of this audit are discussed below.

Frequently Used Acronyms in This Report

CPA – Certified Public Accountant

FCDC – Film Credit Development Committee

PERD – Performance Evaluation and Research Division

Report Highlights

Issue 1: The Film Tax Credit Program Has Produced Minimal Economic Benefit to West Virginia; Therefore, the Legislative Auditor Recommends Termination of the Tax Credit and the Film Office.

- ➢ Out-of-state companies are the top recipients of film industry investment tax credits. In particular, three production companies received 69 percent of all issued tax credits.
- ➢ Film production companies incurred over $49 million in direct and postproduction expenditures; however, wages paid to out-of-state residents constituted approximately $21 million of the expenditures. Out-of-state production companies spend significantly more on wages paid to out-of-state residents compared to West Virginia domiciled companies.
- ➢ Certified Public Accountants (CPAs), the Film Office, and the Film Credit Development Committee (FCDC) allowed questionable expenditures to count as qualifying expenditures. Some egregious examples include the depreciation of paint and paper towel holders.
- ➢ The transferability of the tax credit is important as nearly 85 percent of all film industry investment tax credits were sold. The average price paid for the tax credits was 90 cents on the dollar.
- ➢ The economic impact of the Film Tax Credit Program has been approximately $8.6 million over its 10-year existence, or less than $1 million annually on average. The Legislative

Auditor finds the economic benefit of the program to the State to be minimal. Furthermore, West Virginia currently lacks a strong incentive program, a skilled workforce, and the infrastructure needed to attract large film productions.

Issue 2: Deficiencies in Business Practices Led to the Collection of Revenue Without Statutory Authority, Incomplete Records, and Misleading, Inflated Reports.

- The Film Office conducted workforce training seminars around the state, but accepted registration fees for the seminars without statutory authority to do so.

- Per W. Va. Code §11-13X-11, the Film Office is required to submit a Tax Credit Review and Accountability Report every two years to the Governor and the Legislature. However, PERD's review found the Film Office's reports included misleading and inflated information and do not provide an accurate portrayal of the economic benefits of the Film Tax Credit Program.

- The Film Office's administers an economic development program issuing millions of dollars in tax credits per year, but the Office's recordkeeping practices are outdated and unreliable.

PERD's Response to the Agency Written Response

PERD received a written response to the report from the Tourism Office on December 21, 2017. The full response is provided in Appendix C. The West Virginia Department of Commerce and the Tourism Office concur with the Legislative Auditor's recommendations, and supports the elimination of the Film Tax Credit Program and Film Office. In addition, the Secretary of the Department of the Education and the Arts, who is a codified member of the FCDC, concurred with the Legislative Auditor's recommendations.

Recommendations

1. *The Legislative Auditor recommends terminating the Film Tax Credit Program.*

2. *If the Film Tax Credit Program is continued, the Legislative Auditor recommends suspending the program until the program's issues can be corrected.*

3. *If the Film Tax Credit Program is continued, the Legislative Auditor recommends the Film Office, with the assistance of the Tax Department, prescribe new Agreed Upon Procedures for CPAs. Specifically, the Film Office and the Tax Department should consider:*

    a. *Requiring CPAs to certify the qualification of a film production company's expenditures for tax credits from the list of eligible direct and postproduction expenditures as set forth in W. Va. Code §11-13X;*
    b. *Requiring CPAs to itemize blanket fees such as "service" and "producer" fees;*
    c. *Requiring CPAs to detail the number of new businesses created as a result of the film production company's qualified project;*

d. Requiring CPAs to detail the number of new jobs created as a result of the film production company's qualified project;
e. Requiring CPAs to detail all wages paid to West Virginia residents during the production of a qualified project;
f. Changing "haphazard selection" to "random, statistically significant sample" in Procedure 7-b and Procedure 8-b.

4. *If the Film Tax Credit Program is continued, the Legislative Auditor recommends the Legislature give authority to the Film Office to disqualify all types of expenditures, not just the types of expenditures listed in W. Va. CSR §110-13X-4.4.*

5. *If the Film Tax Credit Program is continued, the Legislative Auditor recommends the Legislature consider including a provision allowing the Tax Commissioner to recapture tax credits from production companies for any portion of tax credits subsequently deemed ineligible or obtained fraudulently.*

6. *If the Film Tax Credit Program is continued, the Legislature should consider removing the provision in W. Va. CSR §4.1.c.1. which allows production companies to apply to the Film Tax Credit Program after a production's completion.*

7. *If the Film Tax Credit Program is continued, the Legislative Auditor recommends the Film Office and the Film Credit Development Committee ensure tax credit productions meet all requirements as mandated by W. Va. Code §11-13X before tax credits are approved and issued.*

8. *If the Film Tax Credit Program is continued, the Legislative Auditor recommends the Tax Commissioner propose new rules for promulgation that reflect the updated annual program cap of $5 million per fiscal year.*

9. *The Legislative Auditor recommends terminating the Film Office.*

10. *If the Film Office is retained, the Legislative Auditor recommends the Film Office stop accepting revenues in the form of registration fees and depositing them into funds without statutory authority.*

11. *If the Film Office is retained, the Legislative Auditor recommends the Film Office issue Tax Credit Review and Accountability Reports in accordance with W. Va. Code §11-13X-11, and cease the inclusion of misleading, inflated information.*

12. *If the Film Office is retained, the Legislative Auditor recommends the Film Office update their file retention systems to an electronic system.*

ISSUE 1

The Film Tax Credit Program Has Produced Minimal Economic Benefit to West Virginia; Therefore, the Legislative Auditor Recommends Termination of the Tax Credit and the Film Office.

Issue Summary

The West Virginia Film Industry Investment Act was passed in 2007 to encourage greater economic growth and development in the film industry. Over the 10 years of the Film Tax Credit Program, over $15 million in tax credits have been issued to film production companies that incurred over $49 million in direct and postproduction expenditures. These production expenditures represent economic stimulus. However, an analysis by PERD finds that over $21 million of the expenditures went to out-of-state residents, which PERD deems to have little economic benefit to the state, and over $3.7 million was for projects that PERD determines to be unqualified. This reduces the economic stimulus to $24.4 million. However, when the State's costs of the program are deducted, $15.1 million in tax credits and $3.1 million for the Film Office, the total economic stimulus reduces to around $6.1 million over a 10-year period. Furthermore, there are some expenditures that PERD argues were not eligible expenditures. In addition, $1.1 million in production costs would likely have occurred without the tax credit. According to WVU's Bureau for Business and Economic Research, the multiplier effect for the West Virginia film industry is 1.411. Therefore, the Film Tax Credit Program has had an estimated economic impact of $8.6 million over 10 years, or less than $1 million annually on average. **The Legislative Auditor concludes the Film Tax Credit Program has produced a minimal economic benefit to West Virginia, and the State's opportunity cost of the Film Tax Credit Program does not justify the program's continuation and recommends termination of the program.**

Over the 10 years of the Film Tax Credit Program, over $15 million in tax credits have been issued to film production companies that incurred over $49 million in direct and postproduction expenditures.

The Film Tax Credit Program has had an estimated economic impact of $8.6 million over 10 years, or less than $1 million annually on average.

Background

In 2007, the Legislature passed HB 3145, the West Virginia Film Industry Investment Act (Act), creating the film industry investment tax credit "in order to encourage greater economic growth and development… through the production of motion pictures and other commercial film or audiovisual projects in this state." The Act allows eligible film production companies to receive nonrefundable tax credits for direct and postproduction expenditures made in West Virginia or incurred with a West Virginia vendor.

Following the passage of HB 3145, the West Virginia Film Office found making the tax credits transferable would increase out-of-state companies' use of the tax credit program. Transferability of tax credits is important for attracting out-of-state companies because most of them will not owe the business franchise tax, corporate net income tax, or personal income tax. Therefore, to recoup the value of the tax credits, production companies sell transferable tax credits to corporations or individuals with a West Virginia tax liability. From 2008 to 2013, four significant changes were made to the Act. These changes include:

- making the tax credit transferable,
- increasing the base tax credit from 22 percent to 27 percent of expenditures,
- increasing the tax credit allowance for hiring at least 10 West Virginians from two percent to four percent of expenditures, and
- reducing the overall program cap from $10 million to $5 million per fiscal year.

Transferability of tax credits is important for attracting out-of-state companies because most of them will not owe the business franchise tax, corporate net income tax, or personal income tax.

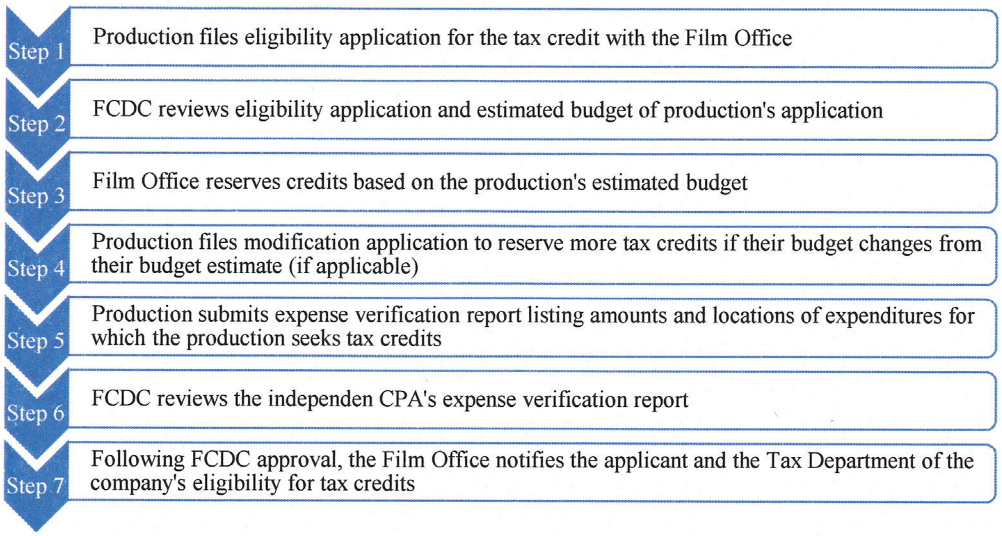
Currently, the Act requires an eligible film production company to incur a minimum of $25,000 in direct or post-production expenditures. The tax credit is worth 27 percent of the amount of expenditures incurred in the state, and there is an additional four percent allowance for hiring 10 full-time West Virginia residents for a possible total tax credit of 31 percent of expenditures.

As shown in Chart 1, before tax credits are issued, film production companies must submit an eligibility application to the Film Office. Once the Film Office receives the application, it is reviewed by the Film Credit Development Committee (FCDC). According to the Film Office, "The [FCDC] implements a checks and balances system to ensure that the Program operates accurately and within the intent of the statute and legislative rules." Another important check in the Film Tax Credit Program is the requirement in *W. Va. CSR §110-13X-4.3.b* that all applicants for the tax credit submit an expense verification report prepared by an independent Certified Public Accountant (CPA). The expense verification report verifies the qualification of the expenditures and is reviewed by the FCDC. As set forth in *W. Va. CSR §110-13X-2.17*, the FCDC is comprised of the following members:

The tax credit is worth 27 percent of the amount of expenditures incurred in the state, and there is an additional four percent allowance for hiring 10 full-time West Virginia residents for a possible total tax credit of 31 percent of expenditures.

- the Secretary of the West Virginia Department of Commerce, or their designee;
- the Secretary of the West Virginia Department of Education and the Arts, or their designee;
- the Director of the West Virginia Film Office, or their designee;
- the Commissioner of the West Virginia Division of Tourism, or their designee;
- the Tax Commissioner, or their designee; and,
- an additional representative of the Film Office, appointed by the Commissioner of Tourism.

Chart 1
Film Tax Credit Program Application Process



Source: PERD analysis of W. Va. Code of State Rules.

West Virginia's film tax credit program competes with the majority of states nationwide to attract film productions, including all five surrounding states.

All Surrounding States and Most States Nationwide Have Some Form of Incentive for the Film Industry.

West Virginia's film tax credit program competes with the majority of states nationwide to attract film productions, including all five surrounding states. Table 1 shows an overview of West Virginia and its surrounding states' film incentive programs.

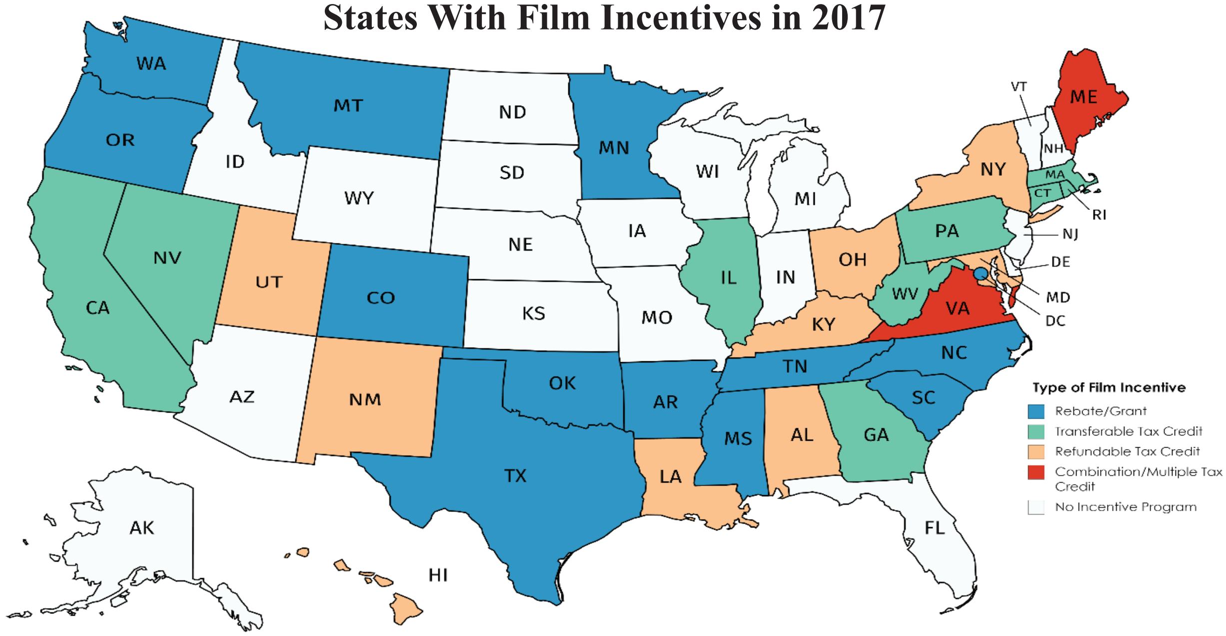
Table 1 Comparison to Surrounding States				
State	**Base Expense Incentive**	**Bonus Incentive(s)**	**Minimum Spend**	**Annual Cap**
KY	30% refundable tax credit	Additional 5% for using KY resident labor or 5% for filming in an enhanced incentive county	$250,000 for feature films and television shows; $100,000 for commercials; $20,000 for documentaries and Broadway shows; $10,000 for KY companies	No cap
MD	25% refundable tax credit	2% additional credit for television series	In-state spending exceeding $500,000 with 50% of filming done in MD	Determined annually as of 2016
OH	30% refundable, transferable tax credit	No bonus incentives	$300,000	$40 million
PA	25% transferable tax credit	5% if project is intended as programming for a national audience at a qualified production facility	$1.5 million in direct expenditures if production costs are under $30 million; $5 million in direct expenditures if production expenses exceed $30 million	$65 million
VA	15% refundable tax credit	5% if production is shot in economically distressed area; 10-20% of payroll expenses of workers from Virginia; 10% for first-time film industry employees domiciled in Virginia	$250,000 with 50% of filming done in Virginia	$6.5 million
WV	27% transferable tax credit	4% if employing 10 or more WV residents	$25,000	$5 million
Source: PERD analysis of surrounding states' film tax incentive programs.				

Compared to surrounding states, West Virginia has the lowest minimum direct and postproduction expenditure requirement and the lowest annual cap. While West Virginia's cap is lower than in surrounding states, it was not exhausted in any fiscal year during the scope of the audit. West Virginia's base incentive is higher than in Virginia, Maryland, and Pennsylvania, and slightly lower than in Kentucky and Ohio. With the added incentive for using West Virginia labor, only Kentucky offers higher incentives.

In addition, West Virginia is one of 32 states that provides film production incentives. However, as shown in Map 1, the type of incentive differs from state to state. Twelve (12) states and the District of Columbia offer a rebate program for film productions, rather than a tax credit for a percentage of production expenditures. Eight states' programs are like West Virginia's, offering transferable tax credits valued at a percentage of the production's total expenditures. Nine states offer refundable tax credits, wherein the State gives production companies the option to claim the credit on their taxes or sell them back to the State for a portion of their face value. Two states offer some combination of refundable credits, transferable credits, rebates, and grants.

West Virginia is one of 32 states that provides film production incentives.

Map 1
States With Film Incentives in 2017



Source: EP Financial Solutions

The 2000s Saw a Rapid Increase in the Number of States With Film Incentive Programs, But Since 2010, Several States Have Eliminated Their Programs.

Louisiana created the nation's first film incentive program in 1992, and as recently as 2003, only five states had a film incentive program.

While filmmaking has been around for over a century, state film incentive programs are a relatively recent phenomenon. Louisiana created the nation's first film incentive program in 1992, and as recently as 2003, only five states had a film incentive program: Hawai'i, Louisiana, Missouri, New Mexico, and Virginia. However, from 2004 to 2010, the nation saw a rapid increase in the number of states with their own programs. At the peak in 2010, 40 states and the District of Columbia had some form of incentive program to encourage production companies to film in their state.

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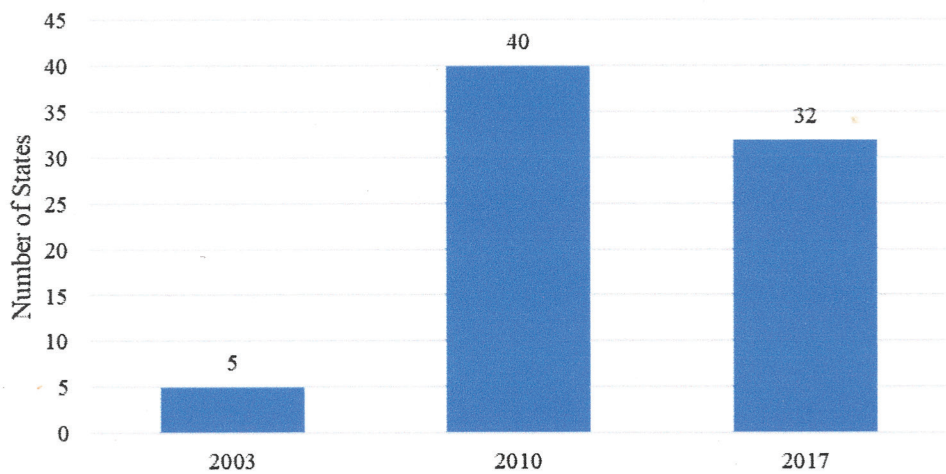
The rapid increase was largely the result of states seeing the success other states and Canadian provinces had attracted film productions. Nonetheless, since 2010, a net of 8 states[1] have eliminated their film incentive programs. Chart 2 shows the number of states with active film incentive programs in 2003, 2010, and 2017.

Chart 2
Number of States With Active Film Incentive Programs



Source: National Conference of State Legislatures and EP Financial Solutions, unaudited

The reasons why states implemented film incentive programs are for the economic stimulus, economic diversification, and visibility production companies can bring to states. For example, Georgia Governor Nathan Deal recently "announced that Georgia-lensed feature film and television productions generated an economic impact of $9.5 billion during FY 2017." Furthermore, over 15,000 individuals were employed in the motion picture and sound recording industries in Georgia in 2016, according to the U.S. Bureau of Labor Statistics. Visibility from

The reasons why states implemented film incentive programs are for the economic stimulus, economic diversification, and visibility production companies can bring to states.

[1] *10 states that had film incentive programs in 2010, did not have an active program in 2017 (Alaska, Arizona, Florida, Indiana, Iowa, Michigan, Missouri, New Jersey, Wisconsin, and Wyoming). Two states that did not have film incentives programs in 2010 now have an active program in 2017 (Arkansas and Nevada).*

film productions can also bring film-induced tourism to areas where the production is made. For instance, tours are regularly scheduled around the Atlanta area to the filming sites of *The Walking Dead*, and *Captain America: Civil War*.

Film incentive programs come at a cost, though. Continuing with the example of Georgia's film tax credit program, the Fiscal Research Center at Georgia State University put out a report in December 2016 that estimated that Georgia's tax credit program would cost the state $376 million in FY 2017 and another $414 million in FY 2018. The cost of film incentive programs has led many states to evaluate their program's effectiveness.

The cost of film incentive programs has led many states to evaluate their program's effectiveness.

One example is Florida, whose Office of Economic and Demographic Research (EDR) calculated in a 2015 report the state's return-on-investment using two different scenarios[2]. In the first scenario, EDR only factored in the cost of the tax credits used during its three-year scope from FY 2011 to FY 2013. EDR calculated the first scenario's return-on-investment to be 0.43. The second scenario factored in the cost of all tax credits issued to production companies whether or not they were used. EDR calculated the second scenario's return-on-investment to be 0.25. Both scenarios show Florida's tax credit program generates a positive return-on-investment, but the tax credit program does not produce enough tax revenues to pay for itself. Florida's Film Tax Credit Program was not renewed after FY 2016.

Another example is Michigan, whose Senate Fiscal Agency in 2010 analyzed the public (state) and private impacts of the state's film incentive program. In its report[3], the Senate Fiscal Agency found that Michigan's film incentive program had an estimated net private impact of $59.46 million in FY 2009-10, however, the estimated net public impact was negative $89.7 million. This means that Michigan's film incentive program cost the state $89.7 million to create $59.46 million in economic benefit. In 2015, Michigan Governor Rick Snyder signed House Bill 4122 ending the state's film incentive program.

Michigan's film incentive program cost the state $89.7 million to create $59.46 million in economic benefit.

The Film Office Issued Over $15 Million in Tax Credits, With the Majority Going to Three Companies.

As shown in Table 2, the Film Office issued over $15 million in tax credits to film production companies between FY 2008 and FY 2016. Those production companies incurred $49,373,381 in direct and postproduction expenditures in West Virginia.

[2] *Florida Legislature. Office of Economic and Demographic Research. Return on Investment for the Entertainment Industry Incentive Programs. 5 Jan. 2015. Web.*

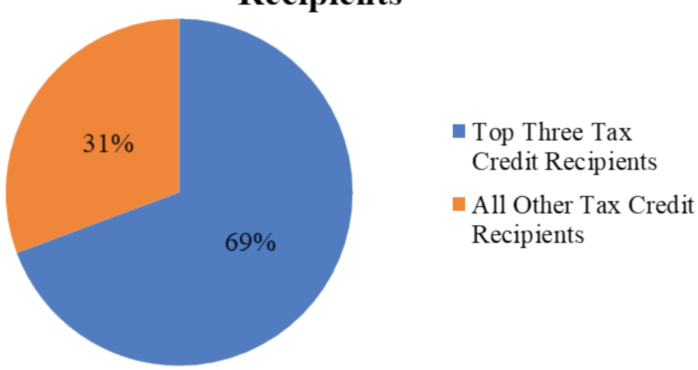
[3] *Michigan Legislature. Senate Fiscal Agency. Film Incentives in Michigan. By David Zin. Sept. 2010. Web.*

Table 2 Tax Credits Issued by Fiscal Year	
Fiscal Year	**Tax Credits Issued**
2008	$0
2009	$46,192
2010	$912,025
2011	$284,933
2012	$5,747,973
2013	$893,945
2014	$2,283,827
2015	$1,612,656
2016	$3,325,010
Total	**$15,106,560**
Source: West Virginia Film Office Tracking Data	

Three production companies received a combined 69 percent of all tax credits issued by the Film Office.

However, a small number of productions received the most tax credits. As indicated in Chart 3, three production companies received a combined 69 percent of all tax credits issued by the Film Office. Collectively, the top three tax credit recipients filmed six qualified productions in West Virginia – incurring an average of $5,599,110 in direct and postproduction expenditures per production. This is in contrast to all other tax credit recipients, who filmed 91 qualified productions while incurring an average of $173,392 in direct and postproduction expenditures per production.

Chart 3
Comparison of Film Tax Credit Recipients



Source: PERD analysis of the West Virginia Film Office Tracking.

Out-of-State Companies Received Almost 90 Percent of All Issued Tax Credits.

Of the approximately $15 million in tax credits issued, more than $13 million in tax credits went to out-of-state companies. While a few West Virginia production companies did consistently partake in the film tax credit program, their production expenditures were on average lower than their out-of-state counterparts. In total, West Virginia production companies incurred $5.8 million in direct and postproduction expenditures, while out-of-state production companies incurred $43.5 million in direct and postproduction expenditures.

Of the approximately $15 million in tax credits issued, more than $13 million in tax credits went to out-of-state companies.

Out-of-state production companies' expenditures were higher than West Virginia production companies partially because out-of-state production companies spent significantly more on wages to out-of-state residents. In fact, out-of-state production companies spent approximately $20.7 million on wages to out-of-state residents, while West Virginia production companies spent less than $500,000. However, spending on wages to in-state residents was more comparable; out-of-state production companies spent $2.7 million while West Virginia production companies spent $2 million.

The amount of out-of-state resident wages used to qualify for tax credits is concerning from an economic impact perspective. First, wages paid to out-of-state residents provide little benefit to West Virginia's economy. While out-of-state workers may spend some of their wages in West Virginia, the vast majority of those earnings benefit their home states. Second, out-of-state resident wages alone resulted in the issuance of approximately $5.7 million of tax credits. Third, allowing production companies to count wages paid to out-of-state residents as qualifying expenditures disincentivizes the companies from hiring a higher proportion of in-state workers.

Out-of-state resident wages alone resulted in the issuance of approximately $5.7 million of tax credits.

Over $1 Million in Film Industry Investment Tax Credits Went to Unqualified Productions.

West Virginia Code §11-13X-4 created the Film Industry Investment Tax Credit to benefit eligible companies producing qualified film projects in West Virginia. In accordance with the Act, eligible companies must produce "film industry production[s]," defined by *W. Va. Code §11-13X-3(b)(8)* as "qualified project[s] intended for reasonable national or international commercial exploitation." The following table outlines the statutory definition of a qualified project.

Table 3 W. Va. Code §11-13X-3(b)(8) Definition of Qualified Project	
Included	**Excluded**
• A feature length theatrical or direct-to-video motion picture, • A made-for-television motion picture, • A commercial, • A music video, • Commercial still photography, • A television pilot program, • A television series, and • A television mini-series.	• News or current affairs programming, • A weather or market program, • An interview or talk show, • A sporting event or show, • An awards show, • A gala, • A production that solicits funds, • A home shopping program, • A program that primarily markets a product or service, • Political advertising, or • A concert production.
Source: W. Va. Code §11-13X-3(b)(8)	

Upon review, PERD found the majority of productions approved for tax credits from FY 2008 to FY 2016 did not meet all eligibility requirements set forth in *W. Va. Code §11-13X*. Specifically, 38 productions that were only intended for local and regional distribution were not in compliance with *W. Va. Code §11-13X-3(b)(5)*, which requires qualified projects to be intended for national or international distribution. The 38 productions received $882,912 in tax credits. It should be noted that one (1) of the 38 productions wherein the project was suspended indefinitely and has no post-production end date or an anticipated release date; however, the production company received tax credits. Another 20 productions, ranging in length from 18 to 38 minutes, were not in compliance with *W. Va. Code §11-13X-3(b)(4)* which requires feature length direct-to-video productions to be in excess of 40 minutes. The 20 productions received $315,907 in tax credits.

Upon review, PERD found the majority of productions approved for tax credits from FY 2008 to FY 2016 did not meet all eligibility requirements set forth in W. Va. Code §11-13X.

In total, 58 of the 97 productions that received film tax credits should not have been approved by the Film Office and the FCDC. The dollar amount of film tax credits that were issued to the 58 unqualified productions was $1,198,820. **The Legislative Auditor finds the Film Office and the FCDC in non-compliance with the requirements for the film tax credit program as mandated in *W. Va. Code §11-13X*.**

Questionable Items Were Allowed as Qualified Expenditures.

As previously mentioned, film productions must have $25,000 in West Virginia direct production expenditures and/or postproduction expenditures in order to be eligible for tax credits. Table 4 includes the definitions of "direct production expenditures" and "postproduction expenditures" as defined in *W. Va. Code §11-13X-3(b)(2)* and *W. Va. Code §11-13X-3(b)(7)*.

Table 4
Qualified and Disqualified Expenditures

Qualified Expenditures, defined by *W. Va. Code §11-13X-3(b)(2) and §11-13X-3(b)(7)*	
Direct Production Payroll Expenditures	Payment of wages, fees, and fringe benefits to talent, management, and labor that are subject to West Virginia income tax. Payment to a personal services corporation for an artist if the artist and personal services corporation are both subject to West Virginia income tax.
Direct Production Vendor Expenditures	Story and scenario to be used by a project; Set construction and operations, wardrobe, accessories, and related services; Photography, sound synchronization, and related services; Editing and related services; Rental of facilities and equipment; Leasing of vehicles; Food and lodging; Airfare and insurance if purchased through a West Virginia based company; Other direct costs of producing a qualified project in accordance with generally accepted industry practices.
Postproduction Expenditures	Soundtrack production Special effects Music and sound editing
Explicitly Disqualified Expenditures in accordance with *W. Va. Code §11-13X-3(b)(7):*	
Disqualified Postproduction Expenditures	Advertising Marketing Distribution Expense payments

Source: PERD analysis of W. Va. Code §11-13X-3.

Per *W. Va. Code §11-13X-4*, direct production expenditures and postproduction expenditures must also be ***directly attributable*** to the production of a qualified project. PERD's review of CPA expense verification reports found many examples of expenditures that do not appear to be directly attributable to the making of a production but were allowed as qualified expenditures by CPAs, the Film Office, and the FCDC. In particular, one production company that consistently participated in the Film Tax Credit Program often included what PERD finds to be overhead business expenses. These expenses included:

One production company that consistently participated in the Film Tax Credit Program often included what PERD finds to be overhead business expenses.

- payments to utility companies for electric, gas, water, and sewer services;
- payments of monthly cell phone bills;
- payments of personal and real property taxes;
- payments to lawn care companies;
- payments for pest control at the production company's office building;
- payments of bank service charges;
- payments of credit/debit card fees;
- payments to banks for interest accrued on vehicle loans; and,
- depreciation expenses.

Since CPA expense verification reports provide no detail beyond the name, location, and amount of expenditures with a business vendor or individual, PERD can only speculate how the above expenditures were directly attributable to the making of a production. The Federal Accounting Standards Advisory Board *Handbook of Federal Accounting Standards and Other Pronouncement, as Amended* (June 2017) defines direct costs as "costs that can be ***specifically identified*** with an output," whereas indirect costs are "costs of resources that are jointly or commonly used to produce two or more types of outputs but are ***not specifically identifiable*** with any of the outputs." However, the expenditures identified above were often included on several consecutive CPA expense verification reports for the production company, suggesting the above expenditures were indirect costs allocated across multiple productions. While fully accounting for all costs associated with the operation of a business is necessary for business management purposes, the inclusion of general and administrative expenses and all other indirect costs is not permissible as *W. Va. Code §11-13X-4* allows only direct and postproduction expenditures that are directly attributable to the production. **PERD concludes indirect costs are by definition not directly attributable expenditures and are inconsistent with the requirements of *W. Va. Code §11-13X-4*.**

PERD's review found the inclusion of several egregious examples of assets that were depreciated and used by the production company mentioned above to qualify for tax credits.

Furthermore, PERD's review found the inclusion of several egregious examples of assets that were depreciated and used by the production company mentioned above to qualify for tax credits. These examples include depreciation of:

- paint,
- paper towel holders,
- pantry cabinets,
- artwork,
- reupholstered chairs, and
- iPhones.

According to *W. Va. Code §11-13X-3(b)(2)* a 'direct production expenditure' means "a ***transaction*** that occurs in the State of West Virginia or with a West Virginia vendor…" When depreciating an asset, no transaction occurs. Depreciation is an accounting tool to apply the consumption of an asset over the asset's useful life, but depreciation is not a cash outflow. **The Legislative Auditor concludes depreciation expense is not a qualified expenditure and finds its inclusion is inconsistent with the requirements of *W. Va. Code §11-13X-3(b)(2)*.**

Depreciation is an accounting tool to apply the consumption of an asset over the asset's useful life, but depreciation is not a cash outflow.

Profit Was Included as a Qualified Expenditure

Upon review of CPA expense verification reports, PERD also found another production company repeatedly included the line item "Total Available to Owners" and other variations such as "Total Available to WV Partners for Services Rendered to Project" and "Profit to Partners" as a qualifying expenditure. The production company included a schedule of payments to the partners/owners for their services to the production as supporting documentation of the expenditure line item. However, PERD found the amount of payments listed in the schedule of payments to the owners/partners were often much lower than what was being claimed as in the "Total Available to Owners" line item. When members of the FCDC asked for an explanation of the line item "Total Available to Owners," the owner/partner of the production company stated, "the expenditure described as 'total available to owners' means profits and compensation for services provided to the production by [the production company's] partners…" **PERD concludes the portion attributable to profit in the line item "Total Available to Owners" and its variations should not have qualified for tax credits.**

It should be noted that without the inclusion of producers' fees, several productions would not have met the $25,000 minimum threshold for receiving tax credits.

It should be noted that in subsequent applications, the line item was changed to "Producer's Fees." While producer's fees are a qualifying expenditure according to *W. Va. Code §11-13X-3(b)(2)(A)*, PERD does not believe the name change constituted a substantive change in the content of the line item. Moreover, it should be noted that without the inclusion of producers' fees, several productions would not have met the $25,000 minimum threshold for receiving tax credits.

Allowance of these expenditures is attributable, in part, to the fact the Film Office is only legally allowed to disqualify the following expenditures:

- services not substantially rendered in West Virginia,
- purchase or lease of property not owned or operated in West Virginia,
- self-dealing expenditures, and
- expenses paid to an alter ego of the purchaser that could constitute self-dealing.

The responsibility and authority for qualifying expenditures are placed with the CPA as they compile a project's expense verification report.

The Film Office is not legally empowered to disqualify other types of expenditures. Rather, the responsibility and authority for qualifying expenditures are placed with the CPA as they compile a project's expense verification report. However, the Agreed Upon Procedures CPAs follow as they compile reports do not clearly communicate the CPA's responsibility for ensuring expenditures' qualification for tax credits. PERD finds, in practice, neither the CPAs nor the Film Office regularly disqualified expenditures that do not appear to be directly attributable to the production of the qualified projects. **The Legislative Auditor concludes that the current Agreed Upon Procedures do not require sufficient detail for the Film Office and the FCDC to determine the qualification of expenditures based upon their location and substance. Furthermore, the Legislative Auditor finds that the Agreed Upon Procedures do not clearly communicate and require CPAs to certify whether expenditures qualify for the Film Industry Investment Tax Credit.**

PERD's review of CPA expense verification reports found the use of blanket fees.

Moreover, PERD's review of CPA expense verification reports found the use of blanket fees (e.g. fees reflecting a wide range of expenditures that are not itemized). For example, an out-of-state production company could contract with an in-state production company to provide services and equipment for a project being filmed in West Virginia. The in-state production company, acting as a local vendor, could charge a blanket service fee. However, if the in-state production company then used a portion of the blanket service fee to buy camera equipment from an out-of-state vendor, the payment of a portion of the blanket service fee to the out-of-state vendor would not be itemized. Under normal circumstances, the purchase of the camera from an out-of-state vendor would not qualify as a West Virginia expenditure, but since the expenditure was made through the in-state production company, it could mistakenly be included as a qualified expenditure. **This practice complicates the Film Office's attempts to determine qualified expenditures for tax credits, since the blanket fees obfuscate the location of vendors used to perform services for the production.**

Nearly 85 Percent of All Film Industry Investment Tax Credits Were Sold, and the Average Price Paid for the Tax Credits Was 90 Cents on the Dollar.

West Virginia Code §11-13X-7 allows film production companies to apply film industry investment tax credits against the following taxes: business franchise tax, corporation net income tax, and personal income tax. Tax credits must be applied against the taxes in the order listed. The film tax credits may be applied in the year in which qualified expenditures occurred and the following two years. However, since the business franchise tax was eliminated in West Virginia in 2015, film production companies are left with two taxes that they can apply the tax credits against. While film production companies can apply any tax credits they receive against corporate net income tax and personal income tax, very few do so.

In total, 85 percent of all issued film tax credits were sold during our audit scope.

The Film Office stated the following in its Tax Credit Review and Accountability Report – Tax Years 2013-2014: "Most companies that participate in the Program are domiciled outside the state, which means they will not owe corporation net income taxes, business franchise tax, or personal incomes taxes." As a result, out-of-state companies sell most of their tax credits. PERD also found West Virginia-based film production companies sold most of the tax credits issued to them. In total, 85 percent of all issued film tax credits were sold during our audit scope. The average price paid by buyers of the film tax credits was 89.6 cents on the dollar.

The Tax Commissioner is currently not able to recapture transferred tax credits for questionable expenditures and unqualified productions.

PERD's review found several different types of entities, from large multinational corporations to individuals, bought film tax credits from production companies. Corporations and individuals buy film tax credits at a discount because they can save money on their corporation net income taxes or personal income taxes.

Once film tax credits are transferred, *W. Va. Code §11-13X-8(h)* states, "The Tax Commissioner shall not seek recourse against the transferee for any portion of the credit that may be subsequently disqualified." Consequently, the Tax Commissioner is currently not able to recapture transferred tax credits for questionable expenditures and unqualified productions. **The Legislative Auditor recommends the Legislature consider including a provision allowing the Tax Commissioner to recapture tax credits from production companies for any portion of tax credits subsequently deemed ineligible or obtained fraudulently.**

The W. Va. Code of State Rules Is Not Updated to Reflect Change in the Statutory Annual Program Cap.

In 2013, the Legislature passed HB 2514 which lowered the annual cap on the amount of film industry investment tax credits available to $5 million per fiscal year. Prior to the passage of HB 2514, the annual program cap was $10 million per fiscal year. In accordance with *W. Va. Code §11-13X-9*, the Tax Commissioner shall and the Secretary of the Department of Commerce may propose rules to the Legislature for promulgation. Neither the Tax Commissioner nor the Secretary of the Department of Commerce proposed an updated rule to reflect the change of the annual program cap in statute. **The Legislative Auditor recommends the Tax Commissioner propose new rules for promulgation that reflect the updated annual program cap of $5 million per fiscal year.**

PERD's review of CPA expense verification reports found numerous instances of production companies applying for film tax credits after the productions were completed.

Allowing Production Companies to Apply to the Film Tax Credit Program After the Production Is Completed Increases the Program's Cost and Can Disincentivize Productions From Relocating to West Virginia.

PERD's review of CPA expense verification reports found numerous instances of production companies applying for film tax credits after the productions were completed. This practice is permissible according to *W. Va. CSR §4.1.c.1.* which states, "…an eligible company may submit an application at any time during production or after production." In instances where production companies apply after a production's completion, the tax credits are allotted from the fiscal year within which the company *applies* rather than the fiscal year in which the production is completed. For example, a production shot in 2014 could apply for, and successfully receive, tax credits from West Virginia in 2016, using 2016's tax credit allocation. Since West Virginia's Film Tax Credit Program is capped at $5 million per fiscal year, this could result in the completed 2014 production exhausting tax credits which could otherwise be used to attract new film productions in 2016.

Productions that apply after completion likely would have filmed in West Virginia regardless of the Film Tax Credit Program.

Additionally, productions that apply after completion likely would have filmed in West Virginia regardless of the Film Tax Credit Program. When production begins on a film prior to tax credit approval, the production company runs the risk of there being no tax credits remaining for the fiscal year after the production is completed because other productions may apply for and receive all available tax credits. Logically, it follows that if these productions did not apply to the Film Tax Credit Program before filming, they would have filmed in West Virginia regardless of whether they could receive tax credits. Production companies receiving the film tax credit that would have filmed in West Virginia without tax credits increase the cost of the program. **The**

Legislative Auditor recommends removing the provisions in W. Va. CSR §4.1.c.1. that allow productions companies to apply after a production has been completed.

The Economic Impact of the Film Tax Credit Program Has Averaged Less Than $1 Million Per Year Over Its 10 Year Existence.

Determining the economic impact of a tax credit program is important to ensure the State maximizes its return on investment.

Determining the economic impact of a tax credit program is important to ensure the State maximizes its return on investment. To determine the economic impact of the Film Tax Credit Program, three things need to be calculated: direct, indirect, and induced effects of film industry expenditures by tax credit recipients. Direct effects are the initial expenditures film production companies incur in West Virginia. Examples of direct effects include payment of wages to film crew members or payments by film production companies for supplies at a home improvement store. Indirect and induced effects arise when the initial expenditures are re-spent in the economy. For example, the money the film production companies spent with the home improvement store will likely be used to help pay the wages of the store's employees. In return, the store employees will spend some of their wages with other local vendors. Indirect and induced effects are calculated using a multiplier.

To calculate the direct economic impact of the Film Tax Credit Program, PERD first started with the amount of direct and postproduction expenditures used to qualify for tax credits from the program's inception to the end of FY 2016: $49,398,697. However, this number is not the true economic impact of the program in West Virginia for the following reasons.

PERD determined the total direct economic impact of the Film Tax Credit Program from inception to the end of FY 2016 was $6,150,005.

1. It factors in wages paid to out-of-state residents which provide minimal benefit to West Virginia's economy.
2. It factors in expenditures from unqualified projects.
3. It factors in expenditures for productions that would have been produced in West Virginia regardless of the tax credit.
4. It does not factor in the costs of running the program.

After taking the above factors into consideration, PERD determined the total direct economic impact of the Film Tax Credit Program from inception to the end of FY 2016 was $6,150,005. Table 5 shows PERD's calculation of the Film Tax Credit Program's total direct economic impact.

Table 5 Film Tax Credit Program Direct Economic Impact	
Direct and Postproduction Expenditures	$49,398,697
Less Wages Paid to Out-of-State Residents	- $21,193,108
Less Cost of Running Film Office	- $3,184,182
Less Cost of Film Tax Credits Issued	- $15,106,560
Less Unqualified Projects	- $3,764,842
Total Direct Economic Impact[1]	**$6,150,005**

[1]PERD rounded the dollar amounts to the nearest whole number.
Source: PERD analysis of the Film Tax Credit Program.

Total economic impact of the Film Tax Credit Program over its 10-year existence was $8,677,657.

As previously mentioned, indirect and induced effects of one dollar spent in the economy are calculated using a multiplier. To determine the economic multiplier for the film industry in West Virginia, PERD contacted West Virginia University's Bureau for Business and Economic Research (BBER). Using the economic modeling software program IMPLAN, the BBER calculated the economic multiplier for the film industry in West Virginia to be 1.411. Applying the 1.411 multiplier against the Total Direct Economic Impact of $6,150,005 shows the total economic impact of the Film Tax Credit Program over its 10-year existence was $8,677,657. PERD's calculation of total economic impact are shown in Table 6. **The Legislative Auditor concludes the Film Tax Credit Program has produced a minimal economic benefit to West Virginia.**

Table 6 Film Tax Credit Program Total Economic Impact	
Total Direct Economic Impact	$6,150,005
Economic Multiplier[1]	1.411
Total Economic Impact	**$8,677,657**
Total Economic Impact Per Year	**$867,766**

[1] Calculated by WVU Bureau of Business and Economic Research, unaudited.
Source: PERD analysis of the Film Tax Credit Program.

Over its 10-year existence, the Film Tax Credit Program has averaged less than $1 million per year in economic benefit to West Virginia.

Over its 10-year existence, the Film Tax Credit Program has averaged less than $1 million per year in economic benefit to West Virginia. Moreover, the two production companies who participate in the Film Tax Credit Program most frequently are both domiciled in West Virginia and have been in business long before the program's inception. Consequently, the two West Virginia domiciled companies would likely produce films regardless of the film tax credit.

Another important consideration when determining whether to continue or terminate an economic development program is the program's opportunity cost. In other words, the State must consider whether it will experience more economic growth by giving the film industry $5 million per year in tax credits versus giving another industry $5 million per year in tax credits. While the future economic benefit of one tax credit program versus another is difficult to accurately ascertain, a criterion the State can look at for comparison is an industry's multiplier effect. As stated previously, the WVU BBER determined the economic multiplier for one dollar of investment in the film industry in West Virginia is 1.411. The BBER stated the film industry's multiplier is comparable to most of the state's industries, but a few industries would have economic multipliers above 1.8, such as electric power transmission and distribution, and wood products manufacturing. Consequently, West Virginia experiences an opportunity cost by providing a tax incentive to an industry with a lower economic multiplier effect.

West Virginia experiences an opportunity cost by providing a tax incentive to an industry with a lower economic multiplier effect.

West Virginia Currently Lacks a Strong Incentive Program, a Skilled Film Industry Workforce, and the Infrastructure Needed to Attract Large Film Productions.

In its 2016 Feature Film Study, Film L.A. (the official film office of the Greater Los Angeles region) compared where the top 100 domestic films were produced by location. At the top of the list was Georgia, followed by the United Kingdom, Canada, and California. While California has been a traditional powerhouse in the film industry, Georgia's success has come about more recently. Its success can be attributed to a generous film incentive program, an existing film industry infrastructure, and a skilled workforce.

Like West Virginia, Georgia offers a transferable tax credit for film industry productions. To qualify for the film tax credit in Georgia, productions must incur a minimum of $500,000 in qualifying expenditures. In return, eligible production companies receive a 20 percent base tax credit and an additional 10 percent for including a promotional Georgia logo. Furthermore, Georgia does not have an annual program cap, so they can offer incentives to an unlimited number of productions. Consequently, Georgia issued $1,744,209,869 in film tax credits from FY 2013 to FY 2016.

Georgia issued $1,744,209,869 in film tax credits from FY 2013 to FY 2016.

Moreover, Georgia has the benefit of having a diverse film sector with a wide range of staff trained in numerous types of film industry-relevant skills. According to a report[4] prepared for the Motion Picture Association of America (MPAA), Georgia is home to infrastructure for all stages of film development, including "script development, conceptualization and business development. . . production before, during and after shooting. . . [and] distribution of the product through publicity and marketing." The availability of such a wide range of film industry-

[4] *Meyers Norris Penny LLP, and W2 Entertainment Finance. Economic Contributions of the Georgia Film and Television Industry. Rep. Motion Picture Association of America, Dec. 2013. Web.*

related services allows producers to create their entire project in Georgia, a filming experience few other states can offer.

For example, to provide a skilled workforce to the film and digital entertainment industry, the University System of Georgia and the Technical College System of Georgia partnered to create the Georgia Film Academy in 2015. The Georgia Film Academy trains students through hands on experience how to become integrated into the film industry as entry-level employees. Georgia is also home to several film studios, including Pinewood Atlanta Studios, the largest purpose-built film industry studio outside of California. Lastly, Atlanta, Georgia is home to the busiest airport in the world. The Hartsfield-Jackson Atlanta International Airport provides ease of access to out-of-state film production companies.

Currently, West Virginia's Film Tax Credit Program is not competitive enough to consistently attract large productions to the state.

To be able to attract large film productions like Georgia, West Virginia would need to invest in a strong incentive program, a skilled workforce, and film industry infrastructure. Currently, West Virginia's Film Tax Credit Program is not competitive enough to consistently attract large productions to the state. Per the West Virginia Film Office's 2016 Annual Report, "production executives at several motion picture studios (e.g. The Walt Disney Company, ABC Television Studios, Warner Bros., Paramount Pictures) as well as many other smaller studios, have repeatedly stated that they no longer look at West Virginia as a place to conduct business because their production budgets are too large for West Virginia's incentive program."

While the MPAA no longer publishes the average cost of producing a studio film production, the MPAA stated in 2007 that the average cost was $106.6 million. Given West Virginia's current annual program cap of $5 million, a production with a budget over $100 million would either exhaust the program cap and still not receive 31% of its expenditures in tax credits, or need to make qualified expenditures in another state simultaneously to receive some of that state's available credits as well. In either scenario, West Virginia's current program would limit the amount of credits to which such a large production would be entitled, incentivizing such a program to film elsewhere with a more robust incentive program.

West Virginia would have to raise the annual program cap to approximately $30 million just to attract one major film production.

As shown in Table 7, West Virginia's current Film Tax Credit Program tends to attract low-budget productions. To be able to attract major film production to West Virginia, the annual cap on film tax credits would have to be raised. Using the MPAA's average cost to produce a studio film production, West Virginia would have to raise the annual program cap to approximately $30 million just to attract one major film production. To attract multiple major film productions, the annual program cap would have to be significantly higher than $30 million or be unlimited like Georgia.

Table 7
Tax Credit Receiving Productions by Expenditure Amount

Expenditure Amount	Number of Productions	Percentage of Productions
$25,000 - $49,999	25	26%
$50,000 - $99,999	30	31%
$100,000 - $199,999	19	20%
$200,000 - $399,999	10	10%
$400,000 - $799,999	3	3%
$800,000 +	10	10%

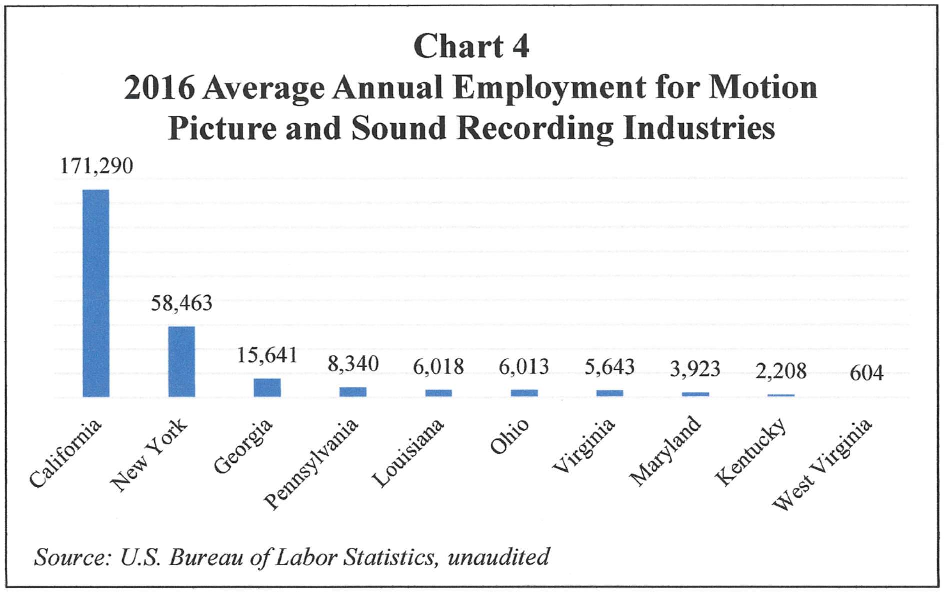
Source: West Virginia Film Office Tracking Data

It should be noted that the largest production claiming tax credits, *Super 8*, incurred $14.8 million in direct and postproduction expenditures in West Virginia. This level of spending resulted in film tax credits of nearly half of the $10 million annual allotment, and would have nearly consumed the full amount at $5 million. While the production incurred $14.8 million in qualifying expenditures, the production's total budget was $50 million. This means most of the production's expenditures were incurred outside of West Virginia. To attract large productions to West Virginia like the production mentioned above, West Virginia would need approximately $10-15 million annually in tax credits. However, West Virginia would also need to raise the minimum spend to approximately $500,000 so smaller productions would not consume the credits.

It should be noted that the largest production claiming tax credits, Super 8, incurred $14.8 million in direct and postproduction expenditures in West Virginia.

Furthermore, West Virginia would need to develop a skilled film industry workforce relative to surrounding states and states known for their high volume of film production activity. As shown in Chart 4, West Virginia employs fewer workers in the motion picture and sound recording industries than all surrounding states, and 15,000 fewer than Georgia. The relatively low availability of a skilled workforce likely contributes to the fact that only 18 percent of all wages used to qualify for film tax credits in West Virginia were paid to West Virginia residents. As discussed in Issue 2 of this report, the Film Office attempted to address the shortage of a skilled workforce in West Virginia by conducting workforce training seminars. Additionally, PERD's review of the Film Tax Credit Program found that the top three tax credit recipients in terms of expenditures all primarily filmed in West Virginia's panhandles. The panhandles' proximity to major metropolitan areas (e.g. Washington, D.C. and Pittsburgh) provide easy access to film industry infrastructure, such as a skilled workforce, supplemental industries (e.g. advertising and sound recording), and multiple international airports.

The top three tax credit recipients in terms of expenditures all primarily filmed in West Virginia's panhandles.



The Tourism Office Is Taking Steps to Address the Concerns Noted in This Report

As PERD informed the Tourism Office of its preliminary findings, the agency began taking steps to address the concerns noted in this report. The Tourism Office has recommended that the FCDC discontinue approving applications for productions that are limited to in-state or regional distribution. In addition, the Tourism Office has recommended that the FCDC discontinue approving applications for direct-to-video productions that are under 40 minutes in length. Furthermore, as noted in Issue 2, the Tourism Office has addressed other concerns, such as record keeping practices and collection of revenues without statutory authority.

As PERD informed the Tourism Office of its preliminary findings, the agency began taking steps to address the concerns noted in this report.

Conclusion

The West Virginia Film Tax Credit Program has attracted a limited number of large productions. In fact, only one major motion picture has applied for, and received, tax credits since the program's inception. Moreover, issues in administration of the program resulted in approval of tax credits for unqualified projects (e.g. under 40 minutes or of a regional nature). In addition, the cap of the program is set at $5 million annually. With an estimated annual impact of $867,766, the program has a minimal economic impact. **Consequently, the Legislative Auditor recommends the Legislature terminate the Film Tax Credit Program. Should the Legislature continue the tax credit, the Legislative Auditor recommends raising the minimum in-state spend to $500,000 per**

Only one major motion picture has applied for, and received, tax credits since the program's inception.

production and increase the annual cap to a minimum of $15 million in order to attract large productions. However, it should be noted that even with large productions, almost half of all expenditures go out-of-state and the program may not achieve desired goals without a solid infrastructure and a skilled film industry workforce that would incentivize a production to film locally.

Recommendations

1. *The Legislative Auditor recommends termination of the Film Tax Credit Program.*

2. *If the Film Tax Credit Program is continued, the Legislative Auditor recommends suspending the program until the program's issues can be corrected.*

3. *If the Film Tax Credit Program is continued, the Legislative Auditor recommends the Film Office, with the assistance of the Tax Department, prescribe new Agreed Upon Procedures for CPAs. Specifically, the Film Office and the Tax Department should consider:*

   a. *Requiring CPAs to certify the qualification of a film production company's expenditures for tax credits from the list of eligible direct and postproduction expenditures as set forth in W. Va. Code §11-13X;*
   b. *Requiring CPAs to itemize blanket fees such as "service" and "producer" fees;*
   c. *Requiring CPAs to detail the number of new businesses created as a result of the film production company's qualified project;*
   d. *Requiring CPAs to detail the number of new jobs created as a result of the film production company's qualified project;*
   e. *Requiring CPAs to detail all wages paid to West Virginia residents during the production of a qualified project;*
   f. *Changing "haphazard selection" to "random, statistically significant sample" in Procedure 7-b and Procedure 8-b.*

4. *If the Film Tax Credit Program is continued, the Legislative Auditor recommends the Legislature give authority to the Film Office to disqualify all types of expenditures, not just the types of expenditures listed in W. Va. CSR §110-13X-4.4.*

5. *If the Film Tax Credit Program is continued, the Legislative Auditor recommends the Legislature consider including a*

provision allowing the Tax Commissioner to recapture tax credits from production companies for any portion of tax credits subsequently deemed ineligible or obtained fraudulently.

6. *If the Film Tax Credit Program is continued, the Legislature should consider removing the provision in W. Va. CSR §4.1.c.1 which allows production companies to apply to the Film Tax Credit Program after a production has been completed.*

7. *If the Film Tax Credit Program is continued, the Legislative Auditor recommends the Film Office and the Film Credit Development Committee ensure tax credit productions meet all requirements as mandated by W. Va. Code §11-13X before tax credits are approved and issued.*

8. *If the Film Tax Credit Program is continued, the Legislative Auditor recommends the Tax Commissioner propose new rules for promulgation that reflect the updated annual program cap of $5 million per fiscal year.*

ISSUE 2

Deficiencies in Business Practices Led to the Collection of Revenue Without Statutory Authority, Incomplete Records, and Misleading, Inflated Reports.

Issue Summary

The Film Office's mission is to "[support] commerce by recruiting motion picture, television, and related media productions to select West Virginia as a place to conduct business." To achieve its mission, the Film Office manages the film tax credit. The Film Office also conducts workforce training seminars and maintains a crew, vendor, and location database. However, deficiencies in Film Office business practices have led to:

To achieve its mission, the Film Office manages the film tax credit.

- the collection of revenue without statutory authority,
- missing and incomplete records, and
- inclusion of misleading and inflated information to the Governor and Legislature.

Background

The Film Office began in 1994 with an appropriation supporting one full time equivalent (FTE) to operate the office. Currently housed within the Tourism Office, the Film Office is funded through an earmark in the 2017 budget. Its self-described mission includes recruiting motion picture, television, commercial, and other media productions to West Virginia filming locations, generating economic benefit for West Virginia. The Film Office states it performs the following duties to recruit film productions to West Virginia:

Although the Film Office was created in 1994, duties for the Film Office were not codified until 2007 when the Legislature passed the West Virginia Film Industry Investment Act.

> *"[The Film Office] does this by promoting business service providers and workforce to business prospects; promoting locations available for filming; acting as a liaison among business prospects and governmental agencies, communities, and property owners; scouting for and compiling photo packages of potential filming locations for business prospects; assisting prospects with business registration issues, research, logistical support, and coordinating itineraries; and administering and promoting the WV Film Industry Investment Act."*

Although the Film Office was created in 1994, duties for the Film Office were not codified until 2007 when the Legislature passed the West Virginia Film Industry Investment Act. From the passage of the Act to present day, the Film Office has only one codified mission: administration of the Film Tax Credit Program.

After the passage of the budget bill in the 2017 special session, the Tourism Office informed PERD there are no longer any FTEs running the Film Office. To manage calls about filming locations in West Virginia, the Tourism Office cross-trained employees from the Call Center to work with production companies.

The Film Office conducted/sponsored 11 workforce training seminars held throughout the state during our audit period.

The Film Office Accepted Revenues for Training Seminars Without Statutory Authority.

To accomplish the goal of "creat[ing] a sustainable industry that provides year-round employment for residential labor," the Film Office conducted/sponsored 11 workforce training seminars held throughout the state during our audit period. The seminars trained attendees on various film industry skill sets, such as those necessary to become a production assistant, a location scout, and a grip. In total, the 11 workforce training seminars had 294 attendees. The workforce training seminars appear to have been successful, with several attendees later being hired onto productions.

PERD found the Film Office collected $7,672 in fees for the training seminars.

However, PERD found the Film Office collected $7,672 in fees for the training seminars. We were unable to locate the statutory authority for the use of Fund 3067, the Lottery Senior Citizens Fund, wherein the Film Office deposited the above fees. Moreover, the Film Office charged fees for these trainings on a sliding scale, providing some attendees preferential treatment (e.g. college students received discounted registration rates). **The Legislative Auditor concludes the Film Office accepted revenues without statutory authority**. During the audit, the Tourism Office informed PERD the Film Office is no longer accepting revenues for training seminars.

The Film Office's Tax Credit Review and Accountability Reports Include Misleading, Inflated Information and Do Not Provide an Accurate Portrayal of the Economic Impact of the Film Tax Credit Program.

Per *W. Va. Code §11-13X-11*, the Film Office is required to submit a Tax Credit Review and Accountability report to the Governor, the President of the Senate, and the Speaker of the House of Delegates. The Film Office is required to evaluate the cost effectiveness of the Film Industry Investment Act using the following criteria:

1. The number of eligible companies claiming the credit;

2. The dollar amount of tax credit certificates issued to taxpayers;
3. The number of new businesses created by the tax credit;
4. The number of new jobs, if any, created by the tax credit;
5. The amount of direct expenditures made on qualified projects; and,
6. The cost of the credit.

Table 8 provides an example of the data as reported by the Film Office.

Table 8
Excerpt From "Tax Credit Review and Accountability Report-Tax Years 2013-2014"

Statistical Item	2012 Value (Supplement)	2013 Value	2014 Value	2015 Value (Preliminary)	Totals [1]
Number of Eligible Companies Claiming the Credit	19 [1]	23 [1]	18 [1]	13 [1]	73
Dollar Amount of Tax Credit Certificates Issued to Taxpayers	$452,128.70 [1]	$2,175,267.06 [1]	$2,892,581.85 [1]	$239,740.98 [1]	$5,759,718.59
Number of New Businesses Created by the Tax Credit	12 [1,2]	19 [1,2]	5 [1,2]	1 [1,2]	37
Number of New Jobs, If Any, Created by the Tax Credit	139 [1,3]	230 [1,3]	258 [1,3]	97 [1,3]	724
Amount of Direct Expenditures Made on Qualified Projects	$1,417,165.06 [1,3]	$7,205,447.84 [1]	$9,365,089.59 [1]	$716,471.90 [1]	$18,704,174.39
(*) Number of Businesses Whose Services Were Utilized	657 [4]	1,237 [4]	881 [4]	557 [4]	3,332
Cost of the Credit	$4,703,534.00 [1]	$698,602.00 [1]	$321,875.00 [1]	TBD [1,5]	

[1] *Since twenty-one (21) productions are still active, these values will be supplemented in the next biennial report. Also, TY 2013 and TY 2014 credits are incomplete due to last available data extraction from the WV Tax Department as well as timing of receipt of tax returns and amended tax returns that will be received in the future (taxpayers have a 3-year statute of limitation to file amended returns.*

[2] *These calculations were determined from a review of the independent CPA expense verification report for each company issued a credit, which sometimes identifies new businesses that provided services to Program participants and that registered with the WV Secretary of State's Office and the WV Tax Department.*

[3] *These calculations were determined from a review of the independent CPA expense verification report for each company issued a credit. The number of jobs created is a reflection of how many West Virginia residents were hired to perform work on a per project basis.*

[4] *These calculations were determined from a review of the independent CPA expense verification report submitted by each Program participant.*

[5] *TY 2015 is currently unavailable as returns are only beginning to be filed by taxpayers.*

PERD is not able to verify some of the numbers in the table because the Film Office has no documentation indicating how it calculated those numbers. Moreover, based on PERD's review of expense verification reports, some data claimed in the Tax Credit Review and Accountability Reports are likely misleading and inflated.

Specifically, the Film Office claims 724 new jobs were created by the Tax Credit Program from 2012 to 2015 and 1,858 over its entire existence. In the third footnote, the Film Office states "the number of jobs created is a reflection of how many West Virginia residents were hired to perform work on a *per project basis*." However, counting the number of new jobs on a per project basis inflates the number of new jobs, as this counts the same individuals multiple times. For example, if a film production company has four projects in which a production assistant works, and those four projects receive film tax credits from West Virginia, the Film Office would count the production assistant's job as four new jobs created by the Film Tax Credit Program, even though it is one person in multiple short-term jobs.

Counting the number of new jobs created by the tax credit program assumes the jobs would not have existed without the tax credit program.

In addition, counting the number of new jobs created by the tax credit program assumes the jobs would not have existed without the tax credit program. This practice is misleading because two West Virginia domiciled companies regularly receiving tax credits existed before the film tax credit program's inception. Consequently, some individuals employed today were likely employed before the Film Tax Credit Program's inception in FY 2007. The individuals who were employed by these companies before FY 2007 should not be included as new jobs, because their jobs already existed without the help of the tax credit.

The number of new jobs created by the tax credit program likely contains many temporary, part-time jobs.

Furthermore, the number of new jobs created by the tax credit program likely contains many temporary, part-time jobs. While the temporary, part-time jobs may be new jobs, the somewhat unique nature of the film industry does not ensure those jobs will stay in-state. For example, a production company coming to West Virginia to film might employ several West Virginians, but when the production company leaves, the jobs leave with them. Many workers in the film industry would therefore have to rely on a constant stream of productions coming to the state to maintain full-time employment. In fact, according to the Film Office, despite 1,858 jobs being created, only 450 residents rely on the film industry for employment.

Moreover, the column "number of new businesses created by the tax credit," leads the reader to believe that the new businesses created were business designed to last several years at minimum. In reality, some businesses created and claimed on CPA reports were created for one production, and once the production completed filming, the new business was no longer active. Consequently, the number of new businesses created by the film tax credit claimed by the Film Office is misleading.

Lastly, the Film Office claims Film Tax Credit Program participants have incurred $18.7 million in direct expenditures from 2012 through 2015 and $49 million throughout the program's history[5]. However, as pointed out in Issue 1, approximately $21 million of the expenditures were wages paid to out-of-state residents. Wages paid to out-of-state residents are qualified expenditures as long as the wages are subject to West Virginia income tax, but the inclusion of these expenditures artificially inflates the economic benefit of the Film Tax Credit Program. **The Legislative Auditor concludes some of the information provided by the Film Office in the Tax Credit Review and Accountability Reports is misleading, inflated, and an inaccurate portrayal of the economic impact of the Film Tax Credit Program.**

Wages paid to out-of-state residents are qualified expenditures as long as the wages are subject to West Virginia income tax, but the inclusion of these expenditures artificially inflates the economic benefit of the Film Tax Credit Program.

The Film Office's Recordkeeping Practices Are Outdated and Unreliable.

PERD's review of the Film Tax Credit Program required a review of the Film Office's files pertaining to production expenditures, production employees, tax credits issued, and tax credits transferred. This review revealed several issues with the Film Office's recordkeeping practices. The Film Office provided PERD with a tracking spreadsheet intended to document the expenditures of each production. However, PERD tested a sample and was unable to verify many of the numbers in the spreadsheet, as they did not correspond with the projects' CPA reports. Consequently, PERD created a new tracking spreadsheet to calculate more accurate figures for production expenditures and employees. PERD's sample encompassed 66 project files. Of those files, nine were missing documentation verifying payroll or vendor expenditures, and four were missing a CPA expense verification report. The Film Office also disqualified expenditures for productions that received tax credits, but did not always make note of which expenditures were disqualified or why.

The Film Office did not always make note of which expenditures were disqualified or why.

In addition, if a tax credit is transferred, the Film Office voids the original Certificate of Entitlement and issues a new one to the transferee. PERD requested Certificates of Entitlement for all transferees claiming the credit against the Business Franchise Tax, the Corporate Net Income Tax, and the Personal Income Tax. In most cases, the certificates were available to PERD; however, four Certificates of Entitlement were missing from the records of both the Tax Department and the Film Office. The missing Certificates of Entitlement total $84,323 of tax credits claimed. The Film Office's record-keeping practices did not adequately document the transfer of those tax credits.

[5] *The Film Office's most recent reports, the Tax Credit and Accountability Report - Tax Years 2013-2014 and the 2016 Annual Report of Recommendations to Expand Film Industry, claim $43 million rather than $49 million in direct expenditures because they do not include some projects filmed in fiscal years 2015 and 2016.*

Lastly, PERD finds the recordkeeping practices of the Film Office to be outdated; project CPA reports, Certificates of Entitlement, and tax credit transfers appear in paper files, but not electronic files. Moreover, PERD is unable to verify some data from the Film Office's tracking spreadsheets with the paper CPA reports provided. The Film Office administers a tax credit program distributing over $15 million in tax credits, yet records of these tax credits are retained only in paper files without electronic backup. During the audit, the Tourism Office informed PERD the Tourism Office has "put in place a single electronic repository where all documents will be maintained."

Conclusion

The Film Office administers an economic development program issuing millions of dollars of tax credits per year, but deficiencies in business practices led to the collection of revenue without statutory authority, the production of misleading, inflated reports, and incomplete records. Furthermore, the only codified duty of the Film Office is to administer the Film Tax Credit Program. **Consequently, along with the termination of the Film Tax Credit Program, the Legislative Auditor recommends termination of the Film Office.**

The only codified duty of the Film Office is to administer the Film Tax Credit Program.

Recommendations

9. *The Legislative Auditor recommends terminating the Film Office.*

10. *If the Film Office is retained, the Legislative Auditor recommends the Film Office stop accepting revenues in the form of registration fees and depositing them into funds without statutory authority.*

11. *If the Film Office is retained, the Legislative Auditor recommends the Film Office issue Tax Credit Review and Accountability Reports in accordance with W. Va. Code §11-13X-11, and cease the inclusion of misleading, inflated information.*

12. *If the Film Office is retained, the Legislative Auditor recommends the Film Office update their file retention systems to an electronic system.*

Appendix A
Transmittal Letter

WEST VIRGINIA LEGISLATURE
Performance Evaluation and Research Division

Building 1, Room W-314
1900 Kanawha Boulevard, East
Charleston, West Virginia 25305-0610
(304) 347-4890
(304) 347-4939 FAX

John Sylvia
Director

December 11, 2017

Chelsea Ruby, Commissioner
West Virginia Division of Tourism
Building 3, Suite 100
Charleston, WV 25305

Mrs. Ruby:

This is to transmit a draft copy of the Agency Review of the Department of Commerce, specifically the West Virginia Film Office. This report is tentatively scheduled to be presented during the January 7-9 interim meetings of the Joint Committee on Government Operations, and the Joint Committee on Government Organization. We will inform you of the time and location once the information becomes available. It is expected that a representative from your agency be present at the meeting to orally respond to the report and answer any questions committee members may have during or after the meeting.

If you would like to schedule an exit conference to discuss any concerns you may have with the report, please notify us by Thursday, December 14, 2017. In addition, we need your written response by noon on Tuesday, December 19, 2017 in order for it to be included in the final report. If your agency intends to distribute additional material to committee members at the meeting, please contact the House Government Organization staff at 304-340-3192 by January 4, 2018 to make arrangements.

We request that your personnel not disclose the report to anyone not affiliated with your agency. Thank you for your cooperation.

Sincerely,

John Sylvia

John Sylvia

Enclosure
C:
H. Wood Thrasher, Cabinet Secretary, Department of Commerce

Joint Committee on Government and Finance

Appendix B
Objectives, Scope and Methodolgy

The Performance Evaluation and Research Division (PERD) within the Office of the Legislative Auditor conducted this performance review of the West Virginia Film Office and the Film Tax Credit Program as part of the agency review of the Department of Commerce as required by West Virginia Code §4-10-8(b)(1). The Film Office's role, per *West Virginia Code §11-13X-6,* is administration of the Film Tax Credit Program. The purpose of the Film Tax Credit Program, as established in *W. Va. Code §11-13X-2*, is to encourage economic growth through the production of motion pictures and other commercial film or audiovisual projects in West Virginia.

Objectives

The objectives of this audit are: (1) to determine if there is a continued need for the Film Industry Investment Tax Credit, and (2) to determine if there is a continued need for the West Virginia Film Office.

Scope

The scope of Issue 1 included a review of the Film Tax Credit Program from its creation in FY 2007 through FY 2016. The scope of Issue 2 was limited to a review of the Film Office's administration of the Film Tax Credit Program and workforce training activities from FY 2007 to FY 2016.

Methodology

With regards to Issue 1 and Issue 2, PERD gathered both testimonial evidence and documentary evidence. Testimonial evidence was gathered through interviews with Film Office and Tourism Office staff. The purpose for testimonial evidence was to gain a better understanding or clarification of certain issues such as administration of the Film Tax Credit Program, and to confirm the existence or non-existence of a condition, or to understand the respective agency's position on an issue. PERD confirmed testimonial evidence with written statements or through corroborating documentary evidence.

To determine the total direct economic impact of the Film Tax Credit Program, PERD obtained digital copies of tracking documents the Film Office staff used to administer the tax credit. The tracking documents included data such as the amount of direct expenditures, wages, and vendor spend made by production companies who applied to the Film Tax Credit Program. To ensure accuracy of the tracking documents, PERD requested and obtained the physical applications, Certified Public Accountants (CPA) expense verification reports, and other supporting documentation submitted by production companies. After receiving the physical documents, PERD conducted a test of the Film Office's tracking documents to ensure accuracy using a statistically significant sample. After determining the total direct and postproduction expenditures made by productions companies (based on a review of the CPA expense verification reports and appropriate adjustments to the Film Office tracking documents), PERD subtracted out wages paid to out-of-state residents, the cost of running the Film Office, and the cost of all issued film tax credits. The amount of wages paid to out-of-state residents and issued film tax credits were obtained from the Film Office tracking documents, and the cost of running the Film Office was obtained through the State Auditor's FIMS and OASIS systems. Lastly, PERD subtracted out the amount of direct and post production expenditures made by unqualified projects since PERD's review assumed the Film Tax Credit Program was run in compliance with *West Virginia Code*. Unqualified projects were identified by the audit team as those not in compliance with the provisions of *West Virginia Code §11-13X-3(b)(8)* et al. PERD maintained a tracking spreadsheet of unqualified projects, which was then applied to the direct and post production expenditures. In addition, the audit team sought legal opinions in order to ensure our understanding of West Virginia Code was accurate. Furthermore, as

CPA expense verification reports were reviewed, the audit team noted any discrepancies between the tracking documents and reports, as well as any questionable items.

In addition to the direct economic impact, PERD calculated the total economic impact of the Film Tax Credit Program. To accomplish this, PERD requested assistance from West Virginia University's Bureau for Business and Economic Research (BBER) in determining the economic multiplier for the film industry in West Virginia. The BBER found the economic multiplier to be 1.411 and was calculated using the economic impact modeling software IMPLAN. PERD multiplied the total direct economic impact and the economic multiplier to determine the total economic impact of the Film Tax Credit Program.

In order to establish the current state of film incentive programs across the nation, PERD reviewed recent reports released by other states, universities, and private organizations such as the Motion Picture Association of America. PERD also reviewed other state's statutes as well as film office websites. Lastly, PERD conducted an analysis of surrounding states' film incentive programs.

We conducted this performance audit 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.

Appendix C
Agency Response

WILD, WONDERFUL WEST VIRGINIA

1900 Kanawha Boulevard East | Charleston, WV 25305

(304) 558-2200 | 1-800-CALL-WVA | GoToWV.com

December 21, 2017

Mr. John Sylvia
West Virginia Legislature
Performance Evaluation and Research Division
Building 1, Room W-314
1900 Kanawha Boulevard, East
Charleston, West Virginia, 25305-0610

PERFORMANCE EVALUATION
DEC 21 2017
AND RESEARCH DIVISION

Dear Mr. Sylvia:

Thank you for your letter of December 11, 2017, and for the time you and your colleagues have devoted to your audit of the West Virginia Film Office, now under the direction of the West Virginia Tourism Office.

The West Virginia Department of Commerce and the Tourism Office concur with the audit recommendations. The Tourism Office therefore supports the elimination of the program. If the program is not eliminated, we agree with the recommended changes to the program.

Again, I appreciate your efforts and those of your office in performing this audit.

Sincerely,

Chelsea A. Ruby

Chelsea A. Ruby
Tourism Commissioner

cc: H. Wood Thrasher, Secretary of Commerce

WEST VIRGINIA LEGISLATIVE AUDITOR
PERFORMANCE EVALUATION & RESEARCH DIVISION

Building 1, Room W-314, State Capitol Complex, Charleston, West Virginia 25305

telephone: 1-304-347-4890 | www.legis.state.wv.us /Joint/PERD/perd.cfm | fax: 1- 304-347-4939