Comments by The Advertising Coalition
Committee on Ways and Means
Tax Reform Working Groups
U.S. House of Representatives
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## EXECUTIVE SUMMARY

Any change to the current tax treatment of advertising would hurt the U.S. economy and would be inconsistent with sound public policy. Advertising is a major driver of economic activity and accounts for $4.1 trillion of the $34.3 trillion in U.S. output. Of the 136.4 million American workers, 15.4 million hold jobs supported by advertising-related activities. In total, 11.3 percent of all U.S. employment is related to advertising, the sales driven by advertising, and the ripples of economic activity that occur throughout the economy.[1]

The treatment of business advertising costs as ordinary and necessary business expenses under section 162(a) of the Tax Code is appropriate and should be maintained. This treatment has been upheld in the U.S. Tax Court[2], supported by a Revenue Ruling from the Internal Revenue Service, and endorsed by two Nobel Laureates in economics. The commitment of Congressional leaders to tax reform can bring productive changes to the Tax Code, including a reevaluation of "tax expenditures" that may be inconsistent with sound tax policy. However, it is essential to distinguish between the treatment of tax expenditures and the need for businesses to deduct ordinary and necessary business expenses such as advertising.

The Congressional Budget Act defines tax expenditures as "revenue losses [to the government] caused by provisions of the tax laws that allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability."[3] In other words, a tax expenditure is a form of federal spending designed to encourage specific behavior, and is an exception to sound tax policy. This is distinct from ordinary and necessary business expenses. Neither the Joint Committee on Taxation nor the Office of Management and Budget has ever classified the deduction for advertising costs as a tax expenditure.

The deduction for advertising costs, along with the cost of employee salaries, rent, utilities and similar costs, is essential to the proper calculation of the net income tax liability of a business. The Internal Revenue Service over a period of several decades has tested the application of this provision to the cost of different types of advertising, but the U.S. Tax Court has upheld the principle that advertising costs should be treated as a current deduction.[4] Notwithstanding the appropriate treatment of advertising costs under current law, for 25 years proposals have been advanced to generate more tax revenues by limiting the amount of advertising expenses that a business may deduct. These proposals generally have focused on three theories.

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1 "The Economic Impact of Advertising Expenditures in the United States and Selected States," IHS Global Insight, November 2012.

2 *RJR Nabisco Inc. v. Commissioner*, 76 T.C.M.71 (1998).

3 Pub.L. 93–344, 88 Stat. 297, enacted July 12, 1974.

4 *Id. RJR Nabisco Inc.*

The first is the theory that advertising is durable and that some portion of the deduction should be postponed to later tax periods in order to achieve a better match between the time the expense is incurred and the period when it generates revenue. The Advertising Coalition asked two Nobel prize-winning economists to examine this question, and they concluded that most, if not all, advertising is short-lived and, that nothing in the economic literature supports a change in its tax treatment.

Another theory contends that advertising contributes to the creation of intangible assets and thus a portion of the cost should be capitalized. The economists we consulted said the real intangible is the innovative product or service being advertised and changing the current tax treatment would make it more expensive for taxpayers to communicate that innovation to consumers. Congress previously has addressed this issue and rejected proposed changes.

Finally, a 1992 U.S. Supreme Court decision, *INDOPCO, Inc. v. Commissioner of IRS*, often is cited in support of capitalizing some advertising costs on the theory that it creates a future expectation of income. The IRS rejected this interpretation of *INDOPCO* and issued a Revenue Ruling that specifically upheld the treatment of advertising costs under section 162(a).

***Advertising creates millions of jobs and adds trillions of dollars to the U.S. economy***

Advertising provides valuable information to consumers and is responsible for trillions of dollars of economic activity. The Advertising Coalition asked one of the nation's leading economists to explain the impact advertising has on the U.S. economy. Dr. Lawrence R. Klein and IHS Global Insight employed a macroeconomic model of the U.S. economy to demonstrate that advertising is a key driver of economic activity and generator of jobs. Dr. Klein was the 1980 recipient of the Nobel Prize for Economic Science based on the development of this model of the U.S. economy.

IHS Global Insight employed the model to demonstrate how advertising accounts for $4.1 trillion of the $34.3 trillion in U.S. output. Their research further shows that 15.4 million of the 136.4 million American jobs are supported by advertising-related activities. In total, 11.3 percent of all U.S. employment is related to advertising, the sales driven by advertising, and the ripples of economic activity that occur throughout the economy.[5]

The report prepared for The Advertising Coalition concludes that the heightened awareness advertising generates among buyers does not merely shift market share among competing firms, but stimulates economic activity that otherwise would not have occurred. This, in turn, triggers a cascade of economic activity and stimulates job creation and retention throughout the U.S. economy."[6]

The IHS Global Insight study quantifies the levels of sales and employment that are attributable to the economic stimulation from advertising. It achieves this through a comprehensive assessment of the total economic impact of advertising expenditures across 52 industries and the activities of all levels of government. The economic impact of advertising consists of advertising

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[5] "The Economic Impact of Advertising Expenditures in the United States and Selected States," IHS Global Insight, November 2012.

[6] "The Economic Impact of Advertising Expenditures in the United States," IHS Global Insight, A Report Prepared for The Advertising Coalition, August 2010.

expenditures, resulting sales, supplier sales, and inter-industry sales. Each of these effects also creates and maintains new jobs that are needed to support a higher level of production.[7]

***Framework For Considering The Appropriate Tax Treatment of Advertising***

For the past quarter century following enactment of the Tax Reform Act of 1986, a wide range of proposals have been advanced to limit the deduction for advertising costs as a means for raising additional revenue for the federal government. "A Description of Possible Options to Increase Revenues Prepared for the Committee on Ways and Means"[8] identified some arguments for and against such a proposal. Following release of that book of revenue options, The Advertising Coalition worked with leading economists to identify economic principles and develop data that would underscore the importance of advertising to the U.S. economy and that called upon decades of economic research to provide a counterpoint to proposals to limit this deduction. The case of *INDOPCO, Inc. v. Commissioner of Internal Revenue*[9] raised additional questions about the characteristics of currently deductible versus capital costs. Finally, the American Institute of Certified Public Accountants examined and rejected a proposal to capitalize advertising costs.

Proposals to change the treatment of advertising as an ordinary and necessary business expense generally are based on the theories that (1) advertising is durable and generates revenues beyond the period in which the cost is incurred; that (2) advertising costs create intangibles assets and should be capitalized in part, and (3) that INDOPCO suggests that advertising, like the legal fees in that case, are incurred with a future expectation of income and should be capitalized in part.

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[7] The IHS Global Insight analysis quantifies the economic impact of advertising on three broad levels:

**Retail and manufacturing**. This tier includes sales of products and services by manufacturers, retailers and their sales people and employees. It includes the preparation of advertising that businesses use to communicate with consumers. It includes the work of advertising agencies as well as the purchase of advertising time and space on radio and television stations, cable operators and networks, in newspapers, magazines, and other media outlets.

**Suppliers to retail and manufacturing.** Advertising generated sales set off chain reactions throughout the economy. They create additional jobs and sales as a second tier of vendors and wholesalers supply and support the first tier of manufacturers, retailers, and service businesses. When advertising encourages consumers to purchase automobiles or trucks, for example, those retail and manufacturing level sales generate demand from suppliers of steel, electrical wiring, semiconductors, fabric and leather for upholstery, plastic, rubber for tires and parts, radio and GPS receivers and other products and services that are used to produce the vehicle.

**Inter-industry activity**. Advertising helps drive sales and create a substantial number of jobs at the third inter-industry level. In the automobile industry example, the manufacturing, retail and supplier level sales help generate economic activity and create jobs in a host of related industries such as rail and truck transportation, gasoline and oil, insurance, and aftermarket sales of automobile products. Without the initial consumer purchases of the cars and trucks, there would be no demand for these third tier products and services and no added sales and jobs at the inter-industry tier. The sales and jobs at all three levels of impact illustrate the powerful energy that advertising injects into the nation's economy.

[8] Joint Committee on Taxation, pp. 138-139 (1987).

[9] INDOPCO, Inc. v. Commissioner of Internal Revenue, 503 U.S. 79 (1992).

***Durability of advertising.*** The argument is that the benefit of amounts paid for advertising extend beyond the year of the expenditure, and that a more proper match of advertising expenses and the income generated by them could be achieved by requiring a portion of advertising costs to be deducted in a later year.

The Advertising Coalition asked Dr. Kenneth J. Arrow and Dr. George G. Stigler, and the economic consulting firm Lexecon, Inc., to explain the role of advertising in the economy. Dr. Arrow was awarded the Nobel Prize for Economic Science in 1972 and Dr. Stigler was awarded the Nobel Prize in 1982 for their research respectively concerning consumer choice and the role of consumer information in the economy. Drs. Arrow and Stigler prepared the "Economic Analysis of Proposed Changes in the Tax Treatment of Advertising Expenditures," along with the economic consulting firm Lexecon, Inc., in which they concluded "proposals to change the tax treatment of advertising are not supported by the economic evidence."[10]

In their research concerning the tax treatment of advertising expenditures, Dr. Arrow and Dr. Stigler specifically examined a number of economic studies which proposed changes that would have increased the cost of advertising to the advertiser. The goal of many of these studies was to demonstrate the longevity of the impact of advertising on sales in order to justify capitalizing all or part of advertising costs. The Nobel economists concluded that the studies of the durability of advertising had reached such different conclusions that they could not be used as a coherent basis for formulating tax policy. Moreover, Arrow and Stigler found that these studies suffered from technical flaws that rendered their conclusions meaningless. Their analysis suggests that most, if not all, advertising is short-lived.[11] The economists cautioned against changing the tax treatment of advertising, which would make advertising more expensive:

> ***"Since the information conveyed by advertising is valuable, one must be particularly cautious about taxes that would raise the cost, and hence lower the quantity of advertising. Such taxes would reduce the overall flow of economic information available to consumers. As a result, we expect that prices would rise, the dispersion in prices for particular products would increase, and consumers would be less able to find goods that satisfy their preferences."***[12]

***Intangible assets***. Critics of the current deduction for advertising costs have contended that it creates a preference for businesses that invest in advertising over those that invest in tangible assets that must be depreciated over time. They also say it raises questions whether the current deduction of advertising costs results in the creation of intangible assets.

The intangible asset is the firm's product, which advertising makes known that to customers. Dr. Arrow and Dr. Stigler said that while some economists have attempted to measure the relationship between a firm's advertising expenditures and its intangible capital, they ignore the fact that there are many economic factors other than advertising that determine the market value of a firm. Indeed, the value of the firm's product – e.g., its effectiveness or innovativeness – is the

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[10] K. Arrow, G. Stigler, E. Landes, A. Rosenfield, Lexecon, Inc., "Economic Analysis of Proposed Changes in the Tax Treatment of Advertising Expenditures," (1990)

[11] K. Arrow, et. al., at p. 23.

[12] *Ibid* at p. iii.

firm's true intangible asset. Advertising is only a means by which the firm can exploit fully the value of that asset. [13]

As an example, Arrow and Stigler offered the innovative user interface developed by Apple Computer. "The 'Finder,' which it provides on its Apple . . . personal computer . . . has been enormously popular and Apple has exploited its value by advertising its advantages to potential users. As a result of the success of this product [and other Apple innovations including the iPhone and iPad], Apple's sales have soared as has its market value. But Apple's advertising [Mac versus PC, et. al.] is not the intangible here; it is only a tool for maximizing the value of the true intangible – the interface."[14]

***Legal Background***

The U.S. Supreme Court addressed the question of whether legal fees related to a corporate acquisition should be deducted in the year incurred or capitalized because they contribute to future company income. The Court held that "the acquisition-related expenses bear the indicia of capital expenditures and are to be treated as such." However, the Court also stated, "The fact that the expenditures do not create or enhance a separate and distinct additional asset is not controlling," under *Commissioner v. Lincoln Savings & Loan Assn.*[15], which raised questions about the treatment of advertising costs.

IRS affirmed the current deduction of advertising costs after INDOPCO. The case law supporting the current deduction of business costs had been settled for more than 20 years when the Court in 1992 introduced a different viewpoint in *INDOPCO, Inc. v. Commissioner of Internal Revenue.*[16] Prior to INDOPCO, an expense would have been required to be capitalized only if it "create[d] or enhance[d] . . . a separate and distinct additional asset."[17] The Court in INDOPCO held that legal fees and other costs incurred by Unilever United States in the acquisition of INDOPCO, Inc., formerly known as National Starch and Chemical Corporation, should be capitalized and not currently deducted in part because the legal structure that was created enhanced the future value of the enterprise.

The decision in *INDOPCO* prompted many industry groups, including those in the media and advertising business, to ask the Internal Revenue Service whether the rejection of the separate and distinct asset test would in the future require any portion of advertising costs to be capitalized. The media and advertising companies and associations in The Advertising Coalition along with other businesses and business organizations sought clarification regarding the standard the IRS would use in the future to require the capitalization of certain expenditures. The Office of Chief Counsel responded on September 11, 1992:

> "Section 162-1(a) of the Income Tax Regulations expressly provides that 'advertising and other selling expenses' are among the items included in deductible business expenses

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[13] *Ibid* at p. 36.

[14] "Economic Analysis of Proposed Changes in the Tax Treatment of Advertising Expenditures," Arrow, et. al.

[15] 403 u.S. 345,354 (1971)

[16] *INDOPCO, Inc. v. Commissioner of Internal Revenue*, 503 U.S. 79 (1992).

[17] Commissioner v. Lincoln Savings & Loan Assn., 403 U.S. 345, 354 (1971).

> under section 162 of the Code. Section 1.162-20(a)(2) of the regulations provides, in part that expenditures for institutional or goodwill advertising which keeps the taxpayer's name before the public are generally deductible as ordinary and necessary business expenses provided the expenditures are related to the [business] patronage the taxpayer might reasonably expect in the future."[18]

Congress in 1993 addressed the subject of the treatment of expenses that a business may incur to build consumer acceptance of a product. Advocates for a change in the tax treatment of intangible assets said some of these costs should be capitalized. The Omnibus Budget Reconciliation Act of 1993[19] addressed a long-standing discussion about the treatment of intangible assets and provided that generally they should be amortized ratably over 15 years. Congress specifically exempted from the definition of an "amortizable section 197 intangible" any intangible "created by the taxpayer."[20] The legislation also excluded from amortization "any franchise, trademark, or trade name."[21] In other words, an expenditure on advertising that promoted an intangible that could be the brand name of a product should not be capitalized, but may be deducted in the year the cost was incurred.

In the period leading up to the Omnibus Budget Reconciliation Act of 1993, the accounting profession conducted a formal examination of the business accounting standards for the treatment of advertising costs. The Accounting Standards Executive Committee (AcSEC) of the American Institute of Certified Public Accountants (AICPA) issued in 1993 a Statement of Position that recommended for accounting purposes the expensing of advertising costs either as incurred or the first time the advertising takes place, unless the advertising meets the criteria of the SOP for capitalizing direct-response advertising.[22] Because the Congress and the Committee on Ways and Means regularly look to the treatment the accounting profession for guidance in the treatment of business expenses, we were pleased that AcSEC affirmed the current deduction of advertising costs.

***Conclusion***

The profile of advertising and the economic activity and jobs that advertising stimulates in the economy, as described by Dr. Lawrence Klein and IHS Global Insight, make a compelling case for avoiding policies that would make advertising more expensive or more difficult to promote the sale of good and services. In addition, the analysis and insights drawn from the decades of research complied by Dr. Kenneth J. Arrow and Dr. George G. Stigler provide economic rationale for the current Tax Code treatment of advertising costs and for avoiding a policy change that would make the purchase of advertising more expensive.

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[18] Rev. Rul. 92-80, 1992-39 I.R.B. 7, 1992-2 C.B. 57, 1992 WL 224893 (IRS RRU), September 11, 1992.
[19] Pub.L. 103–66, 107 Stat. 312, enacted August 10, 1993.
[20] *Ibid*, sec. 197 (c)(2).
[21] *Ibid*, sec. 197 (d)(1)(F).
[22] American Institute of Certified Public Accountants, Accounting Standards Executive Committee, Statement of Position 93-7, December 29, 1993.