Comments by
The Advertising Coalition
To the Committee on Finance
United States Senate
Washington, D.C.

April 15, 2015

Executive Summary

We appreciate the opportunity to submit these comments on behalf of The Advertising Coalition (TAC) to the Committee on Finance. TAC includes national trade associations whose members are advertisers, advertising agencies, broadcast companies, cable operators and program networks, social networks, search engines, digital publishers, and newspaper and magazine publishers. Our coalition represents perhaps the single broadest constituency of advertisers, advertising agencies, online, and media-related companies in this country engaged in protecting the free flow of advertising content. As a consequence, TAC is vitally interested in preserving the ability of businesses to deduct the cost of advertising as an ordinary and necessary business expense.

A 2015 study conducted by the world-renowned economics and data analysis firm IHS Global Insight determined that every $1 spent on advertising supports $19 in total sales in the U.S. economy. Every $1 million dollars spent on advertising supports 28 direct American jobs. In 2015, advertising is projected to support 18.7 percent of U.S. GDP and 20.8 million of the 147.5 million jobs in the United States.[1] The study by IHS Global Insight demonstrates that every form of advertising – ranging from newspapers, magazines, and television to the Internet – strengthens business and triggers a cascade of economic activity that stimulates job creation and retention throughout the U.S. economy.

We are deeply troubled by proposals developed in the 113th Congress to amortize one-half of the advertising costs of a business. Those proposals would, in effect, increase a company's taxable income for every year in which it purchases advertising. TAC believes those proposals failed to consider the hardships that would be created by limiting the deduction of advertising costs for the overwhelming number of companies and firms that purchase new cycles of advertising each year. If these changes were adopted, businesses would have fewer resources to commit to new advertising spending year after year. The resulting decrease in advertising purchases would cause a chain reaction throughout the economy resulting in a decline in consumer demand and significantly lower revenues for media companies that depend on advertising as a critical source of revenue for daily operations. In today's marketplace, more than ever before, advertising provides America's consumers with news and information, entertainment, sports, and an extraordinarily broad range of high quality programming. Given the complex role of advertising in the economy, a tax on advertising would work to counter two key objectives of tax reform – to make the Tax Code simpler and more efficient, and to foster a pro-growth environment.

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[1] "The Economic Impact of Advertising Expenditures in the United States, 2012-2017." IHS Global Insight, Inc. (March 2015). These statistics were developed on a macroeconomic model of the U.S. economy that initially was created by Dr. Lawrence R. Klein, the late professor of economics at The Wharton School and recipient of the 1980 Nobel Memorial Prize for Economic Sciences.

The proposals developed in the 113th Congress to tax advertising are not supported by sound economic or tax policy. Two leading economic experts on the role of advertising in the U.S. economy, Dr. Kenneth Arrow and Dr. George Stigler, concluded that "Proposals to change the tax treatment of advertising are not supported by the economic evidence," and that any policy that makes advertising more expensive would cause a decisive decline in advertising spending.[2] In addition to helping businesses communicate the benefits of their products and services to consumers, advertising is a critical driver of our economy and should remain a fully deductible expense along with other ordinary and necessary business expenses that are deducted pursuant to section 162(a) of the Tax Code.

Advertising Consistently Has Been Defined as an Ordinary and Necessary Business Expense

The deduction for advertising costs is essential to the proper calculation of the net income tax liability of a business. The treatment of the cost of business advertising as an ordinary and necessary business expense under Section 162(a) has been upheld in the U.S. Tax Court,[3] and supported by a Revenue Ruling from the Internal Revenue Service.[4] The commitment of Congressional leaders to reform the Tax Code can result in productive changes, 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 importance of allowing businesses to continue 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."[5] In other words, a tax expenditure is a form of federal spending designed to encourage specific behavior, but it is considered an exception to sound tax policy. Neither the Joint Committee on Taxation nor the Office of Management and Budget has ever classified the current deduction for the cost of advertising as a tax expenditure.

Advertising Creates Millions of Jobs and Generates Trillions of Dollars to the U.S. Economy

As representatives of the nation's leading advertisers and media operators, we understand first-hand the extent to which advertising is a powerful tool that not only promotes goods and services, but also educates consumers about the world around them. Advertising also is responsible for generating trillions of dollars in economic activity. Dr. Lawrence R. Klein and IHS Global Insight, Inc. have demonstrated that advertising is a key driver of economic activity and a generator of jobs by employing Dr. Klein's acclaimed macroeconomic analysis of the U.S. economy.[6] IHS Global Insight concludes that advertising supports 16.6 percent of all personal and proprietor income in the U.S.[7] Additionally, IHS Global Insight previously established that advertising does not merely shift market

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[2] Arrow, Kenneth and George Stigler. "Economic Analysis of Proposed Changes in the Tax Treatment of Advertising Expenditures." Lexecon Inc. (August 1990).

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

[4] Rev. Rul. 92-80, 1992-39 I.R.B. 7, 1992-2 C.B. 57, 1992 WL 224893 (IRS RRU), September 11, 1992.

[5] P.L. 93-344, 88 Stat. 297, enacted July 12, 1974.

[6] This macroeconomic model has been employed by the Treasury Department, Commerce Department, Labor Department, and most Fortune 500 companies.

[7] "The Economic Impact of Advertising Expenditures in the United States, 2012-2017." IHS Global Insight, Inc. (March 2015).

share among competing firms, but rather stimulates new 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."[8]

The IHS Global Insight study quantifies the levels of sales and employment that are attributable to advertising's stimulative effect. It comprehensively assesses the total economic contribution of advertising expenditures across 16 industries, plus government operations, in each of the 50 states, Washington, D.C., and each of the 435 Congressional Districts in the United States. The overall economic impact of advertising consists of the direct impact of advertising dollars and subsequent sales, supplier sales, inter-industry sales, and resulting consumer spending. Each of these effects also creates and maintains new jobs that are needed to support a higher level of production. The IHS Global Insight analysis quantifies the economic impact of advertising along four dimensions:

- **Direct Economic Impact**. This category refers to the dollars and jobs dedicated to developing and implementing advertising in order to stimulate demand for products and services. It includes the work of advertising agencies and the purchase of time and space on a host of media like radio, television, newspapers, magazines, the Internet, and other outlets. This level of impact stimulates transactions such as the sale of an automobile or an insurance policy sold as a direct result of television advertising.
- **Supplier Economic Impact**. Advertising-generated sales set off chain reactions throughout the economy and create sales and jobs supported by first-level suppliers. Using the example of a car sale, this level of impact encompasses activity by the suppliers of raw materials for upholstery, plastic, tires and parts, radio and GPS receivers, and other products and services that are used to produce the vehicle.
- **Inter-industry Economic Impact**. In the automobile example, sales to first-level suppliers generate subsequent inter-industry economic activity that creates jobs in a host of related industries, such as rail and truck transportation, gasoline and oil, insurance, and after-market sales of automobile products. The demand for products and services, sales, and jobs at this inter-industry tier depends upon the initial consumer purchase of the automobile, which is facilitated by advertising.
- **Induced Consumer Spending**. Every person with a direct, supplier, or inter-industry job also plays the role of consumer in the U.S. economy. They spend a portion of their salaries in the economy on items such as food, consumer goods and services, healthcare, and other needs. This spending initiates multiple rounds of economic activity, stimulates additional sales, and creates jobs.

Proposals to Overturn the Deduction for Advertising Costs Have Been Discredited

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 to raise additional revenues for the federal government. These proposals to abandon the treatment of advertising costs 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; (2) advertising costs create intangible assets and should, therefore, be capitalized in part, and (3) advertising costs are incurred with a future expectation of income and also should be capitalized in part.

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[8] "The Economic Impact of Advertising Expenditures in the United States," IHS Global Insight, Inc. (August 2010).

TAC worked with leading economic experts on the role of advertising in the U.S. economy, Dr. Kenneth Arrow and Dr. George Stigler,[9] to identify economic policies and data that would provide a forceful counterpoint to the various proposals being advanced to limit this deduction. Their analysis strongly supports the principle that advertising should be treated as an ordinary and necessary business expense. They also examined a number of articles by economists that advocated the capitalization of all or part of advertising costs and concluded that the theories advanced in those articles were not supported by the research. Below we briefly review those theories and the analysis of Drs. Arrow and Stigler.

Durability of advertising This theory suggests that the benefit of advertising extends beyond the year in which it is purchased, and that it is more appropriate to link advertising expenses and the income they generate by requiring a portion of advertising costs to be deducted in subsequent years. TAC asked Drs. Arrow and Stigler, and the economic consulting firm Lexecon, Inc., to explain the role of advertising in the economy and provide their evaluation of the amortization proposal. Drs. Arrow and Stigler prepared a paper entitled, "Economic Analysis of Proposed Changes in the Tax Treatment of Advertising Expenditures," in which they concluded, "Proposals to change the tax treatment of advertising are not supported by the economic evidence."[10]

Drs. Arrow and Stigler specifically examined a number of economic studies that proposed significant delays in the deduction of advertising costs that would increase the cost of advertising to the advertiser.[11] The goal of many of these studies was to demonstrate the longevity of advertising's impact on sales in order to justify capitalizing and amortizing all or part of advertising costs. The Nobel economists concluded that these studies on the durability of advertising had reached such different conclusions that they could not be used as a coherent basis for formulating tax policy. Moreover, Drs. 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.**[12] 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***

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[9] Dr. Arrow was awarded the Nobel Memorial Prize for Economic Sciences in 1972 and Dr. Stigler was awarded the Nobel Memorial Prize for Economic Sciences in 1982 based on their research into consumer choice and the role of information in the economy directed to consumers.

[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] Abdel-Khalik, "Advertising Effectiveness and Accounting Policy," 50 Acctg. Rev. 657 (1975); Ayanian, "The Advertising Capital Controversy," 56 J. Bus. 349 (1983); Bloch, "Advertising and Profitability: A Reappraisal," 82 J. Pol. Econ. 267 (1974); Bublitz and Ettredge, "The Information in Discretionary Outlays: Advertising, Research, and Development," 64 Acctg. Rev. 108 (1989); Hirshey and Weygandt, "Amortization Policy for Advertising and Research and Development Expenditures," 23 J. Acctg. Res. 326 (1985); Thomas, "Advertising in Consumer Goods Industries: Durability, Economies of Scale, and Heterogeneity," 32 J. Law & Econ. 163 (1989); Winer, "An Analyses of the Time-Varying Effects of Advertising; The Case of Lydia Pinkham," 52 J. Bus. 563 (1979).

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

***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.*"[13]**

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

However, the economic research provided by Drs. Arrow and Stigler shows that a company's intangible value lies in the firm's product, not in its advertising. They demonstrate that advertising communicates information about the product to customers. Drs. Arrow and Stigler said that while some economists have attempted to measure the relationship between a firm's advertising costs and its intangible capital, they incorrectly ignore the fact that there are many economic factors other than advertising that determine a firm's market value. Indeed, the value of the firm's product – e.g., its effectiveness or innovativeness – is the firm's true intangible asset. Advertising is only a means by which the firm can exploit fully the value of that asset. [14]

Drs. Arrow and Stigler offered the innovative user interface developed by Apple Computer as an example of this point. "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."[15]

Legal background

The case law defining the current deduction of business costs had been settled for more than 20 years when the U.S. Supreme Court in 1992 introduced a different viewpoint in *INDOPCO, Inc. v. Commissioner of Internal Revenue*.[16] Prior to *INDOPCO*, an expense would have been 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 National Starch and Chemical Corporation) should be capitalized and not deducted in the year in which they were incurred because the resulting legal structure enhanced the future value of the enterprise.

The decision in *INDOPCO* raised the question of whether legal fees related to a corporate acquisition either should be deducted in the year incurred or capitalized because they contribute to future company income. The Court's ruling prompted TAC and many other industry groups to ask the Internal Revenue Service (IRS) whether this decision would in the future extend to advertising expenditures and require any portion of advertising costs to be capitalized. The IRS Office of Chief Counsel responded on September 11, 1992:

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[13] *Ibid* at p. iii.
[14] *Ibid* at p. 36.
[15] "Economic Analysis of Proposed Changes in the Tax Treatment of Advertising Expenditures," Arrow, et. al.
[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).

> "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 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 keep 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 also addressed the treatment of intangible business expenses that are incurred in the process of generating consumer sales. Supporters of a change in the tax treatment of intangible assets advocated that some of these costs should be capitalized. The Omnibus Budget Reconciliation Act of 1993[19] provided that costs that create intangible assets generally should be amortized ratably over 15 years, but Congress specifically exempted any intangible "created by the taxpayer."[20] The legislation also excluded from amortization "any franchise, trademark, or trade name."[21]

Conclusion

Decades of legal and policy justifications continue to support the current tax treatment of advertising as an ordinary and necessary business expense, rather than an asset to be capitalized and amortized over time. TAC strongly opposes any proposal to amortize a portion of advertising costs over a period of years and respectfully urges the Committee to reject proposals with this objective during its work on tax reform. The coalition includes companies and associations of all sizes that share the common goals of protecting the right of companies to advertise, and securing a fair, affordable business tax rate. We are deeply concerned about the disruptions that would result from a decision to delay the current deduction of advertising costs for companies that market their goods and services in the national marketplace and to the free flow of ideas and information that is so critical to our economy.

Thank you for your consideration of our views.

Sincerely,

James H. Davidson
Executive Director, The Advertising Coalition

American Advertising Federation
American Association of Advertising Agencies
Association of National Advertisers
Interactive Advertising Bureau
MPA – The Association of Magazine Media
National Association of Broadcasters
National Cable & Telecommunications Association
National Newspaper Association
Newspaper Association of America

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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] P.L. 103-66,107 Stat. 312, enacted August 10, 1993.
[20] *Ibid*, sec. 197 (c)(2).
[21] *Ibid*, sec. 197 (d)(1)(F).