The *A*dvertising Coalition

Comments Regarding
Cost Recovery and Accounting Tax Reform Discussion Draft
Committee on Finance
United States Senate

January 17, 2014

Executive Summary

We appreciate the opportunity to submit these comments on behalf of The Advertising Coalition (TAC) in response to the Committee's request for comments on the November 21st Cost Recovery and Accounting Tax Reform Discussion Draft. TAC includes national trade associations whose members are advertisers, advertising agencies, broadcast companies, cable operators and program networks, and newspaper and magazine publishers. Our coalition represents perhaps the single broadest constituency of advertisers, advertising agencies, and media-related companies in this country engaged in protecting the free flow of advertising content and volume. 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. We are disappointed that this Draft would amortize 50 percent of advertising costs over five years and respectfully urge you to preserve the full deduction of advertising costs in the year incurred.

The policy contained within the Draft would be damaging not only to the advertising and media industries, but to all levels of the marketplace that are dependent upon the jobs and sales generated by advertising's ripple effect throughout the economy. A 2013 study conducted by the world-renowned economics and data analysis firm IHS Global Insight determined that every $1 spent on advertising generates nearly $22 in economic activity (sales), and that every million dollars in advertising will support 81 American jobs between 2012-2017. In 2012, advertising drove $5.8 trillion of the $33.8 trillion in U.S. economic output and supported 21.1 million of the 136.2 million jobs in the United States.[1] These figures demonstrate 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 the fact that the Draft's suggested amortization of advertising costs would, in effect, increase a company's taxable income for every year in which a business purchases advertising. TAC also believes that this proposal does not consider the hardships it would create for the overwhelming majority of companies and firms that purchase advertising each year. We are concerned that these businesses would feel the

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[1] "The Economic Impact of Advertising Expenditures in the United States, 2012-2017." IHS Global Insight, Inc. (June 2013).

brunt of this tax annually and would have fewer resources to commit to advertising spending year after year. The resulting decrease in advertising purchases would cause a chain reaction throughout the marketplace and impact media companies that depend on advertising as a critical source of revenue for daily operations. Given the complex role of advertising in the economy, this type of tax policy would not achieve two key objectives of tax reform – to make the Tax Code simpler and more efficient, and to foster a pro-growth environment.

This proposed tax on advertising is not supported by sound economic or tax policy. Two leading economic experts on the role of advertising, Nobel Prize laureates in Economics Dr. Kenneth J. Arrow and Dr. George G. Stigler, concluded that "Proposals to change the tax treatment of advertising are not supported by the economic evidence" and that any policy of making 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, advertising is a critical driver of our economy and should remain a fully deductible expense, just like salaries, rent, utilities, and office supplies.

Additionally, TAC believes that efforts in the Discussion Draft to expand Section 179 would be insufficient in protecting even small advertisers from the effects of this new tax. The proposal would allow companies to expense a total of only $1 million per year under Section 179, an increase from the $500,000 deduction presently allowed. Advertising would be just one of many expenses from which businesses would have to choose to receive Section 179 treatment. Businesses likely would continue using this provision to expense manufacturing equipment or office technology, which could crowd out the costs of advertising. Moreover, we believe that the revised Section 179 guidelines would not benefit most advertisers. Companies ranging through the top 1,000 advertisers have yearly advertising budgets that easily surpass $1 million, and advertising costs over this limit still would not remain fully deductible in the year advertising is purchased. This means that any amount that cannot be immediately expensed would result in an increase in taxable income. Such a system would only make it more difficult for firms to conduct the ordinary and necessary operations that are vital to growing any business, regardless of size.

TAC further is concerned that the Committee's proposed design of this so-called small business exemption unintentionally may harm the very businesses it intends to protect. The Draft would allow businesses to become eligible for Section 179 to the extent their advertising expenses do not exceed $2 million each year. Adding intangible assets such as advertising to this category, which already includes expensive manufacturing and office equipment, may mean that small businesses would no longer qualify for Section 179 because their purchases exceed the $2 million limit. This proposal inadvertently may keep small businesses that presently take advantage of Section 179 from benefiting from this deduction in the future.

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

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

The treatment of business advertising costs as ordinary and necessary business expenses under Section 162(a) of the Tax Code has been upheld in the U.S. Tax Court[3], supported by a Revenue Ruling from the Internal Revenue Service,[4] and endorsed by two Nobel Laureates in economics.[5] 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."[6] 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. <u>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.</u>

The deduction for advertising costs is essential to the proper calculation of the net income tax liability of a business. This principle that has been upheld by the U.S. Tax Court in the face of challenges from the Internal Revenue Service that have tested this standard over a period of several decades.[7]

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

As the nation's leading advertisers and media operators, we understand first-hand the extent to which advertising is a powerful tool that not only may be used to promote goods and services, but also may educate consumers about the world around them. Advertising also is responsible for generating trillions of dollars in economic activity. Dr. Lawrence R. Klein, the 1980 recipient of the Nobel Prize in Economic Sciences, and IHS Global Insight, Inc. demonstrated that advertising is a key driver of economic activity and a generator of jobs by employing an acclaimed macroeconomic analysis of the U.S. economy.[8] Their macroeconomic model is used today by the Treasury Department, Commerce Department,

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[3] *RJR Nabisco Inc. v. Commissioner*, 76 T.C.M.71 (1998).
[4] See Rev. Rul. 92-80, 1992-39 I.R.B. 7.
[5] Arrow, Kenneth et al. "Economic Analysis of Proposed Changes in the Tax Treatment of Advertising Expenditures." Lexecon Inc. (August 1990).
[6] P.L. 93-344, 88 Stat. 297, enacted July 12, 1974.
[7] *Id. RJR Nabisco Inc.*
[8] "The Economic Impact of Advertising Expenditures in the United States, 2012-2017." IHS Global Insight, Inc. (June 2013).

Labor Department, and most Fortune 500 companies. IHS Global Insight concluded in 2012 that 16 percent of all U.S. employment was related to advertising, the sales driven by advertising, and to the induced economic activity that occurs throughout the economy as a result of advertising.[9] Additionally, IHS Global Insight previously had established that advertising does not merely shift market 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."[10]

The IHS Global Insight study quantifies the levels of sales and employment that are attributable to advertising's stimulating effect. It comprehensively assesses the total economic contribution of advertising expenditures across 16 industries, plus government, 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:[11]

- **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.

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[9] "The Economic Impact of Advertising Expenditures in the United States, 2012-2017." IHS Global Insight, Inc. (June 2013).

[10] Ibid.

[11] Ibid.

- **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.

Leading Economists Have Rejected Proposals to Overturn the Deduction for Advertising Costs

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 of raising additional revenue for the federal government. These proposals to change the treatment of advertising as an ordinary and necessary business expense generally have been 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.

In response to the 1987 book of revenue options drafted by the Joint Committee on Taxation that included limits on the deductibility of advertising,[12] TAC worked with leading economists to identify economic policies and data that would provide a counterpoint to proposals to limit this deduction. The American Institute of Certified Public Accountants similarly examined and rejected a proposal to require capitalization of advertising costs for book income reporting.[13] The analyses of our economic advisers support the principle that advertising costs should continue to be treated as ordinary and necessary business expenses while concluding that theories advocating otherwise are not sustainable.

*Durability of advertising***.** This argument centers on the notion 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 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 and provide their analysis of this theory. Dr. Arrow was awarded the Nobel Prize for Economic Sciences in 1972 and Dr. Stigler was awarded the Nobel Prize for Economic Sciences in 1982 for research on 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," in which they

[12] "A Description of Possible Options to Increase Revenues Prepared for the Committee on Ways and Means," Joint Committee on Taxation, pp. 138-139 (1987).

[13] The American Institute of Certified Public Accountants. "Statement of Position 93-7: Reporting on Advertising Costs." (1993).

concluded, "Proposals to change the tax treatment of advertising are not supported by the economic evidence."[14]

Drs. Arrow and Stigler specifically examined a number of economic studies that proposed increasing 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 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.[15] 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."***[16]

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 Dr. Arrow and Dr. Stigler shows that an intangible asset is the firm's product, not the advertising itself. The results indicate that advertising only communicates information about the product to customers. Dr. Arrow and Dr. 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. [17]

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

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

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

[16] *Ibid* at p. iii.

[17] *Ibid* at p. 36.

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."[18]

<u>Legal background</u>. The case law supporting 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*.[19] Prior to *INDOPCO*, an expense would have been capitalized only if it "create[d] or enhance[d] . . . a separate and distinct additional asset."[20] 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 jointly 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:

> "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 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."[21]

Congress in 1993 also addressed the treatment of intangible business expenses that are incurred in 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[22] provided that these costs generally should be amortized ratably over 15 years, but Congress specifically exempted any intangible "created by the taxpayer."[23] The legislation also excluded from amortization "any franchise, trademark, or

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[18] "Economic Analysis of Proposed Changes in the Tax Treatment of Advertising Expenditures," Arrow, et. al.
[19] *INDOPCO, Inc. v. Commissioner of Internal Revenue*, 503 U.S. 79 (1992).
[20] *Commissioner v. Lincoln Savings & Loan Assn.*, 403 U.S. 345, 354 (1971).
[21] Rev. Rul. 92-80, 1992-39 I.R.B. 7, 1992-2 C.B. 57, 1992 WL 224893 (IRS RRU), September 11, 1992.
[22] P.L. 103-66,107 Stat. 312, enacted August 10, 1993.
[23] *Ibid*, sec. 197 (c)(2).

trade name."[24] In other words, advertising that promotes an intangible asset – such as the brand name of a product – should not be capitalized, but rather 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 a Statement of Position in 1993 that recommended expensing advertising costs either as incurred or at the first time the advertising takes place, unless the advertising meets criteria for capitalizing direct-response advertising.[25] Because the Congress and the Committee on Ways and Means regularly look to the treatment the accounting profession recommends or requires for guidance in the treatment of business expenses, TAC was pleased that AcSEC affirmed the current deduction of advertising costs.

Conclusion

Decades of legal and policy justifications support the current tax treatment of advertising as an ordinary and necessary business expense, rather than an asset to be capitalized over time. TAC strongly opposes efforts by the Committee on Finance in its Discussion Draft that would amortize 50 percent of advertising costs over five years and respectfully urges the Committee not to include this provision in its subsequent work on tax reform. Our 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. However, we are deeply concerned about the disruptions that a significant policy change like this would create, both to our marketplace and to the free flow of ideas and information within our society.

Thank you for your consideration of our views.

The Advertising Coalition
American Advertising Federation
American Association of Advertising Agencies
Association of National Advertisers
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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[24] P.L. 103-66, sec. 197 (d)(1)(F)., enacted August 10, 1993.
[25] American Institute of Certified Public Accountants, Accounting Standards Executive Committee, Statement of Position 93-7, December 29, 1993.