The *AD*vertising Coalition

Comments Regarding Hearing on
How Tax Reform Will Grow Our Economy and Create Jobs
To The Committee on Ways and Means
U.S. House of Representatives

May 30, 2017

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 tax reform and the economy. TAC includes national trade associations whose members are advertisers, advertising agencies, broadcast companies, cable operators and program networks, and newspaper, magazine and online publishers. Our coalition represents perhaps the single broadest constituency of advertisers, advertising agencies, and media-related businesses in this country engaged in protecting the free flow of advertising content and volume. As a direct correlation to that objective, TAC members are vitally interested in assuring that any reform of the Tax Code preserves the current ability of businesses to deduct the cost of advertising as an ordinary and necessary business expense.

While we agree with the general goal of lowering the statutory corporate tax rate, we believe that it would be counterproductive and in direct conflict with 104 years of established tax policy to impose limits on the deduction for advertising in an effort to "pay-for" such changes. The stated goals of tax reform are to make the U.S. more competitive, stimulate growth and simplify the tax code, but burdening advertising with additional tax liabilities would not further any of these important initiatives. Our concerns are not merely hypothetical as former Ways and Means Chairman Dave Camp included a $169 billion tax on advertising in his 2014 comprehensive reform proposal (the Tax Reform Act of 2014).

Historically, Congress has reviewed the operation of the Tax Code and proposed revenue raising measures that involved limiting or eliminating nonproductive, revenue losing provisions such as tax expenditures identified by the Joint Committee on Taxation or the Office of Management and Budget. The deduction for the cost of advertising, however, has been an accepted business expense since the adoption of the corporate Tax Code, along with the deduction of other business operating expenses such as rent, salaries and office supplies. This deduction has never been characterized as a tax expenditure or in any way inconsistent with sound tax policy. However, it has become the focus of tax reform for the same reason that Willie Sutton once explained why he robbed banks. "I rob banks because that's where the money is."

One of the unintended consequences of the proposed tax on advertising is that it would result in less information being available to consumers through internet publishers, newspapers, magazines, radio and television stations and networks, and cable networks and operators. Advertising is essential to the operation and even the survival of our national independent providers of news and information, particularly in rural and smaller communities. Reducing the advertising revenue received by these media outlets would reduce their ability to make information available and would weaken a core underpinning of our democracy - an informed electorate.

A tax on advertising such as what was proposed in the Camp legislation would not only damage the advertising and media industries, but also would negatively affect the jobs and sales generated by advertising's ripple effect throughout the economy. A 2015 study conducted by the world-renowned economics and data analysis firm IHS Economics and Country Risk ("IHS") determined that every $1 spent on advertising generates nearly $19 in economic activity (sales), and that every million dollars in advertising supports 67 American jobs. In 2012, advertising drove $5.8 trillion of the $36.7 trillion in U.S. economic output and supported 20 million of the 142 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.

The nation's businesses that advertise would annually feel the brunt of a Camp-like proposal, leaving them with fewer resources to commit to advertising spending year after year. The resulting decrease in advertising purchases would, as described above, cause a chain reaction throughout the economy and sharply affect 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 work counter to the key objectives of tax reform of making the Tax Code simpler and more efficient, and fostering a pro-growth environment.

A tax on advertising is neither supported by sound economic policy nor informed tax policy. Two leading experts on the role of advertising, Nobel laureates in Economics 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 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 U.S. economic activity and should remain a fully deductible expense, just like salaries, rent, utilities, and office supplies.

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

The treatment of business advertising costs as an ordinary and necessary business expense under Section 162 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] as well as endorsed by Dr. Arrow and Dr. Stigler.[5] The commitment by leaders in Congress to improve the way the government identifies and collects tax revenues can bring important and productive changes to the Tax Code, including a reevaluation of

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[1] "Economic Impact of Advertising in the United States." IHS Economics and Country Risk. (March 2015).

[2] Arrow, Kenneth et al. "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] 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).

what constitutes a "tax expenditure," to be more consistent with sound tax policy. However, it is essential to maintain a clear distinction between the definition and 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. However worthy the objective, a tax expenditure is an exception to sound tax policy. ***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 is essential to the proper calculation of the net income tax liability of a business. This principle has been upheld by the U.S. Tax Court in the face of challenges from the Internal Revenue Service that have attempted to test 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 companies, members of The Advertising Coalition 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 helps to educate consumers about the world around them. Advertising also is responsible for generating trillions of dollars in economic activity. IHS Economics and Country Risk, using an economic model developed by Dr. Lawrence R. Klein, the 1980 recipient of the Nobel Prize in Economics, demonstrated how advertising performs as a key driver of economic activity and a generator of jobs.[8] This macroeconomic model has been employed by the Treasury Department, Commerce Department, Labor Department, and most Fortune 500 companies. IHS concluded in 2015 that the jobs of 14 percent (19.5 million) of all U.S. employees are related to advertising, the sales driven by advertising, and the induced economic activity that occurs throughout the economy as a result of advertising.[9] Additionally, IHS previously 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 study quantifies the levels of sales and employment that are attributable to the stimulus produced by advertising. 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

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[6] P.L. 93-344, 88 Stat. 297, enacted July 12, 1974.
[7] *Id. RJR Nabisco Inc.*
[8] "Economic Impact of Advertising in the United States." IHS Economics and Country Risk. (March 2015).
[9] "The Economic Impact of Advertising Expenditures in the United States, 2012-2017." IHS Economics and Country Risk, Inc. (June 2013).
[10] *Ibid*

maintains new jobs that are needed to support a higher level of production. The IHS 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.

- ***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 Reinforced Deduction for 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 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 Drs. Arrow and Stigler 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

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[11] "Economic Impact of Advertising in the United States." IHS Economics and Country Risk. (March 2015).

[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).

proposal to capitalize advertising costs for book income treatment.[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 Arrow and 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 Economics in 1972 and Dr. Stigler was awarded the Nobel Prize for Economics in 1982 for research on consumer choice and the role of consumer information in the economy. Together they prepared the "Economic Analysis of Proposed Changes in the Tax Treatment of Advertising Expenditures." [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 Drs. Arrow and Stigler shows that the intangible asset is the firm's product, not the advertising for the product. The results indicate that advertising only communicates information about the product to customers. 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

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[13] The American Institute of Certified Public Accountants. "Statement of Position 93-7: Reporting on Advertising Costs." (1993).
[14] K. Arrow, et. al.
[15] K. Arrow, et. al., at p. 23.
[16] *Ibid* at p. iii.

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]

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."[18]

Legal background. 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* focused on the tax treatment of legal fees related to a corporate acquisition – whether they should be deducted in the year incurred or capitalized because they contribute to future company income. The Court's ruling, however, prompted TAC and many other industry groups jointly to ask the Internal Revenue Service (IRS) whether this decision might in the future be extended 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

[17] *Ibid* at p. 36.
[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).

amortization "any franchise, trademark, or 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 that would tax the business cost of advertising. 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.

Thank you for your consideration of our views.

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[24] *Ibid*, sec. 197 (d)(1)(F).
[25] American Institute of Certified Public Accountants, Accounting Standards Executive Committee, Statement of Position 93-7, December 29, 1993.