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Academic Presentation

Perspective on Ad Capitalization and Taxation

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Perspective on Ad Capitalization and Taxation

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The Tax Deductibility of Advertising Is Under Attack

- What is covered in this presentation:
  - Current tax treatment of advertising expenditures
  - Financial accounting treatment of advertising expenditures
  - Proposals for change in current treatment
  - Recent proposals for capitalization
  - Prior research on short-term and long-term effects of advertising
  - Marketing Issues

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Current Tax Treatment of Advertising Expenditures

- **For over 100 years of our tax history, advertising expenditures have been considered an "ordinary and necessary" business expense.**
- **This treatment is prescribed because advertising expenditures are recurring in nature and it is presumed the benefit does not extend beyond the tax year or the benefit was too difficult to measure.**
- **Some advertising expenditures have been held to provide future benefits and have been capitalized.**
- **The IRS has recognized that measuring a significant long-term benefit for advertising is challenging.**

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Link to Financial Accounting

- Measurement of taxable income normally follows the method of accounting for keeping books.
- The Financial Accounting Standards Board (FASB) rules state that advertising costs are usually expensed currently because the benefit period is presumed to be short or the periods in which economic benefits might be received or the amount of economic benefit cannot be determined easily and objectively.
- There is an exception to direct-response advertising we need not consider here.

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Very Early Taxes on Advertising

- The 1775 stamp tax required payment of 2 shillings for every advertisement.
- During the Civil War period there was a 3 percent tax on advertising gross receipts from newspaper and magazine ads.

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Early Initiatives for Changes in Advertising Treatment

- Max Geller *(Advertising at the Crossroads (1952))* proposed to integrate advertising expenditures with national welfare by controlling the deductibility of advertising expenses.

- In the 1950s Congress debated using the deductibility of advertising costs as an economic stabilizer to constrain consumption during a period of high demand and inflation.

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Noteworthy Recent Initiatives (Over 30 Since 1986)

- Tax Reform Act of 1986—proposed disallowing 20% of advertising costs to enhance revenue
- The Joint Committee on Taxation Report in 1987 proposed capitalizing 20% of advertising costs and amortizing these capitalized costs over two years to raise government revenues (estimated revenue $37.9 billion over three years).
- Numerous proposals have circulated to deny the deduction of advertising for tobacco products, alcoholic beverages, fast food, and prescription medicines.

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Noteworthy Recent Initiatives (Continued)

- The Congressional Budget Office (1990) proposed 20 percent capitalization of advertising costs and amortization over four years (estimated revenue $28 billion over four years).
- The Progressive Party Institute (1994) proposed that 20 percent of advertising be capitalized as it is related to brand building.
- A proposal from Senate and House members (1994) to capitalize 20 percent of advertising to fund single payer health care reform.

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Very Recent Initiatives (2013)—Raising the Stakes

- David Camp (R-Mich) introduced a proposal to House Ways and Means Committee allowing a deduction of 50 percent of advertising costs and amortizing the balance over 10 years.
- Max Baucus (D-Mont) introduced a proposal to the Senate Finance Committee allowing a deduction of 50 percent of advertising costs and amortizing the balance over 5 years.
- There were strong protests to both proposals by the Association of National Advertisers, the American Advertising Federation and the Advertising Coalition, among others.

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New Tax Reform Developments (2013)

- In the past, revenue raising proposals focused on tax expenditures (revenue losses from special exclusions, exemptions from income, special credits, etc.).
- A new classification has been developed called *non-tax base expenditure base provisions (NTEBPs)* that looks for sources of revenue from within the current income tax structure.
- NTEBPs are included if they do not accurately define income in the traditional economic sense, are subject to substantial abuse, have both business and personal components or conflict with other policy goals.

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New Tax Reform Developments (continued)

- Examples of Business NTEPBs are deductions for employee training costs, state and local taxes, interest expense, meals and entertainment expenses, and amortization of intangible assets.
- Advertising is not considered a tax expenditure but is included among business NTEPBs as it is assumed that some advertising builds brand value and some expenditures should be capitalized (with a suggested write-off of 15 years).

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What These Tax Initiatives Do Not Provide

- A rationale for the measurement of any intangible asset created from advertising (if any), i.e., how much to be capitalized
- A rationale for the measurement of the life of advertising beyond the year of advertising expenditures (if there is one), i.e., the amortization period
- A rationale for understanding the link between advertising and brands, i.e. the elements that build brand value

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Marketing Research—Advertising Short-Term Effects

- Clark (1976) mega analysis of 70 studies from the 1960s & 1970s found that 90 percent of advertising's impact had a median duration of about 20 months.
- The impact varied by the product advertised from .08 months to 117.2 months.
- The upper quartile was 53.4 months and the lower quartile was 3.4 months.
- It is clear that Clark found no general rule as to the duration of advertising's effects but he did conclude that the effects were relatively short-term.

Marketing Research—Advertising Short-Term Effects

- Leone (1995) revised Clark's estimates to correct for bias.
- Leone found that the estimated duration intervals ran about one year shorter than Clark's for the annual studies.

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Marketing Research—Advertising Short-Term Effects

- Arrow and Stigler (1990) examined many of the prior and recent studies for technical flaws.
- They concluded that the economic life of marketing intangibles is often no more than a year.
- “Economic evidence does not support the view that advertising is long-lived.”

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Marketing Research—Advertising Short-Term Effects

- In testimony to Congress, the U.S. Treasury Department (1994) stated advertising assets have a life of a year or less.
- Kerho (2010), in his examination of advertising across different media, found that the useful life of advertising ranged from 3 to 27 weeks depending on the media.

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Research on Short-Term Effects—Some Observations

- The impact of advertising is often less than 12 months, but may be more depending on the product.
- Data interval biases (e.g., frequency of observations of data) limit the conclusions.
- It is argued that long-term effects are not accurately considered in these studies.

Research—Short-Term and Long-Term Effects

- Lostumbo and Sengupta (2013) examined studies on the short-term and long-term effects of advertising on sales.
- They concluded that the long-term effect of advertising was approximately two times the magnitude of the short-term effects and was found principally in the second and third years.

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Research—Short-Term and Long-Term Effects

- Hanssens (2011*) found that advertising's long-term impact is double to triple the impact of year one.
- He concluded that long-term impact develops primarily as a result of…immediate effects, carry-over effects and purchase reinforcement, results of consumer response to advertising and the product.
- Also, he noted if advertising is not successful in year one, then there will be no long-term effects.

*This research was supported by MASB, see *What is Known about the Long-term Impact of Advertising* on the MASB website.

Research—Long-Term Effects

- Herschey (1982) concluded that advertising and R&D expenditures have significant market value effects on the firm and depreciation effects of 20 to 30 percent for advertising and 25 percent for R&D.
- Herschey and Weygandt (1985) hypothesized that advertising and R&D expenditures had "systemic influences on the market value of the firm that persist over time."
- They estimated 90 percent duration intervals of from one to five years for durable goods, and nine to 20 years for non-durables.

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Advertising ≠ Brand Value

- Advertising expenditures are not a surrogate for Brand Value
  - Brand is an intangible asset with value determined in the market
  - If taxed at all, it should be at time of sale (Implications for market economy & policy)
  - Advertising is an expense that may have short- or long-term effects (or no effect at all)

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Problems With Estimation of Effects

- It is easy to determine when expenditure occurs.
- It is not so easy to determine when longer term effects occur:
  - Are changes in baseline that persist over time a one-time effect or a long-term effect?
  - Do different effects in multiple periods exist? Can they be estimated?

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Brand Creation Involves Many Factors (with Interactions)

- Advertising
- Product Experience
- Presence in Channel (Coverage, Self-Space, Reputation)
- Is the Effect of the Creation of Awareness through Advertising That Appears to Persist Because Consumers Buy and Have a Positive Experience a Long Term Effect of Advertising?
- How Do you Separate Such an Advertising Effects From Experience Effects?

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Implications

- There Is a Need to Separate Discussion of Brand Value From Advertising Spending
- MASB's Focus Is On Creating, Managing and Measuring Brand Value
- Revenue Hungry Politicians Will Do What They Do, But …
- MASB Can and Should Contribute to the Dialog and Help Educate All Constituencies

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Thank-you!