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INSIGHT

Proposals to Deny a Federal Tax Deduction for Prescription Drug Advertising Expenses

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High and rising prescription drug prices have long been a source of concern. For most years between 2000 and 2020, retail drug price inflation exceeded overall U.S. consumer price inflation. Finding agreement on effective ways to contain U.S. drug price increases has been a continuing challenge for lawmakers.

Some lawmakers have proposed using the federal income tax to encourage prescription drug companies to reduce prices. Since the 113th Congress, at least nine bills have been introduced that would bar companies from deducting the cost of prescription drug advertising, including two bills in the 117th Congress: S. 141 and H.R. 6392. All but one of the nine bills would have denied a deduction for direct-to-consumer (DTC) prescription drug ads.

This Insight discusses how advertising costs are treated for tax purposes; the rationale for proposed deduction bans for DTC prescription drug advertising; and some of the policy issues raised by this legislation. It does not discuss the impact on commercial free speech of such a ban.

Federal Tax Treatment of Advertising Costs

Internal Revenue Code (IRC) 162(a) allows companies to deduct all "ordinary and necessary" expenses in determining their taxable income. An ordinary expense is defined as an expense that commonly occurs and is broadly accepted in an industry (e.g., the cost of business computer systems). A necessary expense is defined as an expense that is regarded as helpful and appropriate in an industry, but not necessarily indispensable (e.g., the cost of creating and maintaining a business website).

The Internal Revenue Service (IRS) considers advertising to be an ordinary and necessary expense that is generally deductible under the following conditions: the expenses should be intended to promote a taxpayer's business, reasonable in amount, and verifiable. This includes expenses associated with institutional or goodwill advertising intended to keep a company's name among the general public, perhaps with the aim of increasing its future customer base. Companies in all trades and businesses may deduct qualified advertising expenses.

A perennial issue in the federal tax treatment of advertising has been whether it is always appropriate to deduct such expenses in full (or expense them) in the year when they are incurred or paid. Expensing is

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appropriate when a business asset's full economic value is consumed in the year when it is placed in service (e.g., the services provided by workers to employers). Some advertising seems to have that effect, such as ads aimed at selling goods and services within a specified period. But some advertising arguably creates assets with useful lives longer than one year (e.g., ads intended to build brand loyalty and goodwill). In this case, the appropriate tax treatment under an income tax is to partially or fully capitalize the advertising's cost and recover it over the ads' useful life. This treatment is largely unused because expensing for advertising costs is often easier for taxpayers and the IRS to administer.

Rationale for Denying a Tax Deduction for DTC Prescription Drug Advertising

S. 141 and H.R. 6392 would deny a deduction for DTC prescription drug advertising expenses in all media, including the internet and digital platforms such as social media.

Proponents of such a denial say it would (1) end a tax subsidy for activities that can harm consumers and inflate U.S. prescription drug spending and (2) encourage drug companies to cease or reduce the "aggressive" marketing of prescription drugs to consumers on television, on the radio, in print, and on the internet, which they say drives up demand for promoted medications and allows producers to raise their prices. DTC prescription drug advertising grew from $1.3 billion in 1997 to $6.6 billion in 2020. Proponents contend that an effective way to mitigate the potential harm associated with this advertising is to provide the drug industry with a robust tax incentive to reduce or stop it.

Policy Issues

S. 141 and H.R. 6392 raise several policy issues. One issue concerns whether a deduction for advertising expenses is a tax subsidy, as proponents of the legislation have argued. Under the federal income tax, such a deduction is not considered a tax subsidy from an economic perspective, because it is consistent with the principle that taxable income should exclude ordinary and necessary expenses incurred or paid in earning that income and advertising is such an expense. The expensing of advertising costs when they create an asset with a useful life longer than one year would represent a tax subsidy, but not in the sense of proponents of disallowing a deduction for DTC drug advertising.

Another issue concerns how a ban on deducting DTC prescription drug advertising costs would affect investment in new drug development. The ramifications of such a ban are difficult to discern. Among key considerations are (1) how drug industry advertising would respond to the loss of the deduction, (2) what it would do with funds made available by any reductions in DTC advertising, and (3) the effect of the deduction's loss on the demand for prescription drugs no longer promoted through DTC ads and their prices. Everything else being equal, prescription drug companies that continue DTC advertising would likely realize an increase in their effective federal tax rates (since the inability to deduct those expenses would boost the after-tax cost of DTC advertising) and a reduction in their cash flow. These effects might be sufficient to diminish the incentive of some drug companies to invest in developing new drugs. Large established drug firms, which tend to finance their research and development from retained earnings, may experience less of an incentive decline than small start-up drug companies, which typically lack reserves of retained earnings.

Another issue is the suitability of the federal tax code to address concerns about the effects of DTC drug advertising. DTC prescription drug ads are central to a range of policy concerns. These include the cost of prescription drugs, their links to drug industry profits and investment in new drug development, the risks of misuse and overuse for certain medicines, the balance of authority between doctors and patients, and constitutional limits on commercial speech. Whether or not limits should be imposed on DTC drug advertising is a policy decision that lawmakers may want to make on the basis of what is known about the advantages and disadvantages of such advertising. Limiting the deductibility of DTC drug advertising may not be as useful and fine-tuned as other (non-tax) options for mitigating the harmful effects of DTC prescription drug ads and enhancing their benefits.

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