Ongoing Project - Part 4: Pepsi v. Coca-Cola Analysis, John A. Kelly

Income Tax Disclosure and Strategy

**Coca Cola (KO)**

**What is the effective tax rate?**

Under ITEM 7.  MANAGEMENT’S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS:

*Based on current tax laws, the Company’s effective tax rate in 2023 is expected to be approximately* ***19.5 percent*** *before considering the potential impact of any significant operating and nonoperating items that may affect our effective tax rate.*

**Tax concerns**

On ITEM 1A – RISK FACTORS is where KO outlines their tax disclosures on their yearly 10-K, KO is very concerned about special taxation on ingredients and materials predominantly used in the making and sale of their products, that have become subject to public scrutiny lists out increased taxation on their products by local and state governments due to the increasing negative health impact KO’s products, mainly their soda-beverage sweetened products. Taxation on sugar drinks has become adopted to combat obesity. Additionally, environmental “Eco” taxes are levied on KO’s bottlers due to plastic use in manufacturing bottle containers to distribute their beverages. There are environmental concerns over increased plastic use. KO has stressed that such taxes will negatively impact earnings unless they discover alternative products that comply with current public demand in terms of these two concern areas. KO has responded by investing in expansion of its water bottling and sugar-free beverage offerings, specifically “Coke Zero-Sugar” and its derivative flavorings. As wells as investing in health centered companies that make health-based products.

**Has TCJA 2017 affected KO?**

The impact of the Tax Cuts and Jobs Act of 2017 is mentioned under the subject line “*Increases in income tax rates, changes in income tax laws or unfavorable resolution of tax matters could have a material adverse impact on our financial results.****”*** When TCJA 2017 went into effect Jan 1, 2018 KO altered its chart of accounts to reflect it as Transition Taxes Payable. Before TCJA passed in Congress, KO was currently in an ongoing legal tax dispute with the U.S. federal government who sought to increase their overall tax liability from fiscal years 2007-2009 by $3.3 billion creating a potential tax liability under the old federal tax law. The tax trial was held between March 8, 2018, thru May 11, 2018, where court filing, discovery and evidence were gathered before TCJA 2017 was enacted. There was only a “reasonably possible” outcome a federal ruling against KO given the delay in a ruling. KO has disclosed that the negative ruling creating the potential $3.3 billion tax liability (assuming old tax law provisions being applied) will be transferred to their Transition Taxes Payable, an account that will be used to adjust taxes payable.

KO has nevertheless stated that TCJA 2017 significantly impacted their financial position. The company has referred to Staff Accounting Bulletin #118 or “SAB 118” as authoritative guidance to list their estimations on tax liabilities from the new TCJA reforms. These estimates are mentioned in ITEM 7 –MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

On ITEM 7 - MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS. KO management discloses that TCJA 2017 created a tax liability on **$41 billion of foreign earnings post-1986**, kept overseas not subjected to U.S. taxes. Management has used “SAB-118” to **estimate they will incurr a $4.6 billion tax liability on these earnings from the new TCJA law**. disclosed most of the transition taxes payable are from foreign earnings invested in other subsidiaries KO has controlling interest over. KO must pay a one-time transition tax over a period of eight years, which they describe a re-patriation of foreign earnings.

**Do deferred tax assets seem appropriate given the company’s industry?**

Looking at their current FY 2022 10-K, KO’s total deferred tax assets went down to **$4,609 (million)** from $4,937 (million in 2021) in FY 2021. There aren’t any visible differences among the items in their deferred tax asset and liability reconciliation schedules.

Background pattern

Description automatically generated

Under ITEM 7 – MD&A “Income Taxes”. KO discloses that deferred tax assets and liabilities are determined by temporary differences in the book value basis, and the tax basis. The applicable tax rate on these deferred tax assets are the rates enacted in the year these assets are recognized. KO uses forecasted taxable income to define their tax assets based on forecasted operating results. Under current definitions of deferred tax assets. In other words, if KO made a $560 million tax payment, but their tax expense is much less at $200 million, the difference is $360 million. KO’s disclosed effective tax rate is 19.5%, so the tax asset is $360 mil x 19.5% = $70,200,000. KO’s effective rate of 19.5% is less than the 21% permanent corporate rate enacted by TCJA 2017.

**Is there a valuation allowance?**

In the same ITEM 7 “Income Taxes” section, KO has disclosed they do allow for valuation allowances unless management determines that it is more likely than not to realize a tax benefit associated with the tax asset. Valuation allowances are recorded to reduce the deferred tax assets to an amount that will more likely than not be realized.

**Pepsi Co. (PEP)**

**What is the effective tax rate?**

Under ITEM 7 - MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS – “Income Tax Expense and Accruals”

*“In 2022, our annual tax rate was 16.1% compared to 21.8% in 2021. See “Other Consolidated Results” for further information.”*

A reconciliation table was provided to show how they arrived at the current 16.1%

Background pattern

Description automatically generated

**Tax Concerns**

Like KO, PEP is under threat of industry-targeted taxation in regards to sugar content that contributes to obesity and health concerns, and taxation on plastics and other non-environmental-friendly materials for bottling their products. PEP made specific mention to Italy enacting a flat tax on all soda beverages regardless of if they conform to health and environmental guidelines regional and state governments impose on the company. Even if PEP cuts sugar content out of their product, they are subject to the flat tax. PEP is expanding their product line to invest in manufacturing zero-sugar beverages. The star product being “Pepsi Zero Sugar” and centralizing control over its bottling partners. Aside from phasing out sugar ingredients, they are expanding their water-based product offerings.

**Has TCJA 2017 affected PEP?**

TCJA 2017 did have a significant impact on PEP in terms of **taxation of foreign profits** that were not accrued since those monies were constantly re-invested offshore. Unlike KO’s 10-K, PEP does have a Tax Cuts and Jobs Act section under their MD&A disclosure. They have a transition tax liability. On their 10-K for fiscal year 2018 when TCJA 2017 went into effect, PEP had to **recognize a $2.5 billion tax liability on $4 billion in foreign earnings**. However, at the time PEP was able to reduce this tax liability by $1.5 billion provisional benefit resulting from TCJA re-assessing current deferred tax assets that existed before TCJA, that were calculated under the former tax rate, and then re-valued to the new rate of 21%. In fiscal year 2022 PEP made tax overpayments of $309 million. PEP also notes that foreign income be included in gross income as per TCJA, which are referred to as “Global, Intangible, Low-Tax Income” or “GILITI” as in the word “guilty.”

**Do deferred tax assets and liabilities seem appropriate given the company industry?**

PEP began FY 2022 with 5,342 million in tax assets, and ended the year with (71) million. PEP has much less tax assets than previous. This is mainly due to the (5,013 million) in valuation allowances taken in FY 2022 to reduce the tax asset. Currently in FY 2022 they record a **tax loss** of **(71) in millions**. Whereas, before in 2021 they **had over $516 million in tax assets**. That’s a **587 million reduction in tax assets in just 1 year**. As we accountants know, tax assets and tax liabilities do not net against each other in the financial statements. And I do not see any other disclosures on the footnotes that relate to this.

Background pattern

Description automatically generated

PEP has increased its valuation allowances from (4628) in FY 2021 to (5013), this greatly reduced their assets. As for if it’s appropriate, PEP has disclosed on their 10-K they are permitted to use valuation allowances as managers see fit provided strong evidence to do so.