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Deferred Taxes – A Partner in Uncle Sam, Part II: Berkshire's Investment in Coke

In my last memo, I explained the power of deferred taxes and what they can bring to an investment program in terms of super-charging results over time. In this edition I look at a real-world example of the process in action (actually, *inaction* is the operative word) – Berkshire Hathaway's decades-long investment in The Coca-Cola Company.

During 1988, Berkshire Hathaway made its first purchases of Coca Cola shares, ending the year with an investment, at cost, of $593 million. The following year, 1989, its at-cost investment was $1,024 million; and at year-end 1994 its investment was increased to $1,299 million, where it has remained ever since. This original aggregate investment of $1.3 billion was worth, as of December 31, 2014, almost $16.9 billion. Were it to sell, Berkshire would owe Uncle Sam a whopping $5.5 billion. Paradoxically it is this tax that gives Berkshire an economic advantage which is sometimes misunderstood.

Let's take a look at Berkshire's Coke "balance sheet". At the end of 1988 Berkshire's investment had increased to $632 million. Since we're only looking at Berkshire's Coke investment, this is the only 'asset' on the balance sheet. The other side of the ledger is where it gets interesting. Of the $632 million market value at year-end 1988, $14 million was the tax liability incurred on the $39 million increase in value over the $593 million original aggregate purchase price. The remaining $618 million was the true 'liquidating value' (equity), or what Berkshire could have realized in cash if it had sold at that point. At the end of 1988 deferred taxes represented just 2.2% of this hypothetical balance sheet. Fast forward to the end of 1992 – a mere 4 years later – and Berkshire's investment had increased to $3.9 billion, or about $2.9 billion over the $1.0 billion aggregate purchase price at that time. The portion of Berkshire's carrying value of Coca Cola shares representing the Treasury's claim on unrealized appreciation in value (deferred taxes) had increased to over 25%. Over *one quarter* of the $3.9 billion market value, about $1.0 billion, would have had to be remitted to the US Government if Berkshire had liquidated. Of course we know Berkshire has continually decided not to sell, and therefore not actually pay these taxes.

Summary KO Balance Sheet (First and Most Recent Five Years)

BRK Coca-Cola "Balance Sheet"	2014	2013	2012	2011	2010	1992	1991	1990	1989	1988
Investment in KO @ Market	$ 16,888	$ 16,524	$ 14,500	$ 13,994	$ 13,154	$ 3,911	$ 3,748	$ 2,172	$ 1,804	$ 632
Total Assets	**$16,888**	**$16,524**	**$14,500**	**$13,994**	**$13,154**	**$ 3,911**	**$ 3,748**	**$ 2,172**	**$ 1,804**	**$ 632**
Deferred Taxes (35%)	$ 5,456	$ 5,329	$ 4,620	$ 4,443	$ 4,149	$ 1,010	$ 953	$ 402	$ 273	$ 14
Equity	$ 11,432	$ 11,195	$ 9,880	$ 9,551	$ 9,005	$ 2,901	$ 2,795	$ 1,770	$ 1,531	$ 618
Total Liab. + Equity	**$16,888**	**$16,524**	**$14,500**	**$13,994**	**$13,154**	**$ 3,911**	**$ 3,748**	**$ 2,172**	**$ 1,804**	**$ 632**
Deferred Taxes % Total	32.3%	32.2%	31.9%	31.8%	31.5%	25.8%	25.4%	18.5%	15.1%	2.2%

What, then, is the value of these deferred taxes? To determine this we need simply ask how much any alternative investment would have to earn in order to match any given return that Berkshire could generate after selling its stake in Coke and, of course, paying those taxes to the Government. As it turns out, given Berkshire's 35% corporate tax rate, the opportunity cost of switching is high – 37% in 5 years; 29% in 10 years; 16% in 25 years. That is, if KO can be expected to earn 10%, any competing investment must earn at least 3.7 percentage points more per annum more than Coke over the next 5 years; at least 2.9 percentage points more per annum over the next 10 years; and at least 1.6 percentage points more per annum over the next 25 years. To put it another way: If Coke's heyday is over, as some claim it is, and it's simply an "average business", one that might only earn an investor, say, a 7.5% total return going forward, Berkshire's opportunity cost is 9.9% and Buffett has to find a competing investment earning almost 2.4% more per annum over the next 10 years. That's a high bar to clear with eleven figures.

This advantage, as it turns out, is reached fairly quickly. Furthermore, it's affected by tax rate. For most individuals subject to US capital gains taxes of 20%, once an investment has doubled over its original cost, any new investment must earn 9.1% (percent, not percentage points) more per annum over the next 10 years in order to justify the switch. Put another way, if you're holding a two-bagger and its normalized earnings yield dips anything shy of 9% (assuming it's still a long-term viable investment), think twice before selling to buy something yielding higher – your absolute result will be worse than staying put.

If we apply one of Charlie Munger's favorite tools and invert the situation we can see that the tax system provides the long-term investor with another, more subtle, advantage. In essence the economics of deferred taxes counteracts the natural reversion to the mean tendency to which all businesses are subject. As a business's returns naturally drift downward as a result of size or competition, an investor who has held on for years and who would owe a large tax bill, can actually maintain a profitable investment result. It is yet another advantage given to the long-term, patient, investor. It's no wonder Charlie Munger is so fond of holding good businesses for long periods of time. An investor benefits once from holding a strong economic engine; twice from the benefits of the tax system; and third from being able to just, "sit on your ass" (Charlie's words, not mine), and do other activities, such as read.

Simply by virtue of having held its investment in Coke so long Berkshire Hathaway has gained a unique economic advantage over most other shareholders in the company. This advantage changes the economics of any potential sale of the investment in the future, either by Buffett himself (highly unlikely) or his successors. These economic advantages are worth studying as they can be applied to any investment program, albeit likely on a smaller (but no less advantageous) scale.

Rationally yours,

Note: This memo has been updated as of July 15, 2015 to reflect a calculation error in the original June 2015 publishing. The original thesis – deferred taxes create a large and valuable opportunity cost hurdle – remains valid.