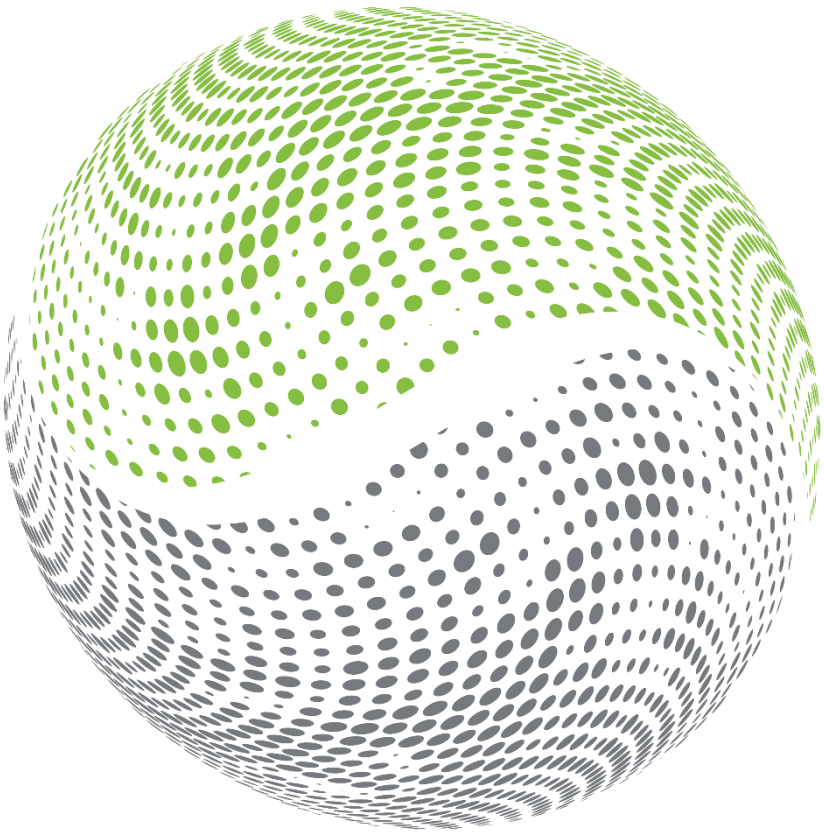
Deloitte.

28 June 2024

Australia 2024/07



Tax Insights

Full Federal Court rules in favour of PepsiCo

Decision overturned the November 2023 first instance decision

Snapshot

On 26 June 2024, the Full Federal Court handed down a 2-1 majority decision in favour of the taxpayer in *PepsiCo, Inc v Commissioner of Taxation* [2024] FCAFC 86. The decision overturned the November 2023 first instance decision which upheld the Commissioner's position.

This is a significant case given the ATO focus on intangible arrangements and in as much as it provided the most authoritative judicial analysis to date of both the Diverted Profits Tax (DPT) and 2012 amendments to the Australian GAAR following an earlier series of Court decisions on Part IVA that went against the Commissioner.

The Tax Insight provides our initial preliminary comments on the decision.

Facts

The case relates to an Exclusive Bottling Agreement (EBA) involving PepsiCo, Inc (PepsiCo) being a US tax resident in connection with the Pepsi and Mountain Dew beverages, and a separate EBA involving Stokely-Van Camp Inc (SVC) in connection with Gatorade. SVC was also a US tax resident and a member of the PepsiCo group.

In this publication, references to PepsiCo should be read as also including SVC unless otherwise stated.

In brief form, the relevant facts of the PepsiCo EBA are as follows:

- The parties to the EBA were PepsiCo, another PepsiCo group entity and Schweppes Australia Pty Limited (SAPL or Bottler);
- SAPL was appointed as the sole distributor and bottler of the Pepsi and Mountain Dew beverages in Australia;
- PepsiCo undertook that it or its nominee would sell concentrate to Bottler. In the relevant years, being years ending 30 June 2018 and 2019, PepsiCo Bottling Singapore Pty Ltd (Seller) was the seller of the concentrate to SAPL. The price paid by the Bottler to the Seller was agreed per the terms of the EBA. Bottler made a payment (EBA Payment) to Seller for the concentrate; and
- PepsiCo granted Bottler a right to use the relevant trademarks and other intellectual property, such as bottle and can design. SVC granted an express licence. No amount was expressed to be payable by Bottler for the use of the trademarks and other intellectual property.

The Commissioner's position

The Commissioner imposed tax on PepsiCo with respect to a portion of the EBA payment as follows:

- Royalty withholding tax (RWHT) pursuant to section 128B, Income Tax Assessment Act 1936 (ITAA 36); and
- In the alternative, pursuant to the DPT.

First instance decision

Moshinsky J at first instance upheld the Commissioner's position in respect of the RWHT argument (primary position) and indicated that if he had not done so, he would also have upheld the Commissioner's DPT position.

PepsiCo appealed to the Full Court which heard the matter in May 2024.

Issues and key findings

In relation to both the RWHT matter and the DPT matter, there were two sub-issues. The four issues and the conclusions reached by the majority (Perram & Jackman JJ) and the minority (Colvin J) are set out in the following table.

	Did s128B apply to result in a WHT liability?	Majority	Minority
1	Were the EBA Payments made by Bottler in part 'consideration for' the right to use intellectual property so that the payments were a royalty for the purposes of s128B?	No	Yes
2	Was any such amount income derived by PepsiCo?	No	No
	Did s128B apply?	**No**	**No**
	Did the DPT apply to impose a DPT liability?		
3	Was there a reasonable counterfactual, so as to identify a "tax benefit"? [s177CB]	No	Yes
4	Was there a requisite principal purpose?	Yes	Yes
	Did DPT apply?	**No**	**Yes**

Whilst the majority and the minority agreed on the s128B conclusion, there was a divergence of views on the essential issue (issue 1). Conversely, whilst the majority and the minority disagreed on the DPT conclusion, they were in agreement on the construction of the DPT and importantly, the effect of s177CB, ITAA 36: the DPT point of difference was due to the conclusions reached on issue 1. That is, the respective conclusions on issue 3 effectively followed the respective conclusions on issue 1. Thus issue 1 is the key argument, and essentially is a contest between "realism" versus "formal expression", or more simply, substance versus form.

RWHT matter

Issue 1: Was there a royalty?

There was no express payment for the use of the trade marks identified in the EBA. In this regard, the majority held:

> *"The ordinary meaning of the language used by the parties therefore suggests that what was to be paid by the Bottler to PepsiCo/SVC or their nominated seller was a price being paid for the concentrate and therefore 'as consideration for' the sale of the concentrate" [13].*

The Commissioner submitted that if it was found that no consideration was paid for the use of trade mark, it would follow that the trade mark was "granted for nothing" [17]. This was rejected by the majority on the basis of mutual benefits obtained and obligations/limitations undertaken by PepsiCo and Bottler. Having so concluded, the next question was whether any part of the EBA Payment was "seen as embedding some value" [21] for the licence to use the trade mark. The majority concluded that "on their proper construction, the EBAs fixed a price for future sales of concentrate alone which did **not** include a component for the licence to use the trade marks and other intellectual property" [25].

Following a discussion of relevant authorities, the majority concluded "It follows that the consideration for the purchase of the concentrate was the price the parties stipulated for it in the EBAs. As such, the payments made by the Bottler to the Seller did **not** include an element which was a royalty for the use of the trade marks (since the payments were not in consideration for the right to use the trade marks)" [37].

Minority view: issue 1

The minority reached a different conclusion on this issue and held that:

> *"In those circumstances, regard to the whole of the terms of the EBAs reveals that the prices to be paid under the terms of the EBAs are not simply consideration for the concentrate. Rather they are **also** consideration moving in favour of PepsiCo for the right to use the valuable brands that are conferred by the terms of the EBAs. They are properly construed as agreements to bottle, sell and distribute branded products, not as agreements for the supply of concentrate. It follows in my view that the amounts provided for by the EBAs as the prices for units of concentrate were **partly amounts in consideration for the use of the trade marks** which the Bottler was licensed to use" [197].*

Issue 2: Was any income derived by PepsiCo?

Although not necessary given the above conclusion, the majority addressed the question of whether moneys had been paid to and derived by PepsiCo. The majority rejected the Commissioner's submission that there had been a direction to pay given to Bottler to pay the amount to Seller: "there can be no payment by direction unless there is an antecedent monetary obligation owed by the Bottler to PepsiCo" [40]. The majority concluded that there was no amount of income which had been derived or which had come home to PepsiCo.

The minority concluded that whilst there was a royalty, and hence an amount "paid or credited" by the Bottler in respect of trademarks licensed by PepsiCo to Bottler, it agreed with the majority conclusion: there was no amount of income derived by PepsiCo.

Conclusion

The requisite elements of s128B were not made out and there was no RWHT liability on PepsiCo.

DPT matter

Issue 3: Was there a reasonable counterfactual, so as to identify a "tax benefit"?

The DPT sits within the general Australian GAAR provisions in Part IVA, ITAA 36 and so relies upon much of the architecture of Part IVA. The Commissioner proposed two counterfactuals as reasonable alternatives in place of the scheme (or actual circumstances) [66]:

a) "the relevant EBA would or might reasonably be expected to have expressed the payments to be made by SAPL to be for all of the property provided by (and promises made by) the PepsiCo Group entities (rather than for concentrate only); or

b) the relevant EBA would or might reasonably be expected to have expressly provided for the payments to be made by SAPL to include a royalty for the use of, or the right to use, the relevant trademarks and other intellectual property (whether or not the amount of the royalty was specified)."

With effect from 2012, s177CB relevantly required that in determining whether a "postulate is a reasonable alternative", it is necessary to "have particular regard to the substance of the scheme and the result or consequence" of the scheme. This case provides the first detailed judicial analysis of that important rider on the counterfactual concept. The majority appear to proceed on the basis of the explanatory memorandum comment that "for a postulate to constitute a reasonable alternative it **should correspond to the substance of the scheme**" [74].

The majority examined the scheme and concluded that the "**commercial and economic substance** of the scheme was that the price agreed for concentrate was for concentrate" [82], and for nothing else. Having so concluded, the majority further concluded that the commercial and economic substance of the two asserted counterfactuals were quite different and thus did **not** correspond with the substance of the scheme [86 & 87]. The majority thus held that "neither postulate is a reasonable alternative to the scheme" [99]. In the absence of a reasonable postulate, there could be no tax benefit. As a result, the DPT could **not** be applied.

Minority view: issue 3

The minority agreed with the general approach to s177CB adopted by the majority [209], however this was then affected by the different conclusions reached on issue 1. The minority proceeded on the basis that the application of the DPT provisions "fall to be considered in respect of a transaction which includes an amount which is consideration for the use of the trade marks" [214]. Further, "On the conclusion that I have reached concerning the royalty question, the EBAs resulted in a tax benefit because, if the EBAs had not been entered into, then a reasonable postulate was that the EBAs would have provided for the royalty to be paid to PepsiCo … as the holder of the rights to the trade mark" [215].

As a result, there was a valid counterfactual and tax benefit. The DPT **could** be applied if there was a requisite principal purpose.

Issue 4: Was there a requisite principal purpose?

Although not necessary given the above conclusion, the majority addressed the purpose issue, doing so "on the highly artificial assumption we must make that the price of concentrate included a royalty" [133]. On that assumption, the majority largely agreed with Moshinsky J that there was a relevant principal purpose. The minority also took the same view.

Conclusion

On the majority view, the requisite elements of the DPT (specifically, a valid counterfactual and tax benefit) were not made out and there was **no DPT liability** on PepsiCo. By contrast, the minority held that there was a reasonable counterfactual, a tax benefit and a requisite principal purpose: on that basis, the Commissioner's DPT assessment was upheld.

On a 2-1 majority basis, the DPT did **not** apply to PepsiCo.

Deloitte comments

- The next key step in the process is whether the ATO seeks special leave to appeal (SLA) to the High Court, and if so, whether the High Court allows leave. So at this stage, it is not clear if this is the final judicial statement on the matter. It is public knowledge that another similar case is subject to dispute and may be heard by the Courts in due course. The facts associated with the EBA and the beverage distribution model are likely bespoke to that industry and so it is not clear what wider consequences can be drawn from this decision.

- The ATO has been expressing concerns about royalties, intellectual property matters and so called "embedded royalties" over recent years. The ATO is also adopting a position that goes beyond the global consensus with respect to the application of the royalty provisions to software distribution arrangements. Intangibles will remain a key area of focus and likely dispute.

- The Government has recently announced that Part IVA will be expanded, in particular to deal with cases that also include a foreign tax advantage. More recently, it has also been proposed that a penalty will be introduced from 1 July 2026 "to [large group] taxpayers …that are found to have mischaracterised or undervalued royalty payments, to which royalty withholding tax would otherwise apply".

All of these developments create uncertainty for taxpayers. At this stage, however it seems that the following observations can be made:

- The Full Federal Court decision rejects a number of key ATO arguments in relation to royalty related matters.

- In particular, the Court rejected that a royalty or an embedded royalty could be extracted out of a commercial arrangement which did not expressly provide for payment of a royalty, and this is the case even where it was clear that there was a grant of a right to use a trademark.

- The Court provided the most authoritative analysis of the DPT to date, although it did not consider the relevant exceptions to the DPT (sufficient foreign tax and sufficient economic substance).

- Importantly, the Court considered for the first time in detail the operation of s177CB in Part IVA.

- On a majority basis, the fallback argument of the DPT was not successful. This principally turned upon the interpretation of s177CB and the extent of "correspondence" that is required as between the substance of the scheme vs the substance of an asserted counterfactual. The Court (majority and minority) adopted a relatively strict application of s177CB. The application of s177B in this case was effectively determined by the position taken on the primary argument as to whether there was, in substance, a royalty under the actual arrangements (issue 1).

- Section 177CB is relevant to all applications of Part IVA: the MAAL, the DPT and the general operation of Part IVA.

- The transfer pricing provisions in Division 815 were not raised or considered in this case, so it is not clear at this stage whether the "arm's length conditions" analysis would affect the outcome.

Contacts

David Watkins
Partner
Tel: +61 2 9322 7251
dwatkins@deloitte.com.au

Christopher Ferguson
Partner
Tel: +61 3 9671 8638
chrferguson@deloitte.com.au

Sharon Murray
Partner
Tel: +61 3 9671 7939
sharmurray@deloitte.com.au

Graeme Smith
Partner
Tel: +61 2 9322 5632
graesmith@deloitte.com.au

Manu Sriskantharajah
Partner
Tel: +61 3 9671 7310
msriskantharajah@deloitte.com.au

Amelia Teng
Partner
Tel: +61 3 8486 1118
amteng@deloitte.com.au

Claudio Cimetta
Partner
Tel: +61 3 9671 7601
ccimetta@deloitte.com.au

Melanie Earl
Partner
Tel: +61 2 9322 5182
mearl@deloitte.com.au

Jacques van Rhyn
Partner
Tel: +61 7 3308 7226
jvanrhyn@deloitte.com.au