



Tax Alert

Full Federal Court reverses royalty finding in PepsiCo, Inc v Commissioner of Taxation appeal

At a glance

- Royalty not found on the terms of the contract which was found to be a "distribution arrangement"
- Royalty withholding tax not applicable
- Diverted Profits Tax elements also found not satisfied by the majority
- Special leave to appeal to the High Court of Australia remains possible
- How EY can help

On 25 June 2024, the Full Court of the Federal Court of Australia delivered a landmark decision in *PepsiCo, Inc v Commissioner of Taxation* [2024] FCAFC 86, overturning the first instance decision in the Federal Court. The Full Court, by majority, found that a royalty did not exist in an agreement between arm's length parties in circumstances where the agreement did not expressly provide for a royalty. Furthermore, the Full Court, also by majority, found the Diverted Profits Tax (DPT) provisions did not apply.

Key highlights

- ▶ The majority comprising of Justices Perram and Jackman determined that no portion of the payment made by the Australian entity was a royalty and therefore royalty withholding tax (RWHT) did not apply. The majority reached this conclusion by giving primacy to the contractual arrangements and concluding that the payment made was for the concentrate.
- ▶ The majority concluded that the contract was a "distribution arrangement" and the parties were not centrally seeking to achieve a contract for the licencing of Intellectual Property (IP).
- ▶ The majority also concluded that the payments were not income derived by PepsiCo, Inc and Stokely-Van Camp, Inc (PepsiCo/SvC). The payments were made by the Bottler to the Seller as per the contractual obligations and did not 'come home' to PepsiCo/SvC.
- ▶ While Justice Colvin found that there was a royalty, he agreed with the majority and found that there was no derivation of income by PepsiCo/SvC and therefore RWHT did not apply.
- ▶ The Full Court was split on the application of the DPT with the majority finding that there was no reasonable alternative to the scheme and therefore the DPT did not apply.
- ▶ The Full Court was however unanimous in finding that there was a principal purpose of obtaining a tax benefit, with the majority doing so based only on "the highly artificial assumption...that the price of concentrate included a royalty."

- ▶ This is an important judgement which reaffirms the long-standing judicial position of giving primacy to the terms of legal agreements and upholding the form and nature of legal arrangements.
- ▶ Our expectation is that the Commissioner of Taxation will lodge a special leave application to appeal to the High Court of Australia.

Relevant facts

PepsiCo/SvC, related US companies and owners of the Pepsi, Mountain Dew and Gatorade brands, entered into Exclusive Bottling Agreements (EBA) with Schweppes Australia Pty Ltd (SAPL) (a third party).

Under the EBA PepsiCo/SvC agreed to sell (or cause a related entity to sell) beverage concentrate to SAPL which was then mixed by SAPL, with other ingredients in accordance with formulas, specifications and other information provided, to produce finished beverages for retail sale in Australia, applying Pepsi branded packaging and under the Pepsi brand name.

Importantly, the EBA provided for SAPL to pay only for the concentrate; there was no express provision for the payment of a royalty for the right to use the relevant intellectual property.

Key issues

The Commissioner of Taxation (Commissioner) contended that PepsiCo/SvC was liable for RWHT under the *Income Tax Assessment Act 1936* (Cth) (ITAA 1936), which is subject to Art 12 of the double tax agreement between Australia and the United States (US DTA). At first instance, Justice Moshinsky agreed with the Commissioner.

Additionally (and alternatively), the Commissioner issued a DPT assessment to PepsiCo/SvC, imposing a 40% punitive tax on the challenged royalties. The DPT's stated aims are to ensure tax paid reflects the economic substance of a Significant Global Entity's (SGE) Australian activities and to prevent diversion of profits offshore through arrangements with related parties. At first instance, Justice Moshinsky also agreed with the Commissioner.

RWHT not applicable

On appeal to the Full Court, the court concluded that the payments made by SAPL under the EBAs were not royalties and therefore there was no liability to RWHT.

The Full Court found:

- ▶ The payments made by SAPL under the EBA were not consideration for the use of, or the right to use, the relevant trademarks and other intellectual property.
- ▶ The relevant portions of the payments were not income derived by PepsiCo/SvC for the purposes of s 128B(2B)(a) of the ITAA 1936 and were not amounts to which PepsiCo/SvC was beneficially entitled for the purposes of Art 12 of the US DTA. Rather the nominated concentrate seller (PepsiCo Beverage Singapore Pty Ltd, an Australian resident) was beneficially entitled to the payments on its own account.

'Consideration for'

The Full Court found, by majority, that no portion of the payments were consideration for various intangible properties listed under art 12(4)(a)–(b) of the US DTA.

Justices Perram and Jackman's key considerations were:

- ▶ In approving the *IBM* decision, their Honours held that the plain language of the contract and the legal form is critical to the determination of the character of the payment, and that the exercise is one of '*orthodox contractual interpretation*'.
- ▶ While there is an IP licence to SAPL, the consideration for such a licence took the form of PepsiCo/SvC obtaining the benefit of having their goodwill sustained and enhanced and SAPL obtained the benefit of being able to exploit PepsiCo/SvC's goodwill to its own advantage.
- ▶ The EBA provides only for a highly restrictive manner of use of the relevant IP by SAPL, namely in selling the beverages, the nature of which was entirely controlled by PepsiCo/SvC. In particular, SAPL could not embark on its own interpretation of the brand strategy. Furthermore, the EBA prescribes rights to inspection, reporting and testing by PepsiCo/SvC.
- ▶ This rebuts the Commissioner's contention that PepsiCo/SvC gave away their IP for 'nothing' which is, in their Honours' view, an '*overly simplistic assumption that the grant of the licence right to [SAPL] was only of benefit to [SAPL]*' and ignores:
 - ▶ The benefits obtained by SAPL in being permitted to use the goodwill attaching to the trademarks
 - ▶ The restrictions both as to product and marketing imposed on SAPL in its utilisation of that goodwill
 - ▶ The burdens placed upon SAPL in complying with testing and inspection regimes
 - ▶ The benefits obtained by PepsiCo/SvC in having SAPL sustain and promote their goodwill in Australia.
- ▶ The stamp duty decisions of *Dick Smith* and *Lend Lease* are not applicable to this scenario as the right to use trademarks and other IP was not the central property disposition or transaction which the EBA contemplated. Rather, it was the concentrate itself.
 - ▶ The majority found that '*what the parties were centrally seeking to achieve was not a contract for the licencing of trademarks and intellectual property. It was a distribution arrangement of which the licencing of intellectual property was merely a part.*'

Justice Colvin differed from the majority, finding there was an amount at least in part which was consideration for the use of the trademarks and was therefore a royalty to that extent.

'Income derived', 'beneficially entitled' and 'paid to'

Justices Perram and Jackman held that there was no 'payment by direction' in favour of PepsiCo/SvC as there was no antecedent monetary obligation owed by SAPL to PepsiCo/SvC on the face of the EBA as PepsiCo/SvC was not the vendor of concentrate (and hence not entitled to payments) when there was a nominated seller. Given the payments did not 'come home' to PepsiCo/SvC, the income was not derived by PepsiCo/SvC. The majority left open the question of whether their answer would have been different had they concluded there was a royalty.

Justice Colvin agreed with the majority justices on this topic and added that there was no payment 'owing' to PepsiCo/SvC once PepsiCo/SvC had nominated a seller of concentrate. This was despite his Honour concluding the payment was a royalty.

In summary, the Full Court unanimously held that no portion of the payments constituted royalties and RWHT was not liable to be withheld and remitted to the Australian Taxation Office (ATO).

Diverted Profits Tax

In finding that DPT would not have applied Justices Perram and Jackman considered that PepsiCo/SvC did not obtain a tax benefit in connection with the relevant scheme as there was no reasonable counterfactual.

While their Honours stated that this finding rendered irrelevant the question of whether the 'principal purpose' test was met, their Honours nevertheless considered that question and concluded that there was a principal purpose to obtain a tax benefit (namely not being liable to pay Australian RWHT) and to reduce foreign tax (namely, US tax on their income). Their Honours noted this finding was based on the '*highly artificial assumption [their Honours] must make that the price of concentrate included a royalty*'.

In concluding that there was no tax benefit, their Honours stated that the Commissioner's scheme "*begs the question of why the concentrate price should be understood as including a royalty*". Their Honours did not agree with the Commissioner's view of the commercial and economic substance of the scheme.

Justices Perram and Jackman found that the Commissioner's counterfactuals (both of which involved a royalty in the EBA) were not reasonable alternatives to the scheme in question because neither counterfactual corresponded to the commercial and economic substance of the scheme. Their Honours also expressed dissatisfaction with the lack of evidence supporting the economics of any royalty component in either counterfactual. In the Court's opinion therefore, PepsiCo/SvC was able to adequately discharge its burden to prove that both counterfactuals failed to evidence that the payment for concentrate also included a payment for something else of value.

In a dissenting judgement, Justice Colvin held that the second counterfactual was a reasonable alternative (but this was predicated on his Honour deciding that

the payment for concentrate did include an embedded royalty) and a tax benefit was obtained.

Importantly, in the context of withholding tax, the Full Court upheld Justice Moshinsky's interpretation of the meaning of 'tax benefit' in s 177C(1)(g) of the ITAA 1936, which carries the consequence that, where a tax benefit arises from a taxpayer not being liable to pay RWHT on an amount, the amount of the tax benefit is the entire royalty amount (not the RWHT). As such, to the extent RWHT applies, it applies at the rate applicable in the relevant DTA (often 5% or 10%) whereas if DPT applies, a rate of 40% is levied irrespective of the relevant DTA rate.

Implications for multinationals

The issue of characterisation continues to be an area of focus for the ATO. It is expected that the Commissioner will apply for special leave to appeal to the High Court (the Commissioner has until 24 July 2024 to file this application). In the interim, it is too early to determine if the judgement will have an impact on the ATO's compliance approach.

Given the decision of the majority, it may also be that there are certain arrangements where the legal form, properly characterised, can be found to have a royalty component. As such, a close assessment of the true nature of any 'quid pro quo' (or bargain) in the context of the legal agreement will be important in evaluating whether any benefits are provided in consideration for some form of IP. As such, it remains important for Australian taxpayers with cross border licencing or distribution arrangements to review their arrangements in light of the judgement. This will include identification of, and consideration of steps to mitigate, any risks particularly relating to the substantive withholding tax issue.

Taxpayers will also need to consider and gather a full suite of evidence concerning both qualitative and quantitative aspects in any arrangement involving IP, incidentally or otherwise, along with clear evidence of the commercial and economic substance of the arrangements more broadly. SGEs should also consider undertaking a review of their arrangements to ensure they have sufficient evidence and documentation relevant to mitigating the risks arising from the DPT.

Given the Court's focus on the contractual terms and the central nature of the bargain, the impact on the practical operation of recent developments in the area of intangibles including Taxpayer Alert 2018/2 (Mischaracterisation of Intangibles), TR 2024/D1 (Software Royalties) and PCG 2024/1 (Intangibles Migration Arrangements) as well as proposed legislation aimed at imposing penalties on the mischaracterisation of payments relating to intangible assets, will be eagerly anticipated by taxpayers.

The comments of the majority in relation to the nature of the agreement reached between the parties and what the parties were centrally seeking to achieve in a contract will be particularly relevant for distribution arrangements and, in the current environment, for software distributors, given the ATO's draft view in TR 2024/D1.

How EY can help

With a team of valuers and tax professionals including transfer pricing advisors, EY can help you to determine:

- Whether a royalty may be embedded within an arrangement or agreement, in light of comments made in the majority judgement
- What (if any) adjustments ought to be made to reflect a potential royalty following the decision
- How to quantify any element that may be considered to be a royalty, and the value of any royalty, using methodologies acceptable by the Commissioner
- How to proactively engage with the ATO to deal with potential (or actual) challenges and obtain certainty
- How to defend the position adopted with a comprehensive suite of evidence and strategic review/audit assistance.

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