

Tax Alert

PepsiCo win: High Court dismisses Commissioner of Taxation's appeal from the Full Federal Court
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At a glance

- The High Court dismissed the Commissioner of Taxation's appeal in the PepsiCo v Commissioner of Taxation royalty withholding tax and diverted profits tax (DPT) case
- The majority of the High Court held that the payments made were for the concentrate only and no part of the payment included any component which was a royalty for the use of intellectual property
- The majority held that the DPT did not apply, as PepsiCo did not obtain a tax benefit in connection with a scheme
- The High Court unanimously held that any payment made was not "paid or credited" to or "derived by" PepsiCo or SvC and thus royalty withholding tax was not payable
- Landmark judgement on royalty characterisation and the first court case on DPT – but the implications and consequences will be far-reaching
- How EY can help.

On 13 August 2025, the full bench of the High Court of Australia (High Court) delivered its long anticipated judgement in *Commissioner of Taxation v PepsiCo, Inc* [2025] HCA 30. The High Court, by majority, found that a royalty did not exist where the agreement did not expressly provide for a royalty. Furthermore, the majority also found that the diverted profits tax (DPT) did not apply as there was no tax benefit.

Key highlights

- The High Court by a majority of 4:3 determined that no portion of the payment made was a royalty and royalty withholding tax (RWHT) did not apply. The decision of the majority turned upon the contractual arrangements: the language used and the underlying obligations.
- The majority concluded that whether payments for concentrate were consideration for the right to use intellectual property (IP) turned on the proper construction of the agreements and what the parties had agreed to. The parties had not bargained that the payments were for IP, and the right to use the IP was part of a comprehensive commercial arrangement and was not obtained "for nothing". Importantly, the payments were at an arm's length price.
- In the first High Court decision on the application of the DPT, the majority of 4:3 found that DPT did not apply as there was no tax benefit, with the Commissioner's counterfactuals found to be not reasonable as they were not commercially or economically equivalent to the scheme in question.
- The conclusion on royalty characterisation will be seen as a 'common sense' outcome by many, bringing welcome clarification to an uncertain area of the law. This is particularly in light of the Australian Tax Office (ATO) guidance products (draft TR 2021/D4 and PCG 2025/D4) which seek to look far beyond the contractual arrangements for the purposes of characterisation.
- The decision also continues the run of judicial clarification on the Part IVA general anti-avoidance rules, bringing more welcome guidance on the onus which taxpayer's bear when defending against Part IVA and confirming (again) that merely considering the tax impacts of an arrangement does not, of itself, attract those provisions.
- The evident issue is whether, given the PepsiCo, Inc (PepsiCo) case was between unrelated parties, the ATO will seek further strategic litigation to test the extent of the precedence set by the High Court in arrangements involving related parties or will rather seek law reform as the faster avenue to close any perceived gaps.



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Relevant facts

- PepsiCo and Stokely-Van Camp, Inc (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).
- 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 found in favour of the Commissioner on both points, however the Full Court of the Federal Court overturned that position, finding both points in favour of PepsiCo/SvC. All issues were contested again before the High Court.

Royalty withholding tax

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

Royalty characterisation

The High Court found that no portion of the payments were consideration for various intangible properties listed under Article 12(4)(a)–(b) of the US DTA.

Justices Gordon, Edelman, Steward and Gleeson's key considerations were:

- The right to use the PepsiCo IP was part of a comprehensive commercial arrangement (having arrived at the conclusion that they formed a composite agreement based on the text and structure of the bottling and distribution agreement, marketing agreement and performance agreement), an essential element of which obliged SAPL to build PepsiCo/SvC's brands and strengthen the PepsiCo/SvC IP. SAPL was able to leverage PepsiCo/SvC's innovation and marketing capabilities and PepsiCo/SvC received the benefit of SAPL's local investment in bottling and distribution equipment and capabilities.
- PepsiCo/SvC did not give away their IP 'for nothing' as the consideration or a condition of, the use by SAPL of the PepsiCo IP was the performance of the monetary and non-monetary undertakings by SAPL under the composite agreement, including the performance of undertakings or exchange of promises in clause 4 of the PepsiCo EBA, one of which was SAPL's promise to pay agreed unit prices for concentrate.
- Critically, there was no contention by the Commissioner that the prices were incorrect or inflated to hide a secret royalty. The importance of the arm's length price paid by SAPL was a key feature throughout the majority judgement.
- The EBA could not be construed as requiring the payment of a royalty where SAPL's monetary contributions to marketing the beverages did not permanently enhance the value of SAPL's business and the composite agreement provided that SAPL did not have any interest in the PepsiCo IP.
- Previous stamp duty decisions did not support the Commissioner's contentions, as neither decision involved looking outside the terms of the arrangements and transactions involved.
- Chief Justice Gageler and Justices Jagot and Beech-Jones dissented, finding the EBA constituted a 'single, integrated and indivisible' transaction, from which followed that to characterise the price payable as consideration only for the sale of concentrate purportedly subdivided the indivisible. Hence, in their Honours' view, 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.

The derivation point

All the judges 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 – such a conclusion was not open on the proper construction of the EBA.

As such, the Court concluded that "*No monetary obligation was owed by SAPL, or payment made by SAPL, to PepsiCo for or in respect of the concentrate... Title to the concentrate was never with PepsiCo; title transferred from PBS to SAPL.*"

Diverted profits tax (DPT)

The majority found that a tax benefit did not arise in connection with the scheme and there was not a principal purpose of obtaining a tax benefit.

- In finding that DPT would not have applied, the majority considered that PepsiCo/SvC did not obtain a tax benefit in connection with the relevant scheme as there was no reasonable counterfactual. The Commissioner's alternative postulates misconceived the economic and commercial substance of the scheme and would involve the entry into of a fundamentally different arrangement.
- Furthermore, the Court provided an important clarification in respect of the onus of proof upon taxpayers in respect of DPT and Part IVA more generally. Their Honours held that there is no requirement for a taxpayer to lead evidence of another reasonable alternative postulate to discharge their burden.
- The Court clarified however that their conclusion on tax benefit was based on "*critical facts, unique to these appeals*" that enabled PepsiCo to demonstrate that there were no other reasonable alternative postulates being (i) the substance of the scheme being that the price paid was only for concentrate, (ii) the scheme was a product of arm's length dealings between unrelated parties and (iii) the absence of a royalty was market standard.
- Notwithstanding their conclusion that no tax benefit arose, their Honours considered the question of principal purpose and concluded that there was not a principal purpose of obtaining a tax benefit. This was significantly influenced by consideration of the manner in which the scheme was carried out being a result of arm's length negotiations, the price for concentrate not being disproportionately high and the model being one of common industry practice.
- Their Honours also observed that "*taking tax outcomes into account does not necessarily justify the application of pt IVA of the ITAA 1936, or, indeed, the imposition of DPT,*" continuing the chain of court decisions in the last 18 months echoing this sentiment in respect of Part IVA.

Implications of the decision

ATO activity

The issue of characterisation has been an area of focus for the ATO and will continue to be notwithstanding the decision.

Given the unique set of facts in the *PepsiCo* case, i.e. unrelated parties with arm's length arrangements and prices, the ATO will likely want to strategically litigate a related party matter on mischaracterisation.

The decision is expected to influence how the ATO will approach finalisation of draft TR 2024/D1 and its administration of arrangements involving intangibles. The ATO immediately issued a media release following the judgement stating it is considering the impact of the decision on TR 2024/D1.

Given the High Court's focus on the terms of the contractual arrangements in determining 'consideration' and the broader view of the exchange of promises in commercial arrangements, the current draft view in TR 2024/D1 will likely need substantial revision.

Policy considerations

Given how close the ATO's loss was at the High Court, on a 4:3 basis, the loss may be used as an impetus by the ATO for broader tax law reform considerations.

During the 2022-23 and 2023-24 Federal Budgets, several measures focused on intangibles were flagged but none have been legislated. While the earlier policy announcement to deny deductions for intangible payments to low-tax jurisdictions has been shelved, the proposal to impose SGE penalties for mischaracterisation of royalty payments is due to start on 1 July 2026. The ATO may seek to lobby government for a broader reform agenda to plug any perceived gaps ahead of those new rules – especially with its publicly stated focus on intangibles and characterisation.

Primacy of evidence

Much turned on the ability of PepsiCo to demonstrate and evidence the substance of its commercial arrangements. Organisations will need to consider whether, when tested by the ATO as part of review and audit activities, they will be able to do the same. It is not hard to see the ATO easily distinguishing the PepsiCo outcome where the facts allow it.

There may be scenarios, and there is no doubt the ATO will seek to identify these, where the legal form, properly characterised, can be found to have a monetary royalty component as part of the bargain between the parties, particularly in arrangements where it cannot be readily proven that the Australian entity provides significant unique non-monetary benefits in the form of market entry/access, customer relationships or similar. A close assessment of the true nature of the bargain in the context of the legal agreement will be important in evaluating whether, how and to what degree any benefits are provided in consideration for some form of IP.

Where the Australian IP user and the foreign IP owner are related parties, a detailed analysis of the legal arrangements and the entirety of the commercial arrangements (including but not limited to an analysis of the functions, assets and risks) will be vital to establishing the mutual benefits exchanged in such an arrangement.

How EY can help

EY can help you to:

- Determine whether a royalty exists
- Review your arrangements and ensure the evidence and legal structure meets the bar set in the PepsiCo decision
- Assess whether the price of goods, services or underlying arrangements are arm's length
- Prepare for and defend an ATO review or audit on intangibles and mischaracterisation.

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