Commissioner of Taxation v PepsiCo, Inc: A guide to the ongoing implications

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The High Court's 4:3 majority judgement in Commissioner of Taxation v PepsiCo, Inc [2025] HCA 30 (**PepsiCo**) brings to an end one of the more significant Australian income tax disputes in recent times, and addresses a number of important and fundamental concepts for multinationals.

In finding in favour of the taxpayer in the long running, embedded royalty dispute against the Commissioner of Taxation (**Commissioner**), and in considering what constitutes an embedded royalty for tax purposes, the High Court clarified the concept of consideration for the use of intangible assets. It also provided definitive guidance on the interpretation and application of Australia's diverted profits tax (**DPT**) and general anti-avoidance provisions.

As foreshadowed in PepsiCo case comes to an end: High Court calls last drinks and closes the bar, the decision is significant for several reasons. It carries with it many implications extending beyond the specific fact pattern that was present in PepsiCo.

In this guide, we delve further into the detail of both the majority and minority judgements of the High Court, and consider what may come next in the context of the vexed question regarding the Commissioner's treatment of royalties and intangibles.

Key takeaways from Commissioner of Taxation v PepsiCo, Inc

01

The High Court reinforced that Australia's royalty withholding tax provisions are to be applied with close regard to the objective characterisation of the relevant 'true contractual arrangements', as well as the importance of establishing the arm's length, or 'fair', pricing of the sale of goods, and clearly documenting and establishing the rationale behind commercial transactions.

02

The High Court considered and confirmed the interpretation of key elements of Part IVA of the *Income Tax Assessment Act 1936* (Cth) (**ITAA 1936**), which will have an ongoing impact on the application of Australia's anti-avoidance rules.

03

The operation of Australia's DPT provisions have now been considered by Australia's highest court. With the United States previously expressing concerns with diverted profits taxes, following the authoritative guidance now provided by the High Court regarding their interpretation and operation, there will likely be a spotlight on how the Commissioner applies these provisions in the future. This is particularly the case in respect of arrangements involving software and technology, and other intangibles.

Background to PepsiCo

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The factual background to the PepsiCo dispute was set out in detail in Full Federal Court decision in PepsiCo falls flat for the ATO, regarding the Full Federal Court decision in *PepsiCo, Inc v Commissioner of Taxation* [2024] FCAFC 86.

Having regard to the majority judgement of the High Court, which affirmed the majority decision of the Full Federal Court, the key facts may be summarised as follows. (References below are to specific paragraphs within the High Court's published decision).

The 'players'

The PepsiCo case had its origins in the long-standing commercial and contractual arrangements governing the bottling and distribution of certain branded beverages in Australia.

- PepsiCo – a US incorporated parent company, holding trademarks, designs, formulas, and other intellectual property for the Pepsi and Mountain Dew brands (at [117]).
- Stokely-Van Camp, Inc (**SVC**) – a PepsiCo group company also incorporated in the US, holding equivalent IP rights for the Gatorade and Propel brands (at [117-118]).
- Schweppes Australia Pty Ltd (**SAPL**) – an unrelated Australian company with exclusive manufacturing, bottling, and distribution rights for the applicable PepsiCo group beverages in Australia under the relevant agreements (at [117-119]).
- PepsiCo Beverage Singapore Pty Ltd (**PBS**) – an Australian incorporated subsidiary of PepsiCo, later nominated to act as the seller of concentrate to SAPL (at [119]).
- Concentrate Manufacturing (Singapore) Pte Ltd (**CMSPL**) – a member of the PepsiCo group incorporated in Singapore and the manufacturer of concentrate and supplier thereof to PBS (at [135-136]).

The contractual arrangements

Central to the case were the Exclusive Bottling Agreements (**EBAs**) entered into between PepsiCo and SAPL, and between SVC and SAPL.

The EBAs provided that PepsiCo and SVC would sell (or cause to be sold by one of its subsidiaries, which was ultimately nominated to be PBS) the flavour concentrates required for the manufacture of certain beverages to SAPL. At the relevant times, SAPL bought concentrate from PBS, and paid for the concentrate in accordance with invoices issued to it by PBS.

The sale price for the concentrate was determined in accordance with the terms of the EBAs. SAPL made no payments to PepsiCo or to SVC, and no provision was made in either EBA for the payment by SAPL to PepsiCo or SVC respectively of a royalty for its use of the PepsiCo group intellectual property.

Notwithstanding, it was common ground that the PepsiCo EBA contained an implied licence to SAPL for the use of intellectual property, with the SVC EBA expressly granting such a licence to SAPL (at [141]). The licences granted SAPL with rights to use trademarks and other PepsiCo group intellectual property in Australia to enable it to manufacture, bottle, sell and distribute the finished beverages in branded PepsiCo group packaging.

Both the majority judgement (comprising Gordon, Edelman, Steward and Gleeson JJ) and the minority judgement (comprising Gageler CJ, Jagot and Beech-Jones JJ) of the High Court also referenced other agreements entered into in connection with the PepsiCo EBA. This was a Co-operative Advertising and Marketing Agreement (entered into between SAPL and a PepsiCo group company, which was ultimately PBS), and a Performance Agreement (entered into between SAPL and another PepsiCo group company registered in Ireland, being Pepsi-Cola International, Cork). Provisions with a similar effect to these other agreements were incorporated within the SVC EBA.

Somewhat significantly, the majority judgement went to some length in analysing the terms and the effect of the three agreements, noting that *"The Performance Agreement recorded that the Performance Agreement, the PepsiCo EBA and the annual Co-operative Advertising and Marketing Agreement contained the entire agreement between the parties"* (at [124]). The majority of the High Court also collectively referenced these three agreements as the **SAPL Bottler, Seller and Distributor Agreement**.

In contrast, and which may partially explain the different conclusions reached by the minority of the High Court, the minority judgement appeared to direct much of their focus and attention only towards the specific provisions and operation of the PepsiCo and SVC EBAs.

Obligations under the agreements

The majority of the Full Federal Court reached the conclusion that a 'complete view' of the licence granted by PepsiCo (and SVC) to SAPL was one which acknowledged (at [47-48] and [156] of the High Court decision):

> *"… the benefits obtained by [SAPL] in being permitted to use the goodwill attaching to the trade marks; (b) the restrictions both as to product and marketing imposed on [SAPL] in its utilisation of that goodwill; (c) the burdens placed upon [SAPL] in complying with testing and inspection regimes; and (d) the benefits obtained by PepsiCo / SVC in having [SAPL] sustain and promote their goodwill in Australia …"*

As a starting point for a further, more detailed consideration of the High Court decision in PepsiCo, both the majority and minority of the High Court agreed with this conclusion.

In the words of the majority, *"… the licence obtained by SAPL was part of a package involving substantial obligations upon SAPL and substantial benefits to PepsiCo and not merely benefits to SAPL"* (at [156]).

As will be seen in the analysis below, the interpretation of the interlinked costs, benefits and promises to both PepsiCo / SVC and SAPL under the applicable commercial and contractual arrangements and transactions, is a critical point of difference between the majority and minority judgements of the High Court. This, in turn, drives vastly different outcomes and conclusions in respect of the specific issues that were in dispute in PepsiCo.

The issues and grounds of appeal

Following the Full Federal Court majority decision in favour of PepsiCo, the Commissioner pursued three grounds of appeal before the High Court (at [122]):

- First, the Full Federal Court ought to have found that payments made by SAPL to PBS included a 'royalty' paid 'as consideration for' the use of or right to use the PepsiCo / SVC intellectual property licensed to SAPL.
- Second, the Full Federal Court ought to have found that such 'royalties' were income 'derived' by and 'paid to' PepsiCo and SVC for the purposes of the royalty withholding tax provisions within the ITAA 1936.
- Third, and in the alternative, if no royalty withholding tax was payable by PepsiCo or SVC, the Full Federal Court ought to have found that PepsiCo and SVC were liable for DPT for the purposes of the DPT provisions within Part IVA of the ITAA 1936.

The High Court decisions

The High Court decisions

Issue 01

Royalty Withholding Tax

Contractual construction – principles

The majority judgement quite succinctly summarised perhaps the key, fundamental issue at the heart of the PepsiCo dispute (at [124]):

> *"Critical to the resolution of these appeals is the proper construction of the agreements between SAPL and PepsiCo, and between SAPL and SVC."*

The majority then provided guidance as to how this task should be undertaken (at [126]):

> *"… The specific contractual rights and obligations of the parties to the SAPL Bottler, Seller and Distributor Agreement are to be construed objectively, by reference to the language used, circumstances addressed and commercial purpose or objects to be secured."*

In the specific context of determining whether any part of the payments made by SAPL constituted a royalty under section 6(1) of the ITAA 1936, the majority confirmed the above (at [159]):

> *"Whether the payments for concentrate from SAPL to PBS were in part 'consideration for' the right of SAPL to use the PepsiCo Intellectual Property turns on the proper construction of the whole SAPL Bottler, Seller and Distributor Agreement of which the PepsiCo EBA formed a part – what the parties had agreed, ascertained objectively."*

The majority cited the decision of the High Court in *Mount Bruce Mining Pty Ltd v Wright Prospecting Pty Ltd* (2015) 256 CLR 104 (***Mount Bruce Mining***) with approval and as support for the propositions set out above.

The minority judgement were in agreement with this statement of principle, confirming (at [51]) that *"The proper construction (and subsequent characterisation) of a commercial agreement …"* should be undertaken *"… in accordance with orthodox principles …."* The minority referred to the decision of the High Court in *Electricity Generation Corporation v Woodside Energy Ltd* (2014) 251 CLR 640 (***EGC***) as an example of those orthodox principles.

It should be noted – for further reference below – that the High Court in *Mount Bruce Mining* cited the decision in *EGC* with approval.

However, there was a critical difference between the approach taken by the respective judgements in objectively construing the commercial and contractual arrangements and transactions between SAPL and PepsiCo, and between SAPL and SVC.

Contractual construction – application

The majority held that, in relation to the supply of concentrate required for the manufacture of the beverages, the PepsiCo and SVC EBAs, properly construed, did not give rise to a 'sale' of concentrate. Rather, the EBAs spoke of obligations and promises for PepsiCo and SVC to sell, or cause to be sold, concentrate in the future (at [130-131]).

The majority then highlighted that the relevant agreements entered into between the PepsiCo group entities and SAPL (at [137]):

> *"… show that the objective, unchallenged evidence was that SAPL placed orders for and paid for concentrate in accordance with invoices for the sale of concentrate issued by PBS. The concentrate sold by PBS had been purchased by PBS from CMSPL …"*

The majority also stated (at [133]):

> *"… Properly construed, each purchase order and invoice evidenced a contract for the supply of concentrates between PBS and SAPL."*

and concluded (at [148]):

> *"The exchange of promises in the SAPL Bottler, Seller and Distributor Agreement between PepsiCo and SAPL was separate from the future agreements that may be, and were, entered into by SAPL for the sale and purchase of concentrate."*

In other words, the majority, in undertaking an objective assessment of what the parties had agreed, concluded that there were two distinct and separate commercial and contractual arrangements between entities within the PepsiCo group and SAPL.

In contrast, the minority, in undertaking an objective assessment of what the parties had agreed, considered that a 'complete view' of the licence granted by PepsiCo (and SVC) to SAPL (as referred to above) was one which acknowledged a *"… series of exchanges of promises and grants of rights"* (at [53]), concluding that *"… What remains, however, is the critical point that the components comprising this 'complete view' of the EBAs, as the Full Court majority recognised, are interlocking and indivisible"* (at [48]).

In other words, the minority concluded that there was one single commercial and contractual arrangement between entities within the PepsiCo group and SAPL, that was unable to be bifurcated.

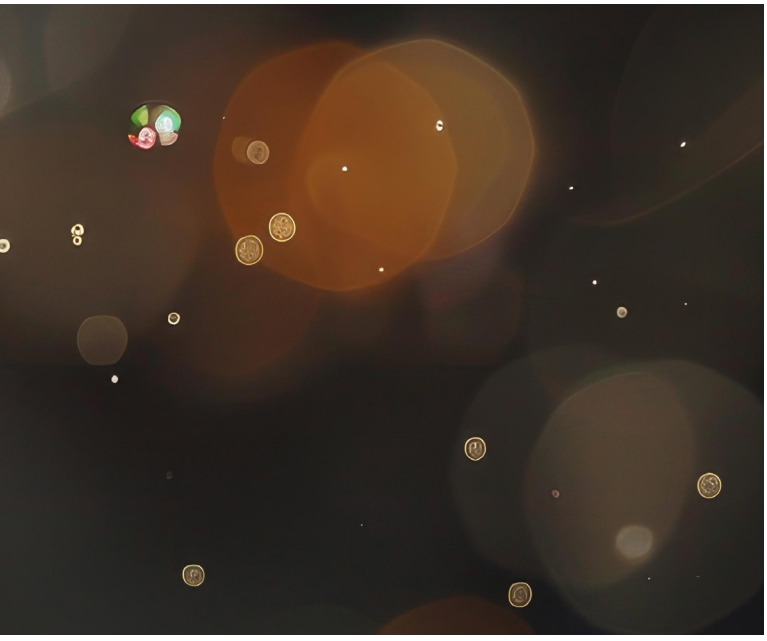
The minority also stated (at [51]):

> *"The proper construction (and consequent characterisation) of a commercial agreement, in accordance with orthodox principles, does not enable a court to subdivide that which is objectively characterised as a single, integrated and indivisible transaction."*

and concluded (at [52]):

> *"The EBAs each provided for an exchange of promises to effect the sale by PepsiCo or SVC or another PepsiCo Group member of the concentrate needed to make and the intellectual property rights needed to sell the branded drinks. As such, the future sales of that concentrate at the agreed rates … were as much an indivisible part of the transactions as the grant of the necessary intellectual property licences enabling SAPL to fulfil its obligations in respect of those branded drinks under the EBAs, including the obligation and right to sell those drinks to retailers and consumers. What cannot be done is to separate the part from the whole or to attribute to each party intentions based on the perceived value to them of any individual promise."*

As will be seen further below, the different conclusions reached by the majority and minority judgements – notwithstanding that both involved the same process of objective construction and characterisation of the same commercial and contractual arrangements and transactions – gave rise to very divergent outcomes regarding whether any part of the payments made by SAPL to PBS for the concentrate, included a royalty.



What is 'consideration for' a royalty?

The majority judgement also quite succinctly summarised the substance of the embedded royalty aspect of the PepsiCo dispute (at [151]):

> *"There was no dispute that if, properly construed, SAPL's obligation to pay for concentrate under the SAPL Bottler, Seller and Distributor Agreement included, in part, a payment which was consideration for the use of the PepsiCo Intellectual Property, then such a payment would be a 'royalty' within the meaning of that defined term in s 6(1) of the ITAA 1936."*

In an important aspect of the High Court's overall decision in PepsiCo, the majority clarified the meaning of the words 'consideration for' in the definition of the term 'royalty'. The majority stated (at [160-161]):

> *"The word 'consideration' has multiple meanings and shades of meaning. In the modern law of contract, 'consideration' has developed as a concern with reciprocity, or a 'quid pro quo' between an offered promise and acceptance. But another meaning of consideration which applied in circumstances broader than modern contracts, such as a conveyance or the making of a payment, was a 'moving cause' or a 'material cause' for the payment. In this broader, alternative sense, the 'consideration' for a payment was the 'purpose' of the payment or conveyance, or the 'basis' or 'condition' upon which it is made."*
>
> *"… Similarly, the phrase 'consideration for' in the definition of 'royalty' in s 6(1) of the ITAA 1936 is unlikely to be confined to whether there is a quid pro quo in the making of an offer and acceptance of that offer. The definition of 'royalty' refers to an amount 'however described or computed' and to an amount 'to the extent to which' it is paid as consideration for the right to use intellectual property. The phrase 'consideration for' in the definition of 'royalty' in s 6(1) of the ITAA 1936 extends to the 'basis', 'purpose', or 'condition' for a transaction by which one party confers a benefit upon another."*

The minority can be said to be in agreement with this statement of principle, stating (at [44]):

> *"It follows that an amount may be consideration for the use of intellectual property so as to meet the definition of 'royalty' without the amount itself being labelled as a 'royalty', and indeed without an 'amount' being specified at all, provided an amount can be 'computed' to be an amount in money."*

What, then, was the 'consideration for' the PepsiCo intellectual property?

In broad terms, the Commissioner had contended that *"… unless the price said to be payable for the concentrate in the EBAs included consideration for the right to use the intellectual property, PepsiCo and SVC were giving those valuable rights to SAPL for nothing"* (see [49] and [123]). Both the majority and the minority found that this contention was erroneous.

Rather, the minority, in finding for the Commissioner, concluded that the proper characterisation of the PepsiCo transactions as a single, integrated and indivisible arrangement, with the EBAs securing the distribution rights to well-known beverages for which the use of the intellectual property was necessary, *"… required a conclusion that part of the payments made by SAPL was for the use of PepsiCo / SVC's intellectual property"* (at [58]).

Expressed in a different way, the minority concluded that the approach taken by the Full Court, in separating the relevant legal rights and obligations, was wrong (at [53]):

> *"The Full Court majority, having rightly found the transaction to involve an integrated and interlocking series of exchanges of promises and grants of rights, were wrong then to engage in a process of subdivision in which the payment (said to be for concentrate) attached to the concentrate and the other exchanges of value attached to other aspects of the agreement."*

In applying the agreed upon, broader meaning of the term 'consideration' for the purposes of the definition of 'royalty' within section 6(1) of the ITAA 1936, the minority concluded:

> *"… the promise to pay imposed on SAPL under the EBAs for the concentrate to some extent moved the grants of the intellectual property licences, the relevant promises forming part of a single and indivisible whole. Accordingly, the payment for the concentrate is to some extent a payment for the grants of the intellectual property licences." (at [53])*
>
> *"… Once it is accepted that within the contractual scheme SAPL's payment for the concentrate in part moved the grant of the intellectual property licences, the answer that the payment included a royalty component is unavoidable." (at [52])*

In applying the agreed upon, broader meaning of the term 'consideration', the majority similarly confirmed that the starting point for *"… whether a payment is a basis, purpose or condition 'for' the conferral of the use of intellectual property will always depend upon what the parties have agreed"* (at [161]).

The majority quite strongly rejected the Commissioner's contention (as referred to above), noting that such analysis *"… oversimplifies what the parties agreed and misconceives the ov.erall arrangement and hence the basis or condition for the licence to SAPL to use the PepsiCo Intellectual Property"* (at [166]).

The majority noted that *"… The SAPL Bottler, Seller and Distributor Agreement constituted a complex exchange of valuable promises"* (at [166]), and it was not *"… an agreement for the sale of goods or an agreement to sell goods in the future … By way of contrast, the contracts between SAPL and PBS, at arm's length, were for the sale and purchase of concentrate"* (at [162]).

It was stated by the majority (at [163]):

> *"Although the licence for the PepsiCo Intellectual Property was a significant part of the architecture of the entire SAPL Bottler, Seller and Distributor Agreement, the Commissioner's contention that the payments for concentrate from SAPL to PBS were in part 'consideration for' the right of SAPL to use the PepsiCo Intellectual Property must be rejected. There was no basis for concluding that the PepsiCo Intellectual Property was given away for 'nothing', or that PepsiCo was not being properly compensated for the use of the PepsiCo Intellectual Property. The 'consideration' in the sense of the basis for, or a condition of, the use by SAPL of the PepsiCo Intellectual Property was the performance of the monetary and non-monetary undertakings by SAPL under the composite SAPL Bottler, Seller and Distributor Agreement, including the performance of undertakings or exchange of promises in cl 4 of the PepsiCo EBA, one of which was SAPL's promise to pay agreed unit prices for concentrate."*

They ultimately concluded that no part of the payments made by SAPL under the two distinct and separate commercial and contractual arrangements entered into, constituted a royalty (at [174], emphasis added):

> *"The contractual price paid by SAPL to PBS for the concentrate was the price paid for goods sold and delivered. The Commissioner did not dispute that it was an arm's length price, or a fair price, or that it was not disproportionately high.* **When the price paid for goods has those characteristics, it cannot be said that a part of the price paid for those goods is payment of a royalty for the use of intellectual property applied to products partly made with those goods."**

Arm's length price

In addition to the conclusions reached by the majority regarding the objective construction and characterisation of the relevant commercial and contractual transactions as forming two distinct and separate arrangements, it is also apparent from the majority judgement that the price paid for concentrate by SAPL formed a key component of the reasoning and ultimate decision.

For example, the majority notes in a number of instances, in addition to the extract (at [174]) as referred to above, that the price paid for concentrate by SAPL was a 'fair price'.

While the minority sought to downplay this factor, stating (for example) *"That the price said to be allocated to the item to be sold (in this case, the concentrate) is not or is not proved to be artificially inflated is not the point"* (at [55]), the majority also specifically noted (at [123]):

> *"The Commissioner was wrong to assert that part of the arm's length price paid by SAPL to PBS for concentrate had to be treated as payment from SAPL to PepsiCo or SVC for the right of SAPL to use the PepsiCo Intellectual Property. There is no legal or economic reason to make that leap in logic. To do so would involve assigning part of the fair price paid for goods to a different commercial bargain. The Commissioner's appeals to this Court should be dismissed."*

By a 4:3 majority, the Commissioner's appeals to the High Court were dismissed.

Duties cases

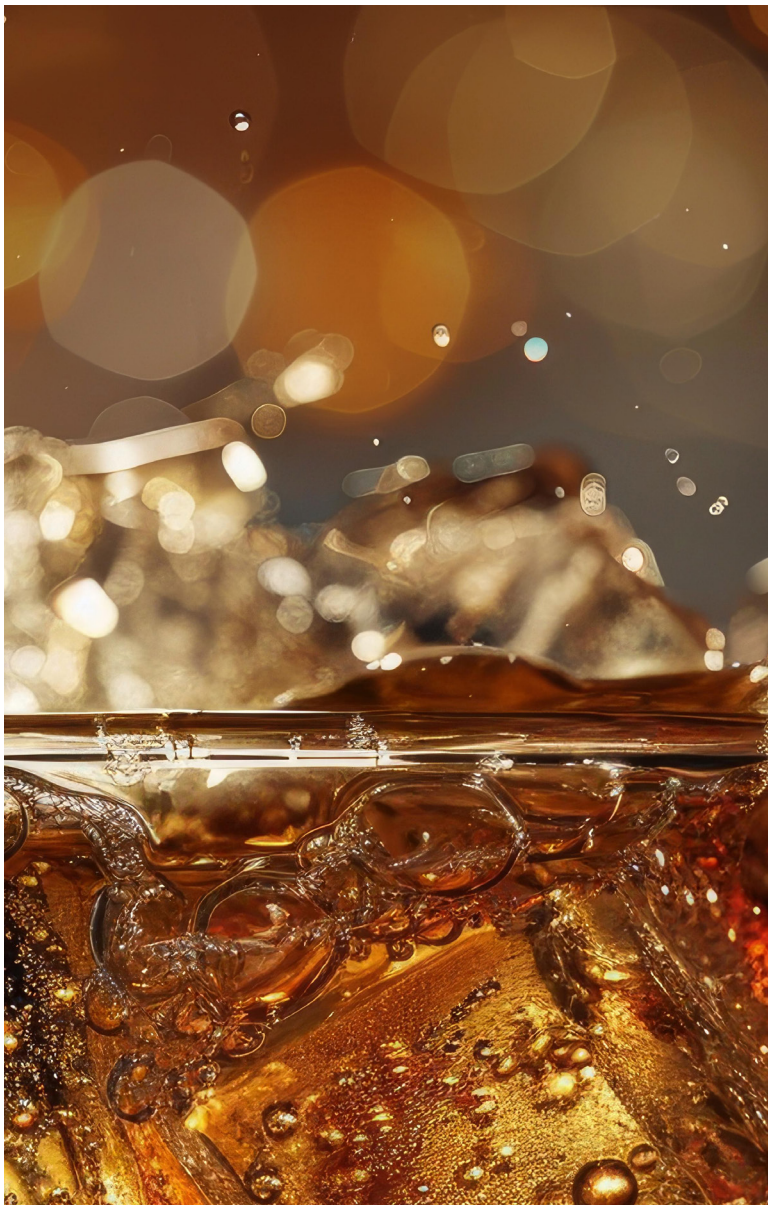
In the Full Federal Court decision, significant time was dedicated by both the majority and minority of the Full Federal Court in reconciling perceived inconsistencies in a previous line of authority of the High Court regarding the imposition of duty on the transfer of property.

This was partly in response to the Commissioner's reliance on these cases to contend *"… that it was necessary for the Court to look beyond the construction of the agreement to the whole of the arrangement and commercial dealing between the parties, including the value of the PepsiCo Intellectual Property and the pricing model adopted in other jurisdictions for other products, in order to characterise the consideration"* (at [172]).

The minority judgement perhaps best summed up the reconciliation of this line of authority, noting that they were not considered to be inconsistent, as *"… The difference in the outcomes between [these cases] involves only the objective characterisation of each transaction"* (at [41]). Importantly, the minority also stated (at [41]):

> *"… The principle remains the same in all cases – if the transaction is characterised as the sale of property, the price of the sale is the consideration, but, if the transaction is characterised as the sale of property and other elements, the consideration is that which moved the sale of the property and those other elements."*

The majority would appear to have reached a similar conclusion, albeit expressed in different terms (at [173]). Significantly, the majority and minority once again expressed similar sentiments regarding the 'orthodox principles' for properly construing commercial agreements, with the minority commenting that the Duties cases show that an objective characterisation of a transaction should not involve *"… any inquiry into the parties' subjective perceptions of the value to them of parts of the transaction"* (at [41]), and the majority noting that the Duties cases show that such process should not involve *"… looking outside the terms of the arrangements and the transactions involved …"* (at [172]).



Issue 02

Derivation

Albeit in separate judgements, the majority and minority of the High Court unanimously concluded that the payments made by SAPL to PBS were not income 'derived' by and 'paid to' PepsiCo and SVC for the purposes of the royalty withholding tax provisions within the ITAA 1936.

This conclusion was primarily reached on the basis that there was no antecedent monetary obligation owed by SAPL to PepsiCo and SVC, as the EBAs were not contracts of sale for the concentrate. Rather, they were contracts that would cause the concentrate to be sold in the future by PBS to SAPL.

Under the terms, substance and effect of the EBAs, in the words of the majority *"No monetary obligation was owed by SAPL, or payment made by SAPL, to PepsiCo for or in respect of the concentrate"* (at [185]), and in the words of the minority *"Nothing supports giving these facts a legal character contrary to their appearance"* (at [68]).

Issue 03

Diverted Profits Tax

Context – scheme, alternative postulates and issues

As PepsiCo and SVC were found not to be liable to pay royalty withholding tax under the ITAA 1936, it was necessary for the High Court to consider, as something more than a hypothetical question, whether they were instead liable to pay DPT.

After spending some time setting out the legislative structure of the DPT provisions within Part IVA of the ITAA 1936, the majority judgement succinctly summarised the relevant key components of the DPT aspect of the PepsiCo dispute, and the customary machinery provisions of Part IVA, as follows (at [195-197]):

Scheme

The Commissioner's identified scheme was, in substance, entry by PepsiCo into the PepsiCo EBA with SAPL on terms where SAPL bought concentrate and was licensed to use the PepsiCo Intellectual Property but paid no royalty for the use of the PepsiCo Intellectual Property.

Alternative postulates

The Commissioner's case was that, had the scheme not been entered into or carried out, there were two alternative postulates:

- firstly, that the PepsiCo EBA would or might reasonably be expected to have expressed the payments by SAPL to be for all the property provided by and promises made by the PepsiCo group entities rather than for concentrate only; or
- secondly, that the PepsiCo EBA would or might reasonably be expected to have expressly provided for the payment by SAPL for the concentrate to include a royalty for the provision to SAPL of the PepsiCo intellectual property.

Under either alternative postulate, the Commissioner contended that a royalty would or might reasonably be expected to have been paid by SAPL to PepsiCo or to another entity on PepsiCo's behalf, or as PepsiCo directed.

PepsiCo contended that neither postulate was reasonable within the meaning of section 177CB(3) of the ITAA 1936.

Issues

These contentions gave rise to the following two issues:

- whether PepsiCo obtained a tax benefit in connection with the identified scheme for the purposes of section 177J(1)(a) of the ITAA 1936; and
- if so, whether it would be concluded, having regard to the relevant specific matters within section 177J(2) of the ITAA 1936, that the person, or one of the persons, who entered into or carried out the scheme or any part of the scheme did so for the principal purpose, or for more than one principal purpose that includes a purpose, of enabling PepsiCo to obtain a tax benefit, or both to obtain a tax benefit and to reduce PepsiCo's liability to tax under a foreign law, in connection with the scheme.

Tax benefit

In a common statement across the High Court decisions in PepsiCo, the majority noted that *"Whether there is a 'tax benefit' in connection with a scheme is to be established as an objective fact"* (at [204]). The majority summarised the key inquiry required by section 177CB(3) of the ITAA 1936, stating that *"… The inquiry directed by Pt IVA requires a comparison between the scheme and an alternative postulate"* and (at [204]):

> *"… As the inquiry involves events and circumstances that did not actually happen, '[a] decision that a tax effect might reasonably be expected to have occurred if the scheme had not been entered into or carried out must be based on a postulate that is a reasonable alternative to entering into or carrying out the scheme'."*

Onus

The majority confirmed, as also correctly understood by the majority of the Full Federal Court, that the taxpayer at all times bore the onus of proving that it had not obtained a tax benefit in connection with a scheme (at [205]). A key point of contention in PepsiCo, however, was what a taxpayer must do to discharge the onus.

The Commissioner contended that this required *"… PepsiCo … to prove the existence of an alternative postulate in which it was not liable to pay royalty withholding tax, and that this postulate had to be reasonable in the sense required by s 177CB(3)"* (at [205]).

The majority rejected this contention of the Commissioner, finding that *"The use of the word 'must' in s 177CB(3) … mandates that there cannot be a tax benefit if there is no postulate that is a reasonable alternative to a scheme"* (at [207]).

In so doing, the majority also reconciled the current line of authority of the courts dealing with similar considerations, noting (at [208]):

> *"The Commissioner also relied upon a number of authorities, including Federal Commissioner of Taxation v Trail Bros Steel & Plastics Pty Ltd, RCI Pty Ltd v Federal Commissioner of Taxation, and the more recent decision in Federal Commissioner of Taxation v Guardian AIT Pty Ltd, in support of the contention that PepsiCo had to prove the existence of an alternative postulate in which PepsiCo was not liable to pay royalty withholding tax, and this postulate had to be reasonable in the sense required by s 177CB(3). Those authorities do not support the Commissioner's contention."*

And further stating (at [207]):

> *"… Put another way, reaching a decision that a 'tax effect' in s 177C(1)(bc) might reasonably be expected to have occurred if the scheme had not been entered into or carried out 'must' be based and only based on a postulate or postulates that is or are 'reasonable'. If none exist, no relevant 'tax effect' can be demonstrated."*

However, in clarifying this important statement of principle, the majority did go on to acknowledge that a taxpayer does not discharge the onus merely by demonstrating that the postulate relied upon by the Commissioner is unreasonable (at [211]). In citing the decision of the Full Federal Court in *RCI Pty Ltd v Federal Commissioner of Taxation* (2011) 84 ATR 785 at 843 with approval, the majority noted (at [210-211]):

> *"… the issue is not whether the Commissioner puts forward a reasonable counterfactual or not; it is a question of the court determining objectively, and on all of the evidence, including inferences open on the evidence, as well as the apparent logic of events, what would have or might reasonably be expected to have occurred if the scheme had not been entered into."*

In this regard, the majority noted *"… that a taxpayer may more usually demonstrate the absence of a tax benefit by identifying, on the evidence, a postulate or counterfactual which shows what it might reasonably be expected to have done, had it not entered into or carried out a relevant scheme"*, although *"Nevertheless, in unusual cases, a taxpayer may demonstrate the absence of a tax benefit by establishing that there is no postulate that is a reasonable alternative to entering into or carrying out the scheme"* (at [212]).

Somewhat curiously, given the significance of this issue in the decision of the Full Federal Court, and the resulting focus thereon in the High Court Special Leave submissions of both the Commissioner and PepsiCo (including the Commissioner's affidavit evidence that *"the operation of the taxpayer's onus in a scheme case impacts all Part IVA litigation"*), the minority judgement considered (at [99]):

> *"… it is unnecessary to consider the Commissioner's further submission that the Full Court majority erred in their approach to the onus of proof as it applies to s 177C(1)(bc) of the ITAA by contemplating that a taxpayer may discharge that onus by proving that there is no reasonable alternative to a scheme."*

The minority arrived at this conclusion based on their finding that each of PepsiCo and SVC obtained a tax benefit in connection with the relevant scheme (at [99]). It is to this aspect that we now turn in further detail.

Reasonableness of alternative postulates

The majority confirmed that *"A correct understanding of the economic substance of the contractual arrangements is important to an application of the DPT provisions"* (at [214]), also succinctly summarising that *"In these appeals, the central question is the economic and commercial substance of the Scheme, as distinct from its legal shape or form"* (at [215]).

In summarising the Commissioner's submissions, the majority noted (at [215]):

> *"… The Commissioner submitted that the economic and commercial substance of the Scheme was that, in return for the making of each payment from SAPL to PBS, SAPL received two valuable benefits – the concentrate and the PepsiCo Intellectual Property. In this respect, the Commissioner submitted that the allocation of the total contract price to concentrate was not the substance of the Scheme but was only a means and form to give it effect. As explained above, that misconceives and oversimplifies the composite SAPL Bottler, Seller and Distributor Agreement."*

and stated (at [216]):

> *"The true economic and commercial substance of the composite SAPL Bottler, Seller and Distributor Agreement was that SAPL was appointed and accepted appointment as the exclusive bottler, seller and distributor of the Beverages as part of a comprehensive arrangement involving an exchange of promises, on an arm's length basis, which included the promise to purchase concentrate at agreed prices which were not disproportionately high, as well as the conferral of intellectual property rights. That conferral of rights did not take place 'for nothing'."*

The majority concluded that the Commissioner's alternative postulates were not reasonable, stating that *"… the problem with the Commissioner's position … is that he misconceived the economic and commercial substance of the Scheme"* and *"It was not the case that the payments made by SAPL to PBS were consideration for the receipt of two benefits"* (at [218]). Rather, in agreeing with the conclusion reached by the majority of the Full Federal Court, the majority found that *"… the commercial and economic substance of the Scheme was that the price agreed for concentrate was for concentrate"* (at [218]).

In reinforcing this conclusion, the majority also found that the following *"Critical facts, unique to these appeals, enabled PepsiCo to demonstrate that there were no other reasonable alternative postulates and therefore no relevant tax effect"* (at [219-220]):

- first, that the substance of the Scheme (as properly construed and characterised) included that the price paid for concentrate was for concentrate and nothing else;
- second, that the Scheme was a product of arm's length dealings between unrelated parties; and
- third, the absence of a royalty was market standard, a substantive element of the business model which was adopted by the PepsiCo group and which had commenced in the early 1900s.

It was for these reasons that the majority concluded that the *"… only postulate here that might have exhibited the same substance and achieved the same results as that found in the Scheme was the SAPL Bottler, Seller and Distributor Agreement"*, with PepsiCo also showing *"… that it was probable that no different arrangement might reasonably be expected to have been entered into"* (at [224]).

In other words, the majority concluded that PepsiCo obtained no tax benefit, on the basis that *"… Where the substance of the Scheme does not permit the conclusion to be drawn that the price for concentrate included a royalty, that conclusion is not reasonably open"* (at [224]).

In contrast (as referred to above), the minority judgement found that each of PepsiCo and SVC obtained a tax benefit in connection with the relevant scheme (at [99]). This was on the basis that (at [94]):

> *"… on their proper construction and characterisation, the EBAs each provide for a single, integrated and indivisible transaction of which the sale of concentrate by PepsiCo or SVC (as applicable) or their nominated PepsiCo Group member to SAPL forms one inseparable part, from which it follows that the price said to be for the sale of concentrate has within it a component for the transfer of the intellectual property rights (the royalty). Once that is accepted, it also follows that PepsiCo and SVC have not discharged their onus by negativing the reasonable alternative postulate to the schemes … On this reasonable alternative postulate to the schemes under s 177CB(3), PepsiCo and SVC each obtained a tax benefit (s 177C(1)(bc)) as, but for the schemes, each might reasonably be expected to have been liable to pay withholding tax on the amount if the scheme had not been entered into or carried out (s 177C(1)(g))."*

Principal purpose

Given the majority's conclusion in relation to the lack of reasonable alternative postulates, the principal purpose threshold was not determinative of the outcome for the PepsiCo dispute with respect to the application or otherwise of the DPT provisions within Part IVA of the ITAA 1936.

Nonetheless, the majority felt it appropriate to make certain observations regarding whether the scheme was entered into by PepsiCo and SVC for the principal purpose of enabling them to obtain a tax benefit, which may be of interest to taxpayers more broadly for the purposes of the application of both the DPT provisions, and the general anti-avoidance provisions.

For example, and perhaps most significantly, the majority noted that *"… It would be unthinkable to suppose that sophisticated commercial operators did not take tax outcomes into consideration in negotiating the form of a transaction,"* and further, *"… taking tax outcomes into account does not necessarily justify an application of Pt IVA of the ITAA 1936, or, indeed, the imposition of DPT"* (at [229]).

In considering the manner in which PepsiCo and SVC entered into and carried out the scheme – one of the many relevant factors at play – the majority identified that there were three significant reasons tending away from a conclusion that PepsiCo and SVC had a principal purpose of enabling them to obtain a tax benefit. These reasons were noticeably similar to the unique factors (as referred to above), which enabled PepsiCo and SVC to demonstrate and discharge the onus that there were no other reasonable alternative postulates to the SAPL Bottler, Seller and Distributor Agreement (at [230]).

In considering the form and substance of the scheme, the majority considered that *"… because the price agreed for concentrate was for concentrate and nothing else, the form and substance of the Scheme were the same"* (at [232]).

More specifically, the majority again reinforced that *"For the reasons already given, the Commissioner's argument is flawed because it misstates the true economic and commercial substance of the Scheme"* (at [232]).

In perhaps the final demonstration of the importance – and the critical difference – between the approach taken by the respective judgements in objectively construing the commercial and contractual arrangements and transactions between SAPL and PepsiCo, and between SAPL and SVC; the majority, in the context of its obiter comments in relation to the principal purpose test, stated (at [232]):

> *"In other words, the composite SAPL Bottler, Seller and Distributor Agreement was a correct and accurate record of the bargain ultimately struck by the parties. It follows that this factor strongly favours the conclusion that the Scheme was not entered into for the principal purpose of enabling PepsiCo to obtain the tax benefit."*

Whereas the minority, in concluding that the considerations in section 177J(2) of the ITAA 1936 weigh in favour of the existence of the requisite principal purpose, stated (at [108]):

> *"It is the commercial and economic substance of the schemes, in which the parties to the EBAs have executed an indivisible transaction involving interlocking promises including the sale of concentrate and the grant of the intellectual property licences along with other promises of value, which drives the outcome."*

Detailed observations and practical tips

Detailed observations and practical tips

While the judgment is ultimately a 'win' for PepsiCo and, by extension, taxpayers more generally, the broader implications of the case are far more nuanced. The outcomes at both the High Court and the Full Federal Court were closely divided, which underscores the finely balanced nature of the key issues that were in dispute.

Contractual interpretation

Both the majority and minority judgements in the High Court confirmed that commercial arrangements and transactions are to be construed objectively and in accordance with their contractual terms and language used, circumstances addressed, and commercial purposes and context. Further, both judgements also confirmed that the subjective perceptions of the transactions that are held by the relevant parties to those arrangements, together with looking outside the terms of those specific arrangements and the transactions involved in order to characterise the consideration under those arrangements, are not relevant to the objective construction process.

The decision and findings of the majority also confirm that the mere presence of intellectual property as a component in a transaction, does not, in and of itself, give rise to the presence of an embedded royalty.

However, the fact that the High Court was split on a 4:3 basis in construing the relevant agreements and arrangements in PepsiCo, while applying the same generally accepted principles of contractual construction, shows just how important it is to ensure that utmost care and attention is taken when drafting commercial agreements and pricing transactions. Going forward, this will particularly be the case in respect of transactions that involve or potentially involve the use of or payments for intellectual property. This, in turn, will likely involve other specialist areas of law (such as copyright / trade mark and patent law).

Draft Taxation Ruling TR 2024/D1

The Australian Taxation Office (**ATO**) has acknowledged, in a recent short press release, the High Court's decision in PepsiCo, noting that they are currently considering the decision, including any broader impact it may have on the reasoning set out in Draft Taxation Ruling TR 2024/D1 *Income tax: royalties – character of payments in respect of software and intellectual property rights.*

While the depth and breadth of any necessary reconsideration and / or rewrite of TR 2024/D1 may be open to debate, some initial observations may include:

- Paragraph 16 of TR 2024/D1 notes that 'consideration' does not have its technical meaning in contract law. The majority of the High Court has some specific comments in this regard (at [160-161]) that may support this position to a certain extent.
- Paragraph 83 of TR 2024/D1 notes that determining the purpose of a payment requires regard to matters beyond the boundaries of any contracts giving rise to the payment … including the commercial and financial relations between the parties. This may now appear to be in direct contrast to certain comments of both the majority and minority (as referred to above; see for example at [172]).
- Further, in connection with the objective construction of specific contractual rights and obligations, the High Court in PepsiCo cites the previous leading decisions of the High Court in *Mount Bruce Mining* and *EGC* with approval. Neither of these cases appear to have previously been incorporated or referenced within TR 2024/D1.
- Somewhat curiously, paragraphs 88 to 102 of TR 2024/D1 analyse the concept of 'consideration' for royalty purposes from the perspective of a GST analysis, whereas in PepsiCo, the Commissioner approached this notion by reference to the High Court line of authority in the Duties cases. While some of those Duties cases are referenced in TR 2024/D1, others are not. Given that the majority and minority in PepsiCo have now reconciled those Duties cases, it may be logical for these conclusions to be reflected in any rewrite of TR 2024/D1.

It may also be expected that the ATO will release a Decision Impact Statement in connection with the High Court's decision in PepsiCo.

Oracle case

The ATO had also previously announced that it would defer the finalisation of TR 2024/D1 pending the outcome of the PepsiCo High Court proceedings. It seems curious that the Commissioner sought to tie the draft ruling to PepsiCo – a matter which neither concerned the use of software nor involved related-party arrangements – particularly given that the previous iteration of the draft ruling was found in Draft Taxation Ruling *TR 2021/D4 Income tax: royalties – character of receipts in respect of software*.

It may be open to speculate that the current 'state of flux' in relation to the draft ruling is referable to the Federal Court's judgement at first instance in favour of the Commissioner in *PepsiCo, Inc v Commissioner of Taxation* [2023] FCA 1490, which was handed down on 30 November 2023, and which may have been a catalyst for the release of TR 2024/D1 on 17 January 2024.

From a practical perspective, it may also have been more logical to align the finalisation of the draft ruling with the progression of a matter such as Oracle Corporation Australia Pty Ltd v Commissioner of Taxation (Stay Application) [2024] FCA 1262 (**Oracle**), which, having regard to the underlying issues that were referenced within the Stay Application proceedings, appears to fall squarely within the ATO's software royalty ruling framework.

However, given the status and complexity of the Oracle proceedings, it may be several years before a court considers and opines on the technical and substantive royalty issues that are in dispute. In any event, further delays to the finalisation of TR 2024/D1 would not be unprecedented. More than four years have already elapsed since *Taxation Ruling TR 93/12 Income tax: computer software* was withdrawn with effect from 1 July 2021, initially replaced by TR 2021/D4, which was released on 25 June 2021. Against that backdrop, the prospect of a further multi-year wait for clarity regarding the specific identification and characterisation of royalties in a software and technology space would be, while unfortunate, perhaps unsurprising.

Arm's length dealings

It is difficult to escape a conclusion that a certain part – perhaps a not insignificant part – of the High Court majority's reasoning in PepsiCo was influenced by the independence of the parties and the arm's length nature of the prices paid by SAPL to PBS for the concentrate.

This factor – together with the comment of the majority that *"Critically, the Commissioner did not contend that these prices were incorrect or had been inflated to hide some secret royalty outlay"* (at [167]), may limit the decision's utility as a precedent for related-party transactions or arrangements lacking demonstrable commercial independence. For such cases, the risk profile remains materially higher, as well as the Commissioner's potential appetite to challenge.

It is apparent from the majority judgement of the High Court that the positions of the Australian courts and the Commissioner on royalty characterisation are not always aligned. Regardless of the outcome, the Commissioner will continue to apply increased scrutiny to commercial arrangements involving intangibles, particularly where there is some valuable intellectual property connected to those arrangements, or where transfer pricing considerations are involved. Taxpayers should, therefore, critically assess any payments for the use of intangibles and ensure there is a robust basis for how such payments are characterised.

The decision in PepsiCo also does not preclude the possibility that a product price could be found to contain an embedded royalty component – particularly in circumstances where the price is found to be inflated to effectively reflect the value of associated intellectual property rights. In such cases, royalty withholding tax implications may still arise, provided the 'consideration for' any embedded royalty component is 'derived' by or 'paid to' a non-resident.

DPT and Part IVA

The specific conclusions reached by the majority and minority of the High Court in relation to the objective construction of the commercial and contractual arrangements and transactions between SAPL and PepsiCo, and between SAPL and SVC, were fundamental to the later conclusions reached regarding the analysis and application of the DPT provisions within Part IVA of the ITAA 1936. On one view, the High Court's comments may be of limited utility to other taxpayers in considering their own specific commercial facts and circumstances in an anti-avoidance context.

However, and not insignificantly, the majority judgement of the High Court has confirmed some critical general propositions that are of broad precedential value to taxpayers.

Onus

The majority of the High Court has established that taxpayers are able to discharge their onus in relation to the tax benefit limb of Part IVA of the ITAA 1936, by demonstrating that there is no postulate that is a reasonable alternative to the entering into or the carrying out of a scheme. This may be viewed as definitive guidance regarding the interpretation of section 177CB of the ITAA 1936, which was introduced in 2013 in an effort to address concerns regarding the prevalence of a 'do nothing' argument in the context of the determination of a reasonable alternative postulate.

The analysis of the majority – in particular the references to the 'unique facts' which enabled PepsiCo to demonstrate there was no reasonable alternative to the arrangements that were entered into – simultaneously confirm that while a 'do nothing' alternative postulate may remain valid following the 2013 amendments to Part IVA of the ITAA 1936, this would not be without risk. A taxpayer must still be adequately prepared to defend the position it has adopted and go through a comprehensive and rigorous evidentiary process to establish such a position.

Reasonable alternative postulate

As part of the introduction in 2013 of section 177CB of the ITAA 1936, section 177CB(4)(a)(i) of the ITAA 1936 provided that, amongst other factors, particular regard was to be had to the substance of a scheme, in determining whether a postulate is a reasonable alternative.

As referred to above, a key issue for the majority of the High Court was correctly understanding the economic and commercial substance of the scheme, as separate from its legal shape or form. In rejecting the Commissioner's submission *"… that the allocation of the total contract price to concentrate was not the substance of the Scheme but was only a means and form to give it effect"* (at [215]), a key finding of the majority was that the Commissioner's argument misstated *" … the true economic and commercial substance of the Scheme"* (at [232]). It can be seen that this conclusion – which had its origins in the majority's objective construction of the contractual arrangements – was critical to both the majority's DPT analysis, as well as the majority's royalty withholding tax analysis.

The majority of the High Court has also established that, in and of itself, taking tax outcomes into account in negotiating the form of a transaction does not necessarily justify an application of Part IVA or the imposition of DPT under the ITAA 1936.

Unique facts

Of particular interest as a post-script to PepsiCo is the progression of the current Federal Court proceedings between The Coca-Cola Company (**Coca-Cola**) and the Commissioner, which also extends to whether payments for concentrate made to an overseas entity ought to have been characterised as royalties subject to withholding tax.

It may be expected that a significant component of Coca-Cola's commercial operations and arrangements share similarities with those of PepsiCo, while also involving a number of their own, separate 'unique facts'. In the context of the Commissioner having assessed Coca-Cola to DPT, which is a key aspect of the current Federal Court proceedings, it remains to be seen how broadly the comments of the majority in the High Court – particularly in respect of the establishment or otherwise of a reasonable alternative and therefore the existence of a DPT tax benefit – are applied to similar but not identical evidence, facts and commercial circumstances.

PS LA 2005/24

In addition to the ATO's consideration of the broader impact of the High Court decision in PepsiCo to TR 2024/D1, there are likely to be a number of additional ATO publications and guidance materials requiring similar reconsideration.

For example, Practice Statement Law Administration *PS LA 2005/24 Application of general anti-avoidance rules*, which the ATO notes is already being reviewed as a result of the decision of the Full Federal Court in *Federal Commissioner of Taxation v Guardian AIT Pty Ltd* (2023) 115 ATR 316 (which decision was referenced by the High Court in PepsiCo), states the following at paragraph 83 in response to the question *"Is all of the case law on the concept of tax benefit still authoritative following the [2013] amendments?"*:

> *83. No. New section 177CB so significantly alters the conceptual framework of the tax benefit test that cases such as Federal Commissioner of Taxation v. RCI Pty Ltd [sic] (2011) 2011 ATC 20-075; (2011) 84 ATR 785; [2011] FCAFC 105 … can no longer be wholly regarded as representing the law, so far as the tax benefit concept is concerned, and should be treated with extreme caution.*

Given that the majority of the High Court has cited and quoted from the decision of the Full Federal Court in *RCI Pty Ltd v Federal Commissioner of Taxation* with approval (see [208] and [210-211]) in the context of 'tax benefit', it may be concluded, with respect, that PS LA 2005/24 will also require further reconsideration and rewriting following PepsiCo.

It will be of interest to observe whether or not other, perhaps less obvious, ATO publications and guidance materials may also be reconsidered. For example, Taxation Ruling *TR 2010/4 Income tax: capital gains: when a dividend will be included in the capital proceeds from a disposal of shares that happens under a contract or a scheme of arrangement relies quite heavily on an extension and application of the High Court's decision in Chief Commissioner of State Revenue (NSW) v. Dick Smith Electronics Holdings Pty Ltd* (2005) 221 CLR 496 (**Dick Smith**), which was one of the Duties cases under consideration in PepsiCo.

Given the comment of the majority in PepsiCo that Dick Smith turned upon an application of a State Duties Act to its particular facts (see [172]), and the implied limitation on the broader application of the case, it may be queried whether the reliance placed by the Commissioner on the Dick Smith decision in the above and other instances, should be revisited.

The post-PepsiCo world for taxpayers

It may be expected that the ATO's Decision Impact Statement will provide some insights into the Commissioner's views regarding the broader application of the High Court's decision in PepsiCo. We anticipate this will highlight that many aspects of the High Court's analysis and comments relate to the particular facts of PepsiCo. In the meantime, what is known is that the ATO continues to receive significant funding from the Federal Government to conduct its ongoing tax avoidance taskforce activity, a component of which is its regular program of assurance and risk-based reviews and audits.

Taxpayers should therefore continue to be proactive and prepared, which, in the specific context of PepsiCo, should include the following:

- Taking the utmost care and attention when drafting commercial agreements, irrespective of whether they involve related intra-group entities or unrelated third parties.
- Considering how the ATO might scrutinise arrangements and transactions. For example, there is still a risk that royalty-type features may arise in respect of commercial agreements involving both tangible goods and intangible property (such as distribution arrangements, licensing and use of patents, data and know-how, marketing and branding, etc.) It therefore becomes critical to be able to identify what goods and / or services are being provided under relevant contract(s).
- Considering also how payments for those goods and / or services are specified or how they may be characterised. For example, might there be an embedded royalty component having regard to some of the aspects of the decision in PepsiCo?
- Objectively evaluating whether there are any payments occurring for the use of intangibles, and if not, why not? How are the relevant transactions priced – are they priced 'fairly' – and is the purchaser paying for intangible or intellectual property, or merely for goods?
- Considering what evidence exists to support the pricing arrangements. Have any comparable arrangements with other parties (including cross border supply and service agreements) been reviewed? Has any valuation of the cross-border licensing of brands, inventions, knowledge, patents, copyright protected works and other intellectual property been undertaken?
- Ensuring contemporaneous documentation has been prepared and formalised to support the positions taken and the commercial decision making process. For example, is there evidence of alternative arrangements that were considered and why they may have been dismissed? The commercial rationale of taxpayers will be critical in a post-PepsiCo world, particularly in respect of arrangements involving intangible assets.

Authors

Cameron Blackwood
Head of Tax
+61 2 9210 6216
+61 421 046 803
cameron.blackwood@corrs.com.au

Angelina Lagana
Head of Tax Controversy
+61 3 9672 3062
+61 417 395 143
angelina.lagana@corrs.com.au

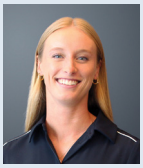
Eugenia Kolivos
Head of Intellectual Property
+61 2 9210 6316
+61 407 787 992
eugenia.kolivos@corrs.com.au

Luke Imbriano
Partner
+61 3 9672 3122
+61 423 169 902
luke.imbriano@corrs.com.au

Craig Boyle
Special Counsel
+61 3 9672 3307
craig.boyle@corrs.com.au

Joseph Tranzillo
Senior Associate
+61 2 9210 6072
+61 420 818 676
joseph.tranzillo@corrs.com.au

James Butterworth
Senior Associate
+61 3 9672 3135
james.butterworth@corrs.com.au



Jasmine Chubb
Law Graduate

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