Australia

Federal Court Rules That Payments for Beverage Concentrate Included Royalties – PepsiCo Judgment Released

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The Federal Court has released its written judgment in the case of PepsiCo, Inc v Commissioner of Taxation [2023] FCA 1490 (*see* Court Favours Australian Tax Authority in First Case Involving Diverted Profits Tax (4 December 2023)) which decided on the application of royalty withholding tax (RWT) and, in the alternative, diverted profits tax (DPT).

(a) Facts. Briefly, an Australian company (Schweppes Australia Pty Ltd, SAPL) entered into a bottling agreement with the PepsiCo group of companies (PepsiCo Group). One of the parties to the agreement was PepsiCo Inc, the owner of most of the relevant trademarks, designs and other rights. The agreement was for a purchase of beverage concentrate from a manufacturing company of the PepsiCo group. The concentrate was manufactured by a Singapore company of the PepsiCo Group (Concentrate Manufacturing (Singapore) Pte Ltd, CMSPL) and supplied to a related company in Australia (PepsiCo Beverage Singapore Pty Ltd, PBS). PBS then sold the concentrate to SAPL, and paid CMSPL for the concentrate while retaining only a small margin. SAPL then used the concentrate to produce beverages under the PepsiCo brand and distribute them in Australia.

PBS treated the payments to CMSPL as payments for the purchase of goods that were not subject to any withholding tax. However, the Australian Taxation Office (ATO) disagreed, and argued that the payments, in part, were royalties and should have been subject to RWT. In the alternative, which would arise only if the payments were not subject to RWT, the DPT would apply to the payments at a rate of 40%.

Briefly, DPT applies where a taxpayer obtained a tax benefit from a scheme, and it could be concluded that the person entered into the scheme with a principal purpose, or with one of the principal purposes, to obtain the tax benefit, which includes a reduction of a tax liability in Australia or elsewhere.

(b) Issue. The main issue in relation to RWT was whether the payments made by SAPL were royalty payments. Alternatively, if DPT were to apply, the issue was whether PepsiCo obtained a tax benefit in connection with the scheme, and whether the scheme was entered into with the principal purpose (or more than one principal purpose) of obtaining a tax benefit and/or reducing foreign tax liability.

(c) Decision. The Court observed that the agreement between SAPL and PepsiCo included clauses that deal with the licensing of trademark and other intellectual property to SAPL, and noted that these clauses were fundamental to the agreement. Without the licence, SAPL would not be able to package and sell the beverages under the PepsiCo brand names. On this basis, the Court found that the payments were, to an extent, royalties to which RWT should have applied.

The Court further noted that the licensed brands were one of the strongest and most valuable brands in the global beverage industry, and it would be surprising if PepsiCo was prepared to license the trademarks for nothing. Based on expert witness evidence, the Court then found the value of such royalties to be 5.88% of the payments under the agreement.

Having found a part of the payments to be royalties subject to RWT, it was not necessary for the Court to rule on the DPT. However, the Court considered it appropriate to do so for the sake of completeness. Proceeding on an assumption that the RWT did not apply to the payments (that is no part of the payments are royalties for the use of intellectual property) the Court noted that it is necessary to perform a counterfactual analysis to consider the application of the DPT, which is determining what the taxpayer would have or might reasonably be expected to have done if the scheme had not been entered into.

The ATO had argued that if the actual agreement was not entered into, the parties would have entered into a different agreement that would specify the payments to be for all of the property provided by that agreement (which presumably would include intellectual property), or would expressly state the royalty amount for the use of the intellectual property. In contrast, the taxpayer had argued that the ATO's alternatives were not reasonable commercial alternatives.

The Court found that if the actual agreement was not entered into, it might reasonably be expected that the hypothetical agreement would have provided for the payments to be made by SAPL to be for all of the property provided by the PepsiCo Group entities (rather than for the concentrate only) and thus the RWT liability would arise, as under both the actual and hypothetical agreements the payments to be made by SAPL are, in substance, for both the concentrate and the licence of the intellectual property.

Having considered the required conditions for the DPT to apply, the Court found that one of the principal purposes of the taxpayer entering into the overall arrangement was to obtain a tax benefit (namely not being liable to pay RWT in Australia) and to reduce foreign tax, and therefore the DPT provisions would have applied to the arrangement.
