HIGH COURT OF AUSTRALIA

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Details of Filing

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Form 27A – Appellant's submissions

Note: see rule 44.02.2.

IN THE HIGH COURT OF AUSTRALIA
MELBOURNE REGISTRY

BETWEEN: **COMMISSIONER OF TAXATION**
Appellant

and

PEPSICO, INC
Respondent

APPELLANT'S SUBMISSIONS

Part I: Certification

1. These submissions are in a form suitable for publication on the internet.

Part II: Concise statement of issues

2. There are six related appeals which raise three issues. *First*, did payments by Schweppes Australia Pty Ltd (**SAPL**) under agreements to bottle and sell PepsiCo branded beverages include an amount paid "*as consideration for*" the use of intellectual property, within the definition of "*royalty*" in s 6(1) of the *Income Tax Assessment Act 1936* (Cth) (**ITAA 1936**). *Secondly*, if so, was the royalty component of the payments income "*derived*" by and "*paid to*" PepsiCo, Inc (**PepsiCo**) and Stokely-Van Camp, Inc (**SVC**) under s 128B(2B) of the ITAA 1936, such that withholding tax was payable under s 128B(5A). *Thirdly*, in the event that PepsiCo/SVC are not liable to withholding tax, were they liable to diverted profits tax (**DPT**) under s 177J and 177P of the ITAA 1936.

Part III: Section 78B of the *Judiciary Act 1903* (Cth)

3. No notices under s 78B of the *Judiciary Act 1903* (Cth) are required.

Part IV: Citation of the decisions below

4. The decision of the Federal Court of Australia is *PepsiCo, Inc v Commissioner of Taxation* [2023] FCA 1490 (Moshinsky J) (**PJ**) (CAB, pp 6-145).

5. The decision of the Full Court of the Federal Court of Australia is *PepsiCo, Inc v Commissioner of Taxation* [2024] FCAFC 86; 303 FCR 1 (Perram and Jackman JJ; Colvin J dissenting) (**FC**) (CAB, pp 192-258).

Part V: Background

6. **Brands:** PepsiCo is a US-resident company which owns intellectual property relating to the Pepsi and Mountain Dew brands, and SVC is a US-resident member of the PepsiCo Group which owns intellectual property relating to the Gatorade brand (PJ [1], [3]). These brands are famous and are amongst the strongest and most valuable in the global beverage industry (PJ [248]; FC [2], [36], [142]-[143]).

7. **EBAs:** On 3 April 2009, SAPL entered into separate exclusive bottling agreements (**EBA**) with each of PepsiCo and SVC (AFM, pp 6-25, pp 26-89). Under the EBAs, PepsiCo/SVC agreed to sell, or cause a related entity to sell, beverage concentrate to SAPL, and granted SAPL the right to use trade marks and other intellectual property in Australia to manufacture, bottle, package, sell and distribute finished PepsiCo Group branded beverages (PJ [5], [57], [91]). The EBAs provided for SAPL to pay for beverage concentrate but did not expressly state that SAPL was to pay for the use of PepsiCo/SVC's valuable intellectual property (PJ [6]). The primary judge found, subject to one mathematical adjustment not relevant for present purposes, that if the EBAs included a royalty for the right to use PepsiCo/SVC's intellectual property, the royalty amount was 5.88% of SAPL's net revenue from sales (PJ [404]). That finding was not challenged on appeal (FC [143]).

8. **Nominated 'Seller':** On 8 December 2015, each of PepsiCo and SVC wrote to SAPL nominating PepsiCo Beverage Singapore Pty Ltd (**PBS**), an Australian member of the PepsiCo Group, as the related entity to be the 'Seller' under the EBAs (AFM, pp 90-93; PJ [108]-[109]). PBS did not become a party to the EBAs (PJ [255]; FC [3]-[4]). On 11 January 2016, SAPL was provided with PBS's bank account details (AFM, pp 94-97; PJ [110]-[111]). The amounts for which SAPL was invoiced were paid into that bank account (PJ [7]).

9. PBS transferred 99.95% of the money it received from SAPL to another PepsiCo Group entity, Concentrate Manufacturing (Singapore) Pte Ltd, a company resident in Singapore which manufactured the concentrate (PJ [7], [125], [456]). No separate amounts were paid by SAPL to PepsiCo/SVC, even though those entities granted SAPL the right to use their valuable intellectual property under the EBAs (FC [148]).

10. **Procedural history:** The appellant (the **Commissioner**) issued PepsiCo and SVC notices under s 128C of the ITAA 1936 on the basis that the payments by SAPL included a royalty for the use of PepsiCo/SVC's intellectual property. As an alternative, the Commissioner also issued DPT assessments to PepsiCo and SVC. PepsiCo and SVC commenced proceedings under s 39B of the *Judiciary Act 1903* (Cth) seeking declarations that no withholding tax was payable, and pursuant to Part IVC of the *Taxation Administration Act 1953* (Cth), challenging the DPT assessments (PJ [8]-[9]).

11. **Primary judge:** In relation to withholding tax, Moshinsky J found that: (a) part of the payments made by SAPL under the EBAs were "*consideration for*" the right to use the intellectual property licensed by PepsiCo/SVC, and, to that extent, included a "*royalty*" as defined in s 6(1) (PJ [18], [237]-[252]); and (b) that the royalty part of the payments was income "*derived*" by and "*paid*" to PepsiCo/SVC notwithstanding that the amounts were deposited into PBS' bank account (PJ [253]-[265]).

12. Had the primary judge found that the payments by SAPL were not subject to withholding tax under s 128B, the primary judge would have found that the DPT provisions applied (PJ [466]). His Honour considered that PepsiCo/SVC obtained a "tax benefit" in connection with a "scheme" arising from the pricing clauses in the EBAs (PJ [426]-[443]) and that one of the principal purposes of PepsiCo/SVC in entering into or carrying out the scheme was to obtain a DPT tax benefit (in Australia) and to reduce liability to US tax (PJ [444]-[465]).

13. **Full Court:** Perram and Jackman JJ allowed PepsiCo and SVC's appeals, finding that: (a) the payments by SAPL were "*for concentrate alone*" and did not include any component which was a royalty, that is, paid "*as consideration for*" the use of PepsiCo/SVC's intellectual property (FC [9]-[38]); and (b) no income from the SAPL payments was derived by or paid to PepsiCo/SVC (FC [39]-[45]).

14. In contrast, Colvin J held that the payments by SAPL did include amounts paid "*as consideration for*" the use of PepsiCo/SVC's intellectual property (FC [154]-[202]), though agreed with the majority that those payments did not result in a derivation of income by PepsiCo/SVC (FC [204]-[207]).

15. In relation to DPT, each member of the Full Court agreed with the primary judge that it would be concluded (under s 177J(1)(b)) that it was a principal purpose of PepsiCo/SVC to obtain a DPT tax benefit (FC [103]-[133], [218]). However, Perram and Jackman JJ found that PepsiCo/SVC did not obtain a tax benefit as their Honours considered there was "*no postulate which is a reasonable alternative to the scheme*" (FC [64]-[101]). Colvin J dissented on this point, finding that there was a tax benefit because, if the (actual) EBAs had not been entered into, a (postulated) bottling agreement might reasonably be expected to have provided for a royalty to be paid by SAPL to PepsiCo/SVC, the holder of the trade marks (FC [210]-[218]). His Honour therefore concluded that the DPT Assessments (and so the Commissioner's appeals) should be upheld (FC [219]).

Part VI: Argument

Ground 1: Part of the payments by SAPL were consideration for intellectual property

16. "*Royalty*" is defined in s 6(1) of the ITAA 1936 to include "*any amount paid or credited, however described … to the extent to which it is paid or credited… as consideration for … the use of, or right to use*" intellectual property.[1] The definition focusses upon whether an amount (or part thereof) is properly characterised "*as consideration for*" the use of intellectual property (see [27]-[29] below).

17. Similar expressions to "*as consideration for*" have been considered by this Court in stamp duty cases. Perram and Jackman JJ wrongly held that the outcome of this appeal was "*governed*" by one of those cases, ***Davis*** *Investments Pty Ltd v Commissioner of Stamp Duties (NSW)* (1958) 100 CLR 392, and incorrectly understood that decision to be in conflict or tension with ***Dick Smith*** *Electronics*

[1] The proceedings have been conducted on the basis that there is no presently relevant difference between the royalty definitions in s 6(1) of the ITAA 1936 and Art 12(4) of the *Convention between the Government of the United States of America and the Government of Australia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income, signed at Sydney on 6 August 1982* (as amended) (**US DTA**) (J [237]; FC [157]).

Holdings Pty Ltd (2005) 221 CLR 496 and *Commissioner of State Revenue (Vic) v* ***Lend Lease*** *Development Pty Ltd* (2014) 254 CLR 142 (FC [26]-[38]).

18. *Davis* concerned the transfer of shares under a sale agreement from a wholly owned subsidiary to its parent at a purchase price substantially less than the market value of the shares. The majority (Dixon CJ, McTiernan and Taylor JJ) held that the only "consideration" was the purchase price for the shares, as expressed in the contract. Their Honours rejected an argument by the taxpayer, which had been based upon the earlier decision in ***Archibald Howie*** *Pty Ltd v Commissioner of Stamp Duties (NSW)* (1948) 77 CLR 143, that part of the consideration for the transfer included the satisfaction of rights that the parent company purchaser had as a shareholder against its subsidiary (at 408-409, 409-410, 420-421).

19. In *Archibald Howie*, the appellant company pursuant to a resolution to reduce its capital distributed to shareholders *in specie* shares the appellant owned in other companies. The Court (Rich, Dixon and Williams JJ) determined that the consideration for the conveyance was the diminution of the value of the shareholders' rights to make claims on the assets of the appellant, which was equivalent in value to the shares distributed *in specie* (at 152-154, 156-159). Dixon J held at 152 that the word "*consideration*" in the stamp duty provision should receive its wider meaning in conveyancing, being "*the money or value passing which moves the conveyance or transfer*", rather than its meaning in contract law.

20. The majority judgments in *Davis* each distinguished *Archibald Howie* (*Davis* at 407-409, 410, 417-419). In *Davis,* shares were transferred by their owner to a purchaser, under a sale agreement which stipulated a price. Unlike a capital reduction involving an *in specie* distribution of a company's assets to its existing shareholders, the *Davis* transfer did not discharge any rights of the purchaser as against the vendor.

21. In *Dick Smith*, the Court was taken to *Davis* and *Archibald Howie*. The vendors in *Dick Smith* had contracted to sell shares in a company upon payment of a 'purchase price', defined as approximately $114 million less a 'dividend amount' (equal to the company's retained earnings up to $27 million). The agreement provided that: (a) prior to completion, the vendors would cause the company to declare a dividend equal to the dividend amount; and (b) the purchaser would provide finance to enable the company to discharge the debt created by the declared dividend. The majority

(Gummow, Kirby and Hayne JJ) determined that the consideration for the transfer of the shares was the $114 million, without subtracting the dividend amount. Their Honours held that "*it would be a misstatement of the operation of the Agreement, and the transaction for which it provided*" to conclude that the receipt of the 'purchase price' of approximately $114 million <u>less</u> the 'dividend amount' was the "*monetary consideration actuating or moving the transfer of the Shares by the Vendors to the Purchaser*" and that "*it is necessary to look further into the provisions of the Agreement*" (at [54], and see analysis at [55]-[59]). It was only in return for the total sum of $114 million (paid by the various steps and in the various forms required by the agreement) that the vendors were willing to transfer their shares (at [75]).

22. In *Lend Lease* a government authority agreed to sell certain land in Melbourne's docklands. The development agreement required the developer to pay the authority not only the amounts recorded as the purchase price in each land sale contract but also certain contribution amounts related to infrastructure and remediation. The Court (French CJ, Hayne, Kiefel, Bell and Keane JJ) emphasised at [49] and [51], by reference to *Dick Smith*, that the 'consideration for' the transaction "*looks to what was received by the Vendors so as to move the transfers to the Purchaser <u>as stipulated in the Agreement</u>*" (emphasis in original). The Court described the rights and obligations in the agreement as "*interlocked"* (at [53]) and concluded that the performance of the *several* promises of payment in the development agreement was the consideration which moved each transfer of land as a "*single, integrated and indivisible*" transaction (at [62]). The consideration for the transfers of land was not limited to the amounts specified in the sale contracts, but included all amounts the developer was bound to pay under the development agreement.

23. In purported reliance upon *Davis*, the majority below stated at [11] that "*it is established that where parties to a conveyance have agreed the purchase price for a transfer on sale then the consideration for the transfer is that agreed price*". As the EBAs expressed amounts payable by SAPL with reference to units of concentrate, their Honours found that the EBAs "*fixed a price for future sales of concentrate alone*" (FC [24]-[25]); and that the payments were "*in no part*" made "*in consideration for*" the use by SAPL of PepsiCo/SVC's intellectual property (FC [9]). Their Honours erred in so concluding.

24. Far from this case being "*governed*" by *Davis*, its reasoning is inapposite. As Colvin J correctly observed at [186], the outcome in *Davis* "*was reached because [of] the legal nature of the agreement*" for the sale of shares, whereby the <u>only</u> consideration passing under it to the vendor was the contracted purchase price. Reasoning of the kind in *Davis* "*would only lead to the conclusion that the amounts paid [under the EBAs] were not paid as consideration for the trade marks <u>if the EBAs were confined to expressing the terms of supply of concentrate</u>*" (emphasis added). The EBAs were not so confined. Under the EBAs, PepsiCo/SVC both: (a) agreed to sell, or cause a related entity to sell, concentrate; <u>and</u> (b) licenced intellectual property. *Davis* does not address a situation where there are two kinds of property passing under an agreement and a single payment.

25. Properly understood, there is no tension or conflict between *Davis* on the one hand and *Dick Smith* and *Lend Lease* on the other (cf FC [29]). In *Dick Smith* and *Lend Lease*, the terms of the relevant contracts viewed as a whole revealed that what was received by the sellers to move the transfer (of the shares or the land) was not limited to the amounts expressed to be the purchase price. The contracts contemplated the transfer of *additional* value (being the funding of the dividend amount and the development contribution respectively). The further 'consideration' unsuccessfully argued for in *Davis* was the "extinguishment" of the parent's rights as shareholder in the subsidiary that had sold its assets to its parent. This was not a part of the consideration moving under the share purchase agreement in *Davis*.

26. The majority's misconception of a need to reconcile the stamp duty cases led them to put a gloss on *Dick Smith* and *Lend Lease,* which approached what a payment is 'consideration for' by seeking to identify the "*central property disposition or transaction*" or the "*central bargain*" (FC [36]). That gloss is not supported by the reasons in *Dick Smith* and *Lend Lease*, or, more importantly, by the text of s 6(1) of the ITAA 1936. The definition of 'royalty' in s 6(1) focusses on whether the amount or *any part* thereof ("*to the extent to…*") was consideration for the use of intellectual property – not whether the use of intellectual property was the "*central bargain*". The majority erroneously substituted their own test for the one in the statute.

27. The question of whether an amount or part thereof is paid "*as consideration for*" the use of intellectual property is ultimately one of <u>characterisation</u> having regard to the

whole of the terms of the agreement under which the payment is made (see *International Business Machines Corporation v Commissioner of Taxation* (2011) 83 ATR 32 at [19], [41]-[42], [52]). The majority's reasoning at [12]-[25] which addresses the <u>construction</u> of the EBAs and "*whether the EBAs fixed a price for the sale of concentrate*" is not dispositive of the statutory inquiry. The majority accepted that the question of <u>construction</u>, as distinct from <u>characterisation</u>, of the agreement is not determinative of what a payment was "consideration for" (FC [25]-[26]). After all, s 6(1) provides that an amount may include a royalty irrespective of how that amount is labelled ("described or computed") under the terms of the agreement.

28. Colvin J correctly held that when regard is had to all of the terms of the EBAs, they are agreements to bottle and sell <u>branded</u> products (FC [194]-[197]). The PepsiCo Group intellectual property was "*known to the parties to be strong and valuable*" (FC [142]-[143]; PJ [246]). The terms of the EBAs demonstrate the primacy of the use of PepsiCo/SVC's intellectual property and that SAPL would not have been willing to purchase the concentrate without the use of that intellectual property (see, for example, PepsiCo EBA cll 3(a), 5(a) / SVC EBA cll 3(a), (b), 4.1, 6.3). The EBAs make explicit links between SAPL's use of the intellectual property and its payment (PepsiCo EBA cll 3(c), 24(a)(i), 27(a) / SVC EBA cll 4.1, 7.4(f), 18.2(a), 18.5(b)(ii)). The licence of the trade marks was "*fundamental*" (PJ [245]).

29. Colvin J accordingly found that it would be a commercially unreasonable operation of the terms of the EBAs, considered as a whole, if the amount required to be paid by SAPL under the EBAs was for the concentrate alone and no part of the payment was attributable to the licence to use PepsiCo/SVC's valuable brands (FC [195]).

30. If Perram and Jackman JJ had not erred in their construction of the statutory definition of "royalty", they would have reached the same conclusion as Colvin J and the primary judge that part of the payments included a royalty. Like Colvin J, their Honours found that "*what [SAPL] ultimately wanted to acquire was … the right to distribute famous beverages in Australia [of which]* <u>*the right to use trade marks and intellectual property was a necessary element in the transaction*</u>" (FC [36]) (emphasis added). However, because the majority adopted an incorrect test which required identification of the "*central transaction [or] bargain*" they concluded that the payments did not include a royalty because "*what the parties were* <u>*centrally*</u>

seeking to achieve was not a contract for the licensing of trade marks and intellectual property" (emphasis added). The majority's finding at FC [36] that the EBAs ultimately secured the right to distribute the famous beverages of which the use of intellectual property was a necessary element required a conclusion that part of the payments made by SAPL was for the use of PepsiCo/SVC's intellectual property.

Ground 2: The royalty was income "paid to" and "derived by" PepsiCo/SVC

31. Section 128B(5A) of the ITAA 1936 imposes a liability to withholding tax at a rate declared by Parliament on a person who derives income to which that section applies that consists of a royalty. Subsection 128B(2B) provides that the section applies to "*income*" that is a royalty "*derived*" by and "*paid to*" a non-resident.[2]

32. The phrase '*income derived*' in s 128B of the ITAA 1936 bears its ordinary meaning, which encompasses gains that have "*come home to the taxpayer in a realised or immediately realisable form"*: *Commissioner of Taxes (SA) v Executor, Trustee and Agency Co of South Australia Ltd* (*Carden's case*) (1938) 63 CLR 108 at 155.

33. Section 6-5(4) of the *Income Tax Assessment Act 1997* (Cth) provides that "*in working out whether you have <u>derived</u> an amount of ordinary income, and (if so) when you derived it, you are taken to have received the amount as soon as it is applied or dealt with in any way on your behalf or as you direct*" (emphasis added).

34. For the purposes of s 128B, s 128A(2) provides that "*a royalty shall be deemed to have been <u>paid</u> by a person to another person although it is not actually paid over to the other person but is … otherwise dealt with on behalf of the other person or as the other person directs*" (emphasis added).

35. **Amounts owed to PepsiCo/SVC:** The Full Court incorrectly held that no amounts were 'paid to' PepsiCo/SVC because there was no "*antecedent monetary obligation owed by SAPL to PepsiCo/SVC*" as the money was owed by SAPL to PBS as the nominated 'Seller' under the EBAs (FC [40]-[44], [205]-[206]). However, there was an antecedent monetary obligation owed by SAPL to PepsiCo/SVC under the EBAs and the payments made by SAPL were in discharge of that obligation. PBS was not a party to the EBAs and it was not pleaded, and leave was not granted for

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[2] As noted at fn 1 above, the proceedings were conducted on the basis that s 128B and the DTA would not produce a different outcome (FC [157]).

PepsiCo/SVC to contend, that a collateral contract existed between SAPL and PBS (AFM, pp 119-129, pp 137-145). Neither the primary judge nor the Full Court made any findings to that effect (see FC [10]). As a non-party, PBS could not enforce SAPL's promise to make payments under the EBAs with PepsiCo and SVC: ***Coulls** v Bagot's Executor & Trustee Co Ltd* (1967) 119 CLR 460; ***Beswick** v Beswick* [1968] AC 58. Only PepsiCo/SVC as a party to the EBA could enforce SAPL's payment obligation.

36. In the event that SAPL failed to make the stipulated payments, PepsiCo/SVC could recover the agreed sum under the EBAs in a claim for debt or damages as opposed to recovering merely nominal damages. SAPL would not succeed in defending such a claim by arguing (even if it were a viable defence) that the claim would require it to pay PepsiCo/SVC when SAPL had only promised to pay the 'Seller' nominated under the EBAs: *Coulls* at 477-479, 501-503; *Beswick* at 88, 101. That is because under the:

(a) SVC EBA, SVC could direct SAPL to pay it or any third party it nominated. Clause 7.4(f) of the SVC EBA provided that "*Unless the parties agree otherwise, payment shall be made by telegraphic transfer to such bank account in the U.S.A. as may be specified by the [SVC] or a Company Affiliate at any time*" (AFM, p 51). The payment by SAPL under the SVC EBA was to be made by telegraphic transfer to a bank account in the United States (unless the parties agreed otherwise), but SVC was otherwise free to nominate any recipient for the payment. SVC could therefore recover the contract price from SAPL: H Beale et al *Chitty on Contracts* (35th ed, 2023) at [21-075]; *Tradigrain SA v King Diamond Shipping (The Spiros C)* [2000] 2 Lloyd's Rep 319 at 331-332; cf *Cathels v Commissioner of Stamp Duties* (1959) 62 SR (NSW) 455.

(b) PepsiCo EBA, SAPL was always contractually obliged to make the payment to PepsiCo, or as PepsiCo directed. Clause 4(a) of that agreement provided that "*Company will sell or cause to be sold by one of its subsidiaries (Company and/or such subsidiary hereinafter both called 'Seller') to [SAPL], and [SAPL] will buy only from Seller all units of concentrate ... required for the manufacture of the Beverages by [SAPL], at the following prices...*" (AFM, p 9). However, the PepsiCo EBA did not expressly identify to whom the payment was to be made. Clause 4(c) of the PepsiCo EBA simply provided that "*Payment in full for each order of Units shall be made by Bottler within 7 days of delivery*". SAPL's obligation to pay is properly construed as an obligation to pay PepsiCo as the counterparty to the agreement or as it directed, rather than any such subsidiary that PepsiCo might nominate from time to time to perform its obligation to supply the concentrate. Under clause 26(a) of the PepsiCo EBA, SAPL was to pay interest on any late payments to PepsiCo – not to any subsidiary that PepsiCo notified as the 'Seller' to supply the concentrate. It would make no sense for SAPL to be required to compensate PepsiCo with interest for late payments under the EBA unless the primary obligation to pay was owed by SAPL to PepsiCo.

37. As the primary judge correctly found, "*PepsiCo and SVC, as the parties to the EBAs, were entitled to receive the payments made by SAPL under the EBAs ... SAPL's payment obligations under the EBAs were owed to them*" (PJ [255]).

38. **Payment by direction:** The majority did not ultimately determine the issue but opined that the arrangements outlined at [8] above "*do not appear to be directions to pay but rather directions under the EBA to buy concentrate from another entity*" (FC [44]). That proposition was based on a misapprehension arising from the majority's perception that, under the terms of the EBAs, SAPL was obliged to pay PBS as the nominated 'Seller' (FC [40]-[43]). However, as set out at [36] above, SAPL was always obliged to make the payment to PepsiCo/SVC or as they directed. When the contractual arrangements between the parties are properly examined, the amounts are "*paid to*" and "*derived*" by PepsiCo/SVC because the payments from SAPL were applied and dealt with on behalf of PepsiCo/SVC or as PepsiCo/SVC directed, notwithstanding that the amounts were "*actually paid over*" to PBS. The character of amounts in the hands of PBS is irrelevant to the question of derivation by PepsiCo/SVC,[3] and the majority erred in contemplating the need for a trust or agency relationship: FC [45].

[3] See, eg, *Commissioner of Taxation v White* (2010) 79 ATR 498 at [24]-[29]; citing *Federal Commissioner of Taxation v McNeil* (2007) 229 CLR 656 at [15], [18], [20].

39. The primary judge correctly concluded for the purposes of s 128B(2B) of the ITAA 1936 that the royalty amounts transferred under the EBAs were "*paid to*" and "*derived*" by PepsiCo/SVC (PJ [255]-[359], [264]-[265]).

Ground 3: Liability to diverted profits tax

40. In the alternative to the above grounds, if no withholding tax was payable by PepsiCo/SVC, the Full Court ought to have found PepsiCo/SVC liable to DPT.

41. A taxpayer is liable to pay DPT under s 177P of the ITAA 1936 where: the taxpayer has obtained a tax benefit in connection with a scheme (s 177J(1)(a)); and it would be concluded (having regard to the matters in s 177J(2)), that a person who entered into or carried out the scheme, or any part of it, did so for a principal purpose of enabling the relevant taxpayer to: (i) obtain a tax benefit, or (ii) both obtain a tax benefit (in Australia) and to reduce the taxpayer's foreign tax liabilities, in connection with the scheme (s 177J(1)(b)).[4]

42. Here, the scheme was Pepsi/SVC entering into an EBA with SAPL on terms where SAPL bought concentrate, licensed PepsiCo Group intellectual property and paid no royalty for use of that intellectual property[5] (**Scheme**): FC [52], PJ [32]. The members of the respective Courts below were evenly divided on whether there was a "tax benefit" in connection with that Scheme (PJ [434]-[443], FC [214]-[217]; cf FC [68]-[101]), but were unanimous in the view that, if there was, the requisite "principal purpose" was present (PJ [452]-[465], FC [109]-[133], [218]).

Tax benefit

43. The question of whether there is a "tax benefit" in connection with a scheme is answered on the assumption that the whole of the scheme was not entered into or carried out: *Federal Commissioner of Taxation v Peabody* (1994) 181 CLR 359 at 383-385. From that starting point, there is an enquiry as to alternatives that might reasonably be expected to have occurred absent the scheme. The postulates must be reasonable alternatives to the scheme: s 177CB.

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[4] The further criteria in ss 177J(1)(c) to (g) are not presently in issue.
[5] The identification of the Scheme proceeds on the basis that the Court does not accept the Commissioner's primary argument as to the payment of a royalty under the EBA.

44. For the purposes of s 177C(1)(bc) (and also ss 177J(1)(a) and 177CB), PepsiCo/SVC obtained a "tax benefit" in connection with the Scheme in not being liable to pay withholding tax, as PepsiCo/SVC "might reasonably be expected to have been liable to pay withholding tax … if the [S]cheme had not been entered into or carried out". Had the EBAs with their *actual* pricing clauses not been executed, as a reasonable alternative under s 177CB(3), PepsiCo/SVC and SAPL may have contracted on a basis that: (i) expressed the payments by SAPL to be for *all* of the property in fact provided by and promises made by PepsiCo/SVC; or (ii) expressly provided for the payments to include a royalty for the licensed intellectual property (whether or not the amount of that royalty was specified) (PJ [32]) (**Commissioner's postulates**).

45. In concluding that PepsiCo/SVC did not obtain a DPT tax benefit (FC [101]), the majority of the Full Court: **(i)** misidentified the "substance of the scheme" referred to in s 177CB(4)(a)(i); (**ii**) incorrectly treated "the substance of the scheme" as being dispositive of the enquiry under s 177CB(3); **(iii)** disregarded evidence and findings pertinent to the reasonableness of the Commissioner's postulates and in so doing inverted the onus resting on the taxpayer with respect to "tax benefit"; and **(iv)** misidentified the operation of the onus in the event that no "reasonable alternative" to a scheme can be identified on the evidence before the Court.

46. <u>(i) Misidentification of substance:</u> Section 177CB directs the enquiry into whether a tax effect might reasonably be expected under s 177C: explanatory memorandum to *Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013* (**2013 EM**), at [1.4]-[1.5], [1.72], [1.85]-[1.121]; *Commissioner of Taxation v* ***Guardian*** *AIT Pty Ltd ATF Australian Investment Trust* (2023) 115 ATR 316 at [172]-[174]. A decision that a tax effect might reasonably be expected must be based on "*a postulate*" that is "*a reasonable alternative*" to the scheme: s 177CB(3). In determining whether a postulate is a reasonable alternative, s 177CB(4)(a) requires particular regard to be had to: (i) the substance of the scheme; and (ii) any non-tax results or consequences achieved by the scheme.

47. The substance of the actual arrangements under the EBAs was SAPL receiving the tangible and intangible property required to bottle PepsiCo/SVC branded beverages, and paying an amount of money to the PepsiCo Group. Under both the EBAs and the Commissioner's postulates, the property SAPL receives and the amount SAPL pays

is the same. The only difference between the actual EBAs and the Commissioner's postulates is a small textual change in the <u>form</u> of the agreement, in the expression of its payment clauses (PJ [217], [439]).

48. The primary judge thus correctly observed that, for the purpose of s 177CB(4)(a)(i), the "*substance of the [Commissioner's] counterfactual is the same as the substance of the EBAs*" (PJ [436]); and that, for the purpose of s 177CB(4)(a)(ii), "*the financial and other consequences for PepsiCo/SVC of the counterfactual are comparable to those of the EBAs* (PJ [437]).

49. The primary judge drew upon these matters, and the importance to the bottler of the PepsiCo/SVC beverage brands, in concluding that an EBA with a royalty payable to PepsiCo/SVC was a reasonable alternative to the Scheme (PJ [440]).

50. Colvin J agreed that the Commissioner's postulates were a reasonable alternative to the Scheme and regarded a contrary submission as having been wrongly premised on the same arguments advanced on the question of whether a royalty was in fact paid (FC [214]-[217]; cf FC [99]). His Honour referred to the evidence and unchallenged findings that the PepsiCo brands were established and amongst "*the strongest and most valuable brands in the global beverage industry*" and that the bottler's use of the trade marks could command a "*commercial royalty rate"* (FC [136], [142]-[143]; PJ [248], [404], [453]).

51. This commercial context supported the reasonableness of the Commissioner's postulates. Further, where the PepsiCo Group licenced intellectual property in the absence of a concentrate sale (the *Aquafina* trade mark for water and the *Tropicana* trade mark for juice), it charged a royalty to "*generate revenue*" where concentrate was not also sold (FC [126]-[127], [165]).

52. Perram and Jackman JJ recognised that s 177CB(4)(a)(i) invites an enquiry into the correspondence between the commercial and economic substance of a scheme and the commercial and economic substance of an alternative postulate (FC [75]). But their Honours erred in the application of that comparison by confusing commercial and economic *substance* with the *form* or *mechanism* by which the substantive aspects of a scheme are implemented (FC [76]-[83]). Their Honours said that the "*commercial and economic substance of the [S]cheme was that the price agreed for*

concentrate was for concentrate" (FC [79], [82]). On that analysis, the "substance" of the transaction became the very tax feature that was under challenge.

53. Pursuant to such an approach, the commercial and economic "substance" of the scheme in *Commissioner of Taxation v* ***Hart*** (2004) 217 CLR 216 at [67] would have been the direction of interest repayments non-rateably to residential and investment loans; and no "tax benefit" would have been discernible (cf at [71]) by comparing that "wealth optimiser" repayment structure with other loan arrangements.

54. Part IVA operates on the basis that there may be different legal forms by which commercial outcomes may be achieved, some of which are implemented to secure a tax advantage: *Hart* at [16], [52], [94]; 2013 EM at [1.16]-[1.17], [1.103]-[1.106]. The majority's granular identification of the purported "substance" of the Scheme as encompassing the way PepsiCo/SVC and SAPL *allocated* the agreed total contract price between concentrate and intellectual property is at odds with the legislative purpose of s 177BC(4)(a). The manner of allocation of the total contract price was not the substance of the Scheme, but a means and form to give it effect.

55. <u>(ii) Substance treated as being dispositive of the s 177CB(3) enquiry:</u> The majority found at FC [93] that "*the results and consequences for PepsiCo / [SVC] under the scheme and the [Commissioner's] postulates are the same*" and that this "*tends to a conclusion that the postulates are reasonable alternatives*". However, the majority's misconception of the "substance" of the Scheme, which led it to find that "*the substance of the scheme and the postulates do not correspond*", was treated as being dispositive of the enquiry under s 177CB(3) (FC [98]-[99]).

56. Subsection 177CB(4)(a) directs "particular regard" to two matters in determining whether a postulate was a reasonable alternative to the Scheme. Having found that the factor in subpara (i) favoured the taxpayer and the factor in subpara (ii) favoured the Commissioner, the majority should not have determined that the Commissioner's postulates were not a reasonable alternative without further consideration. Further, it was also necessary for the majority to consider (and explain) *why* the identified difference between the substance of the Scheme and the Commissioner's postulates (as they perceived it) would make the Commissioner's postulates unreasonable alternatives to the Scheme. PepsiCo/SVC had sought to address that by arguing that a separate licence fee for the intellectual property would have complicated

negotiations with SAPL. The majority eschewed the need to deal with that submission (FC [99]) and thereby failed to undertake the task s 177CB(3) required.

57. <u>(iii) Failure to consider evidence supporting Commissioner's postulates:</u> The majority apprehended that the expert evidence on the DPT case "*proceeded on an assumption that the concentrate price included a royalty*" (FC [49], [80]). From that vantage, Perram and Jackman JJ repeatedly stated that there was "*no evidence … which showed that that value was being recovered through the concentrate price*" (FC [50], and see FC [70], [77], [80]-[82] and [117]).

58. Yet the Commissioner's expert evidence <u>had been</u> specifically directed to why, if the actual EBAs did *not* make provision for a royalty, a payment for the licensed intellectual property might reasonably be expected on an alternative postulate. The primary judge identified the evidence of Mr Malackowski – who had considerable experience in valuing intellectual property rights – to this effect (see PJ [332] (Question 2), and also PJ [336], [400]). That evidence demonstrated it was a reasonable expectation that appropriate compensation would be paid for the relevant items of intellectual property provided to SAPL under the EBAs (AFM pp 98-99, 113-114). Mr Malackowski explained the relative strength, recognition and reputation of the Pepsi and Gatorade brands drive increased sales volumes and prices (AFM pp 100-109 (section 8.3-8.5.2.3); pp 110-112 (section 11.4.2)). Mr Williams' evidence was to similar effect (PJ [173]).

59. The primary judge determined an amount that might be expected to be paid for a licence of the PepsiCo brands from the expert evidence that identified, considered and made adjustments to the royalty rates payable under licence agreements for comparable trade marks (PJ [399]-[402]). On appeal this valuation evidence was not in issue: FC [143]. The resulting royalty rate underlay the calculation of *both* the royalty found to have been paid under the actual EBAs, *and* (on the predicate no royalty was in fact paid) a royalty that might reasonably be expected to have been payable under an alternative postulate (ie, the DPT tax benefit) (PJ [464]).

60. Further, the majority's repeated references to the Commissioner's case "*lack[ing] evidence*" (FC [50]-[51], [80]-[82], [98]-[99]) revealed an inversion of the onus. It was not for the Commissioner to demonstrate that the payments under the (actual) EBAs were capable of adequately compensating PepsiCo/SVC for the licensed

intellectual property *and* for the supplied concentrate (cf FC [80]). Any asserted unreasonableness in the Commissioner's postulates was for PepsiCo/SVC to establish, but they led no evidence of the costs or economics of concentrate manufacture; nor of the return that would remain for the Group's concentrate manufacturing function if a royalty component of the SAPL payment was postulated.

61. Instead, the Commissioner's postulates were resisted by PepsiCo/SVC on specific and limited bases, each of which was rejected by the primary judge on the evidence.

62. *First*, it was argued that recognition of a royalty as part of the payment made by SAPL was not a reasonable expectation as this would have introduced "complexity" and "complication" into the EBAs (PJ [209]). But, as the primary judge observed by reference to a range of PepsiCo Group bottling agreements and the evidence of Mr Williams (who had held senior bottling franchise roles within PepsiCo), there was *already* considerable scope for bottlers to negotiate, considerable variation in the terms (including pricing terms) of bottling agreements, and pricing terms of some complexity (PJ [19(b)], [177]-[182], [210]-[211], [217], [437]-[439]). The evidence offered no basis to conclude that SAPL would have reacted to a small textual change to the EBAs by seeking to renegotiate the arrangements, or that, if that had happened, this would have yielded a commercial disadvantage so great that the postulate could not be regarded as reasonable.

63. *Second*, it was argued that recognition of a royalty would have resulted in an administrative burden on account of a need to "bifurcate" the bottler's payment into a royalty/non-royalty component, and obtain supporting valuations (see FC [76]). However, on at least one of the Commissioner's postulates – a bottling agreement expressing the SAPL payment to be for *all* of the property provided by PepsiCo/SVC – no contractual division of the payment would be required. Further, there was no evidence before the primary judge as to the cost or other effort involved in obtaining any necessary valuations to calculate an appropriate royalty. A bottler in the position of SAPL may in any event be expected to have been indifferent to the allocation of payments it made under the EBAs between tangible and intangible property[6] (at least

[6] See, eg, *Collis v Commissioner of Taxation* (1996) 33 ATR 438.

to the extent the bottler was given an indemnity for any obligation to withhold from royalty payments, as SAPL had been (PJ [102], [198]-[199])).

64. *Third*, a related argument by PepsiCo/SVC, resorting to the history of the PepsiCo Group franchise business, maintained that the express provision for a royalty within a bottling agreement was atypical (PJ [209]). However, the suggestion that the PepsiCo Group had a fixed franchise "pricing model" or "template" was revealed in cross-examination to have been overstated (PJ [174], [177], [180], [210], [452] (as to Mr Williams), and see also, PJ [207] (as to the evidence of Ms Dent, who assisted with preparing PepsiCo EBAs). Absent specific evidence as to the history of negotiations between SAPL and the PepsiCo Group, an appeal to (asserted) historical conformity could not illuminate whether the Commissioner's postulates reflected a reasonable commercial expectation (disregarding the effects of tax).

65. <u>(iv) Misidentification of the operation of the onus where no "reasonable alternative" to the scheme:</u> Furthermore, the majority erred in finding that the taxpayers discharged their onus as to tax benefit once it could be shown that <u>the Commissioner's counterfactuals were not reasonable and</u> "*there is no reasonable postulate*" (at FC [68], [100]-[101]). For the reasons given, the majority ought to have found that the postulates advanced by the Commissioner *were* reasonable, but, irrespective, their Honours misapprehended how the onus operates in connection with the 'tax benefit' criterion defined by ss 177C and 177CB.

66. Before s 177CB was introduced in 2013, in ***RCI** Pty Ltd v Federal Commissioner of Taxation* (2011) ATR 785 it was held that **(i)** the taxpayer bears the onus of establishing that a tax benefit is excessive (*RCI* [128], citing *Federal Commissioner of Taxation v **Trail Bros** Steel & Plastics Pty Ltd* (2010) 186 FCR 410 at [35]-[36], in turn citing *Commissioner of Taxation v **Dalco*** (1990) 168 CLR 614 at 620, 623 – 625); **(ii)** the tax benefit enquiry requires the Court to identify a single positive counterfactual to a scheme (*RCI*, [130], third sentence); **(iii)** in assessing a counterfactual it is permissible to have regard to its tax costs (*RCI* [145]-[150]); **(iv)** for the Commissioner to succeed on "tax benefit" it is not sufficient for him to show that the postulate he advances is reasonable (*RCI,* [131] first sentence); and **(v)** a taxpayer's burden is not discharged merely by showing that the Commissioner's counterfactual is unreasonable (*RCI*, [130], second sentence).

67. The introduction of s 177CB made clear (as a departure from point (ii) above) that there may be more than one postulate that is "***a*** reasonable alternative" to a scheme (see 2013 EM at [1.85]); and (as a departure from point (iv) above) that there is a tax benefit if the Commissioner's postulate is such ***a*** reasonable alternative. Further, (by way of departure from point (iii) above) s 177CB(4)(b) contains an express instruction to disregard tax results of a postulate (2013 EM, at [1.117]-[1.121]).

68. Points (i) and (v) above from *RCI* were not affected by the enactment of s 177CB and remain good law, as reflected by their endorsement in *Guardian* at [156]-[157]. In *Guardian*, it was observed that the taxpayer "*b[ears] the onus of satisfying the Court of what might reasonably be expected to have occurred in the absence of the scheme*" (at [157]). In *Guardian* the taxpayer was unsuccessful because it failed to satisfy the Court of a reasonable postulate: see at [170]. It needed to do so *in addition to* showing that the Commissioner's postulate was not reasonable.

69. Neither before nor after the introduction of s 177CB has it been possible for a taxpayer to discharge their onus by showing that there is no reasonable alternative to a scheme. The majority below erred in viewing the onus to operate in that way.

70. In this respect, the "tax benefit" described by s 177C(1)(bc) is:

> *the taxpayer not being liable to pay withholding tax on an amount where the taxpayer either would have, or 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…*

71. On a plain reading of the positive definition, the matter it describes is *negated* where a taxpayer (bearing the onus under s 14ZZO(b)(i) of the *Taxation Administration Act 1953* (Cth)) demonstrates that: (a) they might reasonably be expected to have undertaken a particular activity in lieu of the scheme; and (b) the activity might reasonably be expected to have resulted in a tax liability consistent with the tax liability under the scheme: see, also *Trail Bros* at [26]-[53].

72. The question as to tax liability posed by s 177C(1)(bc) has to be answered on the basis (hinging from the word "*if*") that the relevant scheme had not been entered into or carried out: *Trail Bros* at [26]. It cannot be answered by simply rejecting that premise as unreasonable: see, 2013 EM, at [1.86]-[1.87].

73. Part IVA proceeds on the basis that there will often be a variety of arrangements by which entities can achieve commercial objectives. If a taxpayer fails to establish a

postulate that is a reasonable alternative to the relevant scheme under s 177CB(3), and which has the same tax effect as the scheme as specified by s 177C, they will not discharge their onus on tax benefit, though may contend that the requisite purpose in s 177J(1)(b) is not met. In a case unlike this one where, on a proper analysis, the commercial substance of a scheme cannot be achieved other than through the specific transaction in fact entered into, so that there is no reasonable alternative to the scheme, it is likely that the taxpayer would have a very strong case on purpose.

74. PepsiCo/SVC abandoned the alternative postulate they ran at first instance (PJ [442]) on appeal. The Full Court thus erred in concluding that they had discharged the onus of proof, and in finding that there was no tax benefit.

Purpose

75. The primary judge and all members of the Full Court correctly found that the purpose requirement under the DPT provisions was satisfied (PJ [444]-[465]; FC [103]-[133], [218]). It follows that, in the alternative to the Commissioner's withholding tax case, the subject DPT assessments must necessarily be upheld.

Part VII: Orders sought

76. The orders sought in the notices of appeal correspond with the Commissioner's primary contention that the orders at first instance in relation to withholding tax should be reinstated and his alternative contention that, if they are not, the DPT Assessments should be confirmed (CAB, pp 289, 294, 299-300, 307-308, 315-316, 323-324).

Part VIII: Time required for presentation of oral argument

77. The appellant estimates that he will need approximately 3 hours and 30 minutes for oral submissions in chief and 30 minutes in reply.

Dated: 8 January 2025

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ANNEXURE TO APPELLANT'S SUBMISSIONS

No	Description	Version	Provisions	Reason for providing this version	Applicable date or dates (to what event(s), if any) does this version apply)
1.	*Income Tax Assessment Act 1936* (Cth)	As at 1 January 2023 (Compilation No 181)	ss 6, 128A, 128B, 128C Pt IVA	Version agreed with the Respondents in the Full Court of the Federal Court of Australia as relevant provisions are materially identical for the relevant income years	Not applicable
2.	*Income Tax Assessment Act 1997* (Cth)	As at 1 January 2023 (Compilation No 184)	s 6-5	As above	Not applicable
3.	*Taxation Administration Act 1953* (Cth)	As at 1 January 2023 (Compilation No 197)	s 14ZZO	As above	Not applicable