HIGH COURT OF AUSTRALIA

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Details of Filing

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Form 27E – Appellant's reply

Note: see rule 44.05.5.

IN THE HIGH COURT OF AUSTRALIA
MELBOURNE REGISTRY

BETWEEN: COMMISSIONER OF TAXATION
Appellant

and

PEPSICO, INC / STOKELY-VAN CAMP, INC
Respondents

APPELLANT'S REPLY

Part I: Certification

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

Part II: Argument

2. The Respondents' submission (**RS**) at [9] that PBS paid tax in Australia "*needs to be understood in context*" (PJ [456]). PBS reported profits of $290,000 over two years with respect to concentrate payments of approximately $240 million (PJ [7], [125]). Virtually no company tax was paid and no withholding tax was paid.

Ground 1: Part of the payments were for the use intellectual property

3. The Respondents do not seek to defend the reasoning which was dispositive of ground one below, namely that the "*central transaction*" was not an intellectual property licensing agreement but a distribution arrangement of which the licensing of intellectual property was only a "*necessary element*" (AS [30]; FC [36]).

4. The Respondents also accept that there is no inconsistency to be reconciled between *Davis* on the one hand and *Dick Smith* and *Lend Lease* on the other (RS [35]). Instead, the Respondents seek to marginalise the relevance of this Court's previous decisions and emphasise their "*strong dissents*" notwithstanding that those decisions

were relied upon by all of the judges below and the Respondents draw from them "*two matters of principle*" (RS [35]).

5. The first of those two matters is inconsistent with the express terms of the statutory definition and this Court's previous decisions. The Respondents contend that in working out what the payments were consideration for "*one should look to what was stipulated in the agreement*" being the "*price specified for the concentrate*" (RS [35]). However, the definition of "royalty" in s 6(1) includes amounts "*however described or computed*". This Court's previous decisions looked at what moved or passed under the agreement, not the labels used by the parties to describe the consideration (AS [17]-[22]).

6. The second of those two matters "*is that, if one looks at what was received by PBS as the vendor of the concentrate ... the answer is ... the whole of the payments*". However, this ignores that the payments enabled SAPL to use PepsiCo/SVC's intellectual property. If SAPL failed to pay, PepsiCo/SVC could terminate the EBAs with the consequence that SAPL would no longer be permitted to use their intellectual property (PepsiCo EBA, cll 24(a)(i), 27(a); SVC EBA, cll 18.2(a), 18.5(b)(ii)). For the same reason, it is wrong to characterise the consideration that passed under the EBAs as being limited to "*a promise to purchase concentrate at unit prices*" and "*a promise to enter into further transactions – being purchases of goods for a price*" only (RS [33]-[34]).

7. Contrary to RS [12], [36]-[38], the Commissioner does not 'remake' the parties' agreement to substitute an 'economic equivalent'. The Commissioner contends, consistent with the words of the statute (AS [27]) and the approach taken by all judges below (PJ [241]-[245]; FC [25]-[26], [154]-[161]), that how the parties describe or calculate the payment is not determinative of whether part of that payment was consideration for the use of intellectual property. Consistent with *IBM*, the question of whether an amount or part thereof was paid "*as consideration for*" the use of intellectual property is to be determined by reference to the <u>whole</u> of the terms of the agreement (see AS [28]).

8. The Respondents at RS [30]-[32], like the majority at FC [17]-[21], posit that the "*significant restriction and controls*" placed upon SAPL and the "*benefit*" to "*PepsiCo/SVC in having [SAPL] sustain and promote their goodwill in Australia*" may 'offset' the existence of a royalty altogether. The majority said at FC [19]

"*whether these benefits were ultimately in favour of PepsiCo/SVC or [SAPL] is unclear and likely in any event to be a close function of market dynamics*". However, all of the evidence indicates that the 'benefit' of PepsiCo/SVC having their goodwill 'sustained' did not outweigh the benefit of SAPL being able to exploit PepsiCo/SVC's intellectual property (cf FC [21]). In transactions where there was no concentrate payment in which to embed a royalty (e.g. water), PepsiCo charged a royalty (see FC [126]); PepsiCo was *never* prepared to licence intellectual property just for 'goodwill promotion'. The evidence of the expert preferred by the primary judge (PJ [400]) was that strong brands demand high royalties because the licensee can charge premium prices and increase sales volumes earlier with less capital investment and less volatility in profits (AFM, p 110). This contradicts the majority's speculation that PepsiCo licensed intellectual property just for goodwill expansion. In any event, "offsetting" benefits are a matter for valuation evidence.

9. The suggestion that (a) the consideration was "*non-monetary*" and only "*a promise to purchase concentrate at unit prices*", or that (b) PepsiCo/SVC received no royalty but 'augmented goodwill', were put forward to address the Commissioner's point that PepsiCo/SVC were otherwise giving away the use of their intellectual property. Once those suggestions are rejected (see [6] and [8] above), it is clear there is no answer to the point, and that supports the characterisation of the payments as including consideration for the use of intellectual property.

Ground 2: The payments were paid to and derived by PepsiCo/SVC

10. The Respondents mischaracterise and fail to engage with the Commissioner's submissions on ground two. The Commissioner does not contend, nor does it follow from his contentions, that "*when SAPL paid the invoices, it paid PBS those lesser amounts for the concentrate and, simultaneously, paid PBS amounts which were not due to it, but were due to PepsiCo or SVC*" (cf RS [10]-[11]).

11. It is common ground that for the payments to be income derived by PepsiCo/SVC there must be an entitlement to payment (RS [16]-[17]). An entitlement exists because: (a) PepsiCo/SVC, unlike PBS, was party to the EBAs; and (b) SAPL was obliged to make the payments to PepsiCo/SVC or as directed: AS [35]-[36].

12. Under the EBAs, the entity that supplied the concentrate was not necessarily the same as the entity entitled to payment (cf RS [20]-[26]). While SVC could sell or cause a Related Corporation or Company Affiliate to sell the concentrate to SAPL (cl 7.1(a)),

SVC could at any time specify the US bank account to which payment was to be made (cl 7.4(f)). Further, if SAPL failed to make payment by the due date, SVC could require immediate payment to it, a Related Corporation or a Company Affiliate (cl 7.4(g)). Clause 7.1(b) of the SVC EBA does not assist the Respondents because PBS could not enforce it as a non-party (RS [24]). Similarly, SAPL's obligation under the PepsiCo EBA is properly construed as one to pay PepsiCo or as PepsiCo otherwise directed. PepsiCo was the counterparty to the EBA, PepsiCo could request information about SAPL's financial condition (cl 16), PepsiCo was entitled to interest on late payments (cl 26(a)), and PepsiCo could terminate the agreement because of a failure to pay (cl 24(a)(i)).

13. The Respondents have mischaracterised the Commissioner's 'pleading point' (RS [27]-[28]). The Respondents' case as pleaded was that SAPL made payments to PBS to purchase the concentrate "*in performance of the EBA*" and "*pursuant to the terms of the EBA*" rather than under some unarticulated collateral contract between SAPL and PBS (AFM 126), as to which they now seek to have a bet each way (cf RS [26] and RS fn 21). Even if the *Sale of Goods Act 1923* (NSW) otherwise applied, s 51 has no application because of the retention of title clause and payment was dependent upon delivery (PepsiCo EBA, cl 4(c); cf RS [29]).

14. The Commissioner's contention that the payments were "*dealt with on behalf of [PepsiCo/SVC] or as [PepsiCo/SVC] direct*" (s 128A(2)) is premised upon the proper construction of the EBAs and the distinction between the entity supplying the concentrate and the entity entitled to payment (AS [35]-[39]). The Respondents dismiss the provisions relied on by the Commissioner as "*machinery clauses*" (RS [26]). The claim there was no constructive receipt is premised on an incorrect construction of the EBAs. The direction identified by the Commissioner was not just to *buy* it was to *pay*; it included bank account details (cf RS [38]).

Ground 3: Diverted profits tax and tax benefit

The Commissioner's alternative postulates are not unreasonable: RS [53]-[59]

15. The Respondents' submissions on the Commissioner's postulates proceed from an error in principle, and are at odds with the facts as found.

16. ***First,*** the Respondents assert that the Commissioner's postulates are not reasonable because they provide "*no commercial benefit*" for the parties to the EBAs relative to

the scheme (RS [53], [56], and see also RS [63]-[64], [75]). Yet neither s 177C nor s 177CB require a postulate to include a benefit that 'commends' it compared to the scheme. The enquiry is not whether there are reasons to have chosen a postulate *over* the scheme. It is an enquiry as to whether an alternative is a reasonable alternative taking into account the terms of s 177CB(4). More than one postulate may be reasonable (AS [67]).

17. ***Second,*** the Respondents repeatedly claim that those postulates "*represent a departure from the pricing model [of] the PepsiCo Group*" (RS [44], and see [51],[53], [55], [57], [59]). The premise of this contention – that the PepsiCo Group had a pricing "*model*" or "*structure*" of selling concentrate and licensing intellectual property royalty-free – was rejected by the primary judge.

18. His Honour observed that under PepsiCo's franchise bottling model (or "**FOBO**" model) the PepsiCo Group sells concentrate to a third-party bottler which produces finished beverages, and remains responsible for developing and innovating its global brands, from which the bottler benefits in local markets (PJ [158]-[159], [162] [165]-[167]). Within this FOBO model, there was "*considerable scope for variation in the terms of exclusive botting agreements entered into by the Pepsi Group*"; and his Honour was not satisfied that the pricing terms in EBAs followed a "*rigid*" or "*simple*" model (PJ [169]-[170], [177]-[182]), [209]-[211], [217], [439]). The Respondents do not identify any error in those findings, nor respond to AS [62], [64]. Instead, they selectively re-present material relied upon below that did not, viewed against the balance of the evidence, demonstrate the asserted "pricing model".

19. In this respect, Mr Williams' affidavit invoked a document known as the "*9 Franchise Fundamentals*" or "*9Fs*", said to record the "*fundamental principles*" of the FOBO model (PJ [171]). Yet in cross-examination he accepted that the "9Fs" was a series of business goals and strategies for the franchise business rather than a template for how an EBA was to be negotiated, and did not direct the contents of an EBA (PJ [172], [174]). The primary judge recorded Mr Williams' acceptance in cross-examination that it may have been overstating things to refer in his affidavit to a "*pricing model*" (PJ [210]). Ms Dent, Pepsi general counsel who had been involved in drafting bottling agreements, said that the FOBO model did **not** involve the use of any standard "*template*" EBA: PJ [207], and see also PJ [180]. Though the "general" FOBO / franchising model remained essentially unchanged since it was created in

the early 1900s, the EBAs in evidence reflected considerable variation, including in pricing terms (PJ [169], [217]; cf RS [44]).

20. Perram and Jackman JJ "*inferred*" (FC [125], [128]) that the FOBO 'model' or 'structure' involved "*charging for concentrate without a separate fee for the grant of any intellectual property rights*". However, that inference did not logically follow from the evidence described at FC [124]-[127] (or elsewhere). It is in conflict with the primary findings of fact to which the majority made no reference, and reduces to the improbable proposition that there was only one available rubric for negotiating an EBA.

21. ***Third***, and relatedly, the Respondents re-agitate their contention that the Commissioner's postulates would involve "*administrative complexity*" (RS [57], [59]), disregarding the findings below. Mr Williams' evidence was that the negotiation of EBAs was *already* a complex process (PJ [217], [438]-[439]; cf RS [54], [59]). Any difficulty arising from 'splitting up of payments' raised in the first three sentences of RS [57] is dealt with by the fact that the Commissioner's postulates do not require any division of payments between entities but rather payments by direction: cf FC [76] (which the Respondents recognise in the immediately following sentence). The further contention in RS [57] that the postulates require valuations for accounting/ tax compliance purposes "*for all parties to the EBAs and for PBS*" is wrong for the reasons given at AS [63] and in any event s 177CB(4)(b) requires tax results of a postulate to be disregarded. The suggestion at RS [55] that including a royalty within the EBAs would be effectively asking the bottler to "*pay twice*" for the same thing was completely undermined by the specific Australian contractual provisions with which Mr Williams was unfamiliar (see PJ [213]-[215]).

22. On the Commissioner's alternative postulates, SAPL would still bottle beverages consistently with the PepsiCo Group FOBO model, there would **still be** a bottling agreement between SAPL and each of the taxpayers, and the **same total amounts** would be paid by SAPL under those agreements as in fact occurred. The only thing that would differ is what the EBAs said expressly about those amounts. The Respondents' submissions do not identify error in the conclusion of the primary judge (PJ [430]-[441]) and of Colvin J (FC [215]) that a postulated EBA with a royalty was a reasonable expectation, but also have not endorsed the contrary approach of Perram and Jackman JJ (see FC [84]-[101], [213]-[217]).

Misconstruction of "tax benefit"

23. The Respondents in any event misapprehend the operation of s 177CB in asserting that *any* alternative postulate with a royalty is unreasonable because the Schemes are defined as the entry into EBAs on terms where no royalty is payable; and this a "taxable fact" which must be replicated in any postulate (RS [45], [51]). That analysis is inimical to the operation of Part IVA – by which (as RS [46] acknowledges) a "tax benefit" arises from a *difference* between the facts of a scheme (which happened) and the facts of a *postulate* (which did not happen but which are a *reasonable alternative* to what did): s 177CB(3). On the Respondents' approach, there would be no tax benefit in *Hart* (see AS [53]), as the postulate there would have included the scheme's allocation of interest to the deductible loan as a 'taxable fact'.

Discharging onus on "tax benefit"

24. The Respondents contend (RS [47]) that the effect of s 177CB(3) is that one "*cannot conclude*" that a taxpayer obtained a tax benefit if there is "*no reasonable alternative to the scheme*". This confuses the *content* or *criteria* of a 'tax benefit' with the forensic *onus* of demonstrating whether or not there is one. The word "*must*" in s 177CB(3) relates to the former enquiry, in stipulating that a decision that there is a relevant tax benefit (as defined in s 177C) must be based on a postulate that is a reasonable alternative to the entering into or carrying out of the scheme. Section 177CB(3) does not direct *how* a taxpayer, having the Part IVC onus, is to demonstrate that there is no such tax benefit.

25. *Peabody* (1994) 181 CLR 359 would be decided differently under s 177CB but in any case did not involve a taxpayer discharging their burden on tax benefit where "*no reasonable alternative postulate*" to a scheme had been identified: cf RS [49]. Mrs Peabody *was* able to demonstrate a (positive) alternative postulate under which the profits on the sale of the "Kleinschmidt shares" would *not* have been included in *her* assessable income. The Court found that, absent the relevant scheme (involving devaluation of those shares), it was reasonable to expect that a company, Loftway, would have purchased and sold the shares at a profit (and not the trustee of a trust of which Mrs Peabody was beneficiary, which could not finance the purchase as Loftway could) (at 384.8-385.2; and see argument in CLR at 370.6-371.5). In that event, there was no reasonable expectation that Loftway's profits from an on-sale of the shares in a listing (on which *it* may have been taxed) would have flowed as

dividends to the trustee and then to Mrs Peabody (385.9-386.5).

Notice of Contention: Purpose of the Schemes

26. No judge below has or would have found for the Respondents on purpose: PJ [465]; FC [133], [218]. The Respondents do not identify any error in the reasoning on the purpose requirement in s 177J(1)(b), re-agitating the same arguments rejected below.

27. Contrary to RS [62], [63], ***Minerva*** *Financial Group Pty Ltd v Federal Commissioner of Taxation* [2024] FCAFC 28 and the other decisions cited do not stand for the proposition that purpose will not be established where there is neutrality between the commercial advantages of a scheme and of an alternative postulate. Those cases reiterate that the mere fact that a taxpayer has obtained a tax benefit does not, without something more, support a positive conclusion on purpose: *Minerva* at [99]. That something more might be a (non-tax) commercial disadvantage arising under the scheme not present on the alternative postulate, but not necessarily; it could be an incongruence between the form and substance of the scheme, or a myriad of other matters arising from applying the eight factors.

The manner in which the scheme was entered into or carried out: s 177J(2)(a) / s 177D(2)(a)

28. The Respondents' submissions on "manner" depend on an assumption that the PepsiCo Group has an "*entrenched*" model (RS [69]) involving the sale of concentrate for a price and the royalty-free licensing of intellectual property (RS [67]-[69]). As identified above at [17]-[20], that assumption is unsupported.

29. In any event, the "manner" criterion is to be examined based on when *the scheme* was entered into or carried out, not for a prior period when PepsiCo initiated its franchise model: s 177D(2)(a); *Federal Commissioner of Taxation v* ***Guardian*** *AIT Pty Ltd* (2023) 115 ATR 316 at [182]; PJ [452], FC [119]-[121]; cf RS [67]-[69]. The Schemes involving the EBAs here were entered into in 2009 when Australian royalty withholding tax was in place. Further, and in any event, it cannot be inferred or assumed that historical bottling agreements relating to the international or USA domestic franchise market were concluded "*absent ... tax considerations*": cf RS [69]. The primary judge found "*it would not be safe to assume that tax considerations did not have a role to play*" (PJ [452]) and Perram and Jackman JJ similarly did not accept that the 2009 EBAs "*merely repeated a business structure which had existed since before the imposition of the royalty withholding tax*" (FC

[129]-[132]). The Respondents have never sought to establish how royalties were taxed under US laws, despite the differential tax treatment of royalties compared to other income having a long history in the United States, dating to at least 1918.[1]

The form and substance of the scheme: s 177J(2)(a) / s 177D(2)(b)

30. The *form* of the Scheme was that SAPL paid amounts as consideration for concentrate alone, and no part of that payment was consideration for the intellectual property rights provided to it by the Respondents. However, the *substance* of the Scheme was a commercial bargain under which SAPL was provided with the means to manufacture and sell PepsiCo Group branded beverages, and SAPL paid amounts of money to the PepsiCo Group. This weighs heavily in favour of the requisite purpose: PJ [453], [465]; FC [112], [133].

31. The Respondents would never sell concentrate to a bottler without also licensing the relevant intellectual property for the brand under which the finished beverage was sold: PJ [175], [247]. Without the concentrate, SAPL had no product to which it could apply the intellectual property. But equally, without the intellectual property, SAPL had the beverage base but not the formulae, specifications and trademark rights to convert it into a finished "Pepsi" branded beverage. To manufacture and sell "Pepsi", SAPL needed both tangible and intangible property from the PepsiCo Group and, the "substance" of the SAPL payments is that they were made pursuant to a contract which provided SAPL with valuable intellectual property.

32. Where there was no concentrate payment in which to embed a royalty, such as where the PepsiCo Group licensed its "Aquafina" water trade mark, a royalty was charged to "*generate revenue*" (FC 126]).[2]

33. The Commissioner's case on form and substance does not rest on any 'value judgment' that SAPL "*should* have" paid for the intellectual property that it licensed: cf RS [72]. Instead, it recognises that, irrespective of the form of the pricing clauses in the EBAs, the trademark licenses and other IP were indispensable to SAPL being able to manufacture and sell PepsiCo beverages.

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[1] M Graetz and M O'Hear, "The 'Original Intent' of US International Taxation" (1997) 46 *Duke Law Journal* 1021 at 1057-1059; R Vann, "The history of royalties in tax treaties 1921-61: Why?", *Comparative Perspectives on Revenue Law* (Cambridge University Press, 2009) at p.178.

[2] Mr Williams' cross-examination: T194.46-195.10, T199.39-199.42.

Change in financial position: s 177J(2)(a) / s 177D(2)(e), (f)

34. The only change in the financial position of the parties to the EBAs under the Commissioner's postulates compared to the Schemes is the Respondents' liability for withholding tax (and US tax): PJ [457]-[458]. The same tangible/intangible property is provided by the same entities under each. This supports the requisite purpose: *Guardian* at [210]-[212]; PJ [457]-[458]; FC [113]-[114]; cf RS [73]-[74].

Nature of any connection between the Respondents and others: s 177J(2)(a) / s 177D(2)(h)

35. Though the Respondents were independent of SAPL in a corporate sense (PJ [460]), they were not dealing at arm's length as to the allocation of the overall amount paid by SAPL under the EBAs. The commercial and economic effects for SAPL (leaving aside any withholding requirements) were the same irrespective of how the total amounts paid under the EBAs were allocated between tangible and intangible property; with SAPL (at least) indifferent to the mode of apportionment.

Foreign tax benefits achieved by the scheme: s 177J(2)(c)

36. The Respondents accepted before the primary judge that the scheme as compared to the Commissioner's postulates resulted in a substantial saving for them of US tax: PJ [463]. The primary judge and Full Court were correct to consider that, where there was (non-tax) economic neutrality between the Scheme and the postulates, this supported the requisite purpose: PJ [463]; FC [115].

Tax result / amount of the Australian and foreign tax benefit: s 177J(2)(d), 177D(2)(d)

37. The Respondents obtained a substantial US revenue benefit and also an Australian tax benefit that was significant, particularly when viewed against the "*small textual change*" (PJ [217]) yielding the postulates. The Australian tax benefit was a royalty approximately 6% of SAPL's net sales revenue (~$48 m) and stood to be obtained over the life of a multi-decade contract: PJ[464], FC [116]-[118]; cf RS [76]. PBS paid minimal tax in Australia given its concentrate margin of 0.05%: PJ [455]-[456]

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