



Australian Federal Court Judge's Arguments in Transfer Pricing and Royalty Tax Dispute Decision in PepsiCo Case

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ABSTRACT

This study analyses the main arguments presented by the Federal Court of Australia in the tax dispute over transfer pricing and royalty taxation in the PepsiCo case. Using a doctrinal research methodology, it examines the legal reasoning behind the Court's decision. The analysis incorporates statutory regulations, case law, and interpretative approaches. Data sources include primary legal materials, such as regulations and court rulings, alongside secondary literature. The research finds that the Court ruled that payments of concentrate do not include royalties, emphasizing the importance of clear contractual documentation. The implications suggest a need for multinational corporations to ensure transparency in their tax-related agreements to avoid disputes over transfer pricing and royalties.

INTRODUCTION

This study analyses the decision of an Australian Federal Court Judge in a tax dispute involving PepsiCo, highlighting the classification of payments received by the company from independent distributors and retailers as “royalties” for royalty withholding tax purposes. The decision also considers the application of the diverted profits tax rules, introduced in 2017, in the context of tax avoidance by multinational companies (Butler et al., 2024). The case's complexity lies in the determination of transfer pricing and the challenge of determining whether transactions between related entities were conducted at arm's length, a common issue in transfer pricing disputes (Butler et al., 2021, 2022; Richard, 2014).

The case is the first in Australia to address embedded royalties, which are not explicitly stated in the contract but are embedded in other payments, making tax assessment difficult (Butler et al., 2024). The study analyses companies and tax authorities' rhetorical strategies to justify their positions on transfer pricing (El Hamad et al., 2023). It also introduces a new perspective on moral and ethical considerations in transfer pricing, going beyond technical analysis to socio-economic impacts. Its uniqueness lies in the future of royalty taxation in Australia and proposes a reconceptualization of transfer pricing rules with an economic basis to improve the tax system (Wilson-Rogers & Pinto, 2015).

This decision reflects the challenges in applying transfer pricing rules, which require careful evaluation of transaction prices between related entities and the practical difficulties in demonstrating compliance with the arm's length principle (Butler et al., 2021, 2022). The decision also serves as a precedent in the tax treatment of royalties, which may influence the handling of similar cases in the future. This decision also aligns with Australia's efforts to align its tax rules with international standards, especially regarding the issues of Base Erosion and Profit Shifting (Burch, 2017; Wilson-Rogers & Pinto, 2015). Overall, this decision emphasizes the importance of transparency and compliance in transactions between multinational companies, which can worsen the scrutiny of international transactions and increase the potential for companies to fall into diverted profits tax provisions (Butler et al., 2024). This study will analyze the main arguments presented by the Australian Federal Court Judge in the transfer pricing and royalty tax dispute decision in the PepsiCo case.

LITERATURE REVIEW

Australia's tax dispute resolution system includes internal mechanisms through the Australian Taxation Office and external mechanisms such as the Administrative Appeals Tribunal, the Federal Court and the High Court. Although intended to ensure fairness, the high cost of litigation is often a barrier for taxpayers with limited financial capacity. The Federal Court sets tax precedents, while the High Court makes final decisions and interprets the conformity of tax laws with the Constitution (Fisher, 2015; French AC, 2024; Tran-Nam & Walpole, 2016). The complexity of tax law and differences in judicial philosophy often led to dissent in the High Court, indicating the difficulty of reaching a legal consensus. Institutional factors, such as the

purposive approach to interpreting anti-avoidance rules and issues of transfer pricing and tax residence, contribute to the increase in dispute rates. Compared with Canada and the United Kingdom, Australia faces challenges in adopting more efficient dispute-resolution mechanisms (Fisher, 2015) (Jones, 2018).

The Australian Federal Court has set important precedents, such as *Vanderstock v. State of Victoria*, which limited state tax powers and Plaintiff S157/2002 v Commonwealth, which affirmed the supremacy of law (Gouliaditis, 2010; Weis, 2024). Evaluation using the Dispute Systems Design principle reveals the need for improvements in efficiency and accessibility, especially regarding litigation costs (Jones, 2018). Although the system has evolved, challenges such as high costs, complex legislation, and judicial dissent require continued adaptation to improve the effectiveness and fairness of tax dispute resolution.

Various factors, including legal norms, gender dynamics, ideology and emotional factors, influence Australian court judges' reasoning. Although Supreme Court judges tend to maintain an impersonal stance when arguing, they sometimes exhibit deviations that reflect the balance between formal rules and individual behaviour (Tutton et al., 2018). Judges also often favour their chosen side, reflecting the influence of ideology, gender and personal experience on their decisions (Jacobi et al., 2023). In judicial reasoning, the Supreme Court has developed a "directed discretion" approach to property rights over human biological material, in contrast to traditional decisions such as *Doodeward v Spence*, and has provided a normative framework for decisions in this area (Falconer, 2019). While the doctrine of separating judicial powers in the Australian Constitution aims to protect human rights, anti-terrorism legislation governing preventive detention may conflict with that doctrine, raising constitutional concerns (Chetty, 2016). Case-based constitutional dispute resolution also has methodological weaknesses (Florczak-Wątor, 2022).

Judges in Australian Courts use a variety of approaches to support their legal decisions, including strict legalism, which emphasizes adherence to the rule of law and precedent, as popularised by Sir Owen Dixon. While this approach is important, it is now considered rigid because it fails to consider social and commercial implications, as seen in the case of *Wilson v Darling Island Stevedoring* (Gava, 2010). In addition, case-based reasoning is used to maintain consistency and predictability of decisions, especially in constitutional disputes (Florczak-Wątor, 2022). Teleological reasoning, which considers the personal values of judges, can also influence legal interpretation, resulting in different understandings of the same rule (Wyner & Zurek, 2023).

The debate between theoretical 'top-down' reasoning and case-based 'bottom-up' reasoning reflects the difference in approach, with 'bottom-up' being preferred in civil law (Conte, 2015). In addition, judges often engage in image management to maintain social legitimacy, particularly in complex or ambiguous cases (Venzke, 2016). Despite differences with the United States Supreme Court, patterns of behaviour such as advocacy and strategic reasoning are found in both courts (Jacobi et al., 2023). Australian judges combine strict

legalism, case-based reasoning, teleological reasoning and strategic advocacy to make decisions that consider legal principles and social, commercial and personal factors.

Disputes related to transfer pricing and royalty taxes are major issues in the global economy, especially in pricing transactions between multinational corporate entities and allocating intellectual property income, such as patents and trademarks. These issues are further complicated by globalization and differences in tax systems between jurisdictions (Kardachaki, 2022) (Butani, 2014). One of the challenges is the mismatch of transfer pricing methods, often due to the incorrect application of the arm's length principle, which requires transactions between related entities to be treated as if they were carried out by independent parties (Borkowski & Gaffney, 2014; Martins et al., 2020).

Multinational Enterprises' strategies, such as shifting intellectual property to low-tax jurisdictions and using high royalties, exacerbate these disputes, as seen in the cases of Apple and (Graham & Silke, 2024; Yang & Metallo, 2018). The Organization for Economic Cooperation and Development (OECD) guidelines and the Base Erosion and Profit Shifting initiative provide a framework for addressing this issue, although legal and practical challenges remain (Das, 2022; Eduardo & Ian, 2014). Dispute resolution mechanisms, such as arbitration and litigation, often produce varying results depending on the quality of the tax authority's arguments (Martins et al., 2020). In addition, Advance Pricing Agreements can provide certainty in the transfer pricing methodology (Kamilah, 2019; J. Li et al., 2020). However, international tax avoidance through high royalties remains a major problem, especially among large technology companies (Graham & Silke, 2024).

Legal issues often arise related to the mismatch in the interpretation of bilateral tax treaties and differences in the application of audit standards and regulations between countries, as seen in Portugal and Singapore (Burch, 2017; Phua, 2014). Differences in the valuation of intangible assets, such as patents and trademarks, cause disputes, especially in the digital economy (Juraneck et al., 2018; Tambunan, 2020). On the administrative side, multinational companies face challenges from complex documentation requirements, which are increasingly tightened by tax authorities in various countries (Bärsch et al., 2019; Solilova, 2013). Therefore, MNES must comply with international guidelines and close legal loopholes facilitating profit shifting (OECD, 2013).

Case studies of large companies such as Apple, Google, and US pharmaceutical companies illustrate how transfer pricing and royalty strategies can reduce the taxes paid by Multinational Enterprises, affecting the tax revenues of the countries where they operate (Stewart, 2018). Transfer pricing manipulation can lead to tax base erosion, resulting in significant revenue losses, especially in high-tax countries (Melnychenko et al., 2017; Solilová et al., 2021). To this end, countries must implement a balanced policy between attracting foreign direct investment and maintaining fairness in the tax system by following international guidelines such as those suggested by the Organisation for Economic Cooperation and Development (Choi et al., 2020; Solilová & Sobotková, 2010). By implementing appropriate strategies, such as

the arm's length principle, MNEs can reduce royalty tax disputes and ensure compliance with transfer pricing regulations (N. Li & Chen, 2010; Matsubara & Garcia, 2023). Legal issues in transfer pricing include differences in the interpretation of tax treaties, valuation of intangible assets, and regulations between countries, which can lead to disputes and erosion of the tax base, so multinational companies need to comply with international guidelines such as the arm's length principle to reduce disputes and ensure tax compliance.

METHODOLOGY

This study is a doctrinal study that analyzes the legal arguments of the Australian Federal Court Judge in the transfer pricing and royalty tax dispute decision in the PepsiCo case. The approaches used are legislation, concepts, cases and interpretative. The data analyzed are secondary in the form of primary legal sources in the form of legislation and Australian Federal Court Decisions, as well as secondary legal sources in the form of related literature studies and then analyzed and interpreted (Irwansyah, 2020).

RESULT AND DISCUSSION

The subject matter of the Federal Court of Australia Decision 86 of 2024 in *PepsiCo, Inc v Commissioner of Taxation* relates to the tax liabilities of PepsiCo, Inc. and Stokely-Van Camp, Inc. (PepsiCo/SVC) in respect of royalties or diverted profits tax, under the provisions of the Income Tax Assessment Act 1936. The primary question is whether they are liable to pay withholding tax on royalties under Section 128B(2B), or if not, whether they are liable to pay diverted profits tax under Section 177J of Part IVA of the Income Tax Assessment Act 1936, which was first introduced following amendments by the Combating Multinational Tax Avoidance Act 2017. In the relevant financial year, Schweppes Australia Pty Ltd acted as the sole distributor and Bottler of Pepsi, Mountain Dew and Gatorade products in Australia, purchasing concentrate from PepsiCo Bottling Singapore Pty Ltd ('the Seller') for approximately \$240 million. The payments made by Schweppes include shipping, insurance and customs duties for which the Bottler is responsible and are based on two Exclusive Bottling Agreements with PepsiCo and SVC, which do not include any obligation to pay royalties for the use of trademarks or other intellectual property rights.

Commissioner of Taxation, The Tax Court, held that the payments made by Schweppes contained a royalty component and should be subject to royalty withholding tax or that the agreement was designed to avoid tax and therefore diverted profits tax under Section 177J of the Income Tax Assessment Act 1936 should apply. However, the first instance court held that the payments by Schweppes were for concentrate only and did not include royalties or the use of intellectual property rights, so the Commissioner of Taxation's claim to impose royalty withholding tax under Section 128B(2B) failed. The Court held that the payments could not be regarded as income received by PepsiCo/SVC and did not meet the criteria for royalty withholding tax.

Schweppes Australia Pty Ltd (Bottler)'s payment to PepsiCo Bottling Singapore Pty Ltd (Seller) was only for concentrate and did not include any

royalties for the use of the trademark, and so did not meet the definition of royalty in s 6(1) of the Income Tax Assessment Act 1936. Although the contract gave the Bottler the right to use the trademark, that right was in relation to an exclusive distribution agreement and not a separate license requiring a royalty. The Commissioner of Taxation argued that the payment included a royalty, but this was rejected because the use of the trademark was part of the distribution agreement and not a separate transaction. Therefore, the payment was not subject to royalty withholding tax under s 128B(2B).

The trial judge found that royalty tax was due because the Exclusive Bottling Agreement provided royalty payments for using the trademark and other intellectual property. However, the Commissioner of Taxation claimed that PepsiCo/SVC engaged in a scheme that provided for the sale of concentrate without charging royalties for using intellectual property. The judge found that this scheme was not evident because the concentrate payments included payment for both concentrate and the right to use the intellectual property, so the judge dismissed the Commissioner of Taxation's alternative claim. However, the Court held that the judge's conclusion was erroneous because the payments did not include a royalty component, and therefore, Part IVA should have applied. The judge also provided an alternative reason that if the payments did not include royalties, then Part IVA should have applied, but this reasoning did not affect the final decision to dismiss the Part IVA case. The Court, therefore, needed to determine whether Part IVA applied to the scheme proposed by the Commissioner of Taxation. In dealing with this case, the Court noted that the judge's findings on royalties were heavily influenced by the valuation evidence of Mr. Malackowski (for the Commissioner of Taxation) and Ms. Wright (for PepsiCo), both of which assumed concentrate prices included royalties, despite the lack of evidence to support that assumption, which requires a more in-depth analysis of the economics of the Exclusive Bottling Agreement and the concentrate price relationship.

The Commissioner of Taxation claimed that PepsiCo was involved in a scheme involving an exclusive agreement with SAPL for the use of intellectual property without paying royalties. However, this claim was not supported by evidence to show that the price of concentrate included royalties at the value given by the valuation, as the scheme was independent of the price of concentrate. A thorough examination of the prices stipulated in the exclusive bottling agreement would be required to analyze this. The main legal issue in dispute was whether PepsiCo derived tax benefits from the scheme, particularly about tax avoidance under Section 177J of the Income Tax Assessment Act 1936, which could lead to diverted profits tax if the scheme were proven. The tribunal examined whether PepsiCo avoided royalty tax that it would otherwise have paid and whether this met the definition of a "tax benefit" in the broader context of tax avoidance. While the concept of a "tax benefit" can be confusing, the key principle is that if the scheme resulted in PepsiCo not paying royalty tax that it would otherwise have paid, then this could be considered a diversion of profits taxable under *the Diverted Profits Tax Act 2017* at a rate of 40%.

The substance of the scheme in s 177CB(4)(a)(i) cannot be understood directly from the language of the section, as the word "substance" can refer to either legal substance or commercial and economic substance, which is ambiguous, by s 15AB(1)(b)(i) of the Interpretation of Regulations Act 1901 (Commonwealth), additional material, such as the explanatory memorandum submitted by the Minister when the Act came into force, can be used to interpret this term. The explanatory memorandum confirms that references to the substance of the scheme must take into account the commercial and economic substance, regardless of the legal form of the scheme itself. Therefore, the scheme's substance must be evaluated from a commercial and economic perspective, as was done in cases such as *Commissioner of Taxation v Sleight* and *Commissioner of Taxation v Hart*. Section 177 CB (4), which was inserted into the Income Tax Assessment Act 1936 through the Taxation Amendment Act 2013, does not provide clear guidance on the application of the substance of a scheme once it has been identified, but the explanatory memorandum states that a reasonable alternative must be consistent with the substance of the scheme. In this regard, the Court must assess the commercial and economic substance of the scheme and its postulates and determine the appropriateness of both.

PepsiCo argued that the scheme's commercial and economic substance was the Bottler's payments for concentrate, which covered only the price of the concentrate itself. The Commissioner argued that the payments included royalties for the use of trademarks and other intellectual property rights, but the evidence did not support this claim, and there was no element in the scheme to suggest that the price of concentrate included such royalties. A thorough economic analysis of the EBA agreement, including the costs of production and other benefits to PepsiCo, would be required to establish the existence of royalties in the price of concentrate. The first postulate assumes that the payments by the Bottler covered all the property and promises of the PepsiCo entities, including the license to use the trademarks, but this is inconsistent with the substance of the scheme, which only covered payments for concentrate. The second postulate, which states that the payments by the Bottler included royalties, is also inconsistent with the substance of the scheme.

The distinction between the outcomes and consequences of a scheme needs to be considered, although the common understanding is that both include the financial and non-financial outcomes arising from the scheme, except those relating to tax. Although the substance of the scheme and the first and second postulates are not entirely consistent, the outcomes and consequences for PepsiCo are similar, so the postulates can be considered reasonable alternatives. However, in assessing whether the postulates are reasonable alternatives, it is important to consider that they must represent a rational alternative, not simply a presumption of the absence of a scheme. This process must be sufficiently credible to be considered reasonable, as explained in the Peabody decision of the Supreme Court of Australia. Although there may be elements to suggest that the payment for the concentrate included the royalty, it cannot be concluded that the price of the concentrate included the royalty. Therefore, neither postulate can be considered a reasonable alternative

to the scheme, and PepsiCo has successfully demonstrated that there is no reasonable alternative on the evidence. Accordingly, there is no reason to charge income tax on the payments received from the Bottler for the concentrate, and PepsiCo does not derive any tax benefit from the scheme.

Section 177J (1) (b) of the Tax Act provides that a scheme that results in a tax benefit may be deemed to have a primary purpose to obtain a tax benefit or reduce a tax liability under foreign law. The Court considered this primary purpose to be a dominant purpose that may involve more than one purpose, with an objective assessment without considering the subjective motives of the parties. In determining whether a scheme is intended to obtain a tax benefit, the Court considers several factors, including its impact on the taxpayer's financial position and the results of applying foreign tax law. In this case, the Court supported the Commissioner of Taxation's position by considering a comparison of the form and substance of the scheme, showing that the concentrate price included a royalty, which affected the tax liability and its effect in allowing PepsiCo to reduce its effective tax rate under United States tax law. Despite the uncertainty regarding the royalty amount, the Court concluded that the scheme provided a significant tax benefit. However, the Court also noted several neutral factors, such as how the scheme was conducted and its impact on the operation of applicable law. The Court discussed PepsiCo's Exclusive Bottling Agreement, which, although it used a particular pricing model, did not have sufficient evidence to ignore the possibility of tax factors in its decision-making. Based on these considerations and assuming that the concentrate price includes royalties, the Court concluded that the objectives referred to in Article 177J (1) (b) (i) had been met.

Based on these considerations and assuming that the price of the concentrate is inclusive of royalties, the Exclusive Bottling Agreement concludes that the objective referred to in Article 177J (1) (b) (i) has been achieved. Although we agree with Judge Colvin J's observations on the substance of *the Exclusive Bottling Agreements*, the reference to the Exclusive Bottling Agreement as something that was "fabricated" does not serve the objective purpose of Article 177J (1) (b) (i). We also agree with Judge Colvin J's conclusion that if the Commissioner of Taxation's postulate is shown to be a reasonable alternative to the existing scheme, Article 177J (1) (b) (i) will apply. However, because there is no reasonable postulate as an alternative, the Commissioner of Taxation's appeal in Part IVA fails. Accordingly, PepsiCo/SVC's appeal in the royalty withholding tax case is allowed, the first judge's order is dismissed, and the notice of determination of royalty withholding tax must be quashed. The Commissioner of Taxation's appeal in Part IVA is dismissed.

In the judgment, Judge Colvin J held that the case concerned an agreement between a well-known beverage brand's intellectual property rights holder and a purchaser who agreed to produce and sell the beverage. The main issue was whether the payment made by the purchaser included a royalty for the use of the brand or was merely part of the scheme of the agreement. In the *Exclusive Bottling Agreement* between PepsiCo/SVC and the Bottler, there were

two key issues: first, whether the price of the concentrate included a royalty that would require the payment of withholding tax on royalties; second, if there was no withholding tax, whether the agreement gave rise to a profit tax liability. In tax terms, the issue was whether the concentrate price included a royalty and whether the payment to the concentrate supplier was considered income to PepsiCo and SVC, even though they did not receive it directly. The agreement allowed the Bottler to produce and distribute the branded beverage at the agreed concentrate price, while the use of the PepsiCo brand was granted without any financial consideration other than the price of the concentrate. Given the high value of the PepsiCo brand, they likely would license the brand with compensation. PepsiCo's supply of concentrate to the Bottler in Australia is made under the terms of the agreement, without any direct payment to PepsiCo or SVC, although they grant the right to use the brand, while the profits from the sale of concentrate are earned by the entity producing the concentrate.

The first instance court held that part of the payment for the concentrate was subject to royalty withholding tax, but if that decision was wrong, the appeal against diverted profits tax was not admissible. PepsiCo and SVC's appeals against withholding tax were successful, while the Commissioner of Taxation's appeal against diverted profits tax was dismissed. As a result, the first instance court's order was quashed, and the final decision favored PepsiCo and SVC. The case focused on whether the Bottler's payment was partly compensation for using intellectual property rights. Under *the Income Tax Assessment Act 1936*, section 128B provides for withholding tax on income in the form of royalties, which includes payments as compensation for the use of intellectual property rights such as formulas, processes or trademarks, and applies to the income of non-residents including royalties paid to them.

PepsiCo and SVC, non-resident US entities, faced an issue regarding the taxation of royalties. Under *the Income Tax Assessment Act of 1936*, the definition of royalties does not depend on how the amount is described or calculated, but rather on whether the amount is paid as compensation for the use of the relevant intellectual property rights. While the manner of payment may be relevant, it does not determine whether the payment is a royalty. The same concept applies in international tax treaties, where the country of origin may tax royalties. For example, even though a payment by a lessee is called "rent," if it includes the right to use the business name of the property owner, it may also be considered a royalty, even though there is no separate component explicitly identifying the right to use the name. In resolving this issue, contractual principles were used to assess whether the payment by Bottler was by the terms of the agreement. Although the term "rent" in the agreement may indicate that the payment is only for the rental of the premises, an analysis based on the business context and other evidence is required to determine whether intellectual property rights are included in the consideration of the payment. Therefore, even if the payment in the agreement is described in specific terms, the decision as to whether it is a royalty must be based on a thorough analysis of the facts, evidence, and value of the intellectual property rights involved.

In this case, Judge Colvin J held that evidence showing that the payment exceeded the market rental value of the property could be relevant, even though there was no suggestion that the parties were aware of the market rental value when agreeing. Evidence showing that the rent was determined based on the significant value of using the business name or the market value of the goodwill involved could also be considered. There needed to be more clarity as to whether the legal terminology should focus solely on the construction of the agreement and the amount paid under the agreement. The Commissioner of Taxation submitted more extensive written evidence, but in oral submissions, they argued that the issue of royalties should be determined on the construction of the *Exclusive Bottling Agreement*. In contrast, PepsiCo argued that whether the payment was considered for the use of intellectual property rights should be determined by the construction of the agreement and how it was executed, particularly concerning the supply of concentrate.

As there was no argument as to whether evidence outside the *Exclusive Bottling Agreement* could be considered, Judge Colvin J did not decide whether it was possible to determine whether the price paid by the Bottler was consideration for something other than concentrate, such as a license to use PepsiCo's trademarks. Judge Colvin J and both parties agreed to restrict the evidence to the terms of the agreement, focusing on the contractual construction, given that the agreement was implemented through the supply of concentrate by a Related Entity, not by PepsiCo or SVC. As explained in the joint reasons, there is an authority on the appropriate approach to identifying consideration in an agreement, one of which is the case of *International Business Machines Corporation v Commissioner of Taxation* [2011] FCA 335, which emphasized the importance of the appropriate construction of the term "royalty" in an international software license agreement. The application of a similar approach in this case suggests that the *Exclusive Bottling Agreement* should not be seen simply as an agreement for the supply of concentrate but as an agreement appointing the Bottler to bottle, sell and distribute branded drinks, with a mechanism that allows PepsiCo to appoint a Related Entity as the seller. Therefore, the question arises whether how PepsiCo executed this agreement (through a Related Entity) affects the conclusion of whether the amount paid constitutes consideration for the use of the trademark.

The approach outlined by Bennett J emphasizes the importance of understanding the nature of the commercial transaction as reflected in the agreement in determining what constitutes an amount paid "in consideration". Although some of the authorities referred to in this case focus more on stamp duty, they provide insight into how an analysis of the character of the transaction can help identify "consideration" and whether the amount paid reflects the full value of the goods or rights acquired. For example, in *Archibald Howie Pty Ltd v Commissioner of Stamp Duties* (1948), the Court explained that "consideration" includes the value motivating the transaction, not just the money paid. A similar approach is applied in cases such as *Davis* and *Dick Smith*, which assess the transaction by its legal character, not just the nominal price. This analysis demonstrates the importance of understanding the

commercial character of the transaction in an agreement, particularly where it involves some additional dimension or provision that affects the nature of the consideration received.

The issue, in this case, relates to understanding the monetary consideration in *the Exclusive Bottling Agreement*. While the agreed price per unit of concentrate is not in question, the issue is whether the payment is only for the concentrate or includes a license to use the PepsiCo trademark. The resolution of this issue depends on the construction of the agreement, which involves payment to a related entity as the seller. Based on previous cases, such as *Lend Lease*, the monetary consideration in a transaction is not limited to the amount stated in the agreement but also includes the entire transaction agreed upon. In this context, although the price is paid for the concentrate, the agreement also includes a license to bottle, distribute and sell PepsiCo-branded products. Because the PepsiCo brand is so valuable, the agreement cannot be viewed as a transaction for the concentrate supply without compensation for the license to use the trademark. Furthermore, although the related entity is acting as the seller, this does not change the commercial nature of the agreement, which still includes a license to use the PepsiCo brand. Thus, although the payment is made to the related entity, part of the payment must be understood as consideration for the license to use the PepsiCo brand.

In *Freedom Foods Pty Ltd v Blue Diamond Growers* [2021], the Supreme Court held that even though the payment was only for the almond base, the price could include remuneration for the brand's value, given the marketing expenditure made by Blue Diamond. This suggests that the payment is not necessarily just for the product but can also include the right to use the brand. In the *Exclusive Bottling Agreement* with SVC, although the license to use the brand was granted without a royalty, part of the payment could still be considered royalty for the use of the brand; as to the income received by PepsiCo or SVC, the appeal court held that they received the payment. However, Judge Colvin J held that if the related entity acted as a seller, the payment was not direct income to PepsiCo or SVC. In the appeal for diverted profits tax, there was a dispute about whether the payment was a royalty for the use of the brand. If it were a royalty, there would be no withholding tax liability. Judge Colvin J rejected PepsiCo and SVC's argument that the payment did not need to be a royalty, as the payment in the agreement included a royalty. The Commission also argued that without *the Exclusive Bottling Agreement*, the payment by the Bottler would have involved a royalty. Based on these considerations, Judge Colvin J upheld *the Commissioner of Taxation's appeal*.

In the Australian Federal Court decision in the PepsiCo case, two main aspects were examined: whether the payments by Schweppes Australia included royalties and whether the scheme was subject to Diverted Profits Tax under s 177J. First, the Court considered whether the payments to PepsiCo Bottling Singapore Pty Ltd included royalties. The Court found that the payments were for concentrate only and did not include royalties for using the trademark. Although the Commissioner of Taxation argued that these payments included royalties, the Court rejected the claim as there was no

evidence to suggest that the concentrate price included royalties. This highlights the importance of documentary evidence and commercial substance in tax law analysis, which are key to avoiding potential tax abuse or avoidance, as highlighted by Martins et al. (2020) and Borkowski & Gaffney (2014).

Secondly, the Court considered whether the payment scheme for concentrate was subject to Diverted Profits Tax under Section 177J of the Income Tax Assessment Act 1936. While there was uncertainty about whether the payments included royalties, the Court found insufficient evidence to support a claim that the payments were intended to evade tax. Tutton et al. (2018) and Jacobi et al. (2023) show that ideological factors and case-based approaches in Australian justice often influence judges' assessments of "tax benefit". However, in this case, the Court found insufficient evidence to suggest that the primary purpose of the scheme was to avoid tax.

Judge Colvin J held that although the payments were made to related entities, part of the payments should be understood as royalties for licensing the PepsiCo brand, which affects the tax liability imposed. Judge Colvin's judgment demonstrates the application of the teleological principle, which considers the brand's commercial value in decision-making. This is consistent with the findings of Tutton et al. (2018), which show that social and ideological factors often influence judges' decisions despite their attempts to maintain objectivity. In addition, *the arm's length principle* is the reference in transfer pricing, as explained by Kardachaki (2022) and Martins et al. (2020), which complicates determining whether such payments should be considered royalties.

In the PepsiCo case the Federal Court of Australia decided, the judge examined two key issues relating to transfer pricing and royalty tax. First, the Court considered whether the payment for concentrate made by Schweppes Australia included a royalty for the use of the PepsiCo brand. The Court found that the payment was for concentrate only and did not include a royalty, despite claims by the Commissioner of Taxation to the contrary. This decision emphasized the importance of documentary evidence and commercial substance in determining tax liability. The judge emphasized that a payment cannot be regarded as a royalty if there is no clear evidence of compensation for using the trademark. In this case, the substance of the transaction and the evidence are more important than the terms of the agreement.

Secondly, the Court considered whether the payments for the concentrate were subject to Diverted Profits Tax under Section 177J of the Income Tax Assessment Act 1936. While there was some uncertainty about whether the payments included royalties, the Court found insufficient evidence to support the claim that the payments were intended to evade tax. This decision indicates that the courts were more concerned with the economic substance of the transaction rather than simply focusing on the formalities of the agreement. In his teleological approach, Judge Colvin J held that even though the payments were made to a related entity as the seller, part of the payments should still be treated as royalties for the license to use the PepsiCo brand. Thus, a more in-depth analysis of the agreement and the evidence is

essential in determining whether the payments meet the criteria for royalties under the *arm's length principle* and international tax law.

CONCLUSIONS AND RECOMMENDATIONS

In *PepsiCo, Inc. v. Commissioner of Taxation* (Federal Court of Australia Decision No. 86 of 2024), the Court held that payments received by PepsiCo, Inc. and Stokely-Van Camp, Inc., from their sole distributor, Schweppes Australia Pty Ltd, were not subject to royalty withholding tax under Section 128B(2B) of the *Income Tax Assessment Act 1936*. Instead, the payments were subject to diverted profits tax under Section 177J Part IVA of the *ITAA 1936* as amended by the *Combating Multinational Tax Avoidance Act 2017*. Therefore, multinational companies should ensure that the agreements and payments made between related entities are clearly described in their documentation to avoid future tax disputes. Transparency in payment structures and a good understanding of applicable tax provisions are essential to ensure compliance with international tax regulations and avoid potential tax avoidance.

FURTHER RESEARCH

The limitation of the research on the analyzed court decision is only one, and the data is secondary. Therefore, further research is needed by increasing the number of court decisions with the same dispute, comparing them with other countries, and adding primary data through interviews with competent parties and experts.

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