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INTERNATIONAL TAX
CASE SUMMARY

AUSTRALIA vs PEPSICO

NOVEMBER 2023

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First Edition Published on 29 November 2024

Published by Academy Of Tax Law

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HEAD OF ACADEMICS

Welcome to the Academy of Tax Law's case and judgment summaries. These documents have been carefully curated to support professionals, students, and researchers navigating the complex landscape of international tax and transfer pricing. At the Academy, we understand that tax law is ever-evolving, with key rulings continuously shaping its practice.

Each summary you'll find here is designed to provide not just the facts, but the context and implications of pivotal legal decisions. These case summaries are created to serve as a valuable resource for legal teams, multinationals, revenue authorities, and academics, offering insights that go beyond the surface. Our goal is to ensure you remain informed and prepared, whether you are dealing with tax planning, dispute resolution, or risk management.

We believe that knowledge is the foundation of sound decision-making, and with these resources, we hope to empower you in your professional journey. As you delve into the analysis, remember that staying ahead in tax law requires not just understanding the rules but how to apply them in a dynamic, global environment.

Thank you for choosing the Academy of Tax Law as your partner in this ongoing learning experience.

Sincerely,
Dr. Daniel N Erasmus

PART 1

SUMMARY

JUDGEMENT SUMMARY

CASE OVERVIEW

Court: Federal Court of Australia

Case No: VID 53 of 2022; VID 55 of 2022; VID 56 of 2022; VID 57 of 2022; VID 74 of 2022; VID 82 of 2022

Applicant: PepsiCo, Inc and Stokely-Van Camp, Inc (SVC)

Defendant: Commissioner of Taxation

Judgment Date: 30 November 2023

Full Judgment: CLICK FOR FULL JUDGMENT

View Online: CLICK TO VIEW SUMMARY ONLINE

JUDGMENT SUMMARY

This case, decided by the Federal Court of Australia on 30 November 2023, addressed key taxation issues involving royalty withholding tax and diverted profits tax in the context of multinational enterprises (MNEs). PepsiCo, Inc and SVC, both US-based entities, entered into exclusive bottling agreements (EBAs) with Schweppes Australia Pty Ltd (SAPL), an Australian company. These agreements granted SAPL the right to manufacture, sell, and distribute beverages using PepsiCo's trademarks and intellectual property, without explicitly stipulating royalty payments for intellectual property usage.

The Commissioner of Taxation argued that payments made by SAPL under these agreements constituted royalties and were therefore subject to royalty withholding tax under section 128B of the Income Tax Assessment Act 1936 and the US-Australia Double Tax Agreement. Alternatively, if the withholding tax did not apply, the Commissioner sought to levy diverted profits tax, asserting that the agreements aimed to secure tax benefits.

The Court ruled that a portion of the payments did constitute royalties and were subject to withholding tax at a rate of 5%. The judgment also highlighted the CUP (Comparable Uncontrolled Price) method in determining the royalty rate, ultimately applying a revised rate of 5.88% of SAPL's net revenue. The Commissioner's alternative contention regarding diverted profits tax was deemed unnecessary due to the application of royalty withholding tax.

This judgment underscores the complexity of taxing intellectual property within MNE structures, the role of implied licenses in agreements, and the growing importance of expert evidence in determining transfer pricing disputes.

KEY POINTS

OF THE JUDGMENT

BACKGROUND

PepsiCo and SVC operate globally, managing a portfolio of trademarks, designs, and intellectual property (IP) related to popular beverage brands such as Pepsi, Mountain Dew, and Gatorade. These companies entered into Restated and Amended EBAs in 2009 with SAPL, allowing SAPL exclusive rights to manufacture, bottle, and distribute PepsiCo beverages in Australia.

Under the agreements, SAPL purchased beverage concentrates from a PepsiCo Group subsidiary. Payments made by SAPL were based on the concentrate's price but did not explicitly include royalties for the use of PepsiCo's trademarks or other IP. However, the agreements implied such rights were granted, as they were essential for SAPL to operate.

The Commissioner issued royalty withholding tax notices, claiming these payments included royalties for IP use. PepsiCo contested this, asserting that payments were solely for concentrate. The alternative claim from the Commissioner was based on diverted profits tax provisions, alleging that the agreements were structured to secure tax advantages.

KEY POINTS
OF THE JUDGMENT

CORE DISPUTE

The primary question was whether payments made by SAPL under the EBAs constituted royalties for IP use, as defined under section 6(1) of the Income Tax Assessment Act 1936 and Article 12 of the US-Australia Double Tax Agreement. Specifically:

- Did SAPL's payments qualify as "consideration for the use of" PepsiCo's trademarks and IP?
- Were these royalties subject to withholding tax at 5%?

If the payments were not deemed royalties, the secondary issue was whether the diverted profits tax applied. The Commissioner alleged that PepsiCo structured the EBAs to avoid royalty payments and minimize global tax liabilities, triggering provisions under Part IVA of the Act.

KEY POINTS
OF THE JUDGMENT

COURT FINDINGS

The Court concluded that a portion of payments made by SAPL under the EBAs constituted royalties:

1. **Implied License:** The EBAs implicitly granted SAPL rights to use PepsiCo's IP. Without such rights, SAPL could not fulfill its obligations.
2. **Royalty Definition:** Payments qualified as royalties under the ITAA 1936 and the US DTA because they represented consideration for IP use.
3. **CUP Method:** Expert evidence determined a reasonable royalty rate using comparable transactions, revising the rate to 5.88% of SAPL's net revenue.

The diverted profits tax claim was considered redundant since the royalty withholding tax provisions applied.

KEY POINTS

OF THE JUDGMENT

OUTCOME

The Court ordered PepsiCo to pay royalty withholding tax at a rate of 5% on a portion of SAPL's payments, reflecting royalties calculated using the CUP method. Additionally:

- The Court accepted the Commissioner's interpretation of royalty payments.
- Adjustments were required to refine the royalty rate, slightly lowering the final rate.

The Court also dismissed the need to apply diverted profits tax, as the withholding tax provisions sufficed to address the revenue implications.

TP METHOD

HIGHLIGHTED (IF ANY)

The Comparable Uncontrolled Price (CUP) method was the primary transfer pricing methodology utilised in this case, a cornerstone of the OECD Transfer Pricing Guidelines. The CUP method compares prices charged in controlled transactions to those in comparable uncontrolled transactions. The Federal Court relied heavily on expert evidence to determine whether the payments under the EBAs included royalties for intellectual property (IP) use and, if so, what an appropriate arm's length rate would be.

The Commissioner initially proposed a royalty rate of 9% of SAPL's net revenue based on comparable licensing agreements. This rate was later revised to 5.88% following expert analysis and adjustments for exclusivity, geographic market factors, and other contractual terms. The experts reviewed agreements for similar trademark licensing arrangements, accounting for differences in the nature of goods, geographic scope, and market conditions.

PepsiCo's experts argued for a significantly lower royalty rate, claiming that the payments were solely for the supply of concentrate and not for IP use. They contended that the Commissioner's analysis improperly attributed the value of trademarks and other intangible assets to the payments made under the EBAs. However, the Court sided with the Commissioner, accepting the CUP method as the most appropriate. It found that the EBAs implicitly granted SAPL rights to use PepsiCo's IP, which was integral to its business operations.

This case underscores the importance of selecting appropriate transfer pricing methods and justifying them with robust evidence. It also highlights the challenges of applying the CUP method, especially in cases involving implicit agreements and bundled transactions.

PART 2

SIGNIFICANCE

MAJOR ISSUES

AREAS OF CONTENTION

Several contentious issues emerged in this case, reflecting the complexities of transfer pricing in multinational enterprises:

1. **Classification of Payments:** PepsiCo argued that SAPL's payments were strictly for the purchase of beverage concentrate, unrelated to the use of IP such as trademarks and brand value. The Commissioner disagreed, asserting that these payments included consideration for the use of IP, thus constituting royalties under Australian tax law.

2. **Royalty Rate:** Expert witnesses for both parties offered starkly different interpretations of appropriate royalty rates. The Commissioner's experts relied on the CUP method, suggesting rates between 8.5% and 9%, later adjusted to 5.88% following further analysis. Conversely, PepsiCo's experts advocated for a much lower rate, emphasizing that no explicit royalties were stipulated in the EBAs.

3. **Implied License:** The absence of explicit royalty provisions in the EBAs created significant debate. The Commissioner contended that an implied license existed, as SAPL could not operate without using PepsiCo's trademarks and other intangible assets. PepsiCo countered that any implied licensing was incidental and should not trigger withholding tax obligations.

4. **Diverted Profits Tax:** The Commissioner's alternative claim under Australia's diverted profits tax provisions added another layer of complexity. The argument hinged on whether the EBAs were structured primarily to avoid tax liabilities, a claim the Court ultimately deemed unnecessary to resolve due to its ruling on royalty withholding tax.

The resolution of these disputes required meticulous examination of contractual terms, industry practices, and expert analyses, showcasing the intricate nature of transfer pricing litigation.

EXPECTED
OR CONTROVERSIAL?

The Court's decision was largely anticipated but carried elements of controversy due to its implications for MNEs with similar agreements. The ruling aligns with established principles under Australian tax law, particularly regarding the treatment of implicit IP use as royalty-triggering events. The judgment reinforced the notion that payments for bundled transactions, even without explicit royalty clauses, can be reclassified for tax purposes if they involve IP.

However, the determination of a 5.88% royalty rate sparked debate. The Court's reliance on the CUP method, though widely accepted, showcased the inherent challenges of finding suitable comparables for unique arrangements like exclusive bottling agreements. Some critics might argue that the adjustments made to derive the final rate lacked sufficient transparency or precision.

The Court's approach to the diverted profits tax claim also raised questions. While it was unnecessary to address this alternative argument, the Commissioner's readiness to invoke anti-avoidance provisions reflects a broader trend of aggressive tax enforcement. This could set a precedent for future cases, where revenue authorities may scrutinise MNE agreements more rigorously, even when traditional tax provisions suffice.

Overall, the decision underscores the evolving landscape of transfer pricing disputes, highlighting the need for MNEs to adopt meticulous documentation and proactive tax planning to avoid adverse outcomes.

SIGNIFICANCE
FOR MULTINATIONALS

This judgment has profound implications for multinationals (MNEs), particularly those operating in jurisdictions with strict royalty taxation and anti-avoidance frameworks. The ruling underscores the importance of clear and comprehensive contractual terms in intercompany agreements, particularly regarding intellectual property (IP) use.

For MNEs, the case demonstrates that payments under bundled transactions—where goods and IP rights are provided together—may be reclassified as royalties even in the absence of explicit licensing clauses. This calls for proactive structuring of agreements to delineate payments for goods, services, and IP usage transparently. The absence of such clarity can expose MNEs to unexpected tax liabilities and disputes.

The reliance on the CUP method in determining royalty rates further highlights the importance of robust transfer pricing policies. MNEs must ensure that pricing for intercompany transactions aligns with arm's length principles and is supported by comparable market data. Failure to do so increases the risk of adjustments by tax authorities, leading to double taxation and costly litigation.

Finally, the case illustrates the value of engaging expert advisors to navigate complex transfer pricing rules. By providing detailed documentation and evidence-based analyses, MNEs can mitigate risks and strengthen their position in potential disputes.

SIGNIFICANCE

FOR REVENUE SERVICES

The ruling bolsters the enforcement capabilities of revenue authorities in addressing tax compliance issues involving royalties and transfer pricing. For the Australian Taxation Office (ATO), the case highlights the efficacy of leveraging robust transfer pricing methodologies like the CUP method to challenge ambiguous agreements and secure fair taxation of multinational enterprises (MNEs).

The Court's acceptance of implied licensing arrangements validates the ATO's approach to scrutinising intercompany agreements, even where explicit terms are absent. This sets a precedent for revenue authorities to examine the economic substance of transactions, ensuring that payments reflecting IP use are properly classified and taxed.

The case also underscores the importance of expert evidence in transfer pricing disputes. By presenting well-supported analyses and appropriate comparables, revenue authorities can strengthen their arguments and withstand challenges from well-resourced MNEs. The ATO's use of adjustments to refine royalty rates in this case demonstrates a pragmatic approach to addressing disputes while maintaining credibility.

Moreover, the Commissioner's alternative reliance on diverted profits tax provisions signals a growing willingness among revenue authorities to use anti-avoidance tools in tandem with traditional tax provisions. This serves as a warning to MNEs that attempts to minimise tax liabilities through complex structures may face heightened scrutiny.

RELEVANT CASES

GLENCORE ENERGY VS AUSTRALIA

Similar to PepsiCo, this case emphasizes the reliance on expert evidence and transfer pricing methods, showcasing the necessity of aligning intercompany agreements with market conditions to withstand scrutiny.

CLICK HERE TO READ THE CASE SUMMARY

GLAXOSMITHKLINE INC. VS CANADA

This case dealt with transfer pricing adjustments for intercompany payments for pharmaceutical ingredients. While it involved goods rather than IP, the focus on the arm's length principle and comparable pricing is highly relevant to PepsiCo.

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ORACLE VS AUSTRALIA

This case is similar to PepsiCo as both involve the classification of payments as royalties under Australian tax law and their treatment under Double Tax Agreements (DTAs). Oracle centered on software sublicenses, while PepsiCo focused on trademark usage in bottling agreements. Both required judicial interpretation of "royalty" and emphasized the importance of clear IP-related agreements. Oracle also highlighted the role of Mutual Agreement Procedures (MAP) in resolving cross-border tax disputes. These cases demonstrate the complexities of taxing intercompany payments involving intellectual property.

CLICK HERE TO READ THE CASE SUMMARY

PART 3

PREVENTION

ENGAGING EXPERTS

Engaging transfer pricing experts is vital for multinational enterprises (MNEs) operating in today's complex tax environment. These experts possess in-depth knowledge of global transfer pricing regulations, including the OECD Guidelines, and can provide invaluable guidance to ensure compliance with the arm's length principle. With their expertise, businesses can effectively structure intercompany agreements to reflect economic realities and reduce exposure to tax disputes.

Transfer pricing experts assist MNEs by identifying the most appropriate methodologies for pricing intercompany transactions. For example, in cases like PepsiCo, they might recommend using the Comparable Uncontrolled Price (CUP) method or other OECD-approved methods, depending on the specific circumstances. They also ensure the accurate selection of comparables by leveraging market data and benchmarking analyses, which are critical for defending pricing structures against tax authority challenges.

Beyond pricing, experts play a key role in drafting and maintaining robust documentation that aligns with legal requirements and withstands scrutiny during audits or litigation. They can preemptively address areas of potential contention, such as royalty classifications or profit allocation, by ensuring contracts are clear and comprehensive.

Moreover, transfer pricing specialists are instrumental in managing tax audits or disputes, providing expert testimony, and navigating complex negotiations with tax authorities. Their expertise minimizes risks of double taxation, penalties, and reputational damage, making them indispensable partners for MNEs seeking to manage cross-border tax risks effectively.

PREVENTATIVE

MEASURES TO AVOID SIMILAR CASES

TAX RISK MANAGEMENT PROCESS

Preventative measures are crucial for multinational enterprises (MNEs) to proactively manage transfer pricing risks and maintain tax compliance. A key strategy is establishing a tax steering committee comprising cross-functional leaders from tax, legal, and finance departments. This committee ensures consistent oversight of tax-related matters, enabling businesses to respond swiftly to emerging risks or regulatory changes.

Adopting a comprehensive tax risk management process is equally essential. Such a process involves identifying high-risk transactions, assessing their compliance with local and international transfer pricing rules, and implementing mitigating controls. By analyzing intercompany agreements in advance, MNEs can address ambiguities, such as royalty classifications, and avoid disputes like those seen in the PepsiCo case.

Leveraging the guidance of transfer pricing experts further strengthens these measures, providing businesses with insights to navigate complex tax landscapes effectively. By fostering a proactive approach, businesses can mitigate risks and safeguard their financial and reputational integrity in an increasingly scrutinized global tax environment.

DOWNLOAD FREE BOOK

TAX INTELLIGENCE: THE 7 HABITUAL TAX MISTAKES MADE BY COMPANIES

Tax Intelligence: The 7 Habitual Tax Mistakes Made by Companies" by Dr. Daniel N. Erasmus is a must-read for businesses seeking to navigate the intricate world of tax compliance and risk management. By highlighting common pitfalls and offering strategic solutions, Erasmus equips companies with the knowledge to improve their tax practices and secure financial stability.

PREVENTATIVE

MEASURES TO AVOID SIMILAR CASES

TAX STEERING COMMITTEE

Establishing a tax steering committee can help ensure that tax policies are aligned with the broader business strategy and that transactions are vetted for both commercial and tax implications. A tax steering committee can:

- Review all significant cross-border transactions before they are executed.
- Ensure that tax decisions are made in the context of overall business objectives, not solely for tax savings.
- Monitor changes in international tax laws to ensure ongoing compliance and avoid disputes like this case.

DOWNLOAD FREE E-BOOK

DRIVING TAX COMPLIANCE: THE ESSENTIAL ROLE OF THE TAX STEERING COMMITTEE

The eBook "Driving Tax Compliance: The Essential Role of a Tax Steering Committee" by Prof. Dr. Daniel N. Erasmus, Renier van Rensburg, and Gilbert Ferreira, emphasizes the critical importance of establishing a Tax Steering Committee (TSC) within multinational corporations to ensure tax compliance and manage tax-related risks effectively.

INTERNATIONAL TAX

CASE SUMMARY

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