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McNab TAX LAWYERS

ATO PepsiCo DIS

The pursuit of “embedded royalties” continues

To help understand the ATO PepsiCo *Decision Impact Statement* (DIS) which has just issued, I have set out below my original 2025 summary of the High Court Judgement. Which is still relevant. And then I have marked up in yellow what I believe the DIS tells us about the ATO’s likely attitude in these points. The ATO does not invite comments on the DIS but does ask for notification “of consequences it may not have identified” by 1 May 2026.

The history

I believe the key message from the DIS is found in two paragraphs:

60. The decision does not disturb our view that, depending on the relevant facts and circumstances, a royalty may be found notwithstanding rights to use IP have been 'embedded' into amounts labelled as consideration for something that is not IP, such as a good or a service. The characterisation of a payment is not determined by the label attached to it by the parties (for example, stating it as being for goods or services, or being 'royalty-free'), or how it is computed.

61. The decision in PepsiCo does not establish any broad proposition that the characterisation of a payment under a contract - whether involving arm's length parties or related parties - can never be challenged. We continue to examine the arrangements of related parties closely.

In other words, “taxpayers with what we consider are facts different to PepsiCo, will not get help from the decision”.

The full ATO Decision Impact Statement can be found at this link:

https://www.ato.gov.au/law/view/document?docid=LIT/ICD/m98-2024/00001

In mid-2025 the ATO also advised that it would consider whether the decision in PepsiCo required further updates to its draft “software” ruling. That draft was issued on 17 January 2024 and has not yet been finalised. In September 2025 (after the PepsiCo decision was handed down, Deputy Chief Tax Counsel, Peter Walmsley said that companies should not expect the decision would lead to substantive changes to the draft ruling. We might, then, have expected to see a final software ruling issue fairly quickly. The DIS at para 79 does not give much hope, simply saying it is still being considered.

My 2025 note:

"Analysis of the PepsiCo High Court decision

What does the full High Court judgment in Commissioner of Taxation v PepsiCo Inc [2025] HCA 30 on 13 August 2025 really mean for taxpayers with Australian distribution models? In this note I have tried to distil the complex factual and legal issues.

The Court's judgment can be found at this link:

https://www.hcourt.gov.au/cases-and-judgments/judgments/judgments-2000-current/commissioner-taxation-v-pepsico-inc

By a majority of 4/3 the Court dismissed the Commissioner's appeal on all grounds, giving the Pepsi Group a comprehensive victory. No further appeals are possible.

What does the decision mean in practice for groups undergoing reviews of their Australian distribution models?

It is likely the ATO will:

1. **Argue that the decision is limited to PepsiCo's precise fact pattern**, with a direct agreement between an arm's length unrelated bottler and PepsiCo Inc which referred to IP rights, and a subsidiary agreement between the bottler and the concentrate supplier (at para 64 the DIS specifically describes this as "uncommon"). He will contest distributor agreements which include IP rights and a fee for service or goods in the one agreement. Evidence of the reasonableness of the fee for service or goods will become important (the DIS explicitly says this in para 62), as will evidence that the promises (consideration) given for any royalty free IP rights are substantial, and evidence that such arrangements are common in the sector.

2. **Still argue about whether IP rights other than in relation to trademarks are "used"** in the relevant sense by distributors in most technology sector models. Particularly in relation to the "communication right" first mentioned in the 2024 redraft of TR2024/D1. Up to date legal analysis of IP right use (including evidence) will **be important.**

3. **Argue that our DPT allows him to say companies would have given greater IP rights to Australian distributors (leading some or all distribution fees to be a royalty), but for their desire to avoid withholding tax.** Evidence of other arrangements that the group might have used which also would not create an Australian withholding tax liability will be important (direct sales from the US to Australia, for instance). Evidence of the factors taken into account when setting up the current business model may be helpful (at para 65 the DIS says that changing an arrangement that had a fee, to one without a fee is "high risk" for Part IVA and DPT). Evidence as to why it would not be commercially reasonable, or necessary, to place greater IP rights in Australia will be important (this is evidence as to why the Commissioner's "alternative postulates" were not "reasonable"). It will be useful to be able to show that the economic and commercial substance of your arrangements would not be reflected in any postulate that the Commissioner might argue was reasonable. Although not considered in the decision, the same information may show the profit of each group entity matched their economic substance in the scheme, giving a section 177M defence against DPT (at para 38

the DIS recognises this defence was not considered in PepsiCo). It will also be useful to show that arrangements such as yours are entered into by arms length parties.

What does PepsiCo not deal with?

It is important to understand that the decision **does not deal with** many of the issues currently pursued by the Commissioner in audits:

1. It does not deal generally with the question of whether most payments under distribution business models will be a royalty. Especially where intangibles (such as software) are used to deliver services. These models require a detailed analysis of the use made of intangible assets to determine whether the Australian distributor actually performs activities which are inconsistent with the argument that it does not "use" the intellectual property of the global group. *(In Pepsico the Commissioner argued that concentrate payments related to "use of trade mark", "provision of commercial, industrial … information" and "ancillary assistance" in relation to those. These were all expressed to be granted "royalty free". The parties proceeded on the basis that these items were indeed "used" by the bottler. Unlike in most technology sector models where there is real dispute about whether there is a "use" of relevant IP.)*
2. It does not deal with models where use of intangibles such as trademarks are granted to the Australian distributor from the same entity to which the distributor makes payments for other goods or services *(In PepsiCo the agreement giving royalty free use of intellectual property was sufficiently separate from the actual agreement for delivery of concentrate, and it was clear that other valuable "consideration" was given for the grant of IP rights (the comments in paras 60-61 clearly indicate the ATO will continue to dispute these)*
3. It does not discuss what facts will give rise to a conclusion that local entities or operations will amount to a permanent establishment of an offshore group
4. It does not deal directly with most "alternate postulates" by which the Commissioner tries to assert Australia's Diverted Profits Tax *(although it may help analyse the ones that could be raised in your particular case)*
5. And, it does not deal with related issues such as any application of Australia's anti-hybrid rules.

So what does it deal with?

The Commissioner has lost, but will argue that the decision has limited application to other taxpayers and does not really help them. He will seek to point out differences between the facts in PepsiCo and those of other taxpayers (the DIS says this is true for the DPT analysis on "purpose" at para 67 and the analysis of obligation to collect withholding tax at para 64).

The Court found that, on the facts, it could not be said that part of the price paid for concentrate was attributable to the permission to use the group trademarks in Australia.

This conclusion was driven by a number of observations, including:

- The language of the bundle of agreements made it clear that the price for concentrate was referable only to concentrate, it was reasonable and the "sale of concentrate" transaction was separately documented.
- There was actually substantial consideration given for the use of trademarks, being the various undertakings to promote the product (benefiting PepsiCo's goodwill) and the agreement to conditions around how the bottler would operate. It could

not be said that there was "zero" consideration, which prevented an inference that in the face of zero consideration for IP, some part of the concentrate price related to the use of IP (the DIS agrees, but seems to imply at para 56 that this broader concept can be relevant to the royalty withholding tax process. It is not clear how this would work. See also para 62).

The State Stamp Duty cases relied on by the Commissioner to interpret the agreements consistently required the full terms of all relevant agreements be considered, and when that was done the taxpayers view was found to be correct (the DIS at para 58 agrees and notes this will mean very broad enquiries by the Commissioner to find all relevant dealings and negotiations). This will affect at least paragraphs 74 to 79 of TR2024/D1 ("Royalties … software and intellectual property rights") which are based on the Commissioner's arguments in PepsiCo. We now expect further delays before it is issued in final form.

The case is the first in Australia which considered our **DPT** provisions. The Commissioner argued that there was a scheme in having all payments made for concentrate, but use of IP granted "royalty free". If the scheme had not been entered into, the agreement between the bottler and PepsiCo US would have expressly provided that the payments were for concentrate and IP use, or that there would have been an express, separate payment for use of IP. Allowing withholding tax to be charged. If these scenarios (the "alternate postulates") were "reasonable", then the scheme gave rise to a "tax benefit" that could be set aside.

The taxpayer has the onus of proving that it did not obtain a tax benefit. There was considerable focus on whether the Commissioner's postulates were reasonable. The Commissioner argued that to defeat his postulates a taxpayer cannot merely show that his are not reasonable but must also show (in an extra step) that there is a reasonable postulate where there is no tax benefit. In other words, there is another way of structuring the relationships where it is also true that no royalty arose. This is an almost impossibly high bar in many cases. And could have meant the Commissioner would succeed even when it was agreed his postulates were not reasonable! The High Court held that the extra step was not in fact required. If all the Commissioner's postulates are not reasonable, the taxpayer may succeed with other evidence (the DIS at para 69 accepts a taxpayer may demonstrate there are no reasonable postulates but says this will be "unusual". The DIS suggests the Commissioner will continue with his approach, subject to the current appeal in the Hicks case).

In PepsiCo, the evidence showed that the price for concentrate was "not disproportionately high", and that the rights were clearly granted for substantial consideration in their own right.

And the Commissioner's postulates were not reasonable because:

- The substance of the scheme (defined by the Court) was that the price paid was only for concentrate,
- The scheme was a product of dealings between unrelated arm's length parties, and
- The absence of a royalty was market standard"