

Intercompany Fees for Internal Carbon Pricing: The Next Frontier?

by Jessie Coleman, Orest Pazuniak, Lorie Srivastava, and Jessica W. Tien

Reprinted from *Tax Notes International*, February 13, 2023, p. 839

Intercompany Fees for Internal Carbon Pricing: The Next Frontier?

by Jessie Coleman, Orest Pazuniak, Lorie Srivastava, and Jessica W. Tien



Jessie Coleman



Orest Pazuniak



Lorie Srivastava



Jessica W. Tien

Jessie Coleman is a principal in the economic and valuation services (EVS) group of the Washington National Tax practice of KPMG LLP, Orest Pazuniak is a senior associate in the EVS group in Philadelphia, Lorie Srivastava is an EVS senior manager in New York, and Jessica W. Tien is an EVS principal in San Francisco.

In this article, the authors explain how companies are measuring internal carbon pricing (ICP) and suggest how transfer pricing practitioners can support ICP and the associated allocations of intercompany carbon fees. They also urge companies to assess if their ICP measurement and subsequent intercompany carbon fees are consistent with their tax and transfer pricing objectives.

Copyright 2023 KPMG LLP.
All rights reserved.

Companies are acting on reducing carbon emissions and mitigating related risks by computing an internal CO₂ price (ICP) as their financial cost of emissions. To effectively act on emission reduction, some companies are considering charging intercompany carbon fees to their business units for management reporting purposes. While these fees are not statutory costs that directly affect their tax filings, they will encourage business units to lower carbon emissions, as well as demonstrate greater profitability for management reporting purposes. Companies should assess if their ICP measurement and subsequent intercompany

carbon fees are consistent with their tax and transfer pricing objectives.

While the introduction of internal carbon pricing is still unrefined, first-mover companies — often without consulting the tax department — have already calculated an internal carbon price and allocated the related emission costs across the company as an intercompany carbon fee for management reporting purposes.

The setting of internal carbon pricing is quickly gaining traction; according to the 2021 CDP (formerly Carbon Disclosure Project) report entitled “Putting a Price on Carbon: The State of Internal Carbon Pricing by Corporates Globally,”

almost half the world's largest companies in terms of market capitalization either have an internal carbon price or are planning on instituting one over the next two years. Transfer pricing practitioners need to understand how their business treats or intends to treat internal carbon pricing and lean in with their expertise to create an arm's-length methodology to support the ICP and the associated allocations of intercompany carbon fees.

What Is Internal Carbon Pricing?

The U.N. framework convention on climate change established the first fundamentals for carbon regulations. The goals were codified by the greenhouse gas protocol in 2001 and the Paris Agreement in 2016, both of which explicitly lay out the conditions under which commercial entities can engage in carbon reduction, including implementing an internal carbon price.

An ICP is a pecuniary price that the firm places on its own greenhouse gas emissions, also referred to as CO₂ equivalent (CO₂e) emissions, so that it can take into account — or *internalize* — its contributions to global greenhouse gas emissions in its business or operational decisions — such as with procurement and suppliers. While there is no universally agreed-upon price for CO₂, according to KPMG Global's recent sustainability report, median prices vary between \$8 and \$28 per tonne of CO₂e depending on the global region of interest. The international measurement and pricing standard for these emissions is per metric tonne of CO₂e emissions. Greenhouse emissions are what economists call a negative externality, a consequence that negatively affects others who are not compensated for the costs or damages that they incur.

Many companies have instituted an ICP. According to the 2021 CDP report, the most common reasons for doing so are:

- to provide incentives for low-carbon investment;
- to promote energy efficiency; and
- to change internal operational behavior to successfully navigate carbon regulations while at the same time harnessing low-carbon business opportunities.

While it is still early days for ICPs, the number of companies with an ICP is expected to grow significantly in the next few years. According to the 2021 CDP report, almost half of the world's largest companies in terms of market capitalization either have an ICP or are planning on instituting one over the next two years. In terms of the numbers, the report noted that since the CDP's 2017 report, there has been an 80 percent increase in the number of companies planning to use an ICP within five years.

Yet companies are struggling to understand the appropriate ICP figure to implement. According to the CDP report, about half of companies use a "shadow price," which is a theoretical price — it is not necessarily based on a carbon market nor the cost of abatement for reducing carbon emissions. A few first-mover companies have started an annual process to calculate the cost of carbon abatement, an "internal tax" or "trading system." These are typically associated with specific carbon scopes or business travel and have started charging out those costs to their operating units for management reporting purposes.

Internal Carbon Pricing: Why Now?

There are at least three key reasons why companies are moving to establish ICPs now:

- increasing stakeholder pressure for companies to be more climate-friendly;
- an increasing number of jurisdictions that have instituted financial disincentives to producing greenhouse gas emissions, such as a carbon tax or an emissions trading system (ETS); and
- potential climate disclosure regulations.

First, as internal and external company stakeholders focus on environmental, social, and governance (ESG) issues, companies will respond by making ESG-related changes to the business. The "2021 Sustainability Reporting in Focus" by the Governance & Accountability Institute Inc. noted that in 2020, 92 percent of the S&P 500 companies — over four times as many companies as a decade ago — published sustainability reports detailing how their businesses address ESG issues. Many of these disclosures contain commitments to emission reduction specifying target net-zero dates, meaning that any

greenhouse gas emissions released will be balanced by an equal amount removed from the atmosphere. While the benefits of net-zero may be well understood throughout the organization, allocating intercompany carbon fees to business units may be an effective tool to concretely prioritize the business to reduce emissions.

Second, an increasing number of jurisdictions have implemented or are scheduled to adopt carbon taxes or an ETS. Also called a cap-and-trade system, an ETS involves placing a limit (or cap) on the total volume of emissions. In an ETS, the government sets the overall cap on emissions produced by regulated entities by limiting the number of allowances available, while the new market sets the price of these allowances. Typically, the regulator will also set a price floor or ceiling. According to the World Bank's 2022 annual report on the "State and Trends of Carbon Pricing," there are 37 jurisdictions with carbon taxes and 34 with an ETS. The OECD announced in February 2022 the creation of an inclusive forum on carbon in which jurisdictions (both OECD and non-OECD) will analyze how governments are approaching this issue. After that announcement, officials from the OECD said that carbon pricing policies are expected to be the next project on a scale equal to the base erosion and profit-shifting initiative.

Third, governments such as the United States and regional bodies such as the European Union have made proposals regarding climate disclosures. If the disclosures in the United States are adopted in their proposed form, SEC filers will need to, among other things, disclose scope 1, 2, and 3 emissions and may need to disclose how they calculate their ICPs. Scope 1 emissions are direct from company-owned and controlled resources. Scope 2 are indirect emissions from the generation of purchased energy from a utility provider. Scope 3 are all indirect emissions not included in scope 2 that occur in the value chain of the reporting company, including both upstream and downstream emissions. Country-by-country climate disclosure may be required for local compliance.

Internal Carbon and Transfer Pricing?

Some first-mover companies have instituted ICPs and started an annual charge-out process of

intercompany carbon fees for management reporting purposes. For example, in 2012 a large technology company began to calculate an intercompany carbon fee related to scopes 1 and 2 and business travel emissions. The original fee was intended to provide funding for the company's sustainability activities. That fee has evolved over the last decade, and in addition to being used to fund sustainability is used to modify internal behavior to reduce overall emissions.

In 2020 this company commenced charging for scope 3 emissions. The company has an annual exercise in which it calculates the prior-year total emissions, aggregating all types such as those related to electricity procurement, supply chain, business travel, logistics of product shipments, and employee computing. The prior-year total figure is allocated to the business and each allocable tonne is charged out based on a set price. The company sets the cost of scopes 1, 2, and business travel emissions at \$15/tonne based on the cost of abatement for renewable energy. The company has a lower ICP for scope 3 in part because of poor (but improving) data quality. The company's finance department collects this charge quarterly, and the proceeds are used to fund sustainability projects. Given that the projects often require investment in technology and create valuable data, transfer pricing practitioners should understand which legal entity is directing and funding these projects to ensure that any developed intangibles are aligned with the business structure.

Given the movement to recognize emissions as a cost to the business, more companies will be inclined to charge their business units with the cost of emissions by some form of charge-out mechanism for management reporting purposes. In other words, these companies are internalizing the cost of CO₂ emissions. Ultimately, this may have the effect of increasing the use of low-carbon-emission-producing companies in a supply chain and reducing the use of high-carbon emitters.

Let's take a simple example: XYZ company has two affiliates (Company A and Company B) that manufacture widgets in different countries. Setting aside carbon emission-related costs, Company A and Company B have the same

manufacturing capacity and the same cost structure, in which each widget costs \$50 to produce. Both affiliates sell all their products to headquarters. The ICPs per widget for Company A and Company B are \$5 and \$15, respectively. If the company charges these costs to the affiliates, the full cost for each widget would be \$55 for Company A and \$65 for Company B. If the ICP is included in the intercompany price, the company will be incentivized to first use capacity at Company A given its overall lower cost structure. Company B would be motivated to lower its overall total emissions to become more aligned with Company A. Until that alignment occurs, Country B will have overall lower profits and could incur losses if its revenues are not sufficient to cover its fixed costs. If the example were expanded to dozens of manufacturing entities in a complex multinational company, it seems likely this could motivate changes across the supply chain. For example, the company may decide to close the plant with the highest overall costs, inclusive of ICP costs. Given that a key outcome of an ICP and associated intercompany carbon fees may be changes to the supply chain and operations, transfer pricing practitioners should understand how ICP allocations will affect the overall intercompany flow of goods, and if changes to the transfer pricing are needed. Companies may allocate an ICP (to understand the fully loaded cost structure) when making other key business decisions about suppliers, expansions, or acquisitions. Transfer pricing practitioners should understand if and how the ICP allocation affects these decisions and what that means in terms of intercompany pricing.

There are other potential long-term knock-on effects to consider. For example, layering on an ICP that ultimately drives overall company sustainability that increases the company brand value or allows a company to charge consumers a higher price (for a product that is viewed as more sustainable) or increases employee productivity or retention. To the extent that an ICP contributes to value creation, companies should contemplate value chain management strategies that consider optimal tax and transfer pricing arrangements.

While at present the charge-outs may be for management reporting purposes only, carbon costs could become recognized as a cost to the

business that should be charged for financial reporting purposes and recognized as a deductible expense. If that occurs, it may be necessary for companies to conduct their ICP allocations in a consistent manner for management reporting, accounting recordation, and tax and transfer pricing compliance.

Practical Next Steps

We set forth five suggestions for tax and transfer pricing practitioners related to internal carbon pricing:

- *Find out if your company has an internal carbon price.* Check with your sustainability group to find out if the company already has or plans to institute an internal carbon price. Because there is no tax impact to implementing an ICP, it is unlikely that the tax group would have been consulted as part of price setting. Also, many companies that have an internal carbon fee have not made it widely known throughout their organizations.
- *If there is an internal carbon price, understand how that price was set.* If there is already an internal carbon fee in place, the transfer pricing team should understand the mechanics of the pricing. Specifically, understand if it is a spot theoretical price or based on some sort of cost of abatement or a real cost to the business. Advise the sustainability group on potential refinements to the internal carbon price.
- *Work with the sustainability group to set an internal carbon price.* Your transfer pricing group — with its experience in understanding related-party pricing — is uniquely positioned to help calculate an internal carbon price. By placing an arm's-length lens on the fee, you can provide a principled way to price carbon. Some factors to consider are whether a company should have different prices for different jurisdictions and for different emissions scopes.
- *Suggest a charge-out method for the internal price of carbon.* A good first step would be to map the company's value chain and operating entities to the global carbon footprint. To do this accurately, consider the

impact of jurisdictions with government-mandated carbon taxes or an ETS. For example, if a U.S.-headquartered Singaporean subsidiary's carbon tax totals \$400 and the company determines the internal fee to the entity in Singapore is \$600, then the question becomes, should Singapore pay only the excess of the internal fee (\$200) because it is already paying a carbon tax to the government of \$400 and the total price would be \$600? Of importance, government-mandated carbon taxes are business costs and may affect transfer prices. For example, if the U.S. parent purchases tangible goods from the Singapore subsidiary at total cost plus 10 percent, the associated carbon tax (the \$400 in the example) would be included in the cost base and charged to the U.S. parent.

- *Stay up to date.* Monitor jurisdictional changes to carbon tax, ETS, and climate-related disclosure requirements. At the same time, there may be opportunities related to ESG credits and incentives that tax departments should review. Many multinational enterprises are considering emissions a real cost of business, and this affects how investment decisions are being made. As companies are required to pay a carbon tax or required to purchase allowances of carbon under an ETS regime, this will be built into their costs of doing business. It also seems likely rules will be needed regarding the deductibility of emission-related fees. Stay abreast of the direction and potential deliverables of the OECD related to carbon. While its initial purpose is gathering of carbon tax and ETS, it seems possible such an organization may ultimately focus on providing guidance to member countries. If this group becomes as large as the inclusive framework on BEPS (over 140 countries as of December 2022), this could mean significant changes in carbon pricing.

Summary

A combination of market forces, regulations, and an evolving climate is creating the impetus for businesses to develop and implement an

internal carbon price to realign business operations and climate-resilient strategy. The next step is for companies to analyze and implement intercompany carbon fees to charge local entities for management effectiveness. While transfer pricing practitioners have generally not contended with ICP yet, they can take steps now to support, inform, and drive how companies are calculating internal carbon pricing.

Annex 1. KPMG and ICP

KPMG is taking action on its commitment to help meet the global need to reduce CO₂ emissions. The firm is tackling climate change in a clear, simple way — by establishing its own ICP. Initially, KPMG focused on business travel, to create a clear monetary incentive to shift its business model to reduce its CO₂ emissions and meet its commitment to be net-zero by 2030. Embracing an ICP may help KPMG continue to showcase its commitment as a leader in the ESG area by actually “walking the walk.”

KPMG's Decarbonization Commitment

In November 2020, KPMG International made a global pledge to be net-zero by 2030 as part of its continued focus on delivering growth in a sustainable way and providing climate solutions for member firms, clients, and society. To fulfill this pledge, KPMG set a goal to halve its greenhouse gas emissions by 2030. Our new global ESG plan includes a more than \$1.5 billion investment over the next three years to focus on our ESG change agenda — designed to support KPMG firms in making a positive difference for clients. In 2022 KPMG agreed to set an ICP to cover business travel and business operations globally. By tracking CO₂ emissions for business travel, KPMG is able to educate employees regarding their carbon footprints created by their travel; employees will be able to track their carbon footprints and can compare them with their peers within the firm through an interactive dashboard.

KPMG receives quarterly emissions estimates for all business travel, converting the CO₂ emissions into dollar values by multiplying by the ICP, and then depositing the money into a fund to help finance investments that decarbonize firm operations, such as use of renewable energy, lighting retrofits, technological deployment,

energy efficiency measures, and the purchase of high-quality offsets.

For business, governments, and society, decarbonizing is an evolving journey, as understanding of the global and community effects of climate change improves through research and policy initiatives. An important objective in implementing an ICP has been achieved — starting the institutional process of attaching a price to some of the firm’s CO₂ emissions. Establishing this process allows the ICP to be regularly revisited to update and modify as necessary, such as when business goals or scientific knowledge change. This commitment to ongoing reevaluation allows KPMG to continue

to focus on implementing new initiatives to reach its 2030 goal, and the internal price of carbon is one important step. ■

¹The foregoing information is not intended to be “written advice concerning one or more Federal tax matters” subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230. The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser. This article represents the views of the authors only, and does not necessarily represent the views or professional advice of KPMG LLP.

Copyright 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Ltd., a private English company limited by guarantee. All rights reserved.