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In this article, the authors examine the transfer pricing issues that companies should take into account in their environmental, social, and governance-related tax planning.

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As companies develop strategies and incur environmental, social, and governance (ESG) related costs, some of these investments may result in the creation of valuable intangible assets. For instance, we see many companies specifically focusing on decarbonization — that is, investing in processes and technology to reduce carbon dioxide emissions — that may be creating related intangibles. Tax planning around ESG in general or decarbonization-specific intangibles should be thoughtful and use consistent frameworks in planning for other product, process, or marketing intangibles.

Decarbonization Investment

Decarbonization efforts are becoming a priority for many companies and industries, especially those looking to mitigate reputational risks, build stakeholder trust, and enhance consumer engagement. A cursory glance at climate-related disclosures across industries reveals initiatives by companies to increase their use of renewable energy along their value chain by changing production processes to improve energy efficiency, and even moving production facilities closer to their customers to reduce their transportation associated emissions. In its World Energy Investment 2022 report, the International Energy Agency found that world energy investment was expected to reach $2.4 trillion (well above pre-COVID levels) with the largest increases expected to be from renewables, the

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electricity grid, and expenditures on energy efficiencies.[1]

Decarbonization strategies often call for innovative business processes, data collection and monitoring, and the use of software technologies to operationalize the strategies. Like any new process, data, or technology investment, decarbonization investments may be experimental and risky. Still, fundamental financial principles apply when those investments require sustainable returns over an appropriate time horizon.

Service or an Intangible?

Spending associated with decarbonization investments may be incurred by one or several legal entities in a group, leading to the creation of an intangible, and where the resulting intangibles may benefit the other group members. Alternatively, spending associated with decarbonization may not rise to the level of the creation of an intangible, but result in a benefit being provided to other group members. Arm's-length transfer pricing policy is required by the tax laws of most countries. Group members benefiting from intercompany services or using available related-party-developed intangible assets is a key topic for corporate tax and transfer pricing professionals to analyze and assess potential tax planning opportunities. From a transfer pricing perspective, the treatment of intercompany services and the licensing or transfer of intangible assets generally require different approaches for determining an arm's-length charge.

Services and the Benefit Test

Operating companies should pay for beneficial services, but not for activities that only provide benefits that are indirect, remote,[2] or that arise from passive association.[3] Multinational groups may engage in non-beneficiary activities that involve group members but are for shareholder purposes or duplicative. For instance, a parent corporation cannot charge its subsidiaries for "stewardship" activities, generally considered to include oversight functions connected with the parent's ownership interest in the subsidiary.[4] Reg. section 1.482-9 contains detailed guidance on what constitutes beneficial intercompany services. Section 482 adopts the term "shareholder activities" to refer to an activity whose "sole effect" is to "protect the renderer's capital investment in the recipient . . . or to facilitate compliance by the renderer with reporting, legal, or regulatory requirements applicable specifically to the renderer, or both."[5] A key analysis for decarbonization investments is to determine whether the investment is a shareholder activity or if it provides a benefit or value to the recipients. The OECD transfer pricing guidelines also use the concept of the benefit test to support intercompany charge-outs.[6]

Today, many U.S. companies assume decarbonization investments are shareholder activities without analyzing how spending is used and what value the investment may be creating. We caution that this assumption may not be true in many cases and that the IRS may challenge it. The benefit test should be done on a case-by-case basis. If decarbonization is likely to provide a benefit across the company, for instance by reducing the manufacturing process risks or by creating value by other operating measures, related parties that assume manufacturing risks would need to be compensated appropriately.

Intangibles Arising From ESG

There are at least three noteworthy types of intangibles that can be created from decarbonization efforts:

- specific business processes or new technology created around decarbonization efforts;
- an explicit technology used to track reductions in carbon dioxide; and
- the emissions data themselves.

[1] International Energy Agency, "World Energy Investment 2022" (June 2022).

[2] *See* reg. section 1.482-9(l)(3)(iii).

[3] *See* reg. section 1.482-9(1)(3)(v).

[4] *See, e.g.*, *Columbian Rope Co. v. Commissioner*, 42 T.C. 800 (1964); *Young & Rubicam Inc. v. United States*, 410 F.2d 1233, 1247 (Ct. Cl. 1969); reg. section 1.861-8(e)(4).

[5] Reg. section 1.482-9(l)(3)(iv).

[6] OECD, "Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2022," para. 7.6 (2022).

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The most obvious intangible would be a new technology or innovative business process. For instance, perhaps a company discovers an innovative way to manufacture products that reduce carbon dioxide emissions by 50 percent. This specific means of decarbonization may be pioneered at a single facility or jurisdiction and then leveraged elsewhere. Thus, potentially valuable intangibles may be created and licensed to related-party entities or across jurisdictions. When well planned, the investor choice and subsequent transfer pricing arrangements may mitigate tax risks, improve tax effectiveness, and help achieve decarbonization.

Companies often need to employ a program or method to determine ESG scope 1 and 3 emissions, understand their emissions at every stage of their value chain, or derive their own internal carbon price. These programs may help create roadmaps, data, and knowledge bases that are valuable intangibles. These programs or methods are often based on licensed tools from a third-party vendor and further developed by in-house engineering teams. Management consulting firms offer tools that help establish emissions baselines and track and project costs of decarbonization initiatives at the asset level.[7] Companies further develop these tools to help outline a decarbonization vision, establish emissions baselines, analyze possible decarbonization scenarios, and develop a roadmap that aligns with a business's capital program strategy.

One interesting and valuable source of an intangible that can arise from decarbonization efforts might be the data themselves. Data at the level required to conduct a meaningful analysis of emissions tend to be highly specific and propriety, often considering inputs and outputs not only at the facility level but at each stage of the value chain. For example, the emissions per kilowatt of electricity based on the power generation source or the amount of water used per unit of good produced are fundamental pieces of information that drive core operations and business profitability. Gathering that information in a single, clean data source may create a valuable amalgamation of company financials that can be employed for multiple purposes aside from decarbonization efforts.

A key message is that companies should review their decarbonization strategies and understand whether any new intangibles are being created. If they are being created, companies should analyze which entities should bear the costs and risks associated with the investments as they identify the beneficiaries of any potential new intangibles. If the related parties make use of the intangibles, intercompany transactions should be implemented to reflect the arm's-length nature of related-party dealings.

Transfer Pricing for Intangibles

Transfer pricing analysis will be a key element of a company's tax strategy. The transfer pricing strategy can be executed more completely once the value creation activities are identified and companies analyze whether their decarbonization investment has created or is expected to create an intangible. Companies can carefully consider which entities should own these related intangibles and whether these intangibles are creating value that others in the group would want to license. For decarbonization-related initiatives, the company may decide to centralize the investment costs as well as the key people making the sustainability investments into one entity that could serve as a sort of decarbonization hub.

Companies must give careful thought to how the United States views intangibles as well as how they are viewed outside the United States — focusing on the discussion in the OECD transfer pricing guidelines and the way companies interpret these guidelines.[8]

Conclusion

Tax and transfer pricing management should collaborate with sustainability teams to understand the company's ESG investment and

[7] Katherine Blue, "Defining Your Decarbonization Pathway," KPMG ESG Alert (2023).

[8] For example, jurisdictions interpret the OECD's six-step risk control framework for analyzing transactions involving intangibles and development, enhancement, maintenance, protection, and exploitation functions differently. *See* Mark R. Martin et al., "A Global Survey on the Application of the Control of Risk and DEMPE Frameworks: The U.S. and U.K.," *Tax Notes Federal*, May 8, 2023, p. 995.

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related business impact. If the investment by any specific legal entity is significant, it may be important to analyze the treatment of the investment to mitigate tax audit risks. Further, it may be that tax effectiveness may be improved by tax planning surrounding these investments. Company-specific analyses from tax and transfer pricing perspectives are required as each company's situation will be unique given their business facts and circumstances, tax jurisdictions, and nature of decarbonization efforts.[9] ■

[9]The 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 author(s) only, and does not necessarily represent the views or professional advice of KPMG LLP.

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