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Transfer Pricing and Environmental Taxation: Carbon Credits

ANALYSIS



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Monique van Herksen and Clive Jie-A-Joen of Simmons & Simmons, Jolanda Schenk of Shell Netherlands, and Marc Levey of Baker McKenzie discuss their personal perspectives on the global commitment to reduce Green House Gas emissions and how international coordination is necessary to aid and encourage compliance by resolving administrative and legal challenges or inconsistencies so that companies and investors may benefit from clear and consistent treatment for tax and transfer pricing purposes.

By the end of 2021, over 80 countries representing almost 75% of global emissions **announced** commitments to achieve net zero emissions. These “commitments” essentially translate into decarbonization rules or legislation. Following the Paris Agreement, countries party to the Paris Agreement put climate plans in place to cut their Green House Gas (GHG) emissions and set Nationally Determined Contributions (NDCs) that serve to measure progression towards reducing their GHG emissions. Examples of commitments include utility decarbonization rules that intend to transition from brown and black coal-based electricity generation to low-emission renewable energy or can encourage switching to clean (or green) Hydrogen. The creation of carbon capture regulatory frameworks serves to regulate and evaluate carbon capture and storage that can be used for example by the manufacturing and construction industry. Improved battery/energy storage is another field that is developing fast but

also regulated and there is an increased focus on how to get the aviation and shipping industry to operate green. It should come as no surprise that the decarbonisation rules, albeit implemented for all the right reasons, are causing a major change in how companies operate.

While the above examples underscore that there have been impressive, if not amazing technology advancements, regardless of all the investments made and available, decarbonizing and transitioning industries will likely take a lot of time. Clean energy is energy that comes from renewable, zero emission sources that do not pollute the atmosphere when used, as well as energy saved by energy efficiency measures. While using clean energy is the way forward, the available volume of new clean energy production will for the time being simply not be able to replace the volume of today's global energy demand, and getting behavior change embedded is similarly time consuming.

Overly simplified, the myriad of rules intended to help change global behavior towards decarbonization include an ambitiously prepared spaghetti of international and local rules, mandatory and voluntary rules, supply and demand (market) processes, carrots and sticks, and mandatory reporting or disclosure requirements that is in dire need of a proper recipe. While the "carrots" include subsidies and (investment) incentives, the "sticks" are made up of penalties, taxes, other levies or sanctions intended to discourage behavior that leads to GHG emissions by making it costly, economically unattractive or outright illegal. The disclosure requirements (like the EU corporate sustainability reporting directive, for example) require companies

to disclose information both about how sustainability-related factors, such as climate change, affect their operations and provide information about how their business models impact sustainability factors. The resulting transparency is set to have its own consequential "carrot and stick" function as it allows a broad audience to see what is happening at company level, compare that against competitors and may encourage climate activists taking note to act.

Matching these developments with the desire to produce, design, manufacture, or sell goods and services that meet market demand, companies increasingly engage in activities that help reduce their GHG emissions and where opportune, have profit potential while reducing carbon emissions. This includes taking on activities that contribute to the generation of carbon credits or buying and selling carbon credits. When doing so, companies enter a world with diverse and complex rules while at the same time making substantial capital investments. Following, some GHG emission reduction activities that companies engage in are considered together with some of the challenges that arise from a transfer pricing perspective. This area would greatly benefit from up-front consideration and preferably, international coordination to allow companies and investors to benefit from clear and consistent treatment for tax and transfer pricing purposes of their actions.

Carbon Credits

Air is not necessarily bothered by territorial borders (beside discussions of territorial air space and violations thereof). Thus, one would think that a reduction of a ton of GHG in one country

resulting in carbon credits could help offset GHG emissions in another country. Clean air essentially is clean air. Reducing emissions of GHG is the best and preferred option to reach the net zero commitment, but as long as that is not viable, offsetting GHG or noxious gas emissions in the air may be the next best alternative, regardless from where that takes place. It should be noted that this conclusion is not universally embraced and carbon credits are not considered a full substitute for a company's own emission reduction. Furthermore, there is concern in the market that not all (voluntary) carbon credits represent genuine GHG reductions. That is why increasingly new governance bodies that establish or monitor high-integrity threshold standards are being formed. However, from an emission offsetting perspective concluding that carbon credits resulting from emission abatement in one country can be used as offset in another country, would be a logical outcome.

The global process of putting in place emission targets and caps or ceilings (provided those are realistic) encourages the trade in carbon credits in the market as long as operating individually at net zero is not possible. The carbon trading systems in place are essentially either cap and trade systems or baseline and credit systems. If optimizing the use of carbon credits is desired, the systems that grant, verify, and record carbon credits should be recognized and applied internationally. Transferring carbon credits crossborder should ideally be a process that is clear, straightforward, easy, and well-regulated. The process should allow for recognition of the carbon credits being transferred between brokers and between sellers and

buyers that want to ultimately apply the credits against their own emissions.

The market-based carbon credit systems in place today are either a mandatory (or compliance) market or a voluntary market. Compliance markets are created and regulated by mandatory carbon reduction regimes that may be national, regional, or international. Voluntary markets enable companies or individuals to purchase carbon offsets on a voluntary basis. Both markets have different project requirements and processes and are generally subject to domestic rules, regional rules (like the European Union Emissions Allowance Trading Scheme (ETS)) and international rules specifically catered to sustainability and climate change.

While carbon credits generated in the mandatory market may be used in the voluntary market, the reverse is not automatically the case, and carbon offsets resulting from a voluntary regime must first be recognized for use in a mandatory compliance regime. Furthermore, the programs and markets in place offer a range of units that reflect a metric ton of reduced carbon dioxide equivalent emissions, for example Assigned Amount Units (AAUs), Emission Reduction Units (ERUs), Certificates of Emission Reduction (CERs), and Removal Units (RMs), to name a few. If the adagio that clean air is clean air holds true, to optimize emission reduction the respective trading schemes and emission reduction units should ideally be fungible, but today, they are not.

While the border issues and market differences create complexities, so does the legal character of a carbon credit. If emission regulation is accepted as a right

of States, and the creation of tradeable carbon credits essentially converts air, a public property, into private property – for our purposes defined as a carbon credit, the contours of this property right allowing the owner thereof to enjoy its (full) benefits should be clear. But carbon emission rights or allowances seem to be a hybrid between a public and a private right as a result of the applicable regulatory regime. Furthermore, carbon credits or allowances tend to have a limited shelf life. They usually grant the right to emit a ton of carbon dioxide equivalent only during a specified period. This means that if they have a determined value, that value is anything but permanent. The carbon credit essentially can be used to comply with an emission limit, and if so used, is to be retired and only used once. It can be held for later use (and will be useful as long as that use is within the specified time period) or it can be transferred and traded to another person assuming it qualifies for transfer or trade.

A Closer Look at Transfer Pricing

Transfer pricing is an area of corporate tax law that relates to intercompany transactions and the pricing thereof. Essentially transfer pricing looks at the setting of prices for goods and services sold between associated entities within a multinational enterprise (MNE) group. According to the OECD Transfer Pricing Guidelines, it is not an exact science but does require the exercise of judgement on the part of both the tax administration and the taxpayer. Alternative descriptions of transfer pricing include that it is a technique used by some multinational corporations to shift profits out of the

countries where they operate and into tax havens that involves a multinational selling itself goods and services at an artificially high price, indicating that transfer pricing *per se* is a negative practice. To set the record straight, it is not. Transfer pricing is required by tax law. When done in compliance with the applicable rules, it is a mechanism to assure correct income allocation to the relevant jurisdictions where an MNE operates. In issue, therefore, is that MNEs correctly price their intercompany transactions consistent with the applicable rules.

MNEs more and more partake in emission reduction related activities as they have no choice. They may be subject to outright emission restrictions (if they are assigned a cap by the government or from an Environmental, Social and Governance (ESG) and public reporting pressure perspective want to reduce emissions in support of reaching net zero goals. This may lead to wanting to obtain carbon credits. The activities to do so may range from the procurement of carbon credits at MNE headquarter level to pursue compliance for the MNE group as a whole with a subsequent allocation of those credits to the relevant associated enterprises in the respective jurisdictions or consist of the investment in and deployment of GHG abatement activities specifically undertaken to generate carbon credits per explicit government requirements when entering into joint ventures with them (this is for example observed in the extractives and mining industry). The activities undertaken may also be for the generation of carbon credits explicitly destined for (commercial) sale.

Whatever they do, to be in compliance with transfer pricing rules, the respective

involved associated enterprises of the MNE group will need to make sure that their resulting income is at arm's length based on transfer pricing rules, which include an analysis that considers their respective functions performed, assets used, and risks incurred. However simple this may seem, the analysis that serves to make sure there is an accurate delineation of functions, assets and risks in practice encounters many issues that need to be considered, included, or discounted and is the most difficult issue to address and frequently raised in a tax audit. These include consideration of the extent of investments made into sustainability measures and related cost allocation, the impact of available subsidies, the significant business risks involved, but also the intended use of any resulting carbon credits. They also include that the comparable firms used to benchmark the arm's length nature of the transfer pricing policy have reasonably similar assets, functions and risks, or proper adjustments are made.

To be able to perform an accurate delineation, it will be useful to get a high level understanding of the carbon credit ecosystem. This ecosystem includes parties that undertake activities that contribute to generating carbon credits, parties that buy these credits, and a host of other players in-between. Furthermore, carbon credit generating projects also need to consider the (impact of the) regulatory regime, the consequences of the (usually significant) investment requirements and the (also significant) risks involved with generating credits.

Carbon Credit Ecosystem

Since the 2015 Paris Agreement and developments related to voluntary carbon credits resulting from the subsequent COP meetings, the carbon credit market is particularly focused on the voluntary market and the buying and selling of carbon credits in that environment. In the compliance market, governments have assigned a cap on emissions that certain industry sectors may release, such as oil, transportation, energy and waste management. If a company in those sectors would go over the prescribed emissions limit, it must buy or use saved credits to stay under the emissions cap. If it remains below the assigned cap, it can sell its excess credits, which leads to a cap and trade market. The voluntary market is where companies generate or acquire credits because of other interests to reach the net-zero goals. While the compliance and voluntary carbon credit markets are originally distinct, voluntary carbon offset programs are influencing and interacting with compliance markets. For example, voluntary credits may on occasion also transition to become eligible for compliance, although this is not further discussed in the current analysis. The voluntary market allows for the offset of emissions outside of a regulatory regime and for the purchase of offsets that have been created either through a voluntary or compliance market program. As indicated, the voluntary offset market includes a wide range of programs, entities, standards, and protocols. These standards and protocols can differ greatly as to their goals and the services provided. At one end there are complete offset programs with developed standards, including rules, requirements, and administrative systems for accounting, quantifying, monitoring, reporting, verifying, certifying, and registering offset projects and credits. At

the other end, there may be limited standards that are adapted by individual offset programs. As a result, the type and quality of carbon credits might need to be considered an issue for consideration also for transfer pricing purposes.

Players in the carbon credit ecosystem include first the carbon project developers. They are the parties that source and initiate carbon offsetting projects; bring implementation partners and finance together; work with carbon credit standards and verification bodies, tend to bear financial risks of carbon projects, and work with a network of distributors and retailers to deliver auditable carbon offsetting claims for corporations' climate action programs. While developers will do what they can to hedge their risk, it should be clear that the sourcing and initiating of carbon offsetting projects requires significant up-front investments and carries risk that the projects (which tend to take significant time) do not generate the targeted carbon offsets.

Developers interact with the (third party) carbon offset programs that set the standards for the carbon credit quality and issue carbon credits that are tracked in their registries to monitor the issuance and retirement of credits. The development projects are generally audited by qualified third party auditors that review, measure, and verify emission reductions achieved by the respective projects.

On the other end of the spectrum are the credit buyers. They buy carbon credits to offset their own emissions or to offset group emissions that are part of their corporate value chain. When the credit buyer and the project developers are not

part of the same MNE, they tend to engage with (unrelated) carbon brokers to acquire carbon credits or directly interact with carbon exchanges where verified credits are listed, bought, and sold.

In-between the above participants, there are the carbon offset programs that set the standards for the: (1) carbon credit quality by certifying and issuing the carbon credits, plus handling the registry of the certified credits including the retirement of the credits; (2) carbon exchanges that serve as the carbon market places where certified credits are listed, bought and sold; (3) carbon brokers or retailers that offer a range of credits and services that reduce the time and efforts needed for investors to interact with the developers; and (4) third party auditors that independently vet emission reduction potential before projects are registered and that vet emission reduction of existing projects.

Overview of Carbon Credit Generating Projects

The World Economic Forum distinguishes three basic types of carbon credits: (i) those resulting from reduced emissions (typically energy efficiency measures); (ii) removed emissions (i.e., carbon capture storage and planting forests); and (iii) voided emissions (i.e., refraining from cutting down rainforests).

To visualize a carbon credit generating project, following an example is provided of a reforestation project undertaken by developers to generate carbon credits.

Reforestation Project Example: Carbon sequestration is the process of capturing,

securing, and storing carbon dioxide from the atmosphere. Carbon dioxide can be naturally captured from the atmosphere through, amongst others, biological processes. Planting trees is considered an effective way to capture carbon and as a result there is an increasing interest in investing in developing appropriate carbon offset projects that use the natural growth process of trees to hold (or sequester) CO₂ in the living wood, roots, and forest soils, thus preventing its escape to the atmosphere. These type of projects are currently considered as being a relatively more mature industry to generate carbon credits.

There are different ways to generate GHG emission reduction by capturing ('bio-sequestering') atmospheric carbon and locking it into the living and dead biomass in the ecosystem. One way is reforestation, which consists of re-planting trees on forest land. There is also a process called afforestation, which entails planting trees on land which had a different original ecosystem, such as planting forests in areas that used to be deserts.

Reforestation projects involve up front capital investment for which in return, carbon credits are (expected to be) granted. Reforestation project developers will need to have specific knowledge, such as making decisions to invest in which land and in which countries (including conducting feasibility studies), and will need to take on tasks such as acquiring the land, obtaining the financing needed to invest in the land, performing operational activities to grow the land (e.g., animal control, site preparation, herbaceous release, reforestation and road and ditch maintenance), carbon management, certification, marketing and sales, and general and administrative

activities (including legal and insurance). The targeted and key source of revenue resulting from these projects is the revenue resulting from carbon sequestration. A small part of the project revenue may be generated through the sale of timber / hardwood or from leasing the land in relation to solar, wind and for other purposes. In any case, carbon projects need to undergo several steps before they lead to carbon credits. These include project design, formal approval, validation, and registration.

Let's assume, for discussion purposes, that a company interested in generating (and selling surplus) carbon credits decides to commence a reforestation project. It can do so as an investor in a reforestation project in return for carbon credits, or it can take on a more involved role in the underlying activities by developing a sustainable business line of activities, one of which involves the buying or leasing of property destined for reforestation purposes while making sure that the property is properly replanted and applying for the necessary approvals to qualify for carbon credits.

When taking on the project activities itself, the company will need to assure that the real estate destined to be used meets necessary requirements. Separate from making sure they have legal title or tenure to undertake the intended activities, it is also necessary to consider that only certain lands may be eligible for reforestation project activities. Countries usually require the issuance of a Letter of Approval (LOA) for these projects, a request for which should be submitted timely, to avoid finding out later that the project is not viable and investments are essentially lost. Furthermore, the site and soil conditions (and the costs of site

preparation) need to be considered early on. For this, the company will need to work with expert brokers to decide on the right property and mode of acquisition (i.e., purchase or lease) or take on this expertise in-house (perhaps as a service center) and follow up with the acquisition once the right property is located.

The process that forms the basis for the issuance of carbon credits consists of several steps, which is discussed below.

A. Once the planned project activity and property meet the required criteria of a program that can certify and award carbon credits, a Project Design Document (PDD) that describes the project background, its objectives, and its benefits and impacts other than emission reduction benefits (particularly the socioeconomic and environmental benefits) is required. The PDD will include the technologies and measures (actions) that will be undertaken to reforest the lands (e.g., assisted natural regeneration, planting of seedlings, aerial sowing of seeds). Information on the species and varieties of trees to be planted, the nursery techniques and planting techniques to be employed and planting machines and equipment to be used should be provided. If genetically improved breeds of trees are to be used, this should be mentioned while describing how any adverse ecological effects of these would be managed or contained. A brief description of what technologies and know-how that will be used is required as well. In short, preparation of the PDD is one of the most important steps in undertaking the project, and its preparation is dependent on specific expertise. The PDD can be prepared with the assistance of outside experts, or alternatively could be

prepared in-house by the aforementioned service center.

B. Validation of an intended project is another critical phase in the process and consists of reviewing whether it can be verified how much carbon was removed – and remains removed – by the forest in that year, and whether all project requirements to ultimately qualify for carbon credits are met. To this end, a Designated Operational Entity (DOE) (an accredited independent auditor) assesses the PDD documents against the project qualification requirements and may ask for further information to satisfy itself that the contents of the PDD are adequate and are supported by justificatory evidence. It may also involve a (public) stakeholder consultation request for input or comments from stakeholders, only after which it is determined whether the proposed project activity should be validated. Only after this, the project may be registered.

C. Once a registered project has been implemented by the project participants and sufficient emission reductions and removals have been achieved, a monitoring report can be prepared in accordance with the monitoring plan contained in the registered PDD. The monitoring report provides the necessary evidence of the emission reductions or removals achieved by the project, and as such, directly impacts the number of carbon credits to be awarded. The monitoring report is submitted to a DOE contracted by the project participants for the purpose of its verification and certification. The DOE makes the monitoring report publicly available on the official website and undertakes a review and assessment of the monitoring report to ensure that the report is in

accordance with the requirements contained in the registered PDD. The DOE can conduct on-site inspections, as appropriate, and test-checks the data underlying the monitoring report. Having satisfied itself of the adequacy of the monitoring report as evidence of the emission reductions or removals claimed by the project participants, the DOE prepares a verification and certification report which is made publicly available on the official website. It can take several years before a reforestation project leads to the generation of sufficient emission reductions to qualify for the issuance of carbon credits. Each step may result in significant (transaction) costs, which are funded by risk capital instead of cash flows. These costs are not recoverable in case the reforestation project fails. There is a considerable amount of risk associated with the investment which makes the return on the project difficult to predict.

Transfer Pricing Analysis Related to the Reforestation Project

Example: From a functions, assets, and risks perspective, an investment in the form of a long-term lease or acquisition of real estate located in a country (which may be undertaken by a special purpose entity) can be distinguished, together with an investment in the (performance of the) actual reforestation process, meaning that the decisions made on what species and varieties of trees are to be planted and the nursery techniques and planting techniques to be employed are executed, together with further investments in planting machines and equipment necessary to maintain the planted trees in good order and good health. This function needs to be performed for the period of time needed to get the reforested area up to the level

where it sequesters carbon and that sequestration meets the PDD standards and is also verified to do so.

In addition, the company must have performed a financing function to make sure the project is properly financed during its lifetime. The P&L of the group is likely to record initial losses. Once carbon credits are awarded, those are likely to be sold in the market, or allocated within the group for internal use and applied as an offset against the company's own emissions.

Therefore, a reforestation project involves assuming several business risks, including physical risks (e.g., natural disasters fire, and windblow, pests and diseases, animal damage or theft and other physical conditions (e.g., the trees may not capture the carbon where the temperature is too hot resulting in less carbon credits), regulatory risk (the rules regarding the qualification for carbon credits are still in flux and subject to changes in regulations), market risk (including carbon credit price risk), land price risk (overpaying for the acquired land), foreign exchange risk (e.g., carbon credits may be sold in a variety of currencies), credit risk that customers do not pay for the carbon credits, and liquidity risk (e.g., a reforestation project will only generate carbon credits after several years so the annual costs will need to be financed).

Assets used in a reforestation project may include intangibles (e.g., trademarks and technology), know-how, financial assets, and the generated carbon credits.

The number of intercompany transactions involved in a reforestation project depends on the business model of the MNE group engaging in such a project.

Not all reforestation projects involve a quagmire of intercompany transactions. In practice, it is often observed that a fund is established to invest in reforestation projects. Here, a (local) company will be set up to invest in the timberland properties located in a local country. For simplicity reasons, in this example it is assumed that the fund incorporates or holds a parent company engaged in making worldwide investments in reforestation projects, while the local operational company that acquires the timberland assets is engaged in all business activities, including operational silvicultural activities (e.g., planting, thinning, harvesting, timber sales management and roadwork), forest operations management (e.g., property inspection, mapping, and site analysis), forest inventory management and lease management, local strategic management (such as contact with local authorities, identifying and examining alternative properties and annual budgeting), carbon credits management, and marketing and sales activities. The local operational company may outsource certain activities to third party service providers. The main intercompany transaction is the provision of an intercompany loan by the parent company to the local operational company for the purpose of acquiring the timberland assets and for having sufficient cash flows to fund the operations. A transfer pricing analysis would typically consist of a debt service capacity analysis and interest rate benchmarking analysis to determine arm's length conditions of the intercompany loan.

Alternatively, the business model can be one where the local operational company performs operational activities at the instruction of the parent company. The

parent company owns the valuable and unique intangibles regarding reforestation projects, performs the worldwide carbon credit management activities, the trading of the carbon credits, and any and all public affairs (establishing requisite and appropriate government relations). Intercompany transactions may consist of the provision of the intangibles to the local operational company by the parent company so that the operational activities can be appropriately conducted, namely the intercompany sale of the carbon credits by the local operational company to the parent company so the latter can sell the carbon credits to third parties. Although the statement reflecting the carbon credits earned may have been issued to the local operational company, this does not mean that the local operational company legally owns the (economic value of the) carbon credits. Usually, the verification report is submitted to the relevant carbon credit registry on behalf of the local operational entity merely for administrative purposes. When subsequent to the review of the verification reports it is determined how many tons of GHG were abated or emission avoided, the corresponding amount of carbon credits are awarded. Based on an accurate delineation of the intercompany transactions, on aggregate the local operational company may be characterised as a service provider (resembling a routine contract manufacturer) that should receive an arm's length remuneration based on applying a basic cost plus or transactional net margin method. This would indicate that the carbon credits awarded would not belong with that local operational entity.

An alternative business model could be that both the parent company and the local company provide unique and valuable contributions such that the transactional profit split method should be selected as the most appropriate transfer pricing method. The local company may own certain valuable and unique local intangibles regarding the reforestation project and conduct the operational activities, while the parent company may perform the key carbon credit management and trading activities.

There appears to be no reason why the comparability analysis of intercompany transactions in relation to carbon credit generation projects, such as a reforestation project, should deviate from any other normal comparability analysis for transfer pricing purposes. The intercompany transactions need to be accurately delineated based on the five comparability factors (i.e., the contractual terms of the transaction, the characteristics of property transferred or services provided, the functional analysis of the related parties (including risks assumed and assets used), the economic circumstances and the business strategies of the parties before selecting and applying the most appropriate transfer pricing method.

The main turnover of a carbon credit generation project consists of turnover derived from trading the generated carbon credits. As described above, notwithstanding that a statement reflecting the number of carbon credits resulting from abatement activities may have been granted to the local operational company that submitted the request to the relevant carbon credit registry, this does not mean that it legally owns the carbon credits and is entitled to the

profits in relation to the carbon credits. The carbon credit registries do not award legal ownership. They register carbon credits and administer which party reportedly holds the relevant carbon credits. For transfer pricing purposes, therefore, the allocation of profits in relation to carbon credits should be based on functions performed, risks assumed, and assets used by the relevant parties to the intercompany transaction.

Alternative Emission Reduction

Projects: There are various other and different types of projects which may generate carbon credits, like mangrove restoration projects (generating “blue” carbon or wetland restoration credits), carbon capture storage projects, or cookstove projects. Projects that capture and destroy high potency GHG like methane or N₂O can similarly qualify. Thanks to these projects emission reduction and generation of carbon credits is in full motion and significant investments are being made by MNEs to get to that result. However, obtaining verified carbon credits is (still) a lengthy and risky process. In addition, many MNEs are investing heavily in renewable projects, such as solar energy, wind farms and hydrogen production, that do not qualify for carbon credits but nevertheless are critical to help avoid emissions and are important to limit global warming and reach net zero targets. Each different type of project will have its own challenges, but whether they lead to carbon credits or not, all have in common that when associated enterprises are involved, the general transfer pricing rules and analyses should allow for an arm’s length allocation of resulting profits and losses.

Challenges That Would Benefit from Clarification

Challenges in the field of carbon credits for transfer pricing purposes that would benefit from clarification and global consistency include, inter alia: (a) determining the entitlement to the (value resulting from) carbon credits; (b) how carbon credits are to be characterized and taxed for tax treaty purposes; (c) how carbon credits are to be characterized for transfer pricing purposes; (d) the treatment of government subsidies available for engaging into sustainable projects; and (e) the allocation of costs related to engaging into sustainable projects that serve to generate carbon credits. Furthermore, if taxing authorities would propose adjustments to taxable income resulting from generating and trading carbon credits based on transfer pricing principles (f) what information would the competent authorities require and consider to resolve double taxation?

A. Entitlement to carbon credit revenue: The awarding of carbon credits is done by organizations (carbon credit registries) to which a claim for carbon credits under a recognized and approved program is submitted. There are several organizations offering carbon credit programs and certification following proper verification. While these organizations may have different standards, all aim to establish a level of scientific integrity that is in sync with their own focus and project requirements. Some examples include the Verified Carbon Standard (VCS) or Verra, the Gold Standard (a best practice standard launched by the World Wildlife Fund (WWF) and some other international NGOs), the CDM standard (under the

Kyoto Protocol), the American Carbon Registry (ACR) standard (a private voluntary GHG registry), China GHG (for use in China), or the CORSIA standard (destined for the aviation industry), but there are more. Whether issued under a regulated or private standard, all carbon units tend to be described as reflecting one metric ton of carbon dioxide. In general, claims for carbon credits are submitted with a LOA from the country where the emission reduction program takes place. Often the request must be submitted by or on behalf of the entity that is engaged in the emission reduction activities for the obvious reason that the emission reduction resulting from its activities are to be reviewed and measured. However, the actual grant is essentially a mere confirmation that the project activities contributed to GHG emission reduction, and that the latter is eligible for a certain number of carbon credits. There is no legal title conferred by the grant of carbon credits, and it cannot be concluded that the credits therefore are legally owned by that entity as opposed to by other entities that are engaged in or contribute to the emission reduction activities. From a transfer pricing perspective, this makes good sense. Where the awarded carbon credits represent a certain economic value, the accurate delineation should determine what associated enterprise in the value chain is entitled to that economic value. Even if the grant would be found to confer some form of legal entitlement, relevant economic value of the carbon credits would nevertheless have to be allocated to the entities that performed key entrepreneurial functions to the project and the generation of carbon credits for transfer pricing purposes. In practice, entitlement to carbon credits is

pragmatically established by contractual arrangements.

B. Tax Treaty Characterization: For corporate taxation and international tax purposes, an issue is whether the generation of carbon credits is to be considered as a financial result of business activities, or possibly whether they are to be seen as the literal fruit of a tree. In the reforestation example they might be treated as revenue resulting from forestry and treated as income resulting from immovable property under Article 6 of the OECD and UN Model Conventions. If carbon credits are treated as intangibles and not dissimilar to financial products, the revenue they generate can be allocated for transfer pricing purposes based on the existing rules for intangibles. Particularly the guidance under Articles 7 and 9 of the OECD and UN Model Conventions, and the existing transfer pricing guidance from the OECD are helpful in that case. If they are treated as income resulting from immovable property for domestic tax or tax treaty purposes, they are characterized to be subject to source taxation in the jurisdiction where they are recognized and (administratively) granted. For a reforestation project, it may appear attractive to conclude that revenue resulting therefrom should be treated consistently with other forestry projects, such as those where forests are grown for the production of timber, for example. But doing so could lead to a difference in the tax treatment of carbon credits depending on whether they result from a reforestation project or result from the placement of a separate turbine and enhanced software in an industrial process to capture noxious gas emissions that originate from the process or whether the carbon credits have been

awarded based on a cookstove project that leads to a reduction of traditional wood or charcoal burning cooking systems. From a transfer pricing perspective, there is much to say for defining income resulting from carbon credits as business profits. From a commercial perspective, the same may be true, as taxation costs impact the return on investment (ROI) of carbon projects. Once the combined indirect and direct tax levies surpass a certain threshold, carbon credit project ROI calculations may become so low or lossmaking that it discourages the continuation of the projects. In any case, if carbon credits could be treated consistently for corporate income tax purposes, that would be encouraging for business investing into the generation of carbon credits. It should also be considered that in some jurisdiction GAAP and local tax rules may contain different definitions of cost, i.e., the United States.

C. Transfer Pricing Characterization: For transfer pricing purposes, there is much to say to characterize carbon credits as intellectual property. Largely because for accounting purposes that already appears to be a preferred characterization, but also because that would allow for an arm's length income allocation for carbon credit-related revenue based on the guidance provided in Chapter 6 of the OECD Transfer Pricing Guidelines on Intangibles. For GAAP/IFRS purposes, it should be considered that emission reduction units have been classified as an intangible asset to be accounted for under IAS 38 (Intangible Assets), unless they are to be treated as inventories under IAS 2 (Inventories) and held for sale in the ordinary course of business. The characterization of carbon credits as intangibles allows for an analogy to be

drawn with the transfer pricing analysis of intangibles in which mere legal ownership of an intangible does not confer any right to the return from its exploitation. Taxing jurisdictions generally look to beneficial ownership to determine from a cost perspective who paid for the actual development of the particular intangible. Therefore, the allocation of returns from the exploitation of intangibles should be based on which parties perform the DEMPE (Development, Enhancement, Maintenance, Protection and Exploitation) functions, assume the risks and provide funds or other assets. Paragraph 6.6. of the OECD TP Guidelines defines intangibles as “something which is not a physical asset or a financial asset, which is capable of being owned or controlled for use in commercial activities, and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances.” See also the OECD Guidelines under BEPS Actions 8 to 10. A carbon credit fits the definition of an intangible from a transfer pricing perspective: it is not a physical asset, it does not seem to be a financial asset, it is issued and registered (much like a patent or trademark), and a transfer thereof would need to be compensated at arm’s length in a market transaction.

D. Subsidies: Subsidies are a form of financial government support for activities believed to be environmentally friendly and play a prominent role in the arsenal of measures that are available to encourage sustainable behavior and emission reduction. They reward a polluter for reducing emissions and are available in many forms. They can be granted by different government departments and under different forms of

legislation. Subsidies may be granted in the form of (domestic) tax credits for wind, solar, carbon capture and electric vehicles or as grants, low-interest loans, favorable tax treatment or procurement mandates that require the government to “buy clean”. While it is usually clear what legal entity can request the application of the respective subsidies, there is little guidance as to whether and to what extent subsidies are to be passed on through the corporate supply chain in an intercompany setting. In this respect, it is also relevant to note that there are few universal subsidies — most of them are based on local government design and implementation. Subsidies have gained more attention because of the Covid-19 pandemic, as companies were materially supported by local country governments to avoid massive bankruptcies and economic shutdowns. Every country had locally designed the subsidies in place, and different country entities belonging to one and the same MNE could qualify under domestic rules for their application. This invariably led to questions as to what the impact was of the subsidies on the arm’s length remuneration to be earned by the respective associated enterprises. Are subsidies to be treated as government policies or as location savings – local market conditions? Can the subsidies be passed on through the value chain, reducing the cost of services or products for the associated enterprise that is the recipient of the services or buyer or do they remain as a financial benefit for the domestic entity that received them. Do the subsidies effectively make finding comparables that included subsidies in income for benchmarking purposes illusive and, if not, could effective adjustments be made? Also, subsidies may differ greatly and adjusting

comparables for subsidies may be a difficult task unless noted in their particular public filings. More detailed guidance on this would be helpful.

E. Cost and cost allocation: Reducing GHG comes at great cost. Carbon capture technology is expensive. Restructuring a business to implement a reduced emissions operation is cost intensive and ramping-up new business models or systems may be slower than expected and lead to a slow (or no) recoupment of costs. Commencing adjacent carbon credit generating activities has significant upfront and investment costs. Procuring carbon credits comes at a cost, and these costs do not generally lead to the generation of revenue. Arguably, they can be part of a cost sharing system with the corporate group as participants, not much different from cost sharing for intangibles. The treatment of carbon credit-related costs may differ if obtaining carbon credits is legally required, e.g., mandatory (in the compliance market), or obtained for ESG and reputation protection purposes (in the voluntary market). Can the costs be considered as necessary to maintain a company brand? If so, they can be reimbursed by charging associated enterprises a royalty. If not, should they be allocated to associated enterprises, and if so, against what allocation key? Other costs in this industry that can be mentioned are (domestic) carbon taxes and related levies. Notwithstanding all the investments made and available, decarbonizing and transitioning industries will be time consuming because the volume of new (clean) energy production will not be able to replace the volume of today's global energy demand, and getting behavior change embedded is similarly time consuming. So carbon taxes and penalties are likely to be a reality for

many MNEs, despite their best efforts to reduce their emissions. Yet the penalties and carbon taxes imposed may not be available for passing on to consumers, leaving MNEs with higher operational costs. For each cost item, an analysis can be made why those costs should or should not be passed on in the corporate value chain. For transfer pricing purposes, however, it is likely that tax authorities will challenge cost allocations that impair profitability or lead to local losses. Are local costs required to be offset by locally granted subsidies first? Can independent analyses be applied per category of costs? Do entity characterizations interfere with the strategy to recoup local costs over time with revenue from carbon credits? Climate change and preparing to avoid as much of it as we can is a corporate game changer. Not participating is prohibitive. A fresh look at carbon related costs may therefore be required.

F. Avoiding double taxation: The previous five challenges already indicate that it is probable that there will be differences of opinion on how carbon credits are to be treated and taxed and on how subsidies and costs related to carbon credits and climate change projects are to be allocated between related parties. This is a very fluid rapidly changing market and business. Assume Country A is of the position that the market value of granted carbon credits should be entirely taxed in Country A. For transfer pricing purposes, however, it may be that the carbon credit value was allocated to an associated enterprise in Country B since that enterprise serves as entrepreneur for the carbon credit project. How would Country B substantiate its position to seek agreement on the arm's length income allocation between the two countries?

The Mutual Agreement Procedure article (Article 25) of the applicable bilateral treaty for the avoidance of double taxation (“MAP”) would make the competent authority process available to seek avoidance of double taxation and obtain a corresponding adjustment in Country B. The corresponding adjustment for corporate tax purposes is not the same or related to the corresponding adjustment that is required under Article 6 of the Paris Agreement that relates to avoidance of double counting of carbon credits (or international mitigation outcomes (“ITMO’s”)) towards a country’s GHG mitigation pledge. Countries all have Nationally Determined Contributions (NDCs), or targets for mitigating GHG. Carbon credits awarded by the carbon credit registries in a country are counted against that country’s NDCs. Transfers of ITMOs across the country borders, for example because of a sale to a buyer outside of the country therefore require a corresponding adjustment against the exporting country’s recorded carbon credits applied against its NDC. While this is a separate administrative and accounting process, the measure could impact the corporate taxation analysis. To illustrate this, consider a case where a country bans the export of carbon credits until that country meets its own climate goals. This would likely be considered a government policy from a transfer pricing perspective, much like price controls or blocked income, and certainly affect the tax and transfer pricing treatment initially applied. The carbon credit generating business models are young, the applicable rules change with regularity and new rules are constantly added. Will the very latest developments drive a MAP analysis regarding earlier years in this dynamic industry? It could be that new findings or legislation

suddenly disqualify (certain) carbon credit projects and therefore also impact legacy carbon credits resulting from a sizeable investment into a previously approved project under an existing program from trading or may even require them to be retired. Will transfer pricing adjustments involving old years be resolved with or without considering the new findings and legislation? What information will taxpayers need to prepare and submit to seek relief from double taxation? Separate and apart from the usual transfer pricing challenges brought to the attention and for resolution of the competent authorities, such as considering the applied transfer pricing methods and interpretations of functional analyses, consideration in this field by competent authorities may be required sooner rather than later.

Closing Observations

Taking into account the regulatory risks involved, the fact that carbon credits can only be awarded several years after the investment in abatement activities are made, the economies of scale needed, market risk and other risks, it cannot be presumed that carbon credit generating projects will lead to profits right away. In the start-up period, operating losses will inevitably arise due to the investment (e.g., in technology development) and economies of scale needed. It will depend on the transfer pricing characterization of the respective entities involved how such losses are to be allocated. Climate change commitments are intended to help the respective countries, companies, and the world reach important climate targets. The more countries, companies, and people comply with the proposed and implemented rules and regulations, the better it is and the more likely that the

ambitious climate targets can be reached. To aid and encourage compliance, resolving the administrative and legal challenges or inconsistencies indicated above is imperative. While lots of attention goes to what requirements can be agreed and put in place to make sure the world limits global warming to 1.5 C, it may be that governments that focus also on the administrative infrastructure needed to allow companies to comply with those rules and implement emission reduction initiatives effectively end up achieving the most optimal result. This would include addressing the resulting transfer pricing and tax challenges, some of which are touched upon in this article.

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