Sustainability in Transfer Pricing - Chance or Risk for Developing Countries: A Review of Greil's Sustainable Value Creation Approach

By:

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I. Introduction

Prior literature has discussed how taxes and other financial means can play their part in sustainability on a national and international level, e.g. the implementation of border tax adjustments as a possible measure to enable high environmental tax rates or a high carbon price in particular countries or groups of countries (VIDC/Tax Justice Europe 2018).

But for the first time *Greil* has addressed how the question of sustainability aspects could be considered in cross-border profit allocation in MNE groups: By

using the principle of sustainable value creation and expanding the triad of functions, risks, and assets with the aspect of sustainability (Greil 2021).

In times of climate and inequality crisis, this progressive proposal has worldwide relevance and might be something worth developing and pushing forward, as a *sustainability in substance approach* could bring much needed sustainability aspects in transfer pricing. This blog post summarizes the significant findings of the Stefan Greil, Sustainable Transfer Pricing article mentioned above. It also critically evaluates the chances and risks from the perspective of developing countries from such an approach.

II. The status quo: Allocating Profits of MNE without considering sustainability aspects

Stefan Greil starts by generally describing that taxation is to occur where the economic activity of companies is performed having regard the performance of functions, the assumption of risks, and the use of assets. This concept of economic allegiance is essential for the allocation of profits, and implemented by the arm's length principle, which uses a value-creation-oriented approach. But instead of getting bogged down in details or the debate whether or not value creation itself is a concept worth following (Elliffe 2021; Phlekhanova 2019; Li et. al. 2019; Christians 2018; Devereux / Vella 2018) *Greil* makes the point that (…) "*the sustainability aspect of the economic activity is completely disregarded. It is therefore completely irrelevant whether entities of the MNE group in a country comply with environmental standards or employ workers under inhumane conditions. At the same time, one of the most significant problems of our society is the increasing exploitation of the earth system*."

Greil argues that failing to take sustainability into account contributes to the depletion of natural resources, pollution of air, water, and soil, deforestation, climate change. This he argues is inconsistent with the increased environmental awareness of people and corporations as exemplified by the Sustainable Development Goals (SDG) and the Paris Agreement on climate change. He also argues that ignoring sustainability undermines the roles that MNE should play because they are likely to contribute to environmental degradation. Although MNE might be proactive in their home country / resident state, they do less to almost nothing to take similar sustainable actions in a

host country / market country, often outsourcing dirty operations, sourcing labour below subsistence pay levels, and fostering poor working conditions while taking advantage of the lax social and environmental standards in foreign countries where they establish businesses in a race to the bottom, while also evading taxes.

He argues that the concept of value creation is nowadays understood as an approach which also considers the demand-side perspective in contrast to a mere supply side perspective that allows more profit allocation to market and source countries. This is because all value is created jointly in modern business models in a so called (data) ecosystems (Jalan/Winterhalter 2020 a). A supply side perspective does not integrate the value (creation and capturing) arising from the sustainability perspective (Jalan/Winterhalter 2020 b).

III. The new approach: Higher sustainability means higher profit allocation for the respective business entity

Greil fills this gap by arguing, that *if it is accepted that the state community basically agrees that sustainable economic activity is necessary to secure life on this planet, then the addition of the sustainability aspect is intended to support this objective from the perspective of the states*. One possibility could therefore be that companies that operate more sustainably should be provided with a comparatively higher profit allocation for taxation purposes.

In this regard, he points out that, from the standpoint of the eco-critical perspective, creating value also means improving people's well-being by simultaneously assuming responsibility for the natural environment and social community. It is an opportunity because it maximises profit the old value creation way, but also because it creates economic, ecological, and social value by integrating these values within their business model for sustainability (Muff/Dyllick 2014).

This subsequently allows for the allocation of taxing rights as this aspect of value creation is created by entities located in a particular national territory using natural capital on site. Or as *Greil* puts it: *The allocation of taxing rights must therefore also take into account sustainability*.

This progressive interpretation of how sustainability must become part of tax law is accompanied by a practitioner's proposal on how to implement this *sustainability in substance approach* in transfer pricing.

IV. A practitioner's proposal: Sustainable Value Creation and the tetrad of functions, risks, assets, and sustainability

Greil provides us with a Use Case Scenario where in a two-country world (a residence and a source country) a multinational enterprise is present in two countries. The parent entity is located in country A, the permanent establishment / subsidiary owned by it is located in country B. The PE / subsidiary is producing industrial raw materials / semi-manufactured goods for the parent company. As this producer is usually a low-risk manufacturer, the parent company in country A would bear most of the risks, hold the relevant functions (management / R&D / marketing / logistics if not outsourced etc.) and assets (above all the intangible assets like patents on the technology and the specific procedures).

As a higher cost base leads to a higher tax rate, for country B it might be better from a tax perspective to gain a higher rate of its general expenditure allowance according to the arm's length principle. But accordingly, to the old value creation system, for a low-risk producer a higher cost rate seems to be out of reach, as risks, functions, and assets are assigned to the parent entity.

Greil proposes that sustainability aspects are now to be taken into account in the allocation of taxation rights. If the producer is then taking such sustainability action and produces its goods e.g., in a more eco-friendly way, then he would contribute to the sustainable value creation, and, following a lack of comparables, could increase its cost markup by e.g., 20% instead of the usual ~10% of low value adding intercompany goods and services (Schwarz et. al. 2016). This could also work the other way around: if comparable companies produce less sustainably, they may have then lower margins.

According to *Greil*, sustainability aspects, although often simply omitted from the discussion, could also easily be integrated in a formulary apportionment like CCCTB or BEFIT (COM 2021 251), e.g., as a variable next to sales, number of employees and their payroll, and (intangible and tangible) assets.

V. Chances and Risks for Developing Countries

The biggest chance for the world in general is, that this *sustainability in substance approach* in transfer pricing could be a progressive step for more sustainability in the economy, rewarding sustainable companies and avoiding that companies can externalize their ecological costs without taking over the responsibility. This might give companies incentives to actually incorporate sustainable purpose into their core business practices. The outcome from this would be promoting the attainment of the United Nations SDGs and *bringing positive change to people, communities, and the planet* (Fromm 2020). Taking into account sustainability in the market countries could therefore help those countries who are often most affected by the *race to the (very unsustainable) bottom*.

As sustainability as well as a higher allocation of tax rights positively affects market countries (e.g. regarding Democracy (Schön 2018) this double effect could be an incentive for market countries to boost sustainability by a more sustainable normative, political, financial and cultural framework and attract investments in technologies of the green revolution necessary for adopting societies for the climate and inequality crisis.

But as *Greil* points out himself, this reallocation of taxation rights may not be in accordance with the interests of the MNE group if the tax burden of the MNE group increases as a result. One can imagine that if the parent company is located in a low tax jurisdiction, a MNE might be encouraged to reduce the cost markup and in the end tax burden in a market jurisdiction with a higher tax burden. Ultimately, this might even be an incentive for MNE to reduce the effort for more sustainability, as it could be considered as a trade-off between lower taxes and higher sustainability.

Additionally, one can think of a two-sided effect for market jurisdiction and resident jurisdiction. If sustainability must be taken into account in the value creation process, there is no certainty or guarantee that a parent entity itself does not contribute sustainable value, e.g., by corporate sustainability and ethical codes (Salvioni et. al. 2015) or green technology and innovation driven (intangible) assets and R&D entities (World Bank 2016). Above all the latter one in the form of the triad of science, technology, and innovation appears to be a

value key driver for sustainable development (Ebrahim 2020; Nersesian 2020; Mani / Ramakrishnan 2019; World Bank 2016; Hansen / Grosse-Dunker 2012; Paramanathan et. al. 2004).

This effect could be accelerated if we assume that especially intangible assets and technology and innovation driven R&D entities as well as progressive management functions are rather located within the parent company in the (high income) resident country, few in developing countries, leading to a higher remuneration for the parent entity, and, in the end, compensating the tax gain for the market jurisdiction with the tax gain of the resident jurisdiction (Dutz / Sharma 2012).

This might turn out as a difficult audit problem as well, as the tax administration to which the MNE group is resident may have much more informal and formal access that helps in designing and implementing tax regimes at an advantage for their fiscal and commercial policies, leading to a power imbalance between developing and developed states (Moore et. al. 2018).

So why not simply increase sustainable value creation in the market jurisdiction? Key findings from different studies (Lino/Lim 2010; Johnson/Lybecker 2009) show that there are a number of characteristics and circumstances of developing nations that hinder the dissemination of environmental innovation: first of all, new technologies are often capital intensive and associated with size and scale economies, requiring access to investment capital. Although there seems to be overall acknowledgment that the budget of a Global Green New Deal needs to be extensive (G7 2021; UNEP 2009), there is a huge gap between state funded programs for sustainability in developing countries and the Green New Deal programs around the world (Puaschunder 2020), e.g. the EU with €1 trillion of green investments.(EU 2020; COM(2019) 640), the US with a (partly green) $2.3 trillion American Jobs Plan (Segers 2021), as well as the (partly green) Chinese Belt and Road Initiative with around $4 trillion (World Economic Forum 2021). Additionally, there is also a lack of scientists and researchers, brain drain, small market size, the lack of infrastructure, importantly telecommunications infrastructure, the quality the business environment and governance conditions, bureaucratic climate and the formal/informal regulations regarding economic transactions, cash-strapped

governments and inability to make public investments in research and infrastructure hinder innovation (Johnson/Lybecker 2009) It remains an open question, if above all the lack of capital for technology in developing countries could be solved, e.g., by a public-private green venture fund to promote development and deployment of sustainable technologies for developing countries (Nassiry/Wheeler 2011).

VI. Conclusion

Sustainable Value Creation and the tetrad of functions, risks, assets, and sustainability, developed by *Greil*, can be a chance for developing countries, possibly tackling the climate crisis and the inequality crisis at the same time. Nevertheless, there are also challenges, above all a lack of (human) capital regarding green technology. Additionally, as *Greil* points out, to address the idea of sustainability in the allocation of profits, two aspects are required: on the one hand, there is a need for a sustainability index, and on the other hand, there is a need for standardised sustainability indicators that are determined and published by companies worldwide. For developing countries, this should mean to be a frontrunner in this development and push forward the idea, always keeping in mind the risks but also chances of a *sustainability in substance approach*.

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