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Transfer Pricing

The impact of ESG on Business Models and Transfer Pricing policies

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The 'green' conversation in TP is still in its infancy stage and TP policies around ESG are not well developed yet. Many in-house tax executives have a multitude of current and potentially more urgent issues to deal with and might think that ESG has no or limited impact on their work of managing the tax position of a MNE. We believe that ESG will in many cases fundamentally change companies, supply chains and value drivers, and TP is critical to ensure a group's business model operates efficiently and reward is aligned to functions, assets and risks across the group. In addition, TP models are commonly set up strategically for a group to operate effectively from both a cost and tax management perspective. Given that various governments are starting to introduce more 'green' incentives, supply chains within traditional business models might not be sufficiently agile to make optimal use of available incentives.

Decision-makers need to make trade-offs between the ESG strategy and the impact that it has on the MNEs financial performance, people, economy and the planet. As such, ESG strategy can lead businesses in a new and different direction, for example making use of more expensive 'sustainable' inputs. TP policies need to take account of this and consider where existing TP policies require change.

ESG strategies have an increasing influence on Business Models. Therefore Multinational Enterprises ("MNEs") should assess how their Transfer Pricing ("TP") policies might need to be changed to take ESG influenced business change into account.

A detailed functional and comparability analysis is at the heart of the application of the arm's length principle. Considering who sets the ESG strategy, controls the risks and bears the costs thereof in the group is an important starting point. After establishing the facts regarding who in the group performs the ESG related functions, bears these risks and employs its assets, it is important to determine whether the ESG strategy creates IP, represents a service and/or is driven by shareholder concerns. These different characterizations impact how the transfer pricing model should deal with ESG related activities.

In addition, the International Sustainability Standards Board ("ISSB") recently issues sustainability exposure drafts, which demonstrate the need for reporting standards to be more transparent regarding Environmental, Social and Governance ("ESG") impact on an entity's financial performance. Also taking this into account, we believe it is the right time for TP models to take ESG into account and to consider whether inter-company arrangements require change

ESG brings new risks and opportunities that will have an impact on the financial performance of groups. Such risks include, but are not limited to:

- the physical impact that the group has on the environment, and any future limitations imposed by governments
- reputational damage in case of non-ESG best practice behavior and/or "greenwashing",
- regulatory penalties, and
- operational and market risks which need to be managed and mitigated..

It is impossible to create an exhaustive list of TP implications as each change in the value chain or business model will need to be analyzed on a case-by-case basis. For illustrative purposes of ESG-TP interactions, a list with some examples is outlined below:

Intellectual Property (IP):

In some cases, innovative technologies and new concepts are being created as a result of adopting ESG strategies. This could represent valuable IP for which users of the IP would or should pay.

ESG efforts may also impact brand value, where for instance reputational damage may arise as a result of adverse ESG events/ publicity and questions around who controls this risk and should bear the costs.

Intercompany Services:

Even where not creating IP, additional ESG related costs, resources and knowledge are being employed. These costs might be incidental benefits to the group entities and might not be seen as a service from a local subsidiary perspective. However, due regard should be given to whether a deliberate and concerted group effort is made that results in the group generating a distinct advantage over the other market players.

Restructuring:

The ESG strategy may result in a change in the key functions performed within the group's supply chain that can result in a transfer of profit potential within the group. It needs to be analyzed whether such change can be seen as a business restructuring from a TP perspective.

Intercompany Loans:

The banking industry is addressing climate change by changing the way it adopts lending practices. Credit agencies developed new techniques for modelling and analytics by incorporating the impact of climate change in these credit rating models. A new concept called 'greenium' arises as a result of the difference in interest rate spread between sustainable bonds and 'traditional' bonds, demonstrating investors willingness to lend at a lower rate to those companies with higher ESG credentials. In analogy with the above, TP questions may arise as to how to take account of lower borrowing costs and who should benefit from such savings in inter-company financing arrangements.

Grants & Incentives:

When it comes to grants & incentives, the main question is who is entitled to the benefit if received. And how. Is it the MNE HQ that decided on location of investment, the entity that supported the claim process, the legal entity that received the benefit, the inter-company contracting partners of the entity that obtained the grant or incentive through reduced pricing, or a combination of these?

Inter-company pricing of Carbon credits (ETS):

Companies have been allotted emission rights, that will decrease over time. Some group companies might need more rights, whereas others where for example investments have been made to reduce emissions, might need less. The question arises what is an arm's length price for the inter-company sale of emission rights. Many dimensions can play a role, including who is in charge of investment decisions that benefitted some group entities.

Given the focus on ESG is ever increasing and is impacting business models, MNEs should review the impact of their ESG strategy on their global functions, assets and risks to ensure they are applying the appropriate and most optimal TP policies. It is better to pro-actively allocate resources to TP implications and plan ahead.

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