How Transfer Pricing Practitioners Can Respond to ESG-Related Changes

By Jessie Coleman and Jack O'Meara

While the breadth and depth of how and if companies embrace ESG varies significantly by industry and company, many companies are moving toward more sustainable business practices. Given this change, companies need to reevaluate the value drivers of their business to determine if they need to modify their transfer pricing policies, say KPMG's Jessie Coleman and Jack O'Meara in this edition of "A Closer Look."

Over the next several years, environmental, social, and governance (ESG) policies and the movement toward greater sustainability will transform many businesses. As internal and external stakeholders of multinational companies (MNCs) focus on ESG issues, MNCs will continue to address these pressures by making ESG-related changes to the business.

The Governance & Accountability Institute Inc.'s 2021 Sustainability Reporting in Focus noted that, in 2020, 92% of the S&P 500 companies—four times as many companies as a decade ago—published a sustainability report detailing how their businesses addresses ESG issues. Given the rapid emergence and broad scope of these initiatives, MNC transfer pricing leaders in the tax departments need to take steps to: understand ESG-related changes to the business, revisit their analyses into what functions drive business profits and create value, and analyze if they need to modify their transfer pricing policies. Tax departments should also update their transfer pricing documentation accordingly. Some MNCs may also wish to consider larger tax planning opportunities to reflect how the business is evolving.

While the analysis itself is extremely fact-specific, this article sets forth five steps transfer pricing practitioners can use to analyze and respond to ESG-related business changes. Although the framework below is a step-by-step process, some of the steps listed below may occur concurrently or, depending on the information available, may occur out of order.

Step 1: Identify the individuals making the ESG recommendations and setting the sustainability strategy.

Tax departments should first identify the key decision makers who are determining the company's ESG strategy and understand where these individuals reside in terms of legal entities and within the management structure. These individuals may be part of the chief sustainability office, part of executive management, or embedded in the business itself. Tax departments should talk to the chief sustainability officer (if the company has one) to identify these individuals. To the extent that tax departments are having problems identifying the ESG decision makers, they can review the MNC's publicly available sustainability documents and talk to the functional lead of each type of identified activity to understand who is responsible for setting each part of the ESG strategy.

Step 2: Identify changes and prospective changes in the business operations.

Tax departments must understand the potential changes to the business from the individuals identified in Step 1. During this review, it is important that tax departments perform an honest evaluation of whether the company's ESG strategy is meaningful and potentially transformative. If not, there may be minimal value to this ESG analysis and limited or no resulting changes to the transfer pricing.

To understand the full changes to the business, it's important that tax departments look beyond their sustainability group and discuss how the business is evolving with the functional groups. Tax departments also should talk to the regulatory team to understand how any expected ESG-related regulations may impact company operations. In addition to talking to the key individuals, tax departments should confirm that the MNC's sustainability reporting that publicly describes the progress the company has made toward key ESG initiatives aligns with the information provided by these individuals. It's possible these reports may identify additional business changes that are important to capture in the analysis.

In March 2022, the US Security and Exchange Commission (SEC) proposed rules that would require public companies to include certain climate-related information in their registration statements and reports, including oversight and governance material impact, risk identification and management and certain types of emissions. These SEC filings will become a key source of information for climate-related ESG matters in the future. Tax departments will want to ensure such public filings support the information they have heard from the business.

Some examples of common ESG-related changes are:

Moving toward more operational sustainability (from the "E" in ESG). Some companies are embracing higher environmental standards. For example, some MNCs are making ESG-related changes on the supply chain to reduce their carbon footprint. This may be in conjunction with rethinking supply chain resiliency in light of the unprecedented disruptions experienced during the pandemic. Many MNCs are redesigning their supply chain to become more flexible and using this as an opportunity to embrace a more environmentally friendly supply chain. Tax departments need to understand the nature and extent of these types of changes from the supply chain, procurement, and logistics groups.

Investing in people and workforce (from the "S" in ESG). Many companies are investing in improving the lives of their workforce through, for example, promoting workforce diversity, pay equality, investing in programs and tools for employees to support general well-being, and embracing inclusive leadership. Tax departments need to understand these types of changes from senior management, who will be making the decisions, as well as the human resources department, who will be implementing the changes.

Governance (from the "G" in ESG). Many companies are voluntarily publishing reports that disclose their vision on ESG issues to demonstrate they are investing in governance. Many of these reports include clear articulation of ESG commitments and milestones to show how MNCs will achieve such promises. Tax departments should discuss with investor relations the scope of what is expected to be publicly reported and who is making the decision to publish this information. Tax departments also should understand how changing regulations will impact reporting.

Step 3: Assess the anticipated impact of prospective changes on business results and the channels through which these changes will be realized.

It is clear that ESG-related initiatives are already changing the business of many MNCs, and MNCs will need to quantify how the proposed changes will impact business results. Taking the examples of changes to the business identified above, tax departments need to understand how each of these changes may impact business results:

Moving toward more operational sustainability. Companies that are embracing higher environmental standards could experience meaningful changes (either higher or lower) in their overall cost structure. Over the last two years, some companies with more resilient supply chains have had a competitive advantage. Having higher operational costs, they have been able to get their products to consumers and sometimes charge higher prices or achieve overall volume increases amid limited supply.

Investing in people and workforce. Some companies that have invested in their workforce by offering higher wages, better benefits, or by encouraging greater diversity have experienced higher retention and productivity. Tax departments should discuss how to measure these factors with the business to quantify the value of this change.

Governance. Moving toward a sustainable, more transparent company can reduce the company's overall risk profile and the company's debt cost, meaning the overall costs of borrowing could be lower. In addition, more transparent companies may be able to access cheaper financing from impact investors.

The combination of ESG-related changes may affect other business changes, too. For example, companies that invest in ESG can increase positive brand awareness. These companies can mitigate negative publicity by proactively discussing how they support sustainability. Some customers may also pay a premium price for products from a sustainable company.

Importantly, ESG initiatives may affect the business through multiple channels. For example, a food manufacturer that moves toward sourcing products from sustainable farmers may experience an increase in sourcing costs. However, that increase may partially or wholly be offset by the potential to raise prices. The impacts of these initiatives may vary over time. For example, the ability to charge premium prices may diminish as competitors move to similar sourcing practices, or the company may lose market share if the competition doesn't follow a similar strategy. Careful analysis of industry and company-specific factors is needed to understand the impact of ESG initiatives.

Step 4: Analyze the transfer pricing policies for ESG-related changes.

Tax departments should determine how the existing tax and transfer pricing model allocates the marginal income or loss associated with ESG projects across legal entities and jurisdictions and assess whether the allocation of income is consistent with functions, assets, and risks of the relevant entities. Some potential changes to consider using the examples above:

Moving toward more operational sustainability. For example, a company with headquarters in Country A and distributors in countries A, B, and C decides to insource manufacturing, as their primary supplier had carbon emissions that were not up to the company's standards. The MNC intends to invest in production facilities using automated robotic technologies and powered by renewable energy sources. The company will need to analyze the parties' expected functions, assets, and risks to understand how that new manufacturing plant should be remunerated and if there are any necessary changes to the overall transfer pricing framework. This may prompt an increase or decrease in total cost. Tax departments should understand which entity bore the risks, made the decisions, and/or incurred the costs related to this change to understand which entity will realize the marginal income or loss.

Investing in people and workforce. For example, management at headquarters in Country A decides that employees who work at the manufacturing plant in Country B should be paid more highly than that what is normal for the industry's wages and receive higher-than-normal industry benefits. This would mean increasing the operating expenses in Country B. If Country

B is a contract manufacturer that earns a cost plus return from Country A—ultimately receives all marginal income or loss—the additional operating costs would be borne by Country A, as those costs would be included in Country B's cost plus markup. Further, Country A would continue to earn the marginal income or loss. However, if the decision to make this change comes from a different legal entity or from Country B, the overall transfer pricing policy may need to be revisited.

Governance. For example, if moving toward a sustainable, more transparent company reduces the company's overall risk profile and lowers the overall costs of borrowing, a company should analyze which individuals made the ESG-related decisions, the costs of the ESG-related decisions, which legal entities bore the costs and assumed the ESG-related risks, and quantify how those decisions impacted the company in terms of borrowing cost.

To the extent that ESG-related changes are increasing brand awareness, the company should quantify the increase's impact—for example, additional customers or higher prices equating to greater sales—understand which legal entity bore the risk and made the investment, and evaluate if the entity that made the investment would be entitled to a return for its investment, such as royalty payment for a measurable increase in value.

This analysis is extremely fact-specific; however, the basics for analyzing the ESG-related changes go back to the fundamental transfer pricing analysis based on the functions performed, assets utilized, and risks assumed. The complexities of the analysis relate to the rapid pace of prospective changes and the need to analyze the impact of multiple channels.

Step 5: Update transfer pricing documentation to include ESG-related changes to the business and related transfer pricing changes.

MNCs need to incorporate how ESG-related changes are affecting the functions, assets, and risks into transfer pricing documentation. MNCs should start with their master file that contains an overview of the company's business operations and transfer pricing policies and incorporate any needed changes. To the extent that ESG is creating value and driving business profit, MNCs should incorporate that discussion into the master file. Next, MNCs should also make changes to the local transfer pricing documentation as needed to reflect changes to transfer pricing results driven by ESG initiatives.

Conclusions

Over the last several years, internal and external stakeholders have demanded that many companies reconsider their businesses in light of ESG considerations. While the breadth and depth of how and if companies embrace ESG varies significantly by industry and company, many companies are moving toward more sustainable business practices. Given this change, companies need to reevaluate the value drivers of their business to determine if modifications to their transfer pricing policies are needed. Companies should also update their transfer pricing documentation accordingly. Some companies may also wish to consider larger tax planning changes to reflect the how the business is evolving.

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