ESG and transfer pricing

How transfer pricing practitioners can respond to ESG-related changes

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Addressing ESG business changes step-by-step

1. Determine who is making ESG recommendations and establishing sustainability strategy
2. Identify prospective changes in the business
3. Assess the anticipated impact on business results
4. Analyze the transfer pricing policies for ESG-related changes
5. Update transfer pricing documentation

While the analysis itself is extremely fact-specific, transfer pricing practitioners can follow these five steps to analyze and respond to ESG-related business changes. Note that steps may occur concurrently or out of order depending on the information available.

Environmental, social, and governance (ESG) policies and the movement towards greater sustainability will continue to transform many businesses.

As internal and external stakeholders focus on ESG policies, multinational companies (MNCs) are responding to these pressures by making ESG-related changes to the business.

Given the rapid emergence and broad scope of these initiatives, transfer pricing leaders in tax departments need to take steps to:

- Understand ESG-related changes to the business.
- Revisit their analyses into what creates value and drive business profits.
- Determine if modifications to their transfer pricing policies are needed.

Transfer pricing documentation should then be updated accordingly. In addition, MNCs may wish to consider larger tax planning opportunities to reflect how the business is evolving.

The Governance & Accountability Institute, Inc.'s 2021 Sustainability Reporting in Focus noted that in 2020, 92% of the S&P 500 companies—over four times as many companies as a decade ago— published a sustainability report detailing how they are addressing ESG issues.

Step 1: Determine who is making ESG recommendations and establishing sustainability strategy

Key ESG decision makers are often listed in the MNC's publicly available sustainability documents. It is important to understand where these individuals reside in terms of legal entities and within the management structure. For example, they may be a part of the chief sustainability office, executive management, or embedded in the business itself. Tax departments should connect with functional leaders to gain insight into who is responsible for setting each part of the ESG strategy.

ESG policies and the movement towards greater sustainability will continue to transform many businesses.

Step 2: Identify prospective changes in the business

Tax departments must perform a thorough evaluation to determine whether the company's ESG strategy is potentially transformative: they must be aware of and understand changes that may be made to the business. To do this in a meaningful way, tax departments must look beyond the sustainability group and discuss how the business is evolving with functional groups. The regulatory team should also be consulted to provide insight into how any expected ESG-related regulations may impact company operations.

The information gathered as a part of the evaluation should be reviewed to confirm that it aligns with the MNC's sustainability reporting that publicly describes the progress the company has made towards key ESG initiatives. It may be that these reports include additional business changes that are important to capture in the analysis. Tax departments will also want to ensure that public filings support the information they have heard from the business.

Common ESG-related changes

The "E" in ESG

- **Moving towards operational sustainability**
  In conjunction with rethinking supply chain resiliency in light of the unprecedented disruptions experienced during the pandemic, MNCs are redesigning their supply chains to embrace higher environmental standards. They are using this as an opportunity to implement a more environmentally friendly approach, such as reducing their carbon footprint. Tax departments need to connect with supply chain, procurement, and logistics teams to understand the nature and extent of these changes.

The "S" in ESG

- **Investing in people**
  Companies are making investments to improve the lives of their workforce. These include 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 a senior management perspective (those making the decisions) and from a human resources perspective (those implementing the changes).

The "G" in ESG

- **Governance**
  To demonstrate they are investing in governance, companies are voluntarily publishing reports that disclose their vision on ESG issues. These reports often include clear articulation of ESG commitments and milestones that show how MNCs will achieve objectives. Tax teams should have discussions with their Investor Relations department regarding the scope of what is expected to be publicly reported and who is making the decision to publish this information. In addition, tax departments should understand how changing regulations will impact reporting.

Step 3: Assess the anticipated impact on business results

Tax departments need to understand the impact current and proposed ESG-related initiatives will have on financial results as well as on other areas of the business

Example:

- Companies that invest in ESG may increase brand awareness and value. They can also mitigate any potential negative publicity by proactively discussing how they support sustainability. And, it's possible that some customers may pay a premium price for products from a company they perceive as environmentally friendly.

ESG initiatives may affect the business through multiple channels.

Example:

- A food manufacturer that moves towards sourcing products from sustainable farmers may experience an increase in costs; however, these may be partially or wholly offset by the potential ability to raise prices.

  It's important to note that the impacts of these changes may vary over time. Charging a premium price may no longer be possible as competitors adopt similar sourcing practices. Or, the company may lose market share if their competition doesn't follow a similar strategy.

Common ESG-related impacts

The "E" in ESG

- **Moving towards operational sustainability**
  Embracing higher environmental standards can lead to meaningful changes in overall cost structure (either higher or lower). Over the last two years, companies with more resilient supply chains may have had a competitive advantage. While their operational costs may have been higher, they were able to get their products to consumers, sometimes charging higher prices or achieving volume increases amid limited supply.

The "S" in ESG

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

The "G" in ESG

- **Governance**
  Moving towards a sustainable, more transparent structure can reduce the company's overall risk profile and the debt cost, leading to lower overall costs of borrowing. In addition, more transparent companies may be able to access more favorable financing from impact investors.

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, they should assess whether the allocation of income is consistent with functions, assets, and risks for the relevant entities. Potential changes to consider are explained in the following example.

Example:

If ESG-related changes are increasing brand value, then company should:

- Quantify the impact of the increase (additional customers or higher prices equating to greater sales).
- Understand which legal entity bore the risk and made the investment.
- 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.

While extremely fact-specific, 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 are the result of the very rapid pace of prospective changes and the need to consider the impact on multiple channels

Common ESG-related analyses

The "E" in ESG

- **Moving towards operational sustainability**
  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 intent is to invest in production facilities using automated robotic technologies and powered by renewable energy sources. The company will need to analyze the expected functions, assets, and risks of the parties to determine how that new manufacturing plant should be remunerated, and if changes to the overall transfer pricing framework are needed. This may result in a change (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 identify which entity will realize the marginal income or loss.

The "S" in ESG

- **Investing in people**
  If management at the headquarters in Country A makes the decision that employees who work at the manufacturing plant in Country B should be paid higher-than-norm industry wages and receive better-than-norm industry benefits (increasing the operating expenses in Country B). If Country B is a contract manufacturer that earns a cost-plus return from Country A (who ultimately receives all marginal income or loss), then 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, then overall transfer pricing policy may need to be revisited.

The "G" in ESG

- **Governance**
  If moving towards a more sustainable and transparent structure reduces the company's risk profile and lowers the overall costs of borrowing, then departments should identify the decision makers, the costs of the ESG-related decisions, and 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.

Step 5: Update transfer pricing documentation

MNCs need to incorporate how ESG-related changes are impacting functions, assets, and risks into transfer pricing documentation. The extent to which ESG is creating value and driving business profit should be reflected in their Master File, which contains an overview of the company's business operations and transfer pricing policies. Local transfer pricing documentation should be updated as needed to reflect changes to transfer pricing results driven by ESG initiatives.

Summary

Internal and external stakeholders continue to demand that companies assess their business with respect to ESG considerations. And while the breadth and depth of how (and if) companies embrace ESG varies significantly, many are moving towards more sustainable business practices. This may require re-evaluating value drivers to determine if modifications to their transfer pricing policies are required, and if so, updating their transfer pricing documentation accordingly. Larger tax planning changes that reflect how the business is evolving should also be considered.

SEC proposed rules on climate-related disclosures

In March 2022, the U.S. Securities and Exchange Commission (SEC) proposed rules that would require public companies to include certain climate-related information in their registration statements and reports, such as 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.

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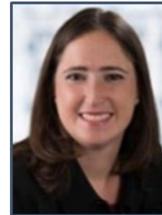

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