International

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ESG Transformation and Transfer Pricing Implications

ESG issues may have an impact on international value chains and, therefore, also the transfer pricing set-up. The transfer pricing topics are manifold and may refer to business restructuring, allocation of functions and risks, service charges and cost allocations.

1. Introduction

Sustainability and environmental, social and governance (ESG) issues affect how companies do business, increasingly so in recent years and the pandemic has additionally fuelled the trend. A number of governmental bodies and other institutions have issued initiatives under the ESG agenda. More companies, and their investors, are recognizing sustainability as a strategic priority that involves significant business risks and opportunities. However, historically, only few companies have implemented organizational structures that are designed to treat sustainability as a material business issue and are now in the process of redefining operational structures to achieve their ESG goals.

This article focuses on the transfer pricing aspects of initiatives which multinational enterprises take in order to align their business models and organizational processes with ESG targets.

2. ESG Transformation

2.1. ESG background and developments: Who Cares Wins

The birth year of ESG was 2004 when former UN Secretary General Kofi Annan invited major financial institutions to participate in a joint initiative under the auspices of the UN Global Compact and with the support of the International Finance Corporation (IFC) and the Swiss government. The goal of the initiative was to find ways to integrate ESG into capital markets. In 2005 this initiative produced a conference report titled “Who Cares Wins”.[1] The report made the case that embedding environmental, social and governance factors in capital markets makes good business sense and leads to more sustainable markets and better outcomes for societies.

In 2015 the member states of the United Nations adopted the Sustainable Development Goals (SDGs) by General Assembly resolution.[2] The aim of this resolution is to achieve 17 goals by 2030 with a view to ending all forms of poverty, fighting inequalities and tackling climate change while ensuring that no one is left behind. A hundred and ninety-three countries, 9000 companies, and investors with more than USD 4 trillion in assets have pledged their support to the United Nations Sustainable Development Goals.[3]

The European Commission introduced the European Green Deal in 2019[4] and as one of the most recent initiatives, the European Commission adopted a package of proposals to make the European Union’s climate, energy, land use, transport and taxation policies fit for reducing net greenhouse gas emissions by at least 55% by 2030, compared to 1990 levels.[5] Numerous actions are included in the proposal, including extending the scope of the European Emission Trading System (ETS). Within the framework of the European Green Deal, the EU Commission has also been developing a policy agenda on sustainable finance (Sustainable Finance Action Plan), including, inter alia, the EU taxonomy. The EU taxonomy is a classification system, establishing a list of environmentally sustainable economic activities. The EU taxonomy is meant to provide companies, investors and policymakers with appropriate definitions for which economic activities can be considered environmentally sustainable.

2.2. ESG reporting

In order for investors to evaluate a company’s ESG standards, corporate disclosure was already on the agenda from the beginning of the 2000s and disclosures on ESG criteria gradually developed. The Global Reporting Initiative (GRI)[6] was launched in 2000 which provided a frame-

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1. I. Knöpfel, Conference Report, *Investing for Long-Term Value – Integrating environmental, social and governance value drivers in asset management and financial research* (26 Aug. 2005), available at https://de.scribd.com/fullscreen/16876744?access_key=key-mfg3d0usaiuaob4taki (accessed 14 Dec. 2021).
2. United Nations, Resolution adopted by the General Assembly on 25 September 2015, *Transforming our world: the 2030 Agenda for Sustainable Development* (21 Oct. 2015), available at https://www.un.org/ga/search/view_doc.asp?symbol=A/RES/70/1&Lang=E (accessed 14 Dec. 2021).
3. S&P Global, *SDG Evaluation*, available at https://www.spglobal.com/esg/solutions/company-analytics-sdg-evaluation?gclid=EAIaIQobChMIvuLcnP6D9AIVbIBQBh13xgxEEAAYASAAEgKoJvD_BwE (accessed 14 Dec. 2021).
4. European Commission, Press Release, *The European Green Deal sets out how to make Europe the first climate-neutral continent by 2050, boosting the economy, improving people’s health and quality of life, caring for nature, and leaving no one behind* (11 Dec. 2019), available at https://ec.europa.eu/commission/presscorner/detail/en/ip_19_6691 (accessed 14 Dec. 2021).
5. European Commission, *Delivering the European Green Deal* (14 July 2021), available at https://ec.europa.eu/info/strategy/priorities-2019-2024/european-green-deal/delivering-european-green-deal_en#key-steps (accessed 14 Dec. 2021).
6. Global Reporting Initiative, *GRI Sustainability Reporting Standards 2021* (5 Oct. 2021), available at https://www.globalreporting.org/how-to-use-the-gri-standards/resource-center/?g=22989eb3-1dcd-4b4d-aa5c-f3715b18fa6e&id=13673 (accessed 14 Dec. 2021).

work for sustainability reporting of companies. Corporate disclosure on ESG issues has steadily improved since the launch of the GRI framework. Additionally, the following other initiatives and bodies were established:

– The International Integrated Reporting Initiative (IIRC)[7] which was founded in 2010 with the goal of creating a widely accepted framework for sustainability accounting, bringing together financial, environmental, social and governmental information in an "integrated" format.
– In June 2021, the IIRC merged with the US-based Sustainability Accounting Standards Board (SASB) to form the Value Reporting Foundation (VRF). The goal of the merger was to provide investors and companies with a comprehensive corporate reporting framework covering the full range of value drivers and standards to advance global sustainability performance. The VRF has adopted the integrated reporting framework as one of its key resources and will now carry it forward under its auspices.

In the European Union, large capital market-oriented companies as well as credit institutions and insurance companies have been required to provide non-financial reporting since 2017.

Since better data from companies about the sustainability risks they are exposed to, and their own impact on people and the environment, is essential for the successful implementation of the European Green Deal and the Sustainable Finance Action Plan, the EU Commission proposed a new Corporate Sustainability Reporting Directive (CSRD) in April 2021. The CSRD envisages the adoption of EU sustainability reporting standards from 2023 and will make companies more accountable for and transparent about their impact on people and the environment. Additionally, the scope of the reporting obligation will be extended to more companies, including all large and listed companies, the information provided will be subject to an audit and it will need to be disclosed in a digital, machine-readable format.

2.3. ESG tax reporting

Last but not least also the role of taxes within the ESG agenda is worth mentioning. Tax plays a vital role in some of the UN Sustainability Development Goals, particularly Peace, Justice and Strong Institutions (SDG 16), and Partnerships for the Goals (SDG 17).

The most important types of ESG tax reporting obligations which were introduced in the past years are:
– DAC6 reporting obligation of aggressive tax planning models[8] within the European Union and similar local rules; and
– country-by-country reporting (CbCR)[9] and similar industry-specific obligations.

Currently, final approval for public CbCR is expected within the European Union in November 2021 which will mean that multinationals with consolidated turnover of more than EUR 750 million will need to provide public reports probably beginning with the business year 2025.

3. Individual Companies' ESG Targets and Strategies

It is quite straightforward that after digitalization, sustainability and particularly decarbonization are already driving the next major transformation. With markets changing fundamentally this requires companies and their business models to adapt.

Against this backdrop where all these crosscurrents are coming together, companies need to deal with this next wave of corporate transformation and therefore have to develop their individual strategies and consider new obligations, such as reporting requirements.

3.1. Outward and inward ESG impact

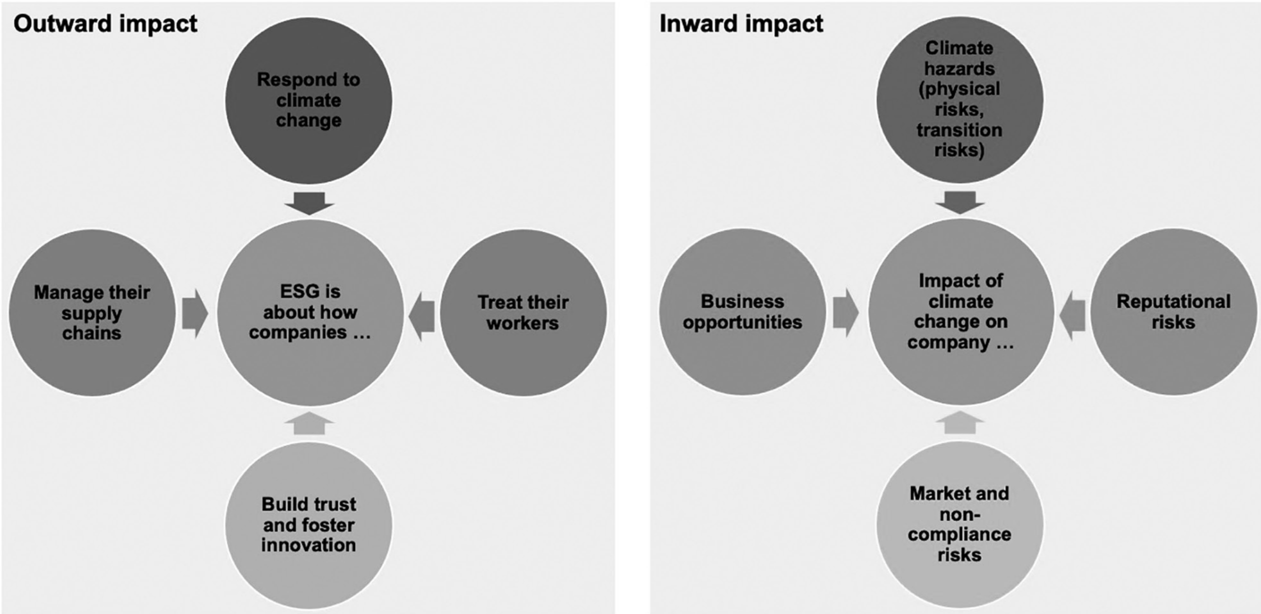
Principally, companies need to consider both the outward as well as the inward impact on their business model as summarized in Figure 1.

Companies need to assess both outward and inward impact on the sustainable development goals which is typically done by building a map of sustainability risk exposure across the value chain based on a company's geographic footprint and key markets. This includes an evaluation of the measures which need to be taken to manage and mitigate the exposure to each sustainability development goal, and assessment of the positive impacts created by a company through its products and services, charitable activities, contributions to economic growth and employment, and commitments to transform business models in line with the sustainability goals. Also, the company's actual or potential negative impact, and the effectiveness with which such impact is managed must be assessed. Inter alia, these are examples of ESG risks that companies face:
– environmental risks may refer to liability risks from litigation against the company because of negative environmental impact;
– social risk factors include employee voice and workforce well-being, diversity and inclusion, health and safety, human rights and labour law policies; and
– governance risks such as poor codes of conduct, lack of anti-money laundering procedures, or deficient ethical standards.

Understanding risk exposure across the sectors and countries in which a company operates is key in order to be able to deploy resources to target those sustainability

7. *See* https://www.integratedreporting.org/ (accessed 14 Dec. 2021).
8. Council Directive (EU) 2018/822 of 25 May 2018 amending Directive 2011/16/EU as regards mandatory automatic exchange of information in the field of taxation in relation to reportable cross-border arrangements, (2018), Case Law IBFD.
9. OECD, *Transfer Pricing Documentation and Country-by-Country Reporting – Action 13: 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project (2015), Primary Sources IBFD.

Figure 1 – Outward and inward ESG impact



goals which are most closely tied to the business model and operations.

3.2. Climate-related hazards and opportunities

Climate hazards, inter alia, include the following risk categories:

– Physical risks: These refer to the manifestations of a changing climate and their associated costs. Physical risks include both chronic changes, or long-term shifts in climate patterns; as well as acute events, which may increase in severity or frequency in light of chronic changes. Examples are heatwaves, cold waves, water stress, hurricanes, wildfires, flood and sea level rise.

– Transition risk: This is the risk inherent in changing strategies, policies or investments as society and industry work to reduce reliance on carbon and impact on climate. These risks may include policy and regulation, litigation, adoption of alternative energy sources, and shifting consumer preferences or behaviour. Examples are changed land-use policies, the costs the energy industry faces in developing low-carbon technologies, the decrease of market value of investments in high-carbon industries as well as the requirements of additional regulation and reporting.

Climate-related financial risks could affect the economy through elevated credit spreads, greater precautionary saving, and rapid pricing readjustments.[10]

Both risks are not confined to businesses that implement – or fail to implement – a transition to a lower-carbon approach. Types of transition risk exist within the broader economy.

Examples are:[11]

– Insurance/consumer: As weather-related insurance claims rise, insurance companies have more to pay out, increasing everyone's premiums. If companies and households are not insured, they may need to foot the bill themselves. In both cases, the consumer ends up paying more.

– Energy companies/financial industry: If government policies worldwide changed in line with the Paris Agreement, two thirds of the world's known fossil fuel reserves could not be burned. As well as affecting energy companies, this might change the value of investments held by banks, insurers or pension funds in coal, oil or gas companies.

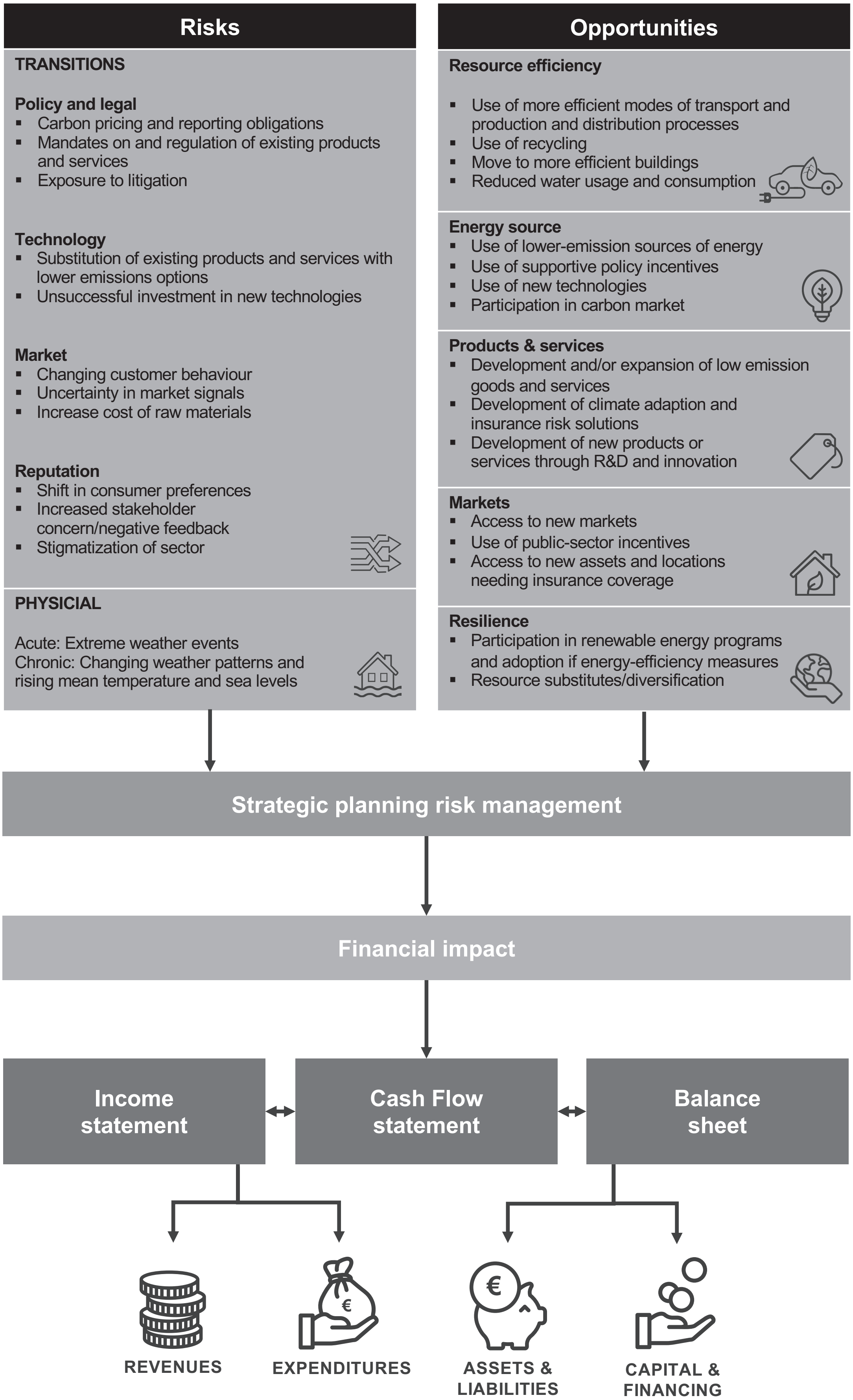
Based on the identified risks a number of actions may be taken, inter alia, prospective risk management mechanisms such as transfer of risks via insurance coverage (depending on availability and/or pricing) or an adaptive strategy to allocate capital expenditures associated with facility or supply moves and retrofits.

On the other hand, climate change may also create new business opportunities for companies, resulting from use of more efficient resource usage, more efficient buildings, etc. Also, demand for products may increase from new markets or the product offering may be expanded because

10. Task Force on Climate-Related Financial Disclosures, Booklet Overview, p. 5 (Mar. 2021), available at https://assets.bbhub.io/company/sites/60/2020/10/TCFD_Booklet_FNL_Digital_March-2020.pdf (accessed 14 Dec. 2021).

11. Bank of England, *Climate change: what are the risks to financial stability?*, KnowledgeBank, available at https://www.bankofengland.co.uk/knowledgebank/climate-change-what-are-the-risks-to-financial-stability (accessed 14 Dec. 2021).

Figure 2 – Climate-related risks and opportunities



Source: Task Force on Climate-related Financial Disclosures, Booklet Overview, p. 12 (Mar. 2021), available at https://assets.bbhub.io/company/sites/60/2020/10/TCFD_Booklet_FNL_Digital_March-2020.pdf (accessed 14 Dec. 2021).

of innovative approaches and competitive advantage or better marketing of "green products".

Figure 2 provides an overview of different categories of climate risk and opportunities.

3.3. New ESG-related corporate management tasks

Regardless of the industry and the actions actually taken by a company, typical management tasks arising within corporate groups in the context of ESG are:
- assessing the impact of ESG-related risks and opportunities on the group organization´s business, strategy and financial planning, including climate-related risks and opportunities;
- assessing location-specific climate risks such as local water availability, regional carbon pricing mechanisms and physical climate risk scenarios;
- overall stress-test regarding material climate risks;
- impact analysis of the European Green Deal on the business, e.g. potential integration of the company into EU Emission Trading System;[12] potentially increased costs from new EU Energy Directive proposal;[13] etc.;
- definition of the organization's sustainability development goals, including net zero plan;
- definition of the targets used by the company to manage ESG-related risks and opportunities and performance against targets;
- development of resilience plans for the group´s strategy, taking into account different scenarios;
- development of durable, long-term climate adaptation strategies;
- development of processes for identifying and assessing sustainability threats;
- integration of ESG-related processes into overall risk management;
- development of climate-optimized supply chains (analyses of suppliers as well as spend categories), analysis of product lifecycle risks and identification of circular economy opportunities;
- defining the metrics used by the group to assess fulfilment of sustainability development goals or assessment of risks and opportunities in line with the strategy and risk management process;
- assessment of the link between ESG risks and credit risk for the group;
- human rights impact assessment and identify ways to mitigate risk;
- development and implementation of human rights policies and processes;
- new workforce strategies, including set-up of workplace ("future of work"), business travel, etc.;
- revision of good governance policies or code of conduct;
- revision of C-suite performance payments to ESG KPIs;
- revision of supplier contracts and integration of ESG-related clauses (beyond legal requirements such as child labour, conflict minerals reporting, etc.);
- fulfilment of reporting obligations, inter alia:
  - preparation of non-financial reporting/sustainability reporting; and
  - ESG disclosures required by banks in line with the European Banking Authority Guidelines on loan origination and monitoring;[14]
- monitoring of (new) reporting obligations, such as extended social responsibility reporting standards or proposed public CbCR;
- development of investor relations strategy regarding ESG commitments: investors recognize that the most significant risks are ESG-oriented rather than operational, so they're evaluating your company based on its ESG efforts. Poor or hastily released products might be major operational risks, but it's far more detrimental in the long term to be caught manipulating carbon emissions tests; and
- development of communication strategy of sustainability development goals in the context of brand management.

4. Transfer Pricing Implications

ESG gives rise to a number of transfer pricing issues that require companies to potentially revise their transfer pricing set-up. It may also be that new transactions evolve from ESG topics within groups. Some of these ESG transfer pricing issues include:
- changes and/or adaptions of the business model;
- major new product costs and/or savings (e.g. energy costs, cooling costs);
- development of new products and processes (e.g. improving facility and fleet functionality);
- impact on new or existing brand value;
- creation or enhancement of intellectual property assets;
- changes to the supply chain and operating models (e.g. improving flexibility of the supply chain, insourcing of production);
- participation in new regulatory or trading regimes (e.g. sharing of emission credits); and
- profit changes that reflect new environmental costs, new products or new processes.

12. European Parliament and Council, Proposal for a Directive of the European Parliament and of the Council of 14 July 2021 amending Directive 2003/87/EC establishing a system for greenhouse gas emission allowance trading within the Union, Decision (EU) 2015/1814 concerning the establishment and operation of a market stability reserve for the Union greenhouse gas emission trading scheme and Regulation (EU) 2015/757, COM/2021/551 final, (2021), available at EUR-Lex - 52021PC0551 - EN - EUR-Lex (europa.eu) (accessed 18 Nov. 2021).
13. European Commission, Proposal of 14 July 2021 for a Council Directive restructuring the Union framework for the taxation of energy products and electricity (recast), COM/2021/563 final, (2021), available at EUR-Lex - 52021PC0563 - EN - EUR-Lex (europa.eu) (accessed 14 Dec. 2021).
14. European Banking Authority, *Guidelines on loan origination and monitoring*, EBA/GL/2020/06 (May 2020), applicable from 30 June 2021, available at https://www.eba.europa.eu/regulation-and-policy/credit-risk/guidelines-on-loan-origination-and-monitoring (accessed 14 Dec. 2021).

To address these issues, multinational companies' transfer pricing policies and procedures may need to be adapted.

4.1. ESG-driven supply chain projects and business restructuring

Chapter 9 of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines) (2017) states that no legal or universally accepted definition of business restructuring exists. In the context of Chapter 9, "... business restructuring refers to the cross-border reorganisation of the commercial or financial relations between associated enterprises, including the termination or substantial renegotiation of existing arrangements".[15] While the OECD Guidelines in a first step refer to the fact that "business restructurings may often involve the centralisation of intangibles, risks or functions,"[16] business restructurings may also be triggered by:

- the concentration of functions in a regional or central entity, with a corresponding reduction in scope or scale of functions carried out locally;
- the allocation of more (valuable) intangibles or risks to operational entities (e.g. to manufacturers or distributors); and
- the rationalization, specialization or de-specialization of operations, including the downsizing or closing of operations.

Business restructurings often involve the transfer of intangible or tangible assets or the renegotiation/restructuring of existing arrangements. As a result of these (cross-border) transfers of assets or the renegotiation of arrangements, a profit potential may be transferred within a multinational group. From a transfer pricing perspective, it must be determined whether the conditions of the business restructuring and the specific transactions involved have been agreed on at an arm's length basis.[17]

Difficulties typically arise in cases where the restructuring is triggered in order to achieve a benefit at the group level (and, therefore, there are legitimate reasons for the restructuring from a consolidated perspective), but the individual entity is worse off after the restructuring.[18]

The OECD Guidelines set out detailed guidance on the determination of the arm's length payments for a business restructuring. The analysis should start with an examination of the transactions involved in making an accurate delineation and checking functions, assets and risks before and after the restructuring to understand the business reasons and the expected benefits from the restructuring, including the role of synergies and other options realistically available to the parties involved.[19]

Each of the following examples of ESG-driven supply chain restructurings must be analysed with regard to potential compensation payments and the arm´s length remuneration model after the restructuring.

4.1.1. Decentralization of manufacturing functions

In order to reduce the carbon footprint within a group a reorganization of a supply chain might be needed. Carbon dioxide emissions stemming from transport typically increase if production is set up in a centralized way, e.g. global manufacturing hub for a certain product or product line at one location from which the distribution to the local markets starts. Therefore, the manufacturing functions within a group might be decentralized in order to reduce transport ways to market jurisdictions. This decentralization may refer to specific product lines, the total production of a group or only to components.

Such restructurings may trigger a reallocation of manufacturing functions, usage of intangible assets such as patents or trademarks and customer stock. These transfers need to be analysed, remunerated and documented based on the OECD principles mentioned above.

In particular, compensation payments to historically established central manufacturing hubs may need to be considered if these entities lose profit potential. Specific considerations regarding the question if there actually is a transfer of "something of value" as well as the point of time at which such a transfer is executed need to be taken into account if such a restructuring is carried out gradually.[20]

Under specific conditions it may be possible to mitigate or reduce compensation payments if the profit split method can be applied. Based on the OECD Guidance this may be the case if both manufacturing entities after the restructuring make unique and valuable contributions[21] or own unique and valuable intangible assets[22] or there is a high degree of integration between the parties.[23]

In this context also potential employee secondments between the manufacturing entities must be carefully analysed. The OECD Guidelines note that

> in some situations, the transfer or secondment of one or more employees may, depending on the facts and circumstances, result in the transfer of valuable know-how or other intangibles from one associated enterprise to another. For example, an employee of Company A seconded to Company B may have knowledge of a secret formula owned by Company A and may make that secret formula available to Company B for use in its commercial operations. Similarly, employees of Company A seconded to Company B to assist with a factory start-up may make

15. *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, para. 9.1. (OECD 2017), Primary Sources IBFD [hereinafter *OECD Guidelines*].
16. Para. 9.2 *OECD Guidelines*.
17. Para. 9.12 *OECD Guidelines*.
18. Para. 9.37 *OECD Guidelines*; D. Amici, *In-Depth Analysis of the Concept of Options Realistically Available in Transfer Pricing*, 27 Intl. Transfer Pricing J. 2 (2020), Journal Articles & Opinion Pieces IBFD.
19. Para. 9.14 *OECD Guidelines*.
20. For a court decision, *see* H. van Dam, W.J. Tom & F. Braken, *The Zinc Case – Burden of Proof and Business Restructurings in the Netherlands*, 25 Intl. Transfer Pricing J. 2 (2018), Journal Articles & Opinion Pieces IBFD; para. 9.70 *OECD Guidelines*.
21. OECD, *Revised Guidance on the Application of the Transactional Profit Split Method: Inclusive Framework on BEPS: Action 10*, OECD/G20 Base Erosion and Profit Shifting Project, para. 2.130 (2018), Primary Sources IBFD [hereinafter *Revised Guidance on TPSM*]; C. Quentin, *Gently Down the Stream: BEPS, Value Theory and the Allocation of Profitability along Global Value Chains*, 13 World Tax J. 2 (2021), Journal Articles & Opinion Pieces IBFD.
22. Para 2.131 *Revised Guidance on TPSM*.
23. Para 2.135 *Revised Guidance on TPSM*.

> Company A manufacturing know-how available to Company B for use in its commercial operations. Where such a provision of know-how or other intangibles results from the transfer or secondment of employees, it should be separately analysed under the provisions of Chapter VI and an appropriate price should be paid for the right to use the intangibles.[24]

For any measures taken by the group in the course of which an EU group entity suffers a downsizing of its functions, risks and assets, a potential DAC6 reporting obligation should also be checked.[25]

4.1.2. ESG-driven aggregation of manufacturing steps

Another possible change to the supply chain may be that manufacturing steps are insourced and manufacturing entities assume additional production functions. This may be particularly the case where groups have non-compliant suppliers with which they cannot come to terms on monitoring arrangements or ESG commitments.

In such cases the functional, risk and asset profile of the manufacturing entity changes which may mean that the transfer pricing method needs to be adjusted.

The typical initial question is whether the previous comparable uncontrolled price (CUP) by the external supplier can be applied for the intercompany transaction. Generally, the OECD Guidelines state that "where it is possible to locate comparable uncontrolled transactions, the CUP method is the most direct and reliable way to apply the arm's length principle. Consequently, in such cases the CUP method is preferable over all other methods".[26]

In practice, however, there are often intense discussions in tax audits at the level of the foreign principal entity if (partially) the CUP method is applied at the level of an entity previously qualified as a toll or contract manufacturer.

The standard of comparability for a successful defence of the application of the CUP method is very high[27] and all comparability factors defined by the OECD[28] should be thoroughly analysed and documented.

If necessary, adjustments to the uncontrolled price need to be made. Differences that might cause adjustments include, inter alia, the contractual terms, regional differences, date of the transactions and foreign currency risks.[29] In such cases it is also useful to prepare a comparison of other options realistically available[30] and evaluate for each party to the transaction if there is an alternative which offers a more attractive opportunity in light of the commercial objectives. If the price charged by the third party – adjusted, if necessary – means that the principal is not worse off than in the next best comparable third-party option, this price should normally be considered to be at arm's length.

4.1.3. Centralized ESG risk management for the supply chain

ESG risk assessment defines the most relevant factors for a specific company to be aware of. In June 2021 the European Banking Authority published a Report on management and supervision of ESG risks.[31] While this report addresses banks and investment firms, general principles still can also be delineated for other industries. It is quite evident that ESG risk management needs to be integrated into the business strategy and it is, therefore, very often located at the level of the headquarters within groups. It may also be that a new central ESG department is established.

The impact of such a central function which manages ESG risks and opportunities for a specific value chain differs depending on business and organizational model and industry. However, it is worth mentioning that this function may have a huge impact on value creation in these areas:

- Growth and competitive advantages: maintain customers with innovative green products.
- Cost reductions: lower energy consumption, reduction of packaging and transport costs, reduce waste disposal costs, etc.
- Avoidance of legal interventions: avoiding legal disputes, avoiding governmental intervention.
- Employee productivity and access to talent pool: creative working conditions, including home office, may boost employee motivation, "green employers" may have better access to talent pool.
- Investment and financing: ensure long-term asset value with sustainable investments, enhance investment returns by better allocating capital to sustainable assets, access to cheaper sustainable finance.

Such more integrated risk management functions may have a strategic character, however, they may also go deep into operational processes. In the latter case, it must be checked if the provision of such central risk management functions only requires the charging of arm's length service fees which are typically charged based on cost plus. If there is, however, a material impact on the group's value creation, it may also be that other methods ranging from the application of the CUP method to the application of the profit split method, e.g. in case of highly integrated transactions, must be considered.

24. Para. 1.155 *OECD Guidelines*.
25. Council Directive (EU) 2018/822 of 25 May 2018 amending Directive 2011/16/EU as regards mandatory automatic exchange of information in the field of taxation in relation to reportable cross-border arrangements, (2018), annex IV, part II, hallmark E.3, Primary Sources IBFD.
26. Para. 2.15 *OECD Guidelines*.
27. Para. 2.17 *OECD Guidelines*.
28. Para. 1.36 *OECD Guidelines*.
29. R. Feinschreiber, *Transfer Pricing Methods: An Applications Guide* p. 65 (Wiley 2004).
30. Para. 1.38 *OECD Guidelines*; Amici, *In-Depth Analysis of the Concept of Options Realistically Available in Transfer Pricing*, 27 Intl. Transfer Pricing J. 2 (2020), Journal Articles & Opinion Pieces IBFD.
31. European Banking Authority, *Report on management and supervision of ESG risks for credit institutions and investment firms*, EBA/GL/2020/06 (May 2020), applicable from 30 June 2021, available at https://www.eba.europa.eu/regulation-and-policy/credit-risk/guidelines-on-loan-origination-and-monitoring (accessed 14 Dec. 2021).

4.1.4. *Centralized carbon-efficient management of logistics or fleet management*

Another possible supply chain restructuring may be the centralization of logistic or fleet management responsibilities for the whole group in order to rely on an expert team reducing the global emission footprint of the group.

Typically such central logistic hubs provide services to other group members which are often remunerated based on cost plus. While not explicitly mentioned in the list of excluded activities,[32] these services normally are part of the core business of the group and it is not possible to apply the OECD simplification rule for "low value adding services"[33] and add a fixed 5% profit margin. Depending on the industry and business model, the services provided by the logistic hub may have a material impact on the group´s net zero policy. It must be analysed if the CUP method may be applied for such services by referring to third-party fees for such services. If not, typically the cost-plus method is referred to. The markup on costs should be duly analysed.

4.2. Other ESG-driven changes of functional, risk and asset allocation

4.2.1. *Local ESG costs*

ESG may have an impact on the group's overall but also on the individual group entity's cost structure. Various factors may trigger additional local costs or may lead to local cost savings:

- increase of personnel costs in order to ensure minimum wages;
- (higher) investments costs for carbon efficient production assets;
- investment in electrification of local fleet and/or local electric vehicle infrastructure (e.g. charging stations);
- investment costs in software for financial planning and measurement of ESG impact;
- investment in digital technology for data gathering and analytics on power usage and to monitor energy consumption;
- realizing savings because of lower energy consumption, packaging costs, lower waste disposal costs; and
- social projects ("purpose projects") for employees and local communities.

Increased costs at the level of routine entities may trigger a number of transfer pricing issues.

The first issue is which party should in principle bear the costs of ESG projects. The cost allocation principally is based on the functional and risk analysis: The functional analysis seeks to identify the economically significant activities and responsibilities undertaken, assets used or contributed, and risks assumed by the parties to the transactions. The analysis focuses on what the parties actually do and the capabilities they provide, including capabilities such as decision-making (e.g. decisions about business strategy and risks).[34] The analysis must also include the risk assumed by the parties.[35] Costs should be allocated to the party which made the decision which triggered the cost and, hence, assumed the contractual and/or factual risk. If the decision for a specific investment is made by the local entity in its business operations, the costs should be allocated to the local entity in the first step.

If extraordinary ESG costs or increase of current costs because of ESG investments cannot be passed on to customers, the difficult question may arise whether the local entity or the principal should bear these costs and potential losses. Again, this must be based on an analysis of the functions, risks assumed and assets employed. Based on the OECD Guidelines an independent enterprise would not continue loss-generating activities unless it had reasonable expectations of future profits. If the functional and risk analysis shows that the local function is a simple or low-risk function, such an entity is not expected to generate losses for a long period of time.[36] In case of extraordinary or one-time cost increases, which the local entity itself decides or which are triggered by the local business operations (e.g. litigation costs because of non-compliance with local environmental standards), it may be that the routine remuneration agreed arguably does not need to be adjusted and that also a routine entity realizes a loss. If, however, the cost basis of the routine entity is affected over a longer period or permanently, the remuneration will need to be adjusted to allow a coverage of such costs.

4.2.2. *Local assumption of ESG risks*

ESG-related topics affect all levels of an organization and it may be that day-to-day monitoring and management of risks needs to be assumed by local entities.

If ESG risks are material in a group's value chain, the local risk management function may require a revision of the historic functions, risk and asset allocation, agreements and also of the applied transfer pricing method.[37] For transfer pricing purposes, an analysis should be conducted based on the six-step approach[38] mentioned in the OECD Guidelines to accurately delineate the risk allocation. Based on the OECD, a legal risk allocation is generally only to be respected to the extent that that party has:
(1) control over the risk; and
(2) the financial capacity to assume the risk.[39]

This concept emphasizes the capability of making decisions with regard to risk, as well as the actual performance of said capability. In this regard, the actual performance is given more weight than the mere capability of making decisions with regard to risk-bearing opportunities.

32. Para. 7.47 *OECD Guidelines*.
33. Para. 7.43 et seq. *OECD Guidelines*; A. Benz, *Practical Application of the Guidance on Low-Value-Adding Services – Case Study*, 28 Intl. Transfer Pricing J. 2 (2021), Journal Articles & Opinion Pieces IBFD.
34. Para. 7.51 et seq. *OECD Guidelines*.
35. Para. 7.56 et seq. *OECD Guidelines*.
36. Para. 3.64 *OECD Guidelines*.
37. F. Arnold, *In-Depth Analysis of the Concept of Control over Risk*, 28 Intl. Transfer Pricing J. 1 (2021), Journal Articles & Opinion Pieces IBFD.
38. Para. 7.71 et seq. *OECD Guidelines*.
39. Para. 1.60 *OECD Guidelines*; F. Arnold, *supra* n. 37.

For example, if such an analysis shows that the local entity actually bears significant risks since it controls these risks and also has the financial capacity to assume the risk, it may even be that a historic cost-plus remuneration is no longer sufficient but that other methods such as the profit split method may be applicable. Based on the OECD Revised Guidance on the Application of the Profit Split Method, this is the case where:

– each party to the controlled transaction shares the assumption of one or more of the economically significant risks in relation to that transaction;[40] or
– the various economically significant risks in relation to the transaction are separately assumed by the parties, but those risks are so closely interrelated and/or correlated that the playing out of the risks of each party cannot reliably be isolated.[41]

4.2.3. Centralized management of supplier contracts

Another example of ESG-driven changes of the functional profile is the centralization of the management of supplier contracts to ensure that these are compliant with the group's ESG criteria and that all necessary information is provided by such suppliers so that the group is able to fulfil its reporting obligations. Very similar to the centralization of logistics, also functions relating to supplier relationships, including negotiation and contract management, may be centralized if these represent significant ESG risks for a group.

Also, for such services, the basic principles mentioned in section 4.3. apply for the transfer pricing analysis.

4.3. ESG reporting and branding: Cost allocation

Various costs may be incurred in the context of ESG within a group. Examples are:

– preparation of non-financial reporting (sustainability reports);
– preparation of detailed ESG information and KPIs for funding purposes (e.g. bank financing, etc.);
– stakeholder communication regarding ESG;
– ESG branding projects and communication measures; and
– preparation of (public) CbCR.

Costs incurred for such projects may only be passed on to group members under the arm's length principle if the benefit test is met.[42] This is the case if the service provides an "economic or commercial value to enhance or maintain the business position" to the receiving group entity.[43] The test is whether either an enterprise in comparable circumstances would have been willing to pay for the activity or would have performed the activity in-house for itself.[44]

On the other hand, costs which are associated with shareholder activities may not be passed on to other group entities. The OECD Guidelines mention the following examples of shareholder activities:[45]

– costs relating to the juridical structure of the parent company itself, such as meetings of shareholders of the parent, issuing of shares in the parent company, stock exchange listing of the parent company and costs of the supervisory board;
– costs relating to reporting requirements (including financial reporting and audit) of the parent company;
– costs of raising funds for the acquisition of its participations and costs relating to the parent company's investor relations such as communication strategy with shareholders of the parent company, financial analysts, funds and other stakeholders in the parent company;
– costs relating to compliance of the parent company with the relevant tax laws; and
– costs which are ancillary to the corporate governance of the MNE as a whole.

ESG reporting as well as ESG branding activities typically are closely related to items which may be considered shareholder activities.

For the test whether or not the activities are for the sole benefit of the parent in its capacity as a shareholder or also provide a benefit, it may also be useful to refer to the specific benchmark test, suggested by the EU Joint Transfer Pricing Forum.[46] The EU Joint Transfer Pricing Forum mentions that judgement is required when an activity not only discharges a shareholder duty but also produces an additional benefit. The suggestion, therefore, is to determine whether the service (i) just reflects a shareholder duty; or (ii) also provides a benefit to the other group members. If there is an additional service supplied and a benefit received over and above that of the parent company's ownership interest, the service may in principle be chargeable and it should be analysed whether the costs are split by way of a reasonable factor between parent and service recipient.

In any of the above ESG projects a careful delineation of the actual activities and their benefit to the individual group member is recommendable, e.g. proof that ESG reports are used by local group entities in order to receive external bank financing.

5. Conclusions

ESG is one of the megatrends for companies worldwide and affects business and organizational models in a variety of ways. It is easy to understand that this has various transfer pricing implications which follow this new dimension in

40. Para 2.139 *Revised Guidance on TPSM.*
41. Para 2.140 *Revised Guidance on TPSM.*
42. Para. 7.54 *OECD Guidelines.*
43. E.Buono, *Transfer Pricing Aspects of Intra-Group Services: What Are the Open Issues and What Can Be Improved?*, 27 . Transfer Pricing J. 1 (2021), Journal Articles & Opinion Pieces IBFD.
44. Para. 7.6 *OECD Guidelines*; A. Benz, *supra* n. 33.
45. Para. 7.10 *OECD Guidelines.*
46. Communication from the Commission to the European Parliament, the Council and the European Economic and Social Committee on the work of the EU Joint Transfer Pricing Forum in the period April 2009 to June 2010 and related proposals 1. Guidelines on low value adding intra-group services and 2. Potential approaches to non-EU triangular cases, para. 27, COM(2011)16 final (25 Jan. 2011), Primary Sources IBFD.

value creation and the respective new management tasks and new functions, assets and risks along the value chain.

This article summarized main ESG drivers, risks and opportunities for companies and provided some examples of transfer pricing implications. Since the whole ESG trend is still gaining momentum and the specific real-life impact for many businesses is still being developed, the list of transfer pricing aspects is far from exhaustive.

It is clear that some of the ESG-related topics have the potential to give rise to transfer pricing disputes. Therefore, a detailed analysis and accurate delineation of potentially new functional, risk and assets profiles is absolutely key and should be done as soon as a group starts to integrate ESG into the business strategy and processes in order to be able to steer and design the transfer pricing set-up.