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What's ESG Got to Do with Transfer Pricing?

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Climate change and the use of natural resources present us all with a major challenge. We all have our part in it and we can all contribute to ensure that we do not live at the expense of future generations. Various reports and goals were agreed upon internationally (e.g. Brundtland Report and Sustainable Development Goals). Multinational enterprise groups (MNE groups) play a key role in this context. They can contribute to reduce CO_2 emissions or waste, establish a circular economy, buy and sell more sustainable products, align their business model sustainably or establish new sustainable business models. In addition, social and governance issues (such as not using child labor and paying employees fairly) can also be taken into account in the corporate strategy. Given this context, ESG[1] strategies implemented within a MNE group are increasingly subject to public transparency through reporting obligations (e.g. Corporate Sustainability Reporting Directive, CSRD).

The question we ask in this blog is the following: **what does this have to do with corporate taxation and, in particular, with the issue of transfer pricing, and the arm's length principle (ALP)?[2]** The majority of global trade consists of international transfers of goods and services, capital and intangibles within a MNE group in two or more jurisdictions. Generally, a MNE group is granted no separate legal personality for tax purposes. The individual entities which are part of the MNE group are taxed as if they were legally and economically independent. Therefore, each individual group member is subject to tax on the income arising to it in its jurisdiction. The taxable profits determined by income and expenses of a MNE can be influenced by transfer prices. Thus, it is important for jurisdictions to establish the appropriate price for intragroup transfers of goods, intangibles and services to allocate taxation rights properly between jurisdictions.

The ALP was established as an attempt to objectify transfer prices and to allocate taxation rights properly between jurisdictions. The ALP is based on economic principles and it is supposed to ensure a level playing field between associated and unrelated enterprises. Although the ALP has been criticized, it remains – for the time being – the globally accepted standard to allocate profits within MNE groups.

The key element of the ALP is the comparability analysis, which must be applied both to the business relationship to be analyzed between the related parties and to the relevant reference data. Only if the business transactions between related parties are comparable with the observed business transactions between unrelated parties they can be used as reference values for the ALP. Depending on the quality and availability of data, the various transfer pricing methods are differently suited to determine appropriate arm's length prices.

Consider now a two-jurisdiction world and the most simplistic example of a MNE group that is present in these two jurisdictions. A Co. is the ultimate parent entity (UPE) of AB Group and is resident in jurisdiction A. AB Group is active in the apparel industry and also owns B Co. which is resident in jurisdiction B. B Co. is the manufacturer of the clothing that A Co. sells worldwide. AB Group is very committed to its ESG strategy and produces in a very sustainable way. All environmental standards are complied with. In order to determine the arm's length compensation for B Co., a comparison has to be made. For this purpose, a comparability analysis is carried out and two production companies are identified in jurisdiction B as possible comparables. The two companies differ only in their compliance with environmental standards. One company complies with environmental standards in a similar way as the AB Group. The other company is not interested in environmental issues. Which company is to be used for the ALP?

The answer is obvious: the environmentally friendly company has to be used for the ALP if one wants to make an appropriate comparison. In practice, however, this is more difficult because the OECD Transfer Pricing Guidelines (OECD TPG) do not directly address how ESG should be integrated in the TP analysis.

The determination of transfer prices is based on economic reality, i.e. the performance of the individual entities belonging to the MNE, which is reflected in the added value. The OECD TPG operationalize value creation based on the following three factors:

1. economic functions performed,
2. assets used, and
3. risks assumed.

The Business Model Canvas (BMC) as introduced by Osterwalder and Pigneur[3] has been widely applied in practice as well as in academia to analyze business models archetypes and their specific value drivers in particular along these three dimensions. Using the BMC, ESG innovations in the context of value creation can be classified very broadly into the following (not conclusive) three categories:

1. **"Supported" by ESG elements**: the BMC shows some elements of a more sustainable approach, including e.g. changes in the production technology or selection of more sustainable suppliers. The ESG elements are, however, an industry standard and support the existing business model that does not specially focus on ESG elements.
2. **"Enabled" by ESG elements**: the BMC shows that ESG elements are important for value creation and thus enable the existing business model to foster further growth or profitability.
3. **"Driven" by ESG elements**: the ESG elements play a crucial role in the value creation and various key elements as identified in the BMC are ESG related. Examples are a new "green" technology that allows the MNE to develop and exploit a completely "new" technology.

From an organizational transfer pricing point of view, two very stylized organizational archetypes can be identified:

1. With a central organizational structure („**ESG-Hub**"), sales or production companies are often considered routine functions. In these cases, the transfer prices are generally determined on the basis of a cost-oriented or a resale price-oriented transfer pricing method so that the residual profit from the business activity flows back to the entrepreneur. In this simplified case, ESG

value creation is incorporated into the residual profit.
2. In a decentralized organizational structure („**ESG-NET**"), numerous parties can be part of ESG value creation. In this case, there is a greater dependency among the group parties with regard to effective ESG functional and risk management, since quality and success depend on uniform and high-quality collaboration along the value chain. In this case, it would be conceivable to regard the group parties.

In practice, a detailed analysis and assessment of all facts and circumstances, and thus also of the ESG strategy, is required in the context of the ALP. If we were to ignore the ESG strategy, it would not be possible to accurately allocate value-added contributions in an MNE group, to apply the most appropriate transfer pricing method or to use reasonable comparables. Non-financial reporting requirements are supportive in this context and should be used for this purpose.

Even though we are convinced that the ESG strategy should already be taken into account today as part of a sound transfer pricing analysis, it does not seem to always be the case in practice. Therefore, it would be helpful if the OECD TPG were to specifically address how ESG should be integrated. So far, sustainability is not at all mentioned in the guidelines.

[1] Economic, social and governance.

[2] Cf. Greil/Schwarz/Stein, ESG Value Creation from a Transfer Pricing Perspective, ITPJ, 58-64 (2023), Greil, Sustainable Transfer Pricing – Sustainability Factors as Missing Variables in Value Creation and Profit Allocation? Vol. 44, ZfU, 150-188 (2021).

[3] C.f. Osterwalder/Pigneur. 2010. Business Model Generation, John Wiley & Sons, 2010.

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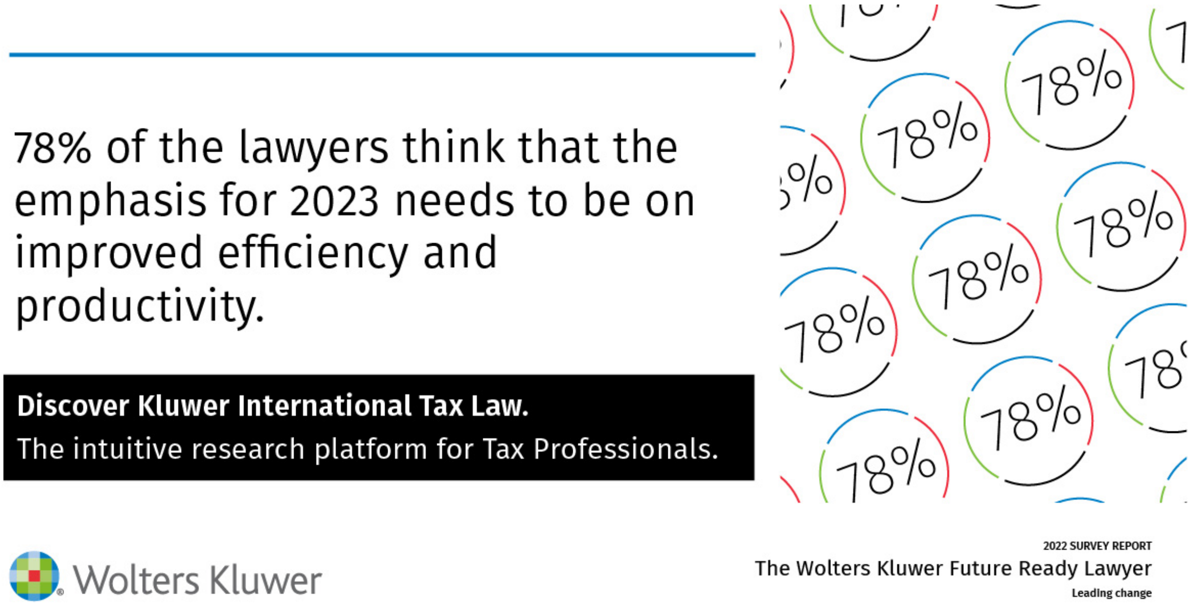

This entry was posted on Monday, May 1st, 2023 at 12:50 pm and is filed under Arm's Length, ESG, International Tax Law, Transfer Pricing
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