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Costs of ESG strategy planning and adoption: transfer pricing impact (1) 3/34/22


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Cross-border business is currently undergoing a huge transformation. Along with taking care of the environment, multinational groups are radically changing their strategy, setting sustainable development goals, and undertaking to considerably reduce their carbon footprint and to develop a socially responsible business according to the best governance practice. The inclusion of environmental, social and governance (ESG) criteria in a business development strategy gives cross-border companies a competitive advantage. In an unprecedented transition to the Green Deal, multinational groups are investing significant amounts and seeing their cost base rise. This article explores which of the companies in a group should cover costs incurred in planning, adopting and implementing their ESG strategy and related measures, looked at from a transfer pricing perspective.

Sustainable business costs and transfer pricing risks

Planning, adopting and implementing ESG measures may result in intragroup costs associated with a variety of measures, such as:

- Changes to business processes
- Non-financial/sustainability reporting[1]
- Preparing information on meeting ESG criteria in business to attract funding (investment)
- Projects and communication campaigns launched to create the image and reputation as a sustainable company
- Paperless accounting/office
- Environmentally friendlier real estate refurbishment
- Steps taken to cut electricity consumption
- Public Country-by-Country Reporting (PCbCR)[2]

Since these costs are usually quite substantial, this raises the question of how to split them between group companies. As cross-border business begins the journey of strategic change, correctly bearing and attributing costs is a common stumbling block because it’s not always immediately clear who should cover those.

Principles for bearing and attributing costs associated with ESG measures are not defined in national rules and are not especially described in the OECD “Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations” (the 2022 version) which the taxpayer might invoke in assessing how ESG costs are borne. Costs associated with the sustainability activities of a particular group company are often covered by that company, while the group’s centralised costs are equally split between all the companies because of the initial impression that the global adoption of ESG principles affects all the companies to a certain extent regardless of their degree of involvement.

Yet this assessment is not appropriate for a few important reasons. While the OECD guidelines don’t give answers as to how ESG costs should be borne, in evaluating these costs, we need to be guided by the general arm's length principle, which indicates two key aspects:

- Before any costs can be attributed to group companies, the Benefit Test has to be carried out to assess whether a particular company's business has benefited economically or commercially, as well as assessing whether any benefit is gained indirectly through being part of the group.
- Costs should be borne by the company that is able to control them (i.e. make a decision on their necessity and size).

As we have written before the benefit is easy to identify by assessing whether an independent company under similar conditions would be willing to acquire a similar service with relevant ESG activities and to cover the related costs. If no benefit can be identified, the costs cannot be attributed to that group company.

Accordingly, it's useful to identify any subsidiaries in the group that drive and develop business, and any low-value-adding and back-office service providers (e.g. accounting, information & communication technology, legal support, marketing, and human capital management companies) that are not directly affected by strategic business changes or unable to control such costs and don't have the financial capacity to cover them, so there might be no reason to attribute costs incurred in adopting ESG measures to subsidiaries with a back-office profile.

Our next article will look at the significance of cost control and give a few more reasons why an equal reapportionment of costs might be wrong, as well as outlining a potential action plan to mitigate transfer pricing risks.

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[1]This reporting has yet to be mandated for all industries across the EU. However, the member states that don't require this are increasingly seeing groups voluntarily report on their ESG strategy and implementation of measures as part of their sustainability or similar reports.
[2]Public Country-by-Country Reporting