

Costs of ESG strategy planning and adoption: transfer pricing impact (2) 2/35/22



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In our previous article, we looked at ESG cost categories and said it's not always right to bear expenses according to the principle of ownership and split them evenly between all companies forming a group. This article continues to examine the reasons.

Costs of sustainable business and transfer pricing risks

In any group, the process of giving up fossil fuels and switching to alternative energy sources isn't usually undertaken by all the group companies evenly. Our experience suggests that measures aimed at climate neutrality are more actively carried out by subsidiaries that hold some capital-intensive assets such as manufacturing facilities. So from a transfer pricing perspective, redistributing costs evenly between companies with very different facilities and different asset sizes and capacities can be a risky decision.

Secondly, in a multinational group, decisions on strategy and business process changes (especially involving significant capital investment in manufacturing facilities or real estate conversions to make them more eco-friendly) are usually made by the group shareholders, while the costs are borne by the companies undertaking those conversions. Significant capital investment may considerably reduce a company's profit or even lead to a loss. It may initially seem the costs have nothing to do with transfer pricing because the company pays to an unrelated service provider for conversion work. In the case of a centralised decision, however, tax authorities may find the costs should be borne by the group (parent) company that decided on the need for conversion, because the local subsidiary was unable to control the costs and might not have had the financial capacity to cover them.

The group should also critically assess the scale, diversity and necessity of any research and development (R&D) activities that are undertaken in the course of preparing its ESG strategy. Any expenses incurred in the early stages of transforming the business model may be wrongly treated as R&D costs and redistributed between all the group companies, although they could essentially be treated as activities carried out in the shareholders' interests.

Thirdly, multinational groups should check that the ESG strategy developed by the holding company and implemented at group level complies with the national rules applicable in a particular company's country of residence. It's important to note that the national tax authority may take a strict approach and claim the subsidiary would never incur such costs exceeding the nationally mandated threshold if the parent company did not force the subsidiary to bear them.

A possible action plan

Risks associated with ESG costs being borne or attributed inappropriately can be mitigated when the ESG strategy is being developed. To achieve this, the holding company should adequately assess the types and substance of potential costs and align those with the subsidiaries that are expected to bear them, by considering each company's operations, business strategy, potential benefit from the ESG implementation,

and financial capacity to bear the costs.

The holding company should carefully review how ESG costs are regrouped and categorised as routine management fees or cost recharges to ensure this practice is permitted locally and meets the arm's length standard.

To validate how ESG costs are borne or attributed, it's advisable for the local company to request information from the group on the types and substance of the attributable costs, to take part in decision-making on any proposed activities directly affecting the local company, and to prepare detailed information, including an explanation of the benefit received. This will help the local company demonstrate that the intragroup cost redistribution is performed objectively by the holding company in good faith and that the costs being incurred locally are also controlled locally.

We will be monitoring ESG policy developments to inform our MindLink subscribers about any topics related to the increasing transfer pricing impact of ESG costs, as well as reporting on how ESG principles are affecting the conduct of cross-border financial transactions between related parties.