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Transfer Pricing Policies Must Integrate ESG to Ensure Compliance

- *Skadden attorneys support holistic approach to ESG policies*
- *Involve transfer pricing teams in strategy, policy shifts*

As multinational enterprises reevaluate their operational policies to comply with environmental, social, and governance regulatory requirements and ethical standards, the interplay between ESG and transfer pricing policies shouldn't be overlooked. MNEs that make ESG-related changes to their business models should revisit transfer pricing practices to ensure continued arm's-length pricing and compliance.

ESG frameworks refer to a set of broad metrics to assess a company's holistic approach to operational sustainability across countless issues. These include carbon emission and energy efficiency, labor standards, governance structure, and diversity in leadership.

Certain sustainability-driven changes can affect a company's functional profile and transfer pricing model. For example, an organization can transform its supply chain from a full-fledged manufacturer into a limited risk manufacturer to address environmental concerns. It can discontinue operations in a jurisdiction due to geopolitical and human rights concerns, or terminate existing arrangements with third parties and insource crucial functions, such as logistics or sales as part of ESG efforts.

All the above moves can transfer valuable assets or reallocate profit potential among related entities. MNEs must evaluate these moves under the arm's-length standard since transfer pricing policies track the global business models of an organization.

Similarly, if MNEs revisit their intellectual property practices or brand strategy to tackle ESG challenges through investments in sustainable technologies or innovation, they must examine whether the new IP gives rise to additional compensation and how returns are allocated when revenue is generated by such IP.

To price any ESG-related transaction, the arm's-length principle normally requires a functional analysis—the cornerstone of any transfer pricing position—to identify economically significant ESG-related functions undertaken, assets contributed, and risks assumed because of new or shifted value creation. Such analyses generally include evaluating parties' contributions (including any benefits or costs related to the transformation), how value is generated, the choice of the appropriate transfer pricing method, and the performance of a comparability analysis.

While navigating the rapidly developing ESG landscape, MNEs should proactively consider the following measures to avoid potential disputes and double taxation related to ESG frameworks.

Transfer pricing policies should incorporate ESG-related changes. As MNEs advance in their ESG efforts, tax and transfer pricing considerations should be a fundamental part of these strategies. MNEs should integrate all sustainable efforts into global transfer pricing policies to ensure that potential ESG-related risks and values are priced in accordance with the arm's-length principle.

This effort should include creating internal processes and systems to link ESG-related facts to analysis of special business conditions that may affect profits, supporting best method selection by demonstrating that the relevant pricing aligns with the actual economic activity, providing clear descriptions of ESG-related business asset and risk allocation between associated parties, and taking a big-picture approach to documenting and providing rationale for these policies.

As transfer pricing continues to be a top audit priority for tax administrations globally, MNEs should consider ways to avoid potential scrutiny related to ESG-related transactions. Finding tax certainty and preventing double taxation should continue to be a top priority for MNEs in an era marked by global international tax reform.

MNEs must be prepared for tax reporting and transparency. In recent years, legislative and voluntary standards have required robust tax reporting by MNEs. For example, tax reporting is considered when assessing an MNE's ESG score—including reporting on tax strategy, tax governance, and tax transparency that highlights how much taxes an MNE paid in certain jurisdictions to assess whether they're paying their fair share.

Even outside the scope of ESG frameworks, tax compliance obligations and stringent data requirements are rising due to OECD Pillar Two's transitional country-by-country safe harbor rules and the EU's public country-by-country reporting requirements that require certain companies to report data on their global taxes and economic activities in each jurisdiction of operation.

A critical aspect of many of these reporting requirements is their interaction with transfer pricing data, as in-depth information on profit allocation, controlled transaction pricing, and transfer pricing adjustment calculations—including those impacted by ESG efforts—underpin compliance efforts. As such, MNEs should assess whether they have the infrastructure to maintain internal requisite data to comply with the various reporting obligations and to help any potential audit or dispute resolution.

MNEs should structure ESG investments to optimize tax and long-term cost savings. The desire to encourage ethical business practices has led to enactment of generous tax incentives and credits in the US, including in the Inflation Reduction Act and CHIPS and Science Act.

As such, MNEs can drive shareholder value while advancing strong durability and sustainability practices. To capitalize on these benefits, MNEs should undertake proper due diligence to determine eligibility under the various tax laws, assess investment costs, track sustainability reporting purposes, and evaluate relevant transfer pricing implications.

The spotlight on ESG issues is a trend expected to continue way beyond 2024. MNEs should undertake a holistic approach to ESG-related strategy implementation, ensuring that tax and transfer pricing teams are involved in all ESG strategic discussions and policy-making processes.

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