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Overview of possible approaches in line with the OECD Transfer Pricing Guidelines

Management of ESG related activities has resulted in significant costs for international groups in recent years, which are generally borne by their headquarters. In practice, the question arises as to whether and what extent groups can pass on these costs from the headquarters to other group affiliates. The OECD Transfer Pricing Guidelines 2022 do not explicitly address these issues.

1. INTRODUCTION

The broad topic ESG (environmental, social, and governance) has become increasingly important in recent years, either in response to new legal requirements or voluntarily by a group in order to improve its public perception. We understand ESG as a comprehensive set of rules for assessing the sustainable and ethical practices of companies, which is implemented, for example, through management actions or public reporting. Many groups now have dedicated ESG departments to identify and operationalise these issues. Depending on the sector and size of the group, the costs associated with ESG can run into the millions. They are usually borne by the group's headquarters in the first instance. The authors have recently been confronted on a daily basis with the challenge of whether and to what extent such costs can or should be passed on to other group companies, considering the applicable transfer pricing regulations. The purpose of this article is to show how to methodically approach these questions.

2. CATEGORISATION OF ESG COSTS

To approach the topic in a structured manner, costs related to ESG activities must first be divided into different categories. It should be noted that the associated costs can vary greatly depending on the group and industry. The following categorisation covers the cost items most frequently discussed in practice:

- ESG reporting
- ESG-driven changes to supply chain and manufacturing
- Products and services
- CO_2 compensation
- People
- ESG teams and committees

3. THE TRANSFER PRICING APPROACH

3.1 General comments. When examining how ESG costs should be analysed from a transfer pricing perspective, it becomes evident that the OECD TP Guidelines [1] do not explicitly address this topic and that there are no specific regulations currently in place that directly govern transfer pricing from an ESG perspective.

The basic principles of the OECD TP Guidelines should therefore be followed in order to determine whether – and how – costs related to ESG initiatives and projects are to be allocated across legal entities or jurisdictions. In this respect, cost allocation is generally based on the functional and risk profile of the relevant entities, whereby costs incurred may only be passed on to group members under the arm's length principle if the "benefit test" is met.

The question as to whether a cost has been incurred by a group member for the benefit of one or more other group members is dependent on whether the activity provides an economic or commercial value to enhance or maintain their business position. In other words, the tests objective is to reveal whether an independent company in comparable circumstances would have been willing to pay for the activity or would have performed the activity in-house for itself [2].

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This will depend heavily on the specific facts and circumstances. The OECD TP Guidelines provide some guidance by indicating certain service/cost categories that may not meet the benefit test, and as such would not justify a charge to other group members:
→ Shareholder-related costs: costs related to activities performed by a group member due to its ownership interest in other members of the group, i.e. in its capacity as a shareholder. These activities are generally performed by the parent company [3].
→ Duplicated costs: costs for activities undertaken by one group member, which merely duplicate a service that another group member is performing for itself [4].
→ Costs incurred in relation to activities that provide an incidental benefit to other group members, e.g. where the benefit is solely attributable to the member being part of a larger concern.

Once it is established that a cost has been incurred for the benefit of other group members, it is necessary to determine whether the amount of the charge is in accordance with the arm's length principle.

There are generally two methods that may be used to charge the amount:
→ the direct charge method, in which the specific costs can be directly allocated to the beneficiary of the services [5], or
→ the indirect charge method, in which specific costs cannot be allocated since there are multiple beneficiaries. In this case, the allocation should be based on an appropriate measurement of the usage of the service (e.g. FTEs, revenues) [6].

Considering the above, for each category of ESG costs, we will provide multiple approaches on how to analyse whether – and, where possible, to what extent – costs could be charged to other group members.

3.2 ESG reporting. The first category includes costs associated with ESG reporting. While such reporting was often voluntary in the past, it is increasingly becoming a legal requirement [7]. The reporting can relate both to the entire group and to the individual group companies in their domicile jurisdictions. Examples include group sustainability reports or voluntary total tax contribution reports, as well as disclosures under new regulations such as the non-financial reporting duty under Art. 964*a* ff. Swiss Code of Obligations (CO) or the supply chain due diligence framework whose reporting elements are embedded into the EU Corporate Sustainability Reporting Directive (CSRD). Mandatory non-financial, ESG-related disclosures in the financial statements according to international accounting standards are also on the horizon. This category also includes costs in connection with ESG ratings [8] and communication with various stakeholders.

As material costs are associated with the compilation of comprehensive ESG reports, it will become increasingly important to determine how these costs should be allocated from a transfer pricing perspective. And whether or not such costs should be considered as relating to shareholder activities.

EXAMPLE 1

Based on Art. 964*a* ff. CO, a group listed on the Swiss stock exchange prepares a report on, among other things, the group's CO_2 targets and its measures to combat corruption. The costs incurred for this report qualify as shareholder activities and cannot be charged to the foreign subsidiaries.

In this respect, the OECD TP Guidelines refer to shareholder costs as being, amongst others:
→ costs for ensuring compliance of the parent company with the relevant tax laws,
→ costs arising from the parent company's investor relations, such as its communication strategy with shareholders, financial analysts, funds and other stakeholders, or
→ costs that are ancillary to the corporate governance of the overall group. [9]

Based on the above, ESG reporting – regardless of whether mandatory or voluntary but prepared at the level of the parent entity for the purposes of stakeholder management or enhancement of brand awareness and reputation – is, typically, closely related to shareholder activities. It is therefore highly unlikely that the costs related to such disclosures will be recharged to group affiliates (see *example 1*).

That being said, it is not always easy to determine if the costs are incurred solely for the benefit of the parent company in its capacity as a shareholder, or whether they might also provide some benefit to other group members. For instance, where detailed ESG information is provided that allows individual group members to receive external funding, the costs relating to the collection and submission of such information might be recharged to the affiliates.

Where local affiliates are obliged to prepare ESG reporting based on local requirements, it might also be considered appropriate to recharge the related costs to the parent entity if the latter could benefit from the local ESG reports for its own disclosures.

Based on the above, even though ESG reporting is typically closely linked to shareholder activities, it still makes sense to consider whether certain benefits are received over and above those arising from the parent company's ownership interest. If so, the costs could in principle be charged in full or in part to the recipients of such benefits.

3.3 ESG-driven changes to supply chain and manufacturing. Various initiatives are in place in the context of efforts to optimise energy efficiency and reduce emissions, particularly in the case of groups in the manufacturing industry. These may involve relatively minor measures such as the purchase of new, more efficient machines, the adaptation of production processes or the use of more expensive renewable energy, as well as strategic projects such as realignment of the global value chain to optimise energy consumption and reduce global transport volumes. Such initiatives are

usually carried out on a voluntary basis to reduce costs and energy consumption but are often also showcased prominently to the public in order to improve the group's image.

The transfer pricing treatment of the costs relating to such ESG-driven changes are dependent on the nature of the changes, where key decisions are made, and which party assumes (and has the capacity to bear) the risks associated with the changes.

Typically, strategic ESG-driven projects are decided at group level (by group management), in view of their importance for the overall group's reputation and the significant value they can create for the group's stakeholders. Such projects cover a wealth of possibilities – from establishing a centralised procurement function to ensure sourcing from sustainable suppliers or investing in in-house production facilities with renewable energy sources, to setting up a centralised, carbon-efficient logistics management system.

Such changes may have a large impact on the transfer pricing model and may trigger an increase or decrease in functions, assets and risks for the parties involved. While it will be important to analyse the changes to the functional and risk profile of the parties from a transfer pricing perspective in order to establish an arm's length remuneration model following the restructuring, any allocation of costs or investments related to such changes should also be analysed.

In this respect, as decisions are mainly made by the management at group level, and since the local entities impacted by such changes are generally remunerated based on a routine return, the costs as well as the risks related to such changes will in fact be borne by the principal (usually the parent entity). Any benefits for the local entities might be regarded as incidental, i.e. solely attributable to their being part of a larger concern, and – as such – the costs could generally remain at the level of the parent entity (see *example 2*).

While ESG may have an impact on the group's overall model, individual group entities may also incorporate ESG factors in their operations and thereby trigger additional costs, such as investing in carbon efficient machines or increasing personnel costs to ensure fair labour practices.

According to the general transfer pricing principles, where decisions are made by the local entities that control and have the capacity to bear the related risks, the costs should in principle remain locally and not be passed on to other group entities or the parent entity.

EXAMPLE 2

A principal company based in Switzerland launches a strategic global project with the aim of reducing CO_2 emissions in production by 30%. The project incurs costs of CHF 2m. As a result of this project, a foreign subsidiary, which works as a contract manufacturer, purchases a new machine for CHF 1m. The costs of CHF 2m for the project are to be borne by the Swiss principal company. However, the acquisition costs for the machine are to be borne by the foreign subsidiary.

EXAMPLE 3

A principal company in the automotive industry develops a new type of battery for electric cars at a cost of around CHF 800m. This new battery doubles the range of electric cars, leading to a massive increase in the number of cars sold. As all DEMPE functions for this new battery were carried out by the principal company, these costs of CHF 800m are to be borne by the company. At the same time, however, the additional income from the exploitation of the battery will be recognised by the principal company.

In summary, the allocation of ESG costs in relation to supply chain or manufacturing should generally be analysed considering any potential changes to the functional profile of the local entities. It should also be noted in this respect that an adjustment to the transfer pricing policy may be required based on the functions, risks assumed and assets employed by the parties involved following any restructuring.

3.4 Products and services. Groups are striving to make not only their manufacturing operations more environmentally and socially responsible, but also the products and services they bring to market. For example, the automotive industry is investing heavily in electric cars and more efficient batteries, while the financial industry is developing new, ESG-friendly financial products. The motivation is usually that such products sell better and that there is market demand for them. The development of such products and services goes hand in hand with research and development in which companies are aiming to design products or services that are more durable, reparable and upgradable.

Prioritising ESG factors in products and services can generally lead to increased customer loyalty, higher sales and a willingness by customers to pay a premium for the company's products and services. Moreover, such companies are often seen as more trustworthy and reliable – which can further enhance their brand reputation.

Whilst the issues in relation to these product and service enhancements are not specifically targeted at understanding the cost allocation between parties, tax departments are questioning whether the additional investments, which are mainly R&D-related and trigger an increase in brand awareness and premium, would allow for a return on investment such as an increase in brand royalty (see *example 3*).

The analysis would depend significantly on the industry, the company's specific fact patterns and its value chain. These aspects are key to understanding the extent to which ESG increases the value of the company's brand/IP and the extent to which it provides a benefit to other group members (mainly the distribution entities).

The fundamentals of the transfer pricing guidelines should however be considered, with detailed review of the functions performed, assets used, risks assumed and – more specifically – of where those who decide on IP and product

EXAMPLE 4

A group producing goods has to purchase CO_2 certificates for its manufacturing subsidiaries in various European countries due to legal obligations. These certificates are purchased centrally for all subsidiaries by a German group affiliate. The costs for the certificates (without profit mark-up) as well as the costs for the activities carried out by the German affiliate (with profit mark-up) are to be charged to the producing subsidiaries.

(ESG) strategy are located, as well as where other DEMPE functions are performed.

3.5 CO_2 compensation. Various companies have now started to offset their energy consumption, in particular CO_2. This can be done on a voluntary basis (e. g. compensation for flight emissions), as well as in response to legal requirements, such as the purchase of CO_2 certificates. The latter can also be traded, resulting in either revenue or cost. Airlines now offer the opportunity to participate financially in sustainable aviation fuel (SAF) and thus to contribute to more environmentally friendly air transport. The topic of compensation can also include payments to social institutions or environmental protection organisations (philanthropy).

It may not always be easy to determine whether such compensation measures are performed for management reporting purposes or whether these costs represent a charge for the business that could be passed on to other group affiliates (see *example 4*).

For instance, where the parent company undertakes measures voluntarily in order to enhance the group's reputation and maintain its business position in consideration of stakeholder and social pressure, the costs related to such measures could be regarded as being closely linked to shareholder and brand awareness activities and thus not appropriate for charging out to other group members.

With respect to CO_2 certificates purchased by the parent entity, these generally provide a benefit to other group members as they help the latter also to meet their environmental and sustainability objectives. Where the local group member already buys CO_2 certificates based on a local mandatory regulation, this may qualify as a duplicated service as such no benefit is considered to be provided and no costs could be recharged by the parent entity in relation to it.

Based on the above, the transfer pricing treatment of compensation costs will depend on the circumstances in which those compensation measures are performed (e. g. voluntary or mandatory) and whether they can be regarded as providing a service or benefit to other group members.

3.6 People. In recent years, ESG has led to an increase in initiatives to promote diversity and inclusion. These may include awareness training for employees, for example, as well as targeted promotion schemes and special bonuses for women. Such initiatives are usually implemented on a voluntary basis, but also increasingly in response to legal requirements. For example, Art. 734*f* of the Swiss Code of Obligations requires the proportion of women on the board of directors to be at least 30 % and on the executive board at least 20 % (see *example 5*).

The benefits of the initiatives may include improved employee engagement, increased innovation, enhanced reputation and improved access to diverse talent.

Many of these initiatives are undertaken on an individual company basis and provide benefits only to that entity and its employees. As such, costs borne by that local company should not be recharged from a transfer pricing perspective.

This would be the case, for instance, if – based on local regulatory requirements – a company needs at least 30 % of women on the board of directors, and implements certain initiatives in order to achieve this. In such a case, the benefits relate only to the company itself and should not be recharged.

However, where the group management at the parent company decides on or implements certain initiatives and bears the related costs for employees across the world, e.g. an awareness training course for employees, such costs could in principle be recharged to all member groups. In this respect, depending on whether a specific group of employees (e. g. female employees up to a certain grade) is targeted, the costs can be directly recharged to the entities based on the number of employees covered by such initiatives.

3.7 ESG teams and committees. It is now standard practice for international groups to have their own team of ESG specialists and dedicated ESG committees, which focus on sustainability and responsible business practices. These teams are generally responsible for identifying such trends and legal requirements, as well as implementing and managing them within the Group.

Where ESG teams and committees provide services to related entities, the treatment of the associated costs from a transfer pricing perspective will depend largely on the nature of the activities and the value that the ESG team creates for the overall group.

If the ESG team is engaged in activities that are directly related to setting sustainability goals for reporting purposes or developing corporate responsibility policies, then the costs associated with such teams could qualify as shareholder costs and should not be recharged.

On the other hand, if the ESG team is more involved with management and strategic decisions in relation to ESG,

EXAMPLE 5

A foreign subsidiary is obliged to employ at least one woman in local management. The Swiss parent company engages a head-hunter to hire a female CFO, for which costs of CHF 50,000 are incurred. These costs must be charged to the foreign subsidiary, as this is a legal requirement abroad.

where such decisions impact the operations of the group or provide benefits to the group, such costs could in principle be recharged to other group entities. This might be done in the context of management fees for instance.

Where the individual members of the ESG team do not reside at the parent entity, these costs may be recharged to the parent entity by the respective affiliate.

In summary, the transfer pricing treatment of ESG teams/committees will depend on the specific activities of the team/committee in question and their impact on the group's business operations.

4. FINDINGS

ESG is a very broad, vaguely delineated issue that is being driven by international groups for a variety of reasons. It can be a response to legal obligations but may also prompt a company to take action voluntarily in order to boost its image. Because of this heterogeneity, there is no "one size fits all" transfer pricing solution. In practice, costs need to be categorised with one or more methodological approaches selected for each category. The focus is often on whether these are shareholder costs, and the extent to which such ESG services generate tangible benefits for group companies. ■

Notes: 1) Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations issued by the Organisation for Economic Co-operation and Development. Latest edition of the OECD Guidelines published in January 2022 (hereafter "OECD TP Guidelines 2022"). **2)** OECD TP Guidelines 2022, par. 7.6. **3)** OECD TP Guidelines 2022, par. 7.9. **4)** OECD TP Guidelines 2022, par. 7.11. **5)** OECD TP Guidelines 2022, par. 7.21 and 7.23. **6)** OECD TP Guidelines 2022, par. 7.24. **7)** Thomas Hug, Tax Accounting & Reporting, Zurich, 2024, N 881 ff. **8)** E.g. MSCI, Sustainalytics (Morning Star) or RobecoSAM (Standard & Poor). **9)** OECD TP Guidelines 2022, par. 7.9.