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ESG & Transfer  
pricing: local approach

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Latvia

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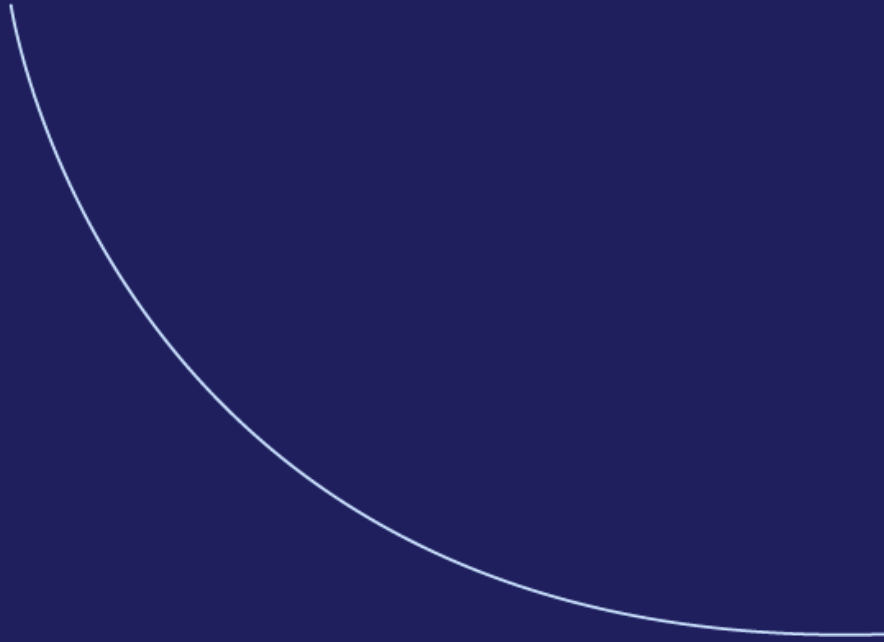
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# 1. OECD TPG & ESG

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## 1.1 ESG impact on the value chain



**ESG** = *governance* historically derives from the economic contribution (including profit issues) in transforming the management of organisations towards sustainable development.

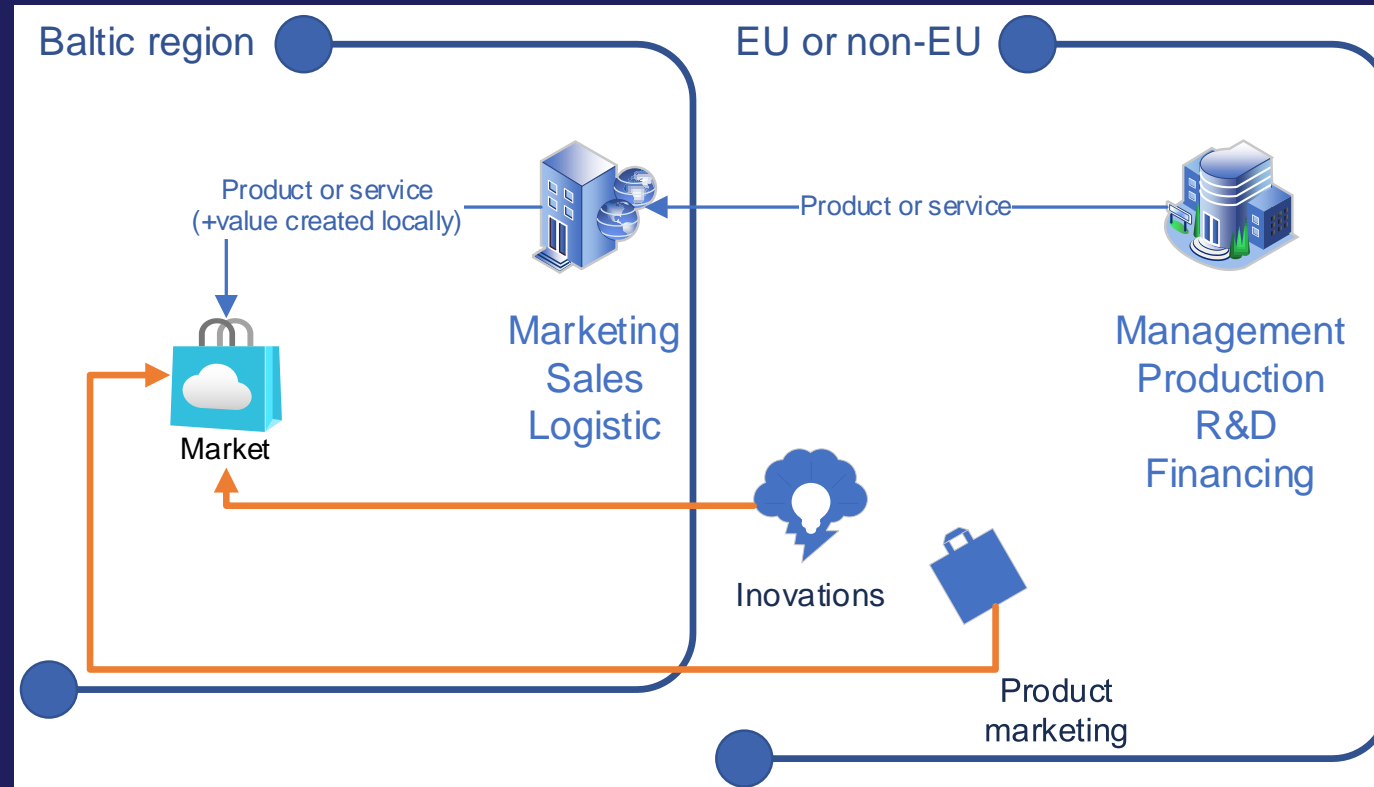
Economic contribution affects the value chain in international business.

Multinational companies are taking on (significant) business risks and opportunities by embracing ESG as a sustainability strategy.

## 1.2 Value chain in international tax law

OECD TPG § 51: "(...) It is important to understand how (1) value is created by the group as a whole, (2) the interdependence of the functions performed by associated enterprises with the rest of the group, and (3) the contribution that associated enterprises make to that value creation."

# 1.3 Business strategy



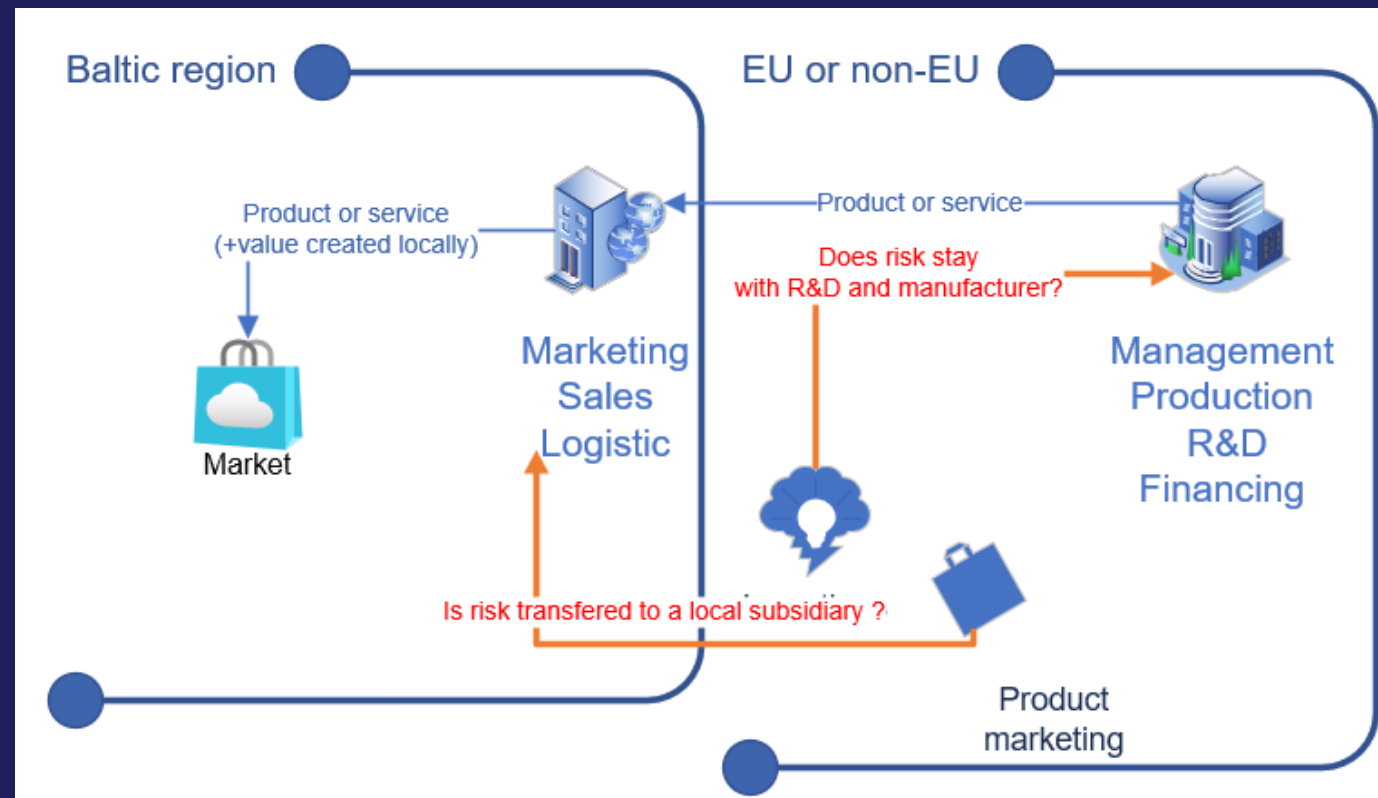
## 1.3 Business strategy

OECD TPG § 1.134: *Which business strategy is relevant in determining the economic substance of a transaction?*

OECD TPG § 1.137: *Which companies should bear the costs based on the economic substance of the transaction?*

OECD TPG § 1.138: *What is a reasonable period over which a profit can be expected from implementing a business strategy, and would a company sacrifice profit to do so in comparable circumstances?*

## 1.4. Risks





## 1.4 Risks

OECD TPG § 1.73 & 1.51: *How do risks affect the determination of transfer pricing depending on the functions in the business value chain and the activities of companies to maintain profits?*

## 1.5 Losses

	PLA (Mil. EUR)	Baltic Company	Foreign Affiliate Company
Year		2024-2027	2024-2027
Net Turnover		<b>644</b>	<b>598,6</b>
Costs of Goods Sold		598,6	407
Cost of Innovation and Development		-	17
Gross Profit		45,56	191,6
Operative Expenses		60	85
Cost of Innovation and Development		-	25
EBT		<b>-14,44</b>	<b>106,6</b>
CIT		1,25	22,6

## 1.5 Losses

OECD TPG § 1.149-1.1.51: *Would a company tolerate losses in the long term, considering the business strategy, the economic situation of the sector and the remuneration for taking on risks?*

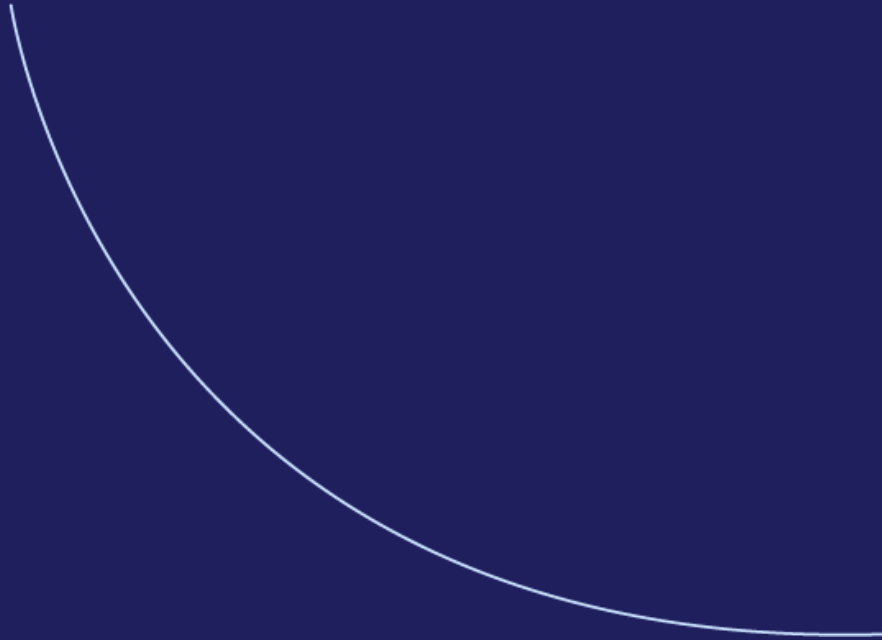
OECD TPG § 3.10: *Should financial data in the transfer pricing documentation (file) be presented at product (accounting) or aggregate (financial reporting) level of detail?*

## 2. Integrating ESG into TP

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## 2.1 Business model classification



9 factors in the value chain, including ESG activities:

- Main cooperation partners
- Main activities
- Key resources
- Product value setting
- Customer relations
- Sales and communication channels
- Customer segments
- Cost
- Revenue

- Low ESG impact
- An ESG-driven company
- A company focused on ESG objectives



## 2.2 Case study

Facts: 4 years of

- Product innovation and development,
- Product sales increase, every year,
- Losses due to innovation and product development costs.

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## 2.2 Case study

### Step 1. Identification of economic factors:

- Product,
- Contractual terms,
- Economic conditions,
- Business strategy.

### Facts:

- A group invests in a new sustainable and innovative premium product. The product is unique in the market.
- The contract between the parties allocates the risks.
- The market is concentrated, and premium products still require resources to develop that reduce profitability. Profits can also be affected by customer payment terms.
- There are no companies with a similar business strategy, and companies are offering less innovative products.

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## 2.2 Case study

### Step 2. Identifying ESG activities in the business model, considering:

- Key resources,
- Product value setting,
- Customer relations,
- Sales and communication channels.

### Facts:

- A product consists of recyclable but long-lasting material.
- Product quality is maintained in the long term through periodic improvements.
- The product's customers are a segmented group with a specific service and communication policy. The aim is to expand the customer segment by reinvesting the profits generated.
- The customer receives information on the sustainable use, quality, recycling, reuse or refurbishment, etc. of the product.

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## 2.2 Case study

### Step 3. Determining the functions, considering functions:

- Research and development (R&D),
- Marketing,
- Sales.

### Facts:

- The foreign associated company carries out R&D, but the Baltic company invests in the process by providing essential information needed for such innovation.
- The Baltic company carries out marketing and sales, using the information provided by the foreign associated company on the results of the R&D studies and recommendations for the marketing and sales function based on product marketing research.

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## 2.2 Case study

### Step 4. Applying TP method

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#### *No (or skip) ESG activity*

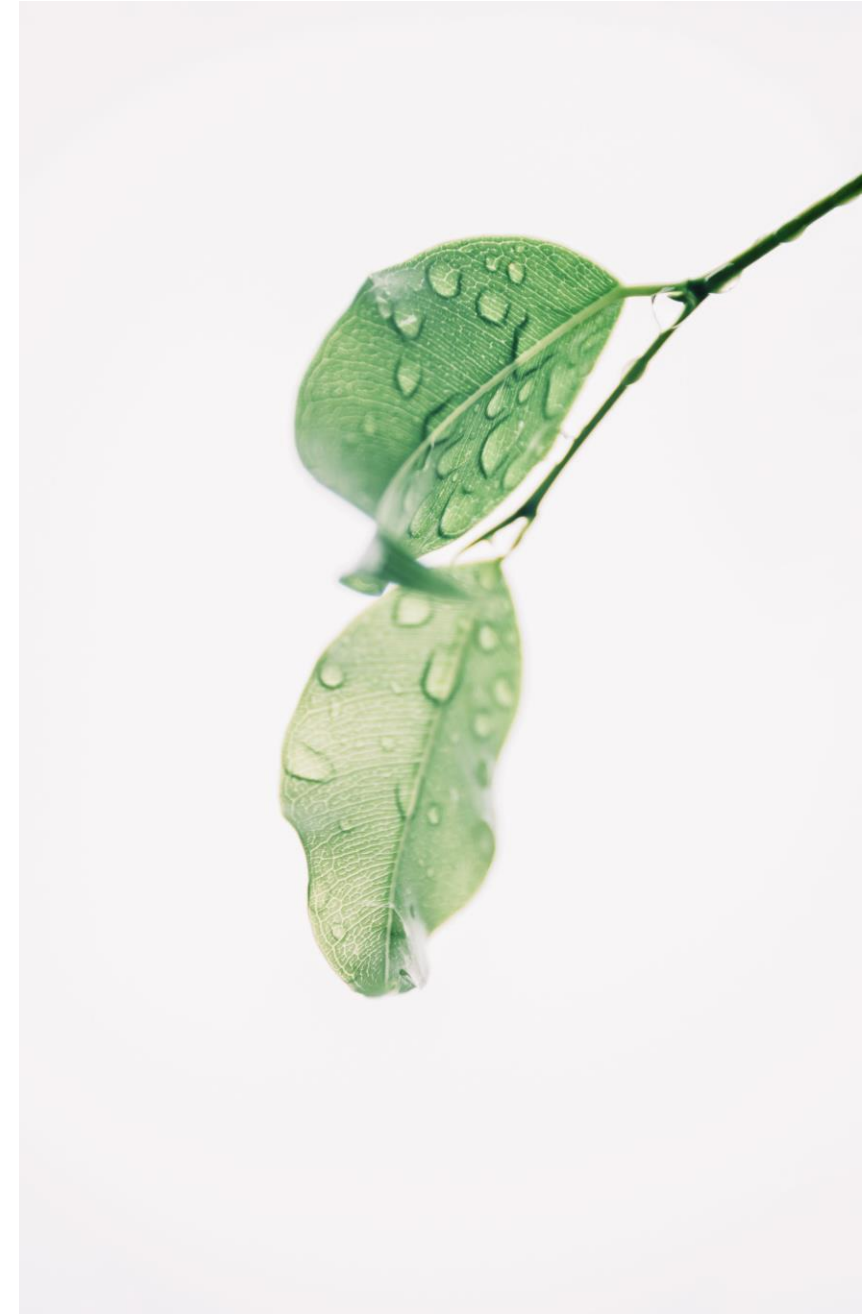
- The transactional net margin method would be applied
- Comparative market data should be used to substantiate losses

#### *With ESG activity*

- Profit split method would be applied as ESG activities **integrate** business functions
- Losses also may be split
- Market data analysis is optional

## Helping clients with ESG and transfer pricing

- Preparation of value chain analysis in global and local transfer pricing documentation,
- Verification and documentation of the impact of ESG activities on the value chain and transfer pricing
- Conducting market data analysis where the value chain is not affected by ESG (or skipped)



# Contact us



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