

ESG and Transfer Pricing

WTS Germany

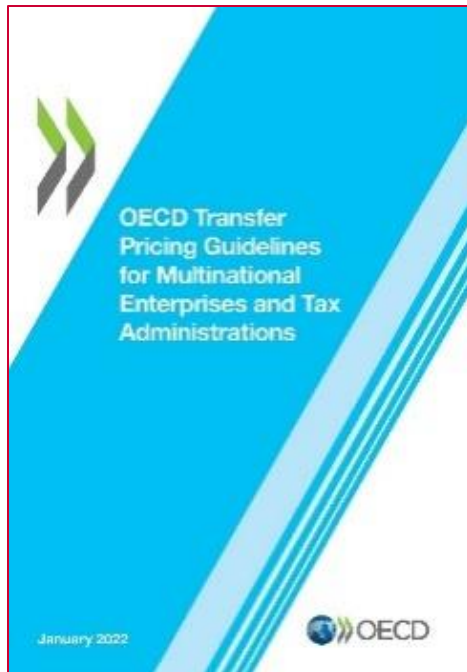
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Introduction

ESG and TP

- › The OECD Transfer Pricing Guidelines for MNEs and Tax Administration 2022 (OECD TPG 2022) do not feature guidance on the consideration of ESG (yet).
- › Therefore, for the time being, ESG may be considered as part of the Typical Process and as part of the Comparability Factors for purposes of conducting the Comparability Analysis.



Comparability Analysis – Typical Process

(cf. OECD TPG 2022 Para. A.1)

1. Years

Determination of years to be covered

2. Broad-based analysis of the taxpayer's circumstances

Analysis of the industry, competition, economic and regulatory factors, and other elements affecting the taxpayer and its environment

3. Intra-group transactions

Obtaining an understanding of the controlled transactions under analysis. Functional analysis, to determine the tested party, most appropriate transfer pricing method and financial indicator to be tested (in the case of a transaction-based profit method)
Identification of the significant comparability factors to be taken into account

4. Internal comparables

Review of existing internal comparables

5. Available sources of information

Determination of available sources of information on external comparables

6. Transfer Pricing method

Selection of the most appropriate transfer pricing method and, depending on the method, determination of the relevant financial indicator

7. Potential comparables

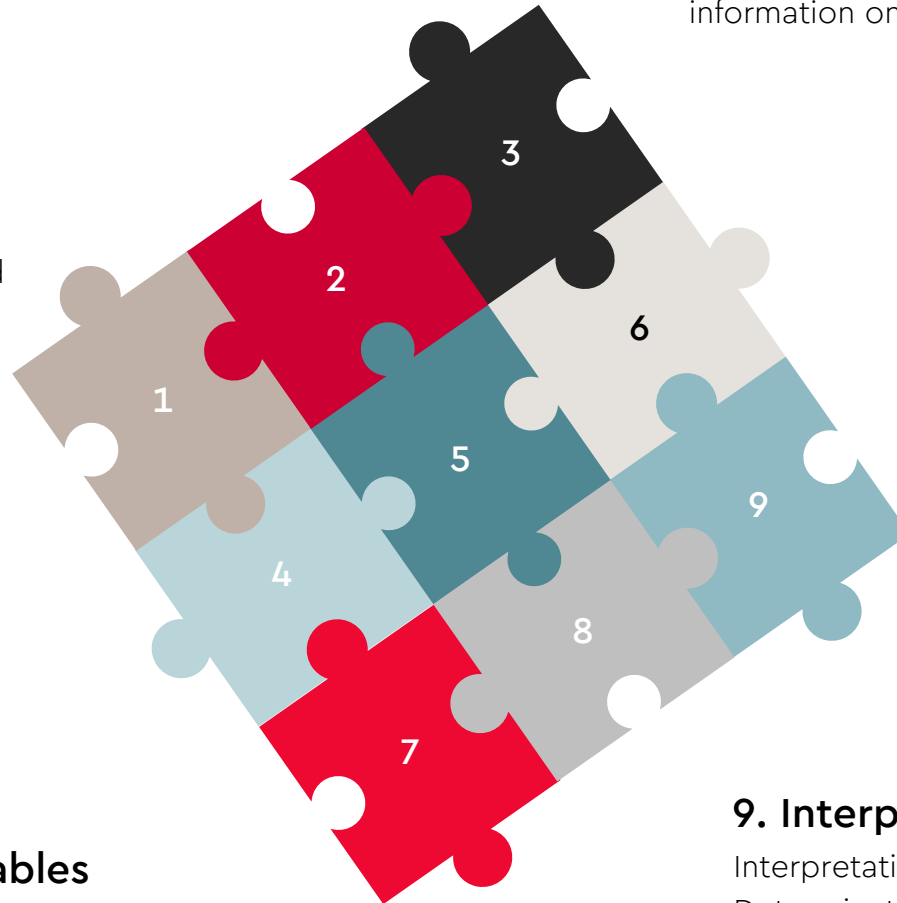
Identification of potential comparables
Determining the key characteristics to be met by any uncontrolled transaction to be regarded as potentially comparable

8. Comparability adjustments

Determination and, if necessary, making comparability adjustments

9. Interpretation

Interpretation and use of data collected
Determination of the arm's length remuneration



Comparability Factors

(cf. OECD TPG 2022 Para. D.1)

1. Contractual conditions

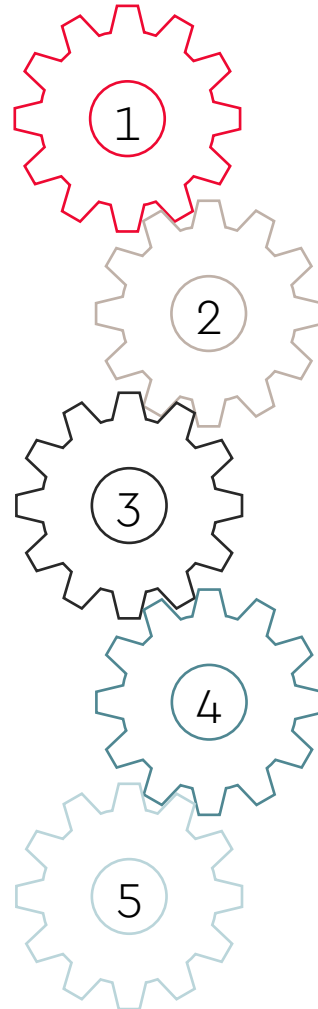
- › the contractual conditions of the business transaction

3. Characteristics

- › the characteristics of property transferred or the services provided

5. Business strategies

- › the business strategies pursued by the parties involved



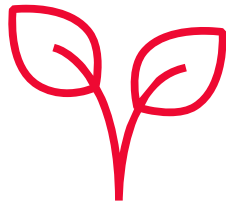
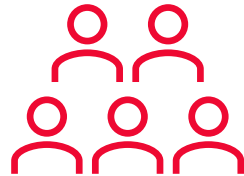
2. Function and risk analysis

- › the functions performed by the individual companies involved in the transaction, taking into account the assets used and risks assumed

4. Economic circumstances

- › the economic circumstances of the parties involved and the market in which they operate

Central vs. decentralized ESG organization



02

Intra-Group Financing

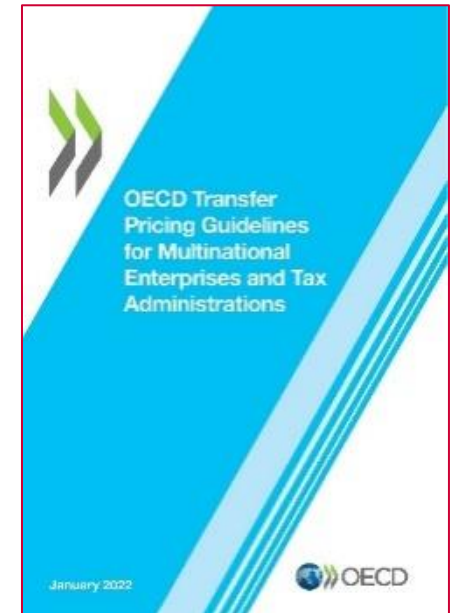
OECD Guidelines | Chapter X | Transfer Pricing Aspects of Financial Transactions

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Key areas

- › We will focus on
 - › Intra-Group financing, incl.
 - › Credit rating and
 - › **Measurement of ESG**

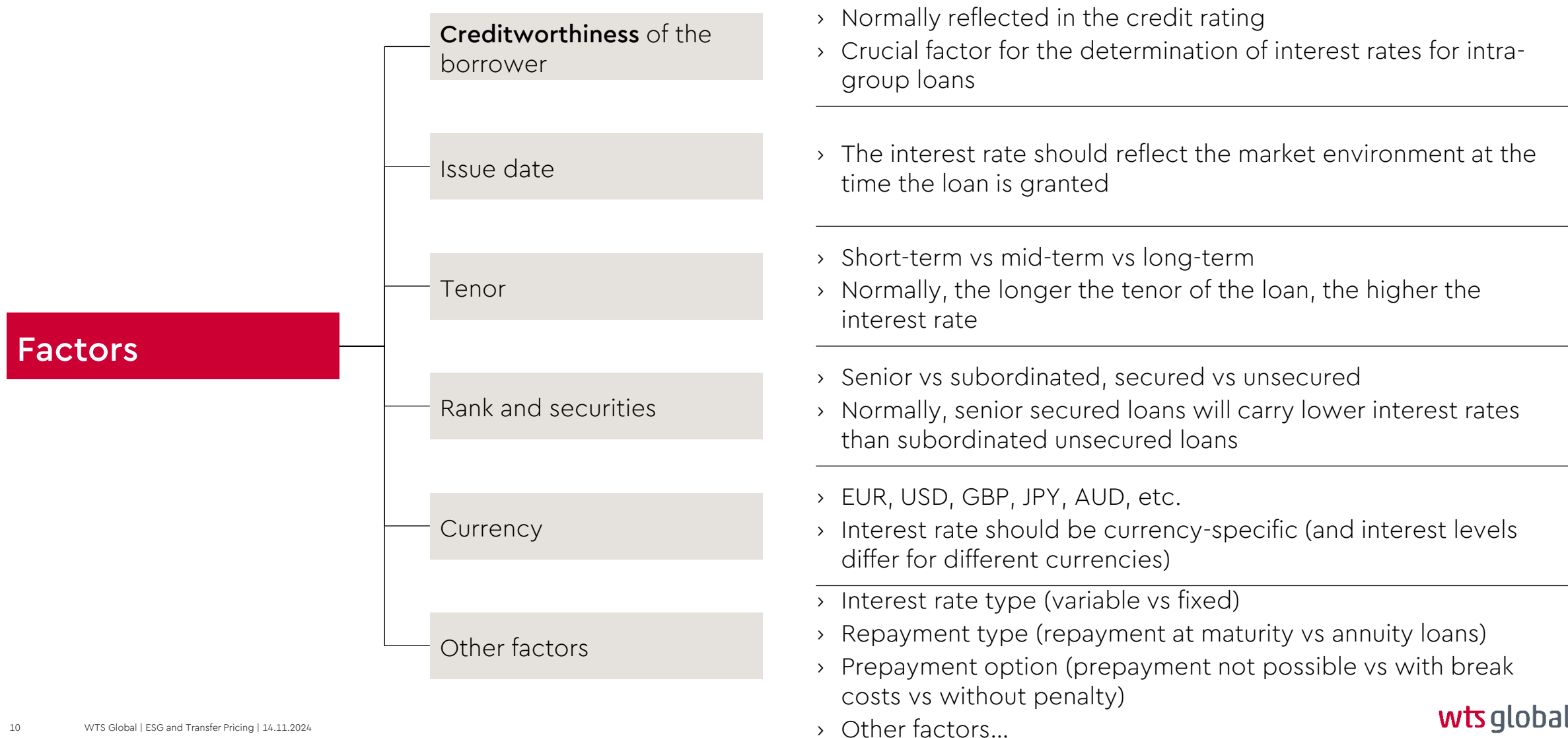


The economically relevant characteristics of actual financial transactions

- › Section B.3 deals with the relevant characteristics of financial transactions.
- › In particular, the economic framework conditions and macroeconomic factors are listed there.
- › However, ESG factors are not addressed in this section and should therefore be assessed on a case-by-case basis in coherence with the OECD Typical Process for conducting comparability analyses.



Which Factors May Significantly Influence Interest Rates?



Credit ratings

Moody's		S&P		Fitch		Rating description		
Long-term	Short-term	Long-term	Short-term	Long-term	Short-term			
Aaa	P-1	AAA	A-1+	AAA	F1+	Prime	Investment-grade	
Aa1		AA+		AA+		High grade		
Aa2		AA		AA				
Aa3		AA-		AA-				
A1	P-2	A+	A-1	A+	F1	Upper medium grade		
A2		A		A				
A3		A-		A-				
Baa1	P-3	BBB+	A-2	BBB+	F2	Lower medium grade		
Baa2		BBB		BBB				
Baa3		BBB-		BBB-				
Ba1	Not prime	BB+	B	BB+	B	Non-investment grade speculative	Non-investment grade aka high-yield bonds aka junk bonds	
Ba2		BB		BB				
Ba3		BB-		BB-				
B1		B+		B+				
B2		B		B				
B3		B-		B-				
Caa1		C	CCC+	C	CCC	C		Substantial risks
Caa2			CCC					Extremely speculative
Caa3			CCC-					Default imminent with little prospect for recovery
Ca			CC					
	C	C						
C	D	/	/	DDD	/	In default		
				DD				
/				D				



What is a credit rating?

- › Credit rating is the result of an assessment of the creditworthiness of a borrower in general terms or with respect to a particular debt or financial obligation.
- › A credit rating can be assigned to entities that seek to borrow money, an individual, corporation, state or provincial authority, or sovereign government.
- › Credit assessment and evaluation for companies and governments are generally done by credit rating agencies such as Standard & Poor's, Moody's or Fitch.
- › The credit rating has an inverse relationship with the credit default risk / probability of default. According to the rating agencies, a high credit rating indicates that the borrower has a low credit default risk / probability of default; conversely, a low credit rating suggests a high credit default risk / probability of default.
- › **The higher the credit rating, the lower the interest rate (and vice versa)!**
- › **"Green premium" or "greenium"?**

ESG and credit ratings

The well-known rating agencies have already taken ESG criteria into account in various ways when determining creditworthiness.

By integrating ESG
criteria into the
existing rating based
on financial results



By introducing a new
ESG rating alongside
the existing financial
rating

Determining an Arm's Length Interest Rate for an Intra-Group Loan

The most common approaches

Internal CUP

- › External refinancing at the level of the borrower / of the group
- › **Comparability adjustments for ESG?**

External CUP

- › Potentially comparable transactions:
 - › Loans
 - › Bonds
 - › Commercial papers
- › In practice, yield curves are also used
- › **Comparability adjustments for ESG?**

Cost of funds

- › Reflects the borrowing costs incurred by the lender in raising the funds to lend
- › Additional components:
 - › Expenses of arranging the loan
 - › Relevant costs incurred in servicing the loan
 - › Risk premium to reflect the various economic factors inherent in the proposed loan
 - › Profit margin (which will generally include the lender's incremental cost of the equity required to support the loan)
 - › **Comparability adjustments for ESG?**

Typical comparability factors

- › Issue date
- › Tenor
- › Creditworthiness of the borrower
- › Currency
- › Rank
- › Security
- › Repayment type / prepayment option

Practical Example

Green Bond / ESG Bond

- › Maturity: 5 years
- › Rate: 1.800%

Conventional Bond

- › Maturity: 5 years
- › Rate: 2.000%

Potential Effects on Arm's Length Intra-Group Interest Rate

- › **Internal CUP / Cost of Funds**
 - › Funds raised from third parties are forwarded by the IC lender to the IC borrower
 - › Interest rate of IC loan (only) is the same if terms and conditions of the external and internal loans are the same
 - › Comparability adjustments (also) regarding ESG if differences between comparable uncontrolled and controlled transactions
- › **External CUP**
 - › IC interest rate is determined based on database comparables, frequently bonds traded on the secondary market
 - › Comparability adjustments (also) regarding ESG if differences between comparable uncontrolled and controlled transactions

IC lender should receive an arm's length remuneration considering its functional, asset and risk profile

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WTS Global TP Service Line, Co-Leader

Education

- › McGill University, Canada (M.A., Economics)
- › American University, USA (B.A., Economics)
- › Research and teaching assistant at McGill University, Canada

Professional Background

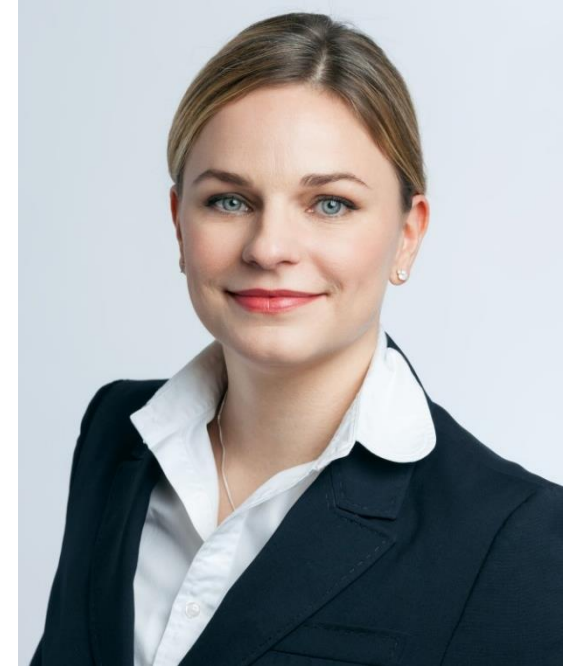
- › Co Head, WTS Global Mindset Hub on Treasury and Financial Services
- › Visiting Faculty, Executive Program of Transfer Pricing, Université de Lausanne, Switzerland
- › Since October 2016 at WTS
- › 10 years at Baker & McKenzie, Dusseldorf, 1.5 years thereof seconded to the Paris office

Specialization

- › More than 15 years of practical TP experience in a broad range of industries
- › Focus on TP treasury and financial transactions as well as on economic TP aspects
- › Long-lasting valuation experience for TP purposes, including valuation of intangibles and valuation for business restructurings
- › Design, enhancement and implementation of global TP systems
- › Management of global transfer pricing documentation and benchmarking projects
- › Experience in APA procedures and tax audit defense on TP matters

Languages

- › German
- › English
- › French



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Thank you for your attention

