

Transfer pricing and the green agenda*



The heart of the matter

Companies support green agendas to grow the bottom line

Climate change and soaring energy costs are driving alternative approaches to doing business, especially in regard to energy use. Consumers—especially in North America and Europe—want companies to show environmental responsibility at each point along their supply chains, from product source and production to delivery, and at the point of consumption. National and local commitments to address environmental challenges and risks compound the situation.

As the public and the market increasingly mandate corporate responsibility as a prominent branding feature, sustainability will touch nearly every action taken by a multinational company. Thus, multinationals are spending—and making commitments to spend—significant sums on projects that in some way help them meet the environmental and sustainability goals of the “green agenda.” Today’s companies understand that green-friendly can also be bottom-line-friendly.

The green agenda also gives rise to expansive transfer pricing issues that require companies to consider the wholly new along with more traditional concepts. Transfer pricing issues arising from the green agenda include:

- Major new product costs and/or savings
- Development of new products and processes
- Impact on new or existing brand value
- Creation or enhancement of intellectual property assets
- Changes to the supply chain and operating models
- Participation in new regulatory or trading regimes
- Profit changes that reflect new environmental costs and benefits and new products

To address these issues, multinational companies’ transfer pricing policies and procedures must be adaptable to achieve the arm’s-length standard and comply with regulations. Companies should also take advantage of opportunities to structure their business models and transfer pricing policies to improve the effective tax rate.

For the greatest return on these opportunities, companies must take action before undertaking major strategic initiatives, investments, and decisions. Those responsible for transfer pricing must engage across their organizations to ensure they are positioned to influence decision-making, address challenges, and seize opportunities.

An in-depth discussion

Understanding how a green agenda affects transfer pricing

Business leaders see a green future. H. Lee Scott, president and CEO of Wal-Mart, has described sustainability as “the single biggest opportunity of the 21st century” and “the next source of competitive advantage.”¹

PricewaterhouseCoopers’ research² shows that larger companies anticipate investing a greater proportion of their incomes to address the risks and opportunities associated with climate change. GE, for example, plans to double its investment in cleaner technologies by 2010 to more than \$1.5 billion and expects its revenues from associated products to be in excess of \$20 billion.³

Investments that will create minimal long-term impact on the environment are already taking place across a wide range of areas, including research and development, evolution of products and processes, satisfaction of new regulatory requirements, and implementation of new trading opportunities.

The strategic importance and scale of the investment required means that development decisions are often made centrally, while the interdependent nature of multinationals means that changes in one location will inevitably impact others. The green agenda is, by definition, a global undertaking, and activities in one entity may create costs and benefits for part or all of an organization.

This impacts the function, asset and risk profile across a multinational group and thereby alters the flow of intragroup transactions or creates new value transfers that must be considered from a transfer pricing perspective.

Due to PricewaterhouseCoopers’ experience in addressing the transfer pricing implications of the green agenda, we understand the key areas of focus and can develop ideal practices for minimizing risk and leveraging benefits. The following is a summary of the key focus areas:

Cap and trade: targeted industries and general carbon caps

One of the most powerful macroeconomic impacts of the green agenda is the incorporation of environmental costs of doing business that have been avoided or undervalued by some companies. Major costs associated with pollution and waste that have largely been met through public expenditure or ignored, are being pushed onto companies to curtail a “free-rider” perception.

The green agenda’s implicit need to both limit and provide incentive is driving new mechanisms alongside old-fashioned taxes and tariffs to ensure that the polluter pays. Chief among these are cap-and-trade schemes for carbon and other emissions, which allocate credits up to a cap, then require the purchase of other companies’ surplus credits if that cap is exceeded, which creates a cost for emissions.

¹ **Source:** PwC, The Sustainability Agenda: Industry Perspectives, 2008, www.pwc.com/sustainabilityagenda

² **Source:** PwC, 11th Annual Global CEO Survey, 2008, www.pwc.com/ceosurvey.

³ **Source:** The Economist Special Report: “The greening of corporate responsibility,” Jan, 17, 2008

The creation of active markets in emissions credits places an observable value on them. However, the regional nature of cap-and-trade schemes, as well as market fluctuations, creates differences that mean these values can be both variable and volatile. This can be further complicated by the emergence of futures markets and transactions, such as loans of surplus credits, or the absence of trading because of competitive pressures.

The sharing of carbon or emissions credits between affiliated companies will not only require an appropriate pricing mechanism for a group's transfer pricing policy, but will also create challenges and opportunities in identifying an arm's-length price because of the impact on cost. In addition, although the policy must accommodate price fluctuations, differing regional market values and different values in various parts of the business may be optimized for tax purposes.

This new understanding of what now constitutes full cost will require consideration with regard to existing transfer pricing policies, supporting documentation, and benchmarking. "Full-cost plus" charging mechanisms, or benchmarked ranges based on pregreen models, for example, may not appropriately reflect this new cost structure.

Liftoff for a new green industry

The desire to reduce the environmental impact and cost of industrial, transportation, and consumer activities has inspired significant activity, especially in the search for alternative clean energy sources. Governments and international organizations are providing incentives and favorable financial structures to businesses that invest in the development of these new technologies. Though estimates vary, the value of investment in clean energy alone topped \$150 billion in 2007;⁴ more than a 60 percent increase from the previous year.

In many ways, today's green industries resemble the computer industry of the late 1970s, with strong echoes of the model shift that gave birth to a whole new set of industries. The green agenda is triggering start-up activity from both new independent businesses and new business streams in mature multinational companies. These new endeavors will face traditional issues as they get under way, including initial losses from high expenditure relative to income, potentially exacerbated by increasing fuel and emission costs.

⁴ **Source:** *New Energy Finance*

Accordingly, losses or low profits resulting from adoption of a green agenda will need support from the company's transfer pricing policy, which should provide a clear and robust defense of any profit profile changes. The distribution of income and losses must reflect not only a company's strategic value drivers and its assumption of risk, but also its unique market structure in promoting green initiatives.

For example, the emerging photovoltaic or solar energy production industry is heavily supported by certain government programs and incentives specific to geographic regions or markets. Different countries use combinations of these incentives to promote the growth of their domestic renewable-energy markets, including photovoltaic. Without the implementation of such programs, the photovoltaic industry would not benefit from the increased demand and the resulting economic rents. Certain programs and incentives give solar system installers and solar power producers either a direct reduction in the upfront solar system costs or a payment for solar energy produced.

Companies must consider the effects of these programs and incentives on transfer pricing policy. In particular, international companies should consider how these programs relate to the distribution of income and losses across divisions. In many jurisdictions, these start-up situations need to be documented *ex ante*.⁵ This gives companies the opportunity to consider where, if possible, to locate start-up losses as well as the underlying functions, assets, and risks.

Development costs of new technologies, products, and processes may also contribute to start-up losses. Because these cost advances are likely to create intellectual property, they need to be provided (for example, licensed) to group users at an arm's-length rate. Asset ownership can be structured with a lower-tax territory, either through correct location of development direction and costs or through the early sale of existing intellectual property.

Business models are also changing through the increased involvement of central offices or the realignment of logistics around local hubs to take millions of miles (and dollars) out of the supply chain. These changes represent the greatest opportunity to integrate transfer pricing planning and commercial opportunities.

As the green agenda forges ahead on a wide variety of fronts, initiatives will require finance. Although arm's-length lending rates are a conventional transfer pricing concern, they must still be achieved. Care is required around levels of debt and thin capitalization defense as finance, profit, and asset levels change, especially where agreements with tax authorities are already in place.

In summary, the changes to business models and the creation of and investment in new businesses and technologies will always generate risks and rewards. Companies that are aware of the changes and adopt a proactive approach to them will secure the best possible outcomes.

⁵ **Source:** Treas. Reg. § 1.482-1(d)(4)(i).

Growing green intangibles

Consumer demand is a major driver of the green agenda. To capture the fast-growing market for sustainable consumption, many businesses are reviewing their brand and product portfolios to develop new green assets with strong appeal.

How these developments to product, technology and process intellectual property are initiated, executed and received by the market will be reflected in both company and product brands. Brand protection and enhancement may be one of the main drivers of corporate response to the green agenda.

When multinational companies achieve their green agenda, brand owners might be expected to share in the risk and reward through the transfer pricing policy. As for technical intellectual property, this is best addressed as early as possible in the change process to establish both clear ownership and, where the brand is the driving force, the appropriate substance -- for example through meeting cost or taking appropriate development risks.

Responding to regulatory initiatives

Aside from market pressures, governments are using regulation to influence and change behavior. For example, the EU REACH (Registration, Evaluation and Authorisation of Chemicals) regulation that went into effect June 1, 2007, requires many European companies to invest heavily in compliance and management of commercial risk. For

EU resident companies, the new law has far-reaching obligations that go beyond the European group. This is in large part because of integrated supply chains, whereby an impact in one jurisdiction may have a knock-on effect on other jurisdictions in terms of costs and benefits.

One company may act, meet requirements, and incur cost on behalf of the European group. The risks and benefits, however, may be broader in that they may also affect the intellectual property assets of a group's product portfolio. How these costs and risks are valued, characterized, met, and shared must be determined and integrated into a group transfer pricing policy. Key to assessing the impact of governmental regulation is to ask questions such as, "whose obligation is this?" and "for whose benefit is it performed?"

Although many companies operating in Europe need to evaluate the effect of new regulations, it is a safe bet that future regulatory requirements will generate similar scenarios for businesses around the globe. As with emissions credit trading, groups must be able to link the pricing of these disparate costs into an effective transfer pricing policy, as well as determine the effect of these additional costs on benchmarking and other historic arrangements.

Similar evaluation and analysis will be required for costs associated with corporate social responsibility programs. But in the end, companies will see many long-term benefits to having the best possible transfer pricing solution that not only provides robust compliance, but also creates conditions that result in significant tax savings.

What this means for your business

How the green agenda impacts company transfer pricing policy

As this brief discussion demonstrates, the green agenda will unquestionably trigger many transfer pricing issues. Challenges will arise, but among them will be significant opportunities for effective planning so that businesses can understand the implications of their present and planned green agenda strategies.

That agenda is not fixed, but rather in constant flux and development. It changes according to a range of drivers including regulation, innovation, new market conditions, and shocks. Transfer pricing leaders need to stay abreast of these changes as they build a policy that is both robust and stable for new and existing business streams and models and also flexible enough to achieve maximum tax benefits from future developments.

To start integration of the green agenda into a company's transfer pricing policy, the following questions must be answered:

- Which entities benefit from the adoption of green agenda initiatives?
- Who takes the risk?
- Is a new asset created or an existing asset improved?

- Who bears the cost and who reaps the benefit from additional income?
- Do changes in the value chain impact entity characterization?

To understand and effectively address these questions, those responsible for a group's transfer pricing must gather information on all activities taken across the business in pursuit of the green agenda. They need to engage a wide range of stakeholders to enable the development of transfer pricing policy alongside green initiatives and to uncover the tax benefits of business change relating to intellectual property and the location of functions, assets, and risks in the supply chain.

Through PricewaterhouseCoopers' sustainability initiatives, we are familiar with the kinds of issues that can emerge on a wide range of tax projects.⁶ These projects are often complex, with knock-on effects on existing business and transfer pricing models. However, they are also ripe with opportunity. Like the green initiatives, compliance requirements and tax planning opportunities emerge daily. To reap the benefits and achieve the best results, companies should start now to tackle the issues head-on as soon as they arise. By acting now, forward thinking companies will realize long-term benefits to having the best possible transfer pricing solution that provides robust compliance and creates conditions that result in significant tax savings.

⁶ Source: www.pwc.com/sustainability

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