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ESG and Tax Governance

The need for transparency

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The state of affairs

The foundation of the environmental, social and governance (ESG) framework can be traced back to 2004, when the United Nations Global Compact (UNGC) released its report Who Cares Wins. The report encouraged financial institution stakeholders to adopt ESG principles for the long term, and highlighted the benefits of responsible investment as well as its positive impact on society and the environment.

In Malaysia, ESG has gained traction with the national 2024 Budget where funds were allocated to promote ESG practices in businesses by introducing some tax deductions for companies' ESG-related spending. The government is focused on promoting ESG practices to ensure Malaysia can maintain effective access to global supply chains and markets, which are increasingly ESG-sensitive. This commitment was further reinforced in the recent 2025 Budget with the proposed introduction of Carbon Tax, starting with the iron, steel and energy sector in 2026.

The **Environmental pillar** focuses on the organization's behavior and impact on the planet. Managing emissions, energy consumption, water resources, waste, and materials sourcing to conserve natural resources are some of the focus areas. The **Social pillar** emphasizes reducing inequalities, upholding human rights and employment standards, promoting diversity, equity, and inclusion, and safeguarding the health and safety of workers and communities, amongst others.

In this context, Malaysia must address issues such as forced labor and employee welfare to ensure ESG compliance. Non-compliance can lead to significant business losses, particularly in markets such as the US and EU as sanctions can severely impact business profits, causing greater financial damage compared to the cost of implementing proper compliance measures. The **Governance pillar** involves establishing a robust governance structure, implementing clear and transparent policies, managing, and reporting risks effectively, preventing corruption and protecting customer privacy, with the aim of ensuring ethical practices and building trust.

With increasing requirements across ESG domains, organizations must be equipped with the right knowledge, stay abreast of the latest regulations and trends, and adopt a strategic ESG approach. As organizations increasingly embed ESG within their operations, the push to advance sustainability as a requirement is also enhanced, as seen in the mandatory sustainability disclosure standards and ESG reporting by Bursa Malaysia.

Today, ESG considerations have transcended to vital importance in corporate strategy. This shift stems from the growing recognition that long-term business success hinges on sustainable practices. As a result, ESG factors have started yielding substantial influence on investment decisions, operational strategies, and regulatory frameworks across industries around the globe.

The role of tax in ESG

Historically, minimal regulation and insufficient reporting guidelines have led to limitations on tax disclosures and non-unified statements. These factors make it difficult to obtain correct and timely information for tax risk management in portfolios, as well as other investment and commercial decisions. The emergence of various global developments has advocated the need for companies to be responsible taxpayers and pay the right amount of tax. This, coupled with increased calls for tax transparency, board accountability, adoption of technology by tax administrators and the complexity of legislative changes (particularly when supply chains operate in the international arena), emphasizes the urgency to have an overarching and robust tax structure in place. Combined with rapid advances in technology and increased information sharing among tax authorities, the world of tax is more transparent than ever. It is increasingly important to not only pay the right amount of tax but also be in a position to demonstrate it to the stakeholders (which include tax authorities, shareholders, customers, employees and others).

More specifically, tax governance involves strategies employed by companies to ensure compliance with tax laws. However, tax governance is not merely limited to such strategies but also encompasses how such strategies reflect the company's commitment to corporate social responsibility. Stakeholders are increasingly demanding greater transparency and accountability from corporations – not only in terms of how much tax they pay but also on contribution towards ESG. The growing trend of moving away from just shareholder profit to meeting the needs of key stakeholders has driven changes in reporting. For instance, some major fund investors apply an ESG lens when assessing their investments. This includes conducting ESG due diligence and referring to sustainability indices such as the FTSE4Good Bursa Malaysia and the Dow Jones Sustainability Indices (DJSI) that may be adopted in their potential investments. Good governance has become an enabler for effective management and communication of issues that impact our social, economic, and environmental ecosystems. With the introduction of a tax corporate governance framework, this will enable companies to enhance their ESG reporting requirements.

Transparent tax policies play a key role in cultivating trust among stakeholders and the public. Thus, companies that are open with their tax dealings are viewed as more trustworthy and responsible. This is because tax contributions are fundamental to financing public services such as healthcare, education, and infrastructure and therefore a big portion ends up being used for social initiatives. Therefore, tax contribution forms a key part of the social pillar of ESG and companies that align their tax practices accordingly demonstrate social responsibility.

Tax governance

Tax governance continues to gain traction in the wake of global tax transparency trends. In addition to the growing list of mandatory disclosure requirements implemented by tax authorities worldwide, there has also been a proliferation of voluntary transparency measures introduced, such as the release of the first global standard for tax transparency by the Global Reporting Initiative (GRI). The GRI 207 for tax disclosures, which came into effect on 1 January 2021, has been a catalyst for more initiatives among stakeholders such as regulatory bodies and industries that cut across borders.

Malaysian Institute of Accountants (MIA) and the Malaysian Institute of Certified Public Accountants' (MICPA) Tax Governance Guide. Their expectations alongside MIA and MICPA were promoted extensively in the first quarter of 2022 in the form of public forums. This was further supported by Bursa Malaysia's release, including road shows, of its second guidebook on ESG under the Public Limited Companies Transformation (PLCT) program in June 2022, which has a section dedicated to taxation.

This requires the Board of Directors and the senior management to play the crucial role of setting the tone at the top, and overseeing the implementation of tax strategies that are ethical and transparent.

Therefore, to effectively integrate tax governance and ESG goals, companies must develop a comprehensive tax governance framework that ensures transparency and compliance in alignment with broader sustainability objectives. This requires the Board of Directors and the senior management to play the crucial role of setting the tone at the top, and overseeing the implementation of tax strategies that are ethical and transparent. This would entail actively monitoring the company's tax practices and preventing aggressive tax planning that may harm their reputation and stakeholder trust. The leadership should also ensure that tax policies are regularly reviewed to reflect the company's commitment to responsible business practices.

Some institutional investors have started considering responsible tax behavior as a crucial factor in their investment decisions. Additionally, the GRI 207 standard, which focuses on tax transparency, provides a clear framework for comprehensive disclosure about tax practices for companies.

Never before has there been so much guidance on reporting and collaboration between regulators and industry to encourage cooperative compliance among taxpayers. In November 2021, Bursa Malaysia, as part of its overall guidance on disclosures, made reference to the

The Malaysian Inland Revenue Board (IRB) issued its Tax Corporate Governance Framework (TCGF) guidelines in April 2022. This adopts six key principles which are the building blocks identified in the Organization for Economic Co-operation and Development's 2016 report on good governance, and they serve as the foundation for many other TCG frameworks, both locally and internationally. The six key principles are:

1. Establishment of a tax strategy or a tax risk appetite statement
2. Consistent application of the tax strategy throughout the organization
3. Clarity of roles and responsibilities in applying the tax strategy
4. Documentation of governance in place
5. Regular testing
6. Assurance to stakeholder

The IRB will assess both the TCGF and the Tax Control Framework (TCF) specific to the processes within a tax function. Key points to note include:

- Stakeholders such as business, legal, procurement and finance units need to be aware of tax risks and controls, which impact other business processes.
- Active involvement of the Board in the organization's tax risk and compliance management.
- Tax-aligned business processes should enable a timely flow of relevant information among stakeholders like operating business units, legal, procurement, finance and tax that facilitate informed and effective decision-making, plus better risk management.

In addition, having a comprehensive and robust TCGF in place enables an organization to comply with other disclosure requirements, such as FTSE4Good and DJSI, that align with business and ESG strategies. The TCGF, updated in July 2022, and the PLCT programs, implemented by the IRB and Bursa Malaysia respectively have encouraged more companies to reassess and align their tax strategies with organizational corporate governance and risk management strategies and policies.

An effective way to start on tax governance is to look at it in a three-step approach starting with the strategic first step. At the **strategic** level, it is mainly about the overall governance, tax risk appetite and key objectives. The next step is the **compliance** level, which involves mapping out the possible tax risks for each tax type, ensuring tax obligations are complied with, and that corresponding processes are in order – from posting of data to lodgments of returns. This entails not only direct tax, but the coverage should extend to indirect taxes and all other forms of taxes. Stepping into the heart of tax governance is the last step – **management**. This involves tax administration, such as ensuring returns are filed on a timely basis and that right documentation is maintained to support tax positions taken.

Indeed, with business reputation at stake, a sound tax governance framework would provide the credibility that the company's numbers can be relied upon for decision making and risk management. It also allows companies

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to properly allocate or redeploy limited resources towards higher priority focus areas. At the same time, it ensures tax compliance with the relevant laws and that risks are managed.

Companies that have a strong tax governance framework and practices should typically be susceptible to a much lower level of tax authority audit intensity and scrutiny than similar companies with a weaker tax governance structure and practices. Increasingly, the tax risk profile that the tax authorities assign to a taxpayer is driven and informed by the tax governance practices of the organization as well as technical tax risks. Knowing this, it would be prudent to allocate resources to re-evaluate their tax governance framework and ensure that controls and processes are in order.

It is no longer acceptable to assume that the source information provided by the finance team is accurate. Tax authorities are increasingly expecting the local tax team to be accountable for and be able to explain the information flows reported in the tax returns, even if these data sources are based overseas. It is thus critical for the tax team to be able to articulate such needs to the management so that it can obtain the necessary support to optimize tax operations and ensure tax considerations are accounted for.

Challenges

However, integrating tax strategies within an ESG framework is not without its challenges and complexities. The primary challenge is to find alignment with the intricate requirements of different jurisdictions. These jurisdiction-specific requirements are complemented by evolving global standards, such as the Organization for Economic Co-operation and Development's Action Plan on Base Erosion and Profit Shifting (OECD BEPS). While these varying requirements have a common aim to curb tax evasion and ensure fair tax practices, their application and enforcement can vary significantly across jurisdictions. In addition, given that regulatory dynamics are changing faster than ever, companies are required to continuously adapt tax governance. This includes ensuring adherence to sustainability-themed indices and frameworks.

As effective tax governance is supported by three key pillars – people, processes, and technology – it is essential that the Board of Directors and senior management allocates adequate resources to enable continuous improvements.

The use of technology cannot be further emphasized in tax governance. With tax authorities investing in technology adoption and integrating data for more sophisticated analytics, companies need to take heed and invest in technology to get a grip on its position and to stay ahead. Companies should consider the need to put in place a tax technology strategy and roadmap, as well as use tools to move towards real-time tax reporting and management of tax risks. Whether it is automation, analytics, or the use of artificial intelligence, leveraging technology is increasingly no longer a good-to-have but a must-have.

Looking ahead

In the future, tax governance is expected to be significantly influenced by technological advancements and international cooperation. First, technological innovations such as digital reporting platforms and blockchain are expected to enhance the efficiency and overall transparency of tax compliance. This would facilitate more accurate and timelier ESG data collection.

Additionally, the growing trend towards international cooperation driven by initiatives such as the OECD BEPS action plan is expected to eventually harmonize tax regulations. As such cross-border initiatives take off, it will become easier for businesses to comply with ESG-related tax obligations.

Integrating tax governance with ESG strategies will become of vital importance for businesses aiming to build and maintain trust with stakeholders. Therefore, businesses are encouraged to adopt transparent and responsible tax practices as part of their commitment towards sustainability. This will not only help them comply with the regulatory demands but also position them favorably in the eyes of investors and the public, who are increasingly prioritizing ethical practices and transparency in their engagement with corporations.

Companies that have yet to adopt ESG practices may be missing out on the opportunity to benefit from the market's preference for ESG-compliant firms. However, it is not too late to seize the benefits that ESG compliance can bring. Early adopters stand to gain significant competitive advantages, enabling them to engage with EU and US companies, and avoid substantial future penalties and mandatory compliance costs. These benefits have been shown to far outweigh the investment in adopting ESG principles.

Contact us

Soh Lian Seng
Partner – Head of Tax
KPMG in Malaysia

E: lsoh@kpmg.com.my

Dr Veerinderjeet Singh
Senior Advisor on Tax Policy
KPMG in Malaysia

E: veerinder@kpmg.com.my

Ng Sue Lynn
Partner – Head of Indirect tax
KPMG in Malaysia

E: suelynnng@kpmg.com.my

Phang Oy Cheng
Partner – Head of ESG
KPMG in Malaysia

E: oychengphang@kpmg.com.my

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