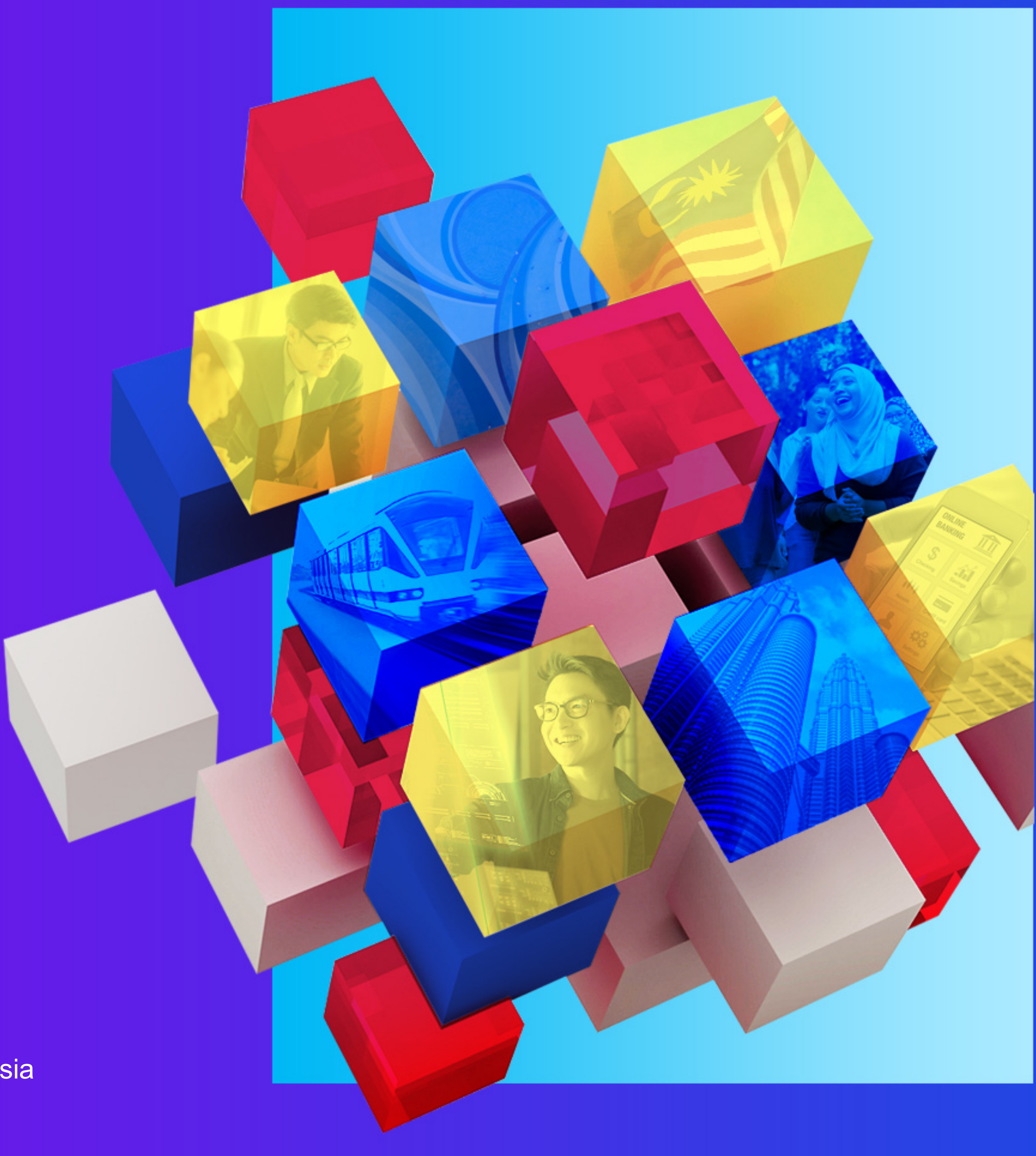
The "T" in "ESG"

A Piece of the Puzzle

February 2023 update



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KPMG in Malaysia

Overview and Commentary

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Key Message

"COVID-19 puts corporations' ESG practice under close scrutiny. More businesses have begun to recognize that ESG is no longer 'nice to have' and that there will be risks to consider and opportunities forgone had corporations not embarked on the ESG journey now.

Despite tax being an essential component of the ESG dimension, the trend to incorporate tax in ESG strategies is still in its infancy. Tax leaders should start considering implementing ESG-driven tax strategies to ensure the function remains relevant and evolves with the importance of ESG."

The "T" in "ESG" – A Piece of the Puzzle

Broadly, Environmental, Social, and Governance (ESG) is a framework that provides stakeholders insights into how an organization manages risks and opportunities around sustainability issues.

While not reflected in the ESG acronym, there is an important element of tax (T) that is central to each of these pillars.

Environmental

An essential part of the Environmental element concerns the reduction of carbon dioxide and other greenhouse gas emissions which is the main factor of climate change. In line with the goal of net zero carbon emission by 2050, carbon reduction measures such as carbon pricing and carbon tax were first mentioned during the tabling of the 12th Malaysia Plan in 2021. Apart from a carbon tax regime, the study of the implementation of which is still underway, an emission trading scheme ("ETS") is an alternative method to price carbon emissions. Bursa Malaysia recently launched the Voluntary Carbon Market ("VCM") exchange in December 2022, which is akin to an ETS, enabling companies to voluntarily buy carbon credits from climate-friendly projects and solutions. This effectively puts a Ringgit value on carbon (and pollution) which "penalizes" activity that produces carbon emissions. Companies that have carbon emission reduction goals can consider offsetting their emissions by purchasing carbon credits at the VCM. Carbon credit transactions are thus far untested and the tax implications arising therefrom such as the deductibility of the costs incurred or availability of capital allowances on capital expenditure would need to be examined.

While ETS is a stick approach to taxation of the Environmental element within ESG, a carrot approach in the form of tax incentives is also available. In tandem with the Malaysian Government's agenda to drive the growth of Malaysia's green economy, the Green Technology Tax Incentive was introduced in 2014.

Companies seeking to acquire green technology assets listed under the MyHijau Directory or those undertaking qualifying green technology projects for business or own consumption may apply for the Green Investment Tax Allowance (“GITA”). The Green Income Tax Exemption (“GITE”) is also available for qualifying green technology service provider companies listed under the MyHijau Directory. The application period for GITA and GITE is expected to expire by 31 December 2023.

In addition, through Budget 2023 tabled on 24 February 2023, the Government proposes to extend exemptions on import duty, excise duty and sales tax on completely built-up (CBU) electric vehicle (“EV”), and locally assembled and completely knocked down (CKD) EVs until 31 December 2025 and 31 December 2027 respectively. It also proposes 100% tax exemptions on the statutory income of manufacturers of EV chargers from year of assessment (“YA”) 2023 until YA 2032, as well as 100% Investment Tax Allowance (“ITA”) for a period of 5 years. Other Sustainability related tax measures that have been proposed are as follows:-

- Tax deduction on issuance cost of Sustainable and Responsible Investment-linked Sukuk approved or permitted or deposited with the Securities Commission Malaysia;
- Tax deduction for sponsorship of smart artificial intelligence (AI) – Driven Reverse Vending Machine which is used for plastic waste collection in local communities;
- Tax deduction of up to RM300,000 for a company that rents non-commercial EV; and
- Income tax exemption or ITA, import duty and sales tax exemption, and tax deductions for companies undertaking Carbon Capture and Storage (“CCS”) in-house activity, companies providing CCS services as well as companies using CCS services.

Social

On the social front, tax is one of the main mechanism for companies to contribute (or give back) to society in which they operate. Increased awareness in taxes, government policies, and the media and general public scrutiny into whether companies are paying a ‘fair share of tax’ have led to tax issues becoming an important ESG consideration. Tax responsibility could soon be the next report card in assessing a socially responsible company.

Following from this, the tax lens on the social aspect has expanded significantly beyond the basic narrative of total tax contribution to society. Travel restrictions brought about by the Covid-19 pandemic have resulted in an evolved workforce i.e. the remote and digital workforce. Businesses that adopt these employment policies should carefully examine whether a taxable presence or permanent establishment (“PE”) has been created in other jurisdictions where their employees are remotely working from. Where a taxable presence or PE arises in one or more foreign jurisdictions, businesses would need to consider the employment reporting and contribution obligations in local jurisdictions as well as the potential tax exposure attributable to the taxable presence or PE. Local Governments would seek to ensure that the individuals working remotely are lawfully working in their countries and are taxed appropriately on the employment income earned in the respective jurisdictions.

Governance

Sustainability has led to external pressure for greater tax transparency from businesses, including proactively disclosing tax information beyond statutory obligations and to a wider base of stakeholders, including investors, clients, the media, and the general public. As a result, tax governance and control frameworks are at the top of the board's agenda seeking to mitigate tax risks and demonstrate responsible and sustainable tax behavior of their businesses.

Bursa Malaysia's Sustainability Reporting Guide (second edition) provides a list of sustainability themes that are aligned with international sustainability reporting frameworks or guidelines such as the Global Reporting Initiative (GRI) Standards which was introduced in January 2021. Among the GRI Standards is GRI 207 which covers both qualitative disclosures (e.g. governance, controls, and risk management) and quantitative disclosures (e.g. country-by-country reporting information and total tax contributions) related to taxation. In October 2021, the Malaysian Institute of Accountants and the Malaysian Institute of Certified Public Accountants jointly published a Tax Governance Guide to provide guidance, which aims to enhance tax transparency, to directors of listed issuers in reporting the management of tax matters affecting the companies in their annual reports.

In April 2022, the Malaysian Inland Revenue Board ("MIRB") released the first version of the Tax Corporate Governance Framework ("TCGF") as part of the MIRB's initiatives towards adopting a cooperative tax compliance process that is both fair and effective in Malaysia.

Participating taxpayers whose TCGF meets the requirements will enjoy the benefits as follows:

- Reduced scrutiny or lesser tax audits by the MIRB;
- Expedited tax refunds;
- Appointment of a dedicated MIRB officer as a single contact point concerning the taxpayer's taxation matters; and
- Given priority consideration for reduced tax penalty rates.

Although the TCGF programme is currently in its pilot phase until June 2024, interested taxpayers may submit a letter/ e-mail to the respective tax office branch handling their tax files to indicate their interest. A robust TCGF helps to align an organization's tax strategies with its business objectives, provide clarity on roles and responsibilities, processes and controls to mitigate errors and non-compliance as well as for proper and timely escalation and resolution of tax issues. Hence, taxpayers should begin assessing the adequacy and robustness of their tax governance framework now rather than later as it will help to manage tax risks and prepare the organization for future disclosure requirements.

In conclusion, tax plays a principal role in a company's ESG strategy. Companies that are unaware of the vital interactions between tax and ESG strategy may find themselves dealing with unexpected tax costs, challenges in raising capital, and risks in reputational damage.

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