Corporate tax: a critical part of ESG

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With much written about the relationship between strong environmental, social, and governance (ESG) practices and corporate performance, institutional investors are integrating ESG factors into investment decisions. Companies are also adopting sophisticated ESG practices as a critical part of risk management and as a means to differentiate their business with both investors and consumers. An increasing number of asset managers are offering ESG funds and, at times, noting performance better than traditional benchmarks.

What is ESG?

A variety of terms are used to refer to ESG, including responsible investing or sustainability. Regardless of the nomenclature, ESG generally regards the concept that long-term value is created by companies that embed ESG issues into their strategy.

A number of organizations and initiatives are promoting the widespread adoption of ESG factors, including the Principles for Responsible Investment (PRI), which supports a global network of over 2,000 signatories to incorporate ESG factors into their investment and ownership decisions. These signatories include some of the world's most influential asset owners, investments managers and service providers, including CPPIB and BlackRock. The Sustainability Accounting Standards Board (SASB) recently released the first industry-specific sustainability accounting standards defining ESG factors most likely to have a material financial impact on a company. Well known corporations including Nike, Kellogg's, CBRE and Diageo use the SASB standards.

Among institutional investors, Norges Bank Investment Management is at the forefront of ESG issues and excludes companies it views as not ESG-compliant from the fund's investment universe. It places other companies on an observation list. These lists are public and are based on guidelines adopted in 2014. Other institutional investors have also taken public positions on ESG, most recently the Ireland Strategic Investment Fund (ISIF), which announced it is integrating ESG factors into its Irish portfolio.

While investors and executives may emphasize different ESG factors depending on geography, industry or investment perspective, there are common ESG factors. They include:

Environmental

- Climate change risks and opportunities
- Waste and water management

Social

- Human rights
- Employee health, safety and wellbeing
- Labor practices and talent management
- Workplace diversity and inclusion

Governance

- Executive compensation
- Political contributions
- Board independence, composition and renewal

ESG and corporate tax

Increasingly, corporate tax has become a leading governance consideration, specifically corporate income tax responsibility and disclosure targeting aggressive tax strategies. The OECD/G20 Principles of Corporate Governance state,

> "Boards oversee the finance and tax planning strategies management is allowed to conduct, thus discouraging practices, for example the pursuit of aggressive tax avoidance, that do not contribute to the long-term interests of the company and its shareholders, and can cause legal and reputational risks..."

Incorporating ESG is not a choice for many investors. In France, the AMF requires institutional investors and asset managers to publish an annual report explaining how they incorporate ESG criteria into their investment policies. As it relates to tax, the UK requires certain businesses to publish a 'tax strategy,' including how the business manages its UK tax risks, its attitude to tax planning and level of risk the business is prepared to accept.For others, such as pension funds, there might be a fiduciary obligation under local law to adhere to ESG principles.

The OECD's Action Plan on Base Erosion and Profit Shifting (BEPS) is also a catalyst for increasing tax transparency. BEPS addresses many aspects of aggressive tax planning, including treaty shopping, hybrid structures, earnings stripping, transparency and substance. Among the many provisions of BEPS is Country by Country Reporting (CbCR). While CbCR was intended to be a disclosure to tax authorities, there is rising sentiment in favor of public CbCR.It is still unknown whether there will be public CbCR, but advocates of this approach, including Norges and the French government, view public CbCR as another step forward in terms of tax transparency.

The EU's requirement that tax intermediaries disclose qualifying cross-border arrangements to tax authorities is another advance towards greater tax transparency. The new mandatory disclosure rules require that intermediaries and relevant taxpayers disclose potentially aggressive tax planning arrangements. This information will subsequently be exchanged among tax administrations. The provisions, which came into force on 25 June 2018, must be implemented by member states before 31 December 2019 and will apply from 1 July 2020.

More broadly, the PRI has developed guidance documents for investors to support engagement with investee companies on tax policy and transparency. They also provide investor recommendations for disclosure by companies. Reflecting the significance of tax morality, KPMG has also adopted Principles for a Responsible Tax Practice which align with its Global Code of Conduct and list the standards by which KPMG tax professionals operate. KPMG also sponsors a Global Responsible Tax Project that encourages discussion about the key issues that are shaping globalization and taxation.

Components of an ESG tax program

In the investor context, the tax considerations of establishing an ESG program entail evaluating the investor's tax framework as well as that of investee entities. Creating a tax risk appetite statement is a starting point.

The benefits of a tax risk appetite statement are:

- increasing transparency and accountability of the investor's current and future risk profile
- improving decision-making on risk mitigation (i.e. accepting, reducing, avoiding or transferring risk) and performance management (i.e. risk versus return)
- strengthening risk awareness as part of an enterprise-wide risk culture.

The tax risk appetite statement will often be part of a broader, enterprise-wide, risk governance framework.

In terms of evaluating investments, investors will need to assess the impact on tax risk of investing in entities since the entity's tax situation can impact the investor's tax position.

As part of tax due diligence, investors should consider the following:

- Does the entity have a tax risk statement?
- Is tax risk included as part of the board's risk oversight function?
- Is the entity's tax function adequately staffed?
- Does the entity make use of complex structures?
- Are tax risks adequately disclosed?
- Does the entity's ETR seem reasonable, both in the aggregate and by jurisdiction?

The ability of an investor to conduct diligence of the tax position of an entity will depend on numerous factors, including the level of investment. This relationship will generally correlate with the level of control, since an investor seeking a majority position will generally have a greater ability to influence the tax risk policy of an entity. However, regardless of level of investment or control, institutional investors could be criticized for investments in entities that do not follow ESG principles as they apply to tax. Therefore, it will be important for investors to carefully consider the consequences of investing in entities that are less than fully transparent about their tax risk profile.

Conclusion

Adopting sustainable tax principles, either as part of a broader entity-wide ESG program, or as a stand-alone effort, is a significant undertaking that requires commitment from the board and senior management. A myriad of issues must be addressed and a wide range of functions are impacted.

However, the direction of travel is clear. Integration of ESG factors has become a core part of investment decision-making and institutional investors are advised to stay ahead of the curve to avoid tax, reputational and other risks that might arise. The journey will vary by institution and each institutional investor will need to determine those aspects of ESG that are relevant to its investment approach and ultimately most material to the companies it invests in.

To be most effective, ESG principles should be embedded in the entity's corporate culture, requiring further consideration of the approach and timeframe for implementation, training and continuous improvement.

Contact us

David Neuenhaus
Global Lead, Institutional Investors Group
Global Tax Lead Sovereign Wealth, Pensions and Infrastructure Networks
Principal
KPMG in the US
T: +1 973 912 6348
E: dneuenhaus@kpmg.com

Americas

US: David Dietz
Managing Director
KPMG in the US
T: +1 917 331 3623
E: ddietz@kpmg.com

Canada: Carla Hannemann
Partner
KPMG Canada
T: +1 416 505 4302
E: carlahannemann@kpmg.ca

ASPAC

Minh Dao
Partner
KPMG Australia
T: +61 294559655
E: mdao@kpmg.com.au

Europe

Rachel Hanger
Partner
KPMG United Kingdom
T: +44 07919045817
E: rachel.hanger@kpmg.co.uk

Middle East

Stuart Cioccarelli
Partner
KPMG UAE
T: +971543058680
E: scioccarelli@kpmg.com

kpmg.com/socialmedia

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