



# ESG and Tax: Increasing importance to Institutional Investors

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# ESG and Tax: Increasing importance to Institutional Investors

**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. Investment managers and portfolio companies are also adopting sophisticated ESG practices as a critical part of risk management and as a means to differentiate their business. Tax is playing a critical role in the developments.**

## What is ESG?

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

A number of organizations and initiatives are promoting the widespread adoption of ESG factors through the development of frameworks and standards for ESG reporting. The Global Reporting Initiative (GRI), the Principles for Responsible Investment (PRI) and the Sustainability Accounting Standards Board (SASB), the EU Taxonomy and the Task Force on Climate-related Financial Disclosures (TCFD) are among the leading reporting standards and have established criteria for categorizing and reporting ESG metrics.

Three main efforts are underway to harmonize the standards and create globally adopted common reporting systems, separately led by SASB, the International Financial Reporting Standards Foundation (IFRS), and the World Economic Forum's International Business Council (IBC) with the support of KPMG and the other Big Four firms. These developments are supported by a number of the world's most influential Institutional Investors and asset managers.

Many commercial organizations have developed ESG ratings and rankings, evaluating ESG factors based on the various standards and providing quantifiable metrics. MSCI, S&P, and Sustainalytics are a few industry leaders among many ESG ratings providers. There is no single, accepted methodology for calculating ESG ratings, and various

ratings agencies may provide different assessments of the same company. However, ratings help provide a snapshot of a company's performance to support more sustainable investment decisions. In that regard, KPMG has also worked with standard-setters, non-governmental organizations and international organizations through the World Economic Forum 2020 whereby a set of 21 core metrics were created for companies to disclose their progress in the ESG areas of people, planet, prosperity and governance. Through [KPMG IMPACT](#), a platform has been built to guide clients through the insights and tools to fulfill their ESG goals.

Tax is an important part of these standards and metrics. For example, the World Economic Forum ("WEF") has outlined "total tax paid" as a reportable metric to reflect a corporation's contribution to public finances through direct and indirect tax. GRI identified tax as a significant component of economic value generated for a country in Standard 201-1.

Institutional investors are starting to use this information to make informed investment decisions. One large Institutional Investor vocally supports ESG issues, excludes companies it has determined as not ESG-compliant from their investment universe and has even publicly divested from companies with weak or no reporting related to tax and transparency. Other Institutional Investors are also taking public positions on ESG. A group of Danish pension funds have developed and signed a Tax Code of Conduct to help support goals of responsible tax behavior in their investments and through their investment partners. Actions like these underscore the public approach investors are taking in supporting tax as a critical component of ESG.

While investors and executives may emphasize different ESG factors depending on geography, industry or investment strategy, there are common ESG factors, such as:



## Environmental

- Climate change risks and opportunities
- Waste and water management
- Energy efficiency
- Carbon taxes and green incentives



## Social

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



## Governance

- Executive compensation
- Political contributions
- Board independence, composition and renewal
- Whistleblower schemes
- Accountability for responsible tax policy

## ESG and corporate tax

Increasingly, corporate tax has become a leading governance consideration, specifically tax transparency and corporate income tax responsibility.

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...”

US Supreme Court Justice Louis Brandeis once said, “sunlight is the best disinfectant”; an observation that transparency can encourage good behavior (or discourage bad behavior!). Transparency has become a key element of ESG and tax, and various initiatives have been integral in advancing the concepts. As Institutional Investors continue to consider governance as a key part of the ESG journey, they can look to international developments for tools to help with their analysis.

For example, the OECD’s Action Plan on Base Erosion and Profit Shifting (BEPS) has been 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 provisions of BEPS is Country by Country Reporting (CbCR), which is now widely adopted by many countries. CbCR mandates global reporting of income, profit, taxes paid and economic activity among tax jurisdictions in which multinational enterprises operate. While CbCR was originally intended to be a disclosure to tax authorities, the EU recently mandated that enterprises with more than EUR750m in annual turnover are required to make public tax disclosures. It is still unknown whether there will be public CbCR beyond the EU, but advocates of this approach, including Norges and the French government, view public CbCR as key step forward in promoting tax transparency.

Another tax transparency development is the EU’s requirement that tax intermediaries disclose qualifying cross-border arrangements to tax authorities. The mandatory disclosure rules (“MDR” or “DAC 6”) require that intermediaries and relevant taxpayers disclose potentially aggressive tax planning arrangements. This information is subsequently exchanged among tax administrations. The provisions are designed to discourage aggressive tax practices and ultimately promote the payment of responsible levels of tax.

The tax transparency landscape in the US is still developing. Recent proposed legislation in the US would require public company disclosure of corporate structure, profits, and taxation. However, while such legislation has not yet passed, it underscores the growing public and government interest for transparency initiatives. But, where the US may still be developing its stance on transparency, the Biden administration supports increased levels of corporate taxation both for US companies, as well as MNE’s operating globally.

The US and more than 130 other countries recently endorsed the key components of the OECD two-pillar proposals to address major changes to certain rules of international taxation. As of July 2021, the global community now collectively support the OECD’s efforts to apply a global minimum corporate tax of at least 15 percent, and to allocate certain taxation rights based on profits and nexus. Once finalized, the Pillar One and Two frameworks will be the culmination of a multi-year effort to reform international taxation rules and ensure that multinational enterprises pay a fair share of tax wherever they operate. These developments are indicative of the global pivot toward the concept of “responsible tax.”

As Institutional Investors incorporate these global developments into their stakeholder discussions and policies, there are resources available to guide their approach to the development of their own responsible tax policies. For example, the Principles for Responsible Investment (“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.

Leveraging its deep expertise in tax policy and implementation, KPMG is advancing this dialogue. 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 sponsors a [Global Responsible Tax Project](#) that encourages discussion about the key issues that are shaping globalization and taxation. More broadly, [KPMG IMPACT](#) is a program that supports clients in fulfilling their purpose and helping deliver on their ESG goals, including tax elements.

## Components of an ESG tax program

The tax considerations of establishing an ESG program often begin with the evaluation of the investor’s tax framework as well as that of investee companies and their third party investment managers. In connection with this, the creation of a tax risk appetite statement is a starting point.



The potential 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 can often be part of a broader, enterprise-wide, risk governance framework.

In terms of evaluating ESG and Tax, investors should consider how tax risk is managed by its investment partners. Investors may want to assess the impact of tax risk through their relationships with its investments in investee companies and third party investment managers.

For example, as part of tax due diligence, investors should consider the following:

- Does the investee company have a tax risk statement?
- Does the manager have a tax risk policy?
- Is tax risk included as part of the board's risk oversight function?
- Is the tax function of the investee company or manager adequately staffed?

- Does the investee company or manager make use of complex structures?
- What level of tax risk is the investee company or manager willing to accept?
- Are tax risks adequately disclosed?
- Does the investee company's ETR seem reasonable, both in the aggregate and by jurisdiction?
- Does the manager report an ETR? Are returns identified on a pre and post-tax basis?

The ability of an investor to conduct diligence of the tax position of its investment partners will depend on numerous factors, including the level of investment. This relationship may 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 through board seats or other interactions. However, given the high profile of many Institutional Investors, they could be criticized for investments that do not follow ESG principles as they apply to tax regardless of the investor's level of investment or control. Therefore, it will likely be important for Institutional Investors to carefully consider the consequences of investments with parties that are less than fully transparent about their tax risk profile.



### **Developments among Institutional Investors around the world**

Institutional Investors and governmental approaches to ESG tax continue to evolve. In the Institutional Investor sphere, one large investor is actively reviewing their portfolio and divesting from companies considered to have unacceptable tax transparency; other investors, such as the Danish funds pursuant to the Tax Code of Conduct, are conducting spot checks on managers to ensure that tax restrictions, undertakings and obligations are observed.

The Australian Tax Office (“ATO”) implemented the Justified Trust program in 2016 to develop tax transparency by Australian taxpayers and increase public confidence in the corporate tax system. Australian investors like Superfunds are disclosing how good tax governance is embedded in positions taken, disclosures in returns and tax calculations. To achieve justified trust, the investors must provide objective evidence that would lead a reasonable person to conclude a particular taxpayer



paid the right amount of tax. As an opportunity to identify potential weaknesses, non-Australian Institutional Investors have used the Justified Trust criteria to self-evaluate how their governance compares to the ATO's requirements.

In response to requests from Provincial parliaments for more tax transparency, several Canadian pensions have begun reporting ETRs across their portfolios, categorized by asset class, industry and geography. Their investment process accounts for payment of responsible tax at the investee company level.

The development of ESG and Tax focused policies and practices by governments and investors around the world have knock-on effects. Asset managers are actively developing and disclosing tax policies to respond to both existing and new investors' requests. Investee companies are publishing annual tax reports highlighting their tax policies and contributions. These developments are creating an acceleration in the rate of change, as

the development by a few becomes a request by many. Institutional Investors are helping drive change toward responsible tax stewardship and policy.

### **Conclusion**

Institutional Investors are integrating ESG factors into their stakeholder discussions and institutional policies. Governments, NGOs, investment managers and portfolio companies are rapidly developing sophisticated ESG policies, measurements and practices. Tax is a critical component in the developments.

The direction of travel seems clear. Integration of ESG factors has become a core part of the investment process and Institutional Investors must stay ahead of the curve to avoid tax, reputational and other risks that might arise.

The journey will vary by institution. Each Institutional Investor will need to determine the aspects of ESG that are relevant to its investment strategy and material to potential investment companies and managers.

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