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September 2021

Tax and the ESG agenda: Enabling opportunity and managing risk

Introduction

The tide has turned...

The fundamental role and purpose of business in society is under an intense level of scrutiny in the current climate. Historically, the main priority of business has been to generate profit and return on investment for shareholders. In today's world, however, stakeholders are increasingly expecting business to help address the big issues facing society such as climate change, sustainability, and societal inequalities.

Against the backdrop of the Covid-19 Pandemic and the advent of the 26th UN Climate Change Conference of the Parties ('COP26') which is being held in Glasgow in November, the prominence of the Environmental, Social and Governance ('ESG') agenda is only set to magnify and, as the public discourse surrounding social and economic disparities and the desire for a fair transition to a more sustainable world continues, there is heightened interest in whether organisations are paying their 'fair share' and helping to tackle economic inequality. The way in which organisations manage their tax affairs is an increasingly important aspect of the ESG agenda.

In the wake of the pandemic, there has been a fundamental reevaluation of the relationship between the private sector and the state, at a time of unprecedented government support for businesses across the globe. The development of ESG standards is the main product of these stakeholder-driven expectations, and represents a wide-array of metrics which companies can align with in order to report how they are addressing the topics stakeholders consider material. These topics are broad and can range from standards such as those on energy consumption, waste disposal, and water; to standards on anti-corruption, human rights and more recently tax.

All of these factors, together with increased investor demand for ESG-focused funds and a realisation of the commercial growth opportunities, mean that ESG issues are now front of mind for the asset management industry. Dealing with these issues will present a significant amount of complexity to overcome in the coming years.

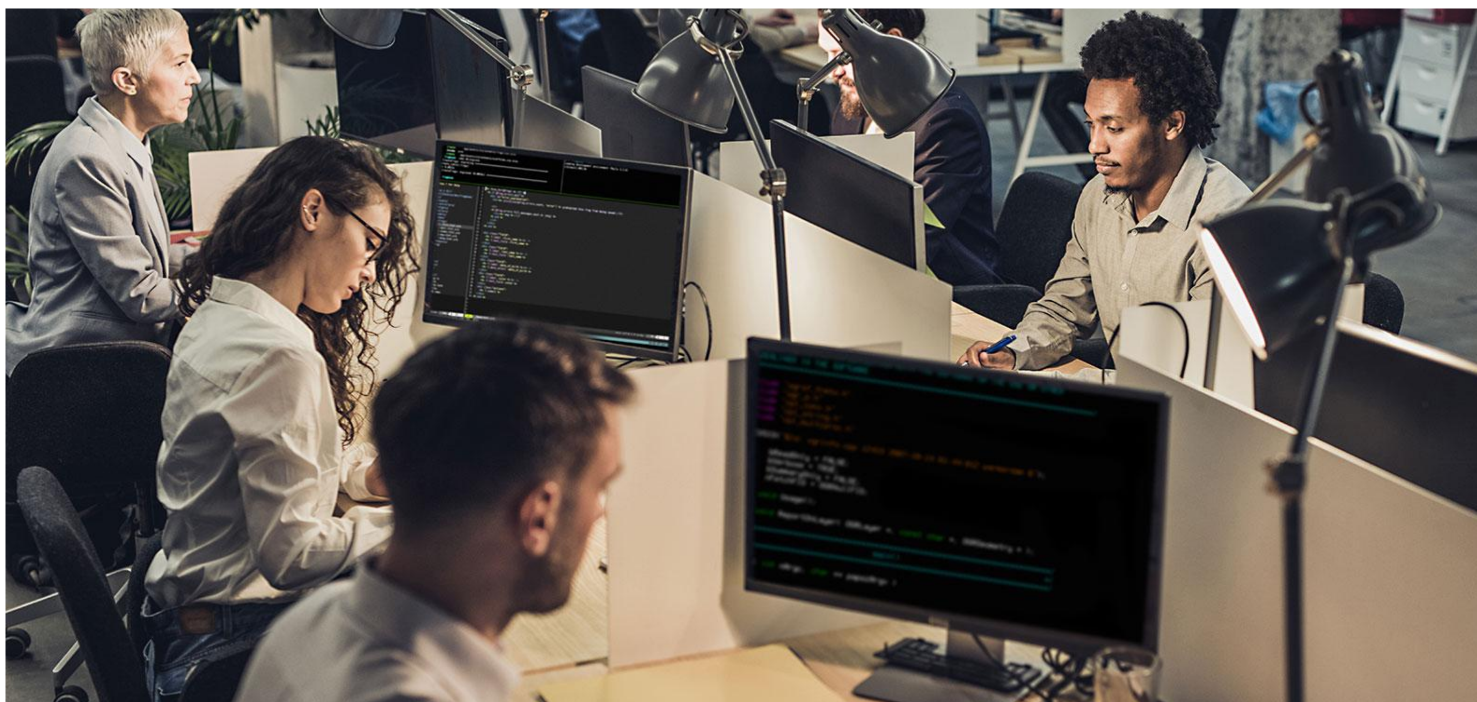
... and it is set to rise

There is no sign of ESG's importance waning, or of public, governmental and regulatory scrutiny fading. Instead, these are only likely to increase with time. In the wake of COP 26, we are expecting pressure to continue to be applied to businesses to act decisively and demonstrate leadership, embedding ESG concerns at the heart of their operating models.

The asset and wealth management industry occupies a unique position in the current climate: Not only are ESG considerations coming to the fore when considering operating models and strategic priorities, but firms are contending with their ramifications at the investment decision-making level too. In short, both how you run your business, and how the businesses in your investment portfolios are run, are beginning to hold the same weight as financial performance indicators.

ESG has become a central tenet of the AWM landscape

PwC's research suggests institutional investors in Europe expect ESG and non-ESG products to converge and, from next year, 77% of these institutions expect to stop buying the latter. We believe that in Europe, ESG fund assets under management could account for more than 50% of mutual fund assets by 2025, representing compound annual growth of 28.8% between 2019 and 2025. The wave of ESG regulation worldwide has prompted acute awareness among asset managers of the need to comply with a host of new regimes. Some 44% cite regulation as a 'very significant' driver of their focus on ESG, and of ensuring their approach to ESG goes well beyond greenwashing concerns.You can read more on the asset and wealth management industry and ESG in our report: **Embracing ESG Transformation: How asset managers are leveraging regulation to drive value creation**



The tax function has a key role to play

Providing a strong foundation to build upon

As a core part of the architecture of any business, the tax function has a key role to play in ensuring that an organisation's ESG journey is as smooth as possible, helping to shape good ESG governance, which will be essential to substantiate authentic ESG credentials and favourable ESG ratings. Strong tax reporting and governance requirements are an opportunity to build trust and reputation.

Dealing with complexity

Tax functions need to be clear on the myriad ways in which they will play a vital role in ensuring compliance with regulatory compliance obligations, as well as shaping and meeting any internal or publicly disclosed targets on ESG. It often appears that the public discussion on ESG focuses on the 'E' in the acronym, but this is also starting to change, with tax once again at the forefront of the global debate around corporate transparency and the net contribution which organisations make to the societies in which they operate. This won't just be about publishing metrics and meeting the ever-growing set of tax compliance and disclosure obligations which go hand-in-hand with the complex operating models of the asset and wealth management sector.

Owning the narrative

Tax functions are also likely to be charged with the task of communicating lucidly and effectively with the public and other stakeholders on how their firm's approach to managing tax, the tax governance arrangements that are in place, the approach taken to stakeholder engagement as well as their tax contribution is compliant with an ESG-focused policy framework. To do so effectively, it is important that they are embedded in the formulation of the organisation's broader ESG strategy.

Tax strategy and the 'E' the 'S' and the 'G'

It is vital that organisations find a balance across their ESG policies – getting the environmental, social and governance elements right while addressing ESG and its nuances in the round.

Environmental

This is likely to manifest itself in increasing measures levied by governments on environmental taxes, levies, and incentives to encourage the societal transition to 'net zero'. Keeping across these requirements in each territory the business operates in is already no small compliance task. This can also add to the overall tax burden, with measuring global impacts a real challenge. Increased reporting requirements can also be an issue.

An example of this can be seen in recent proposals from the FCA in the UK on climate related disclosures for asset managers, insurers and pension providers. These focus on how climate related risks and opportunities are taken into account in managing or administering investments on behalf of clients.

Tax incentives are set to play an important role in accelerating the move towards sustainable finance. For example, the Luxembourg government has introduced a scheme to reduce its subscription tax for retail investment funds, based on the percentage of sustainable assets in a fund's portfolio, as determined in relation to the EU taxonomy for sustainable activities. Organisations will need to ensure that the correct processes are in place to take advantage of such incentives. In this case, the asset manager needs to file a request to the Luxembourg Tax Authorities with the evidence that the taxonomy alignment figures have been reviewed by a local audit firm.

Social

Much of the focus here is on how organisations manage their tax affairs and on the contribution they make to society. Governments are ratcheting up pressure on organisations to be more transparent over the taxes they pay and the choices they make around tax planning. Financial institutions continue to be in the spotlight for the public, regulators, investors and governments following the recent financial crises. The recent re-emergence of public country by country reporting proposals and EU Mandatory Disclosure Reporting/DAC6 is evidence of a trend for greater tax transparency. This can be expected to continue.

Governance

Good tax governance requires robust tax control frameworks and risk management systems so that public ESG statements can be confidently supported and, as needed, defended. Tax directors will be well aware of the 'alphabet soup' of tax governance and compliance requirements that already exist and continue to proliferate.

Governments and supranational bodies, such as the EU and OECD have tax governance firmly in focus. We have recently seen new tax avoidance reporting obligations (EU Mandatory Disclosure Regime/DAC6), former transparency proposals re-emerge (EU Public Country by Country Reporting), and multiple OECD publications urging global tax authorities to take action on various topics such as tax evasion, cooperative compliance and tax control frameworks.

Building a tax function fit for strong ESG performance

A well articulated tax strategy aligned with how the business approaches ESG

This is about coherently articulating how the organisation approaches the key elements of the strategy in practice, while ensuring that the strategy is aligned with ESG developments – connectivity with the organisations' wider ESG agenda is essential.

Key features of an effective tax strategy should include:

- How tax is managed as an integral part of the organisation's wider sustainability strategy and linking it to ESG and Sustainable Development Goals (SDGs);
- The key areas covered by the tax strategy – linking to the ESG agenda, a tax strategy should include how Tax aligns to the organisation's purpose, the approach it takes to ensuring that tax planning and stakeholder engagement is consistent with that purpose, and the controls it has in place to ensure adherence with the strategy.
- The range of stakeholders from across the organisation that feed into formulating and delivering the strategy – the tax function certainly won't have the organisational reach or bandwidth to do it all, so tax needs to 'live and breathe' in how the business operates.

A robust tax governance, risk and control framework to underpin the strategy

The organisation needs to stand behind its tax strategy; an appropriate governance, risk and control framework is needed to enable this. Key considerations include:

- How tax risks and issues across the organisation are managed. This should cover all functions including front office/deals teams, product design teams, finance, support functions and, of course, tax. Typically these risks are recorded and monitored through a risk and control matrix.
- Ensuring that the mandate, roles and responsibilities, authorities and interactions between different areas of the organisation, as they apply to tax, are clearly defined, understood and agreed. This should include external parties; custodians, administrators, service providers, and others. Typically this is set out in a roles and responsibilities matrix to ensure a common understanding.
- Documenting tax related processes and risk management procedures to assess their relevance and effectiveness. Typically this includes some form of process mapping to ensure that activities are actually conducted in accordance with control objectives; surprisingly this is often not the case.
- Data and technology enablers – these warrant particular consideration. A critical component in ensuring effective delivery of the strategy is having the right data and information to hand. Both the challenges and opportunities here are growing exponentially for tax. Increasingly, financial institutions are moving towards a more sophisticated approach and exploring areas such as increasingly accounting system tax sensitised reporting systemssation, data analytics and aggregation tools, and data visualisation. The good news here is that technology developments mean that this is now moving from niche to mainstream.

A clear stance on tax transparency

The transparency landscape is evolving rapidly and poses many challenges, with increasing pressure from stakeholders – both internally and externally – calling for greater transparency and proactive engagement. It is vital that organisations bring together the expertise of relevant teams such as investor relations, sustainability, tax and the board, in order to canvass views and formulate a robust strategy around transparency – even if the conclusion reached is to do nothing.

Within the investment community, alignment with ESG standards is also increasingly being used to evaluate investment portfolios – with transparency around tax becoming a key metric for ESG investors and analysts. Norges Bank Investment Management (NBIM), for example, published a **tax transparency expectations document** in 2017, which outlines the values and behaviours it expects companies to demonstrate around tax and transparency. In early 2021, NBIM withdrew investment in a small number of companies over their tax policies for the first time – citing a lack of transparency and information over where and how they pay tax.

Understanding your mandatory obligations

1

In April 2016, the European Commission presented proposals on public country by country reporting (CbCR) requirements for multinational companies (MNCs) with operations in the EU with a total consolidated revenue of at least EUR 750 million. The proposal was for MNCs to report publicly on where their profits arise and where these are taxed. The information required to be disclosed under the proposals would cover all EU member states in which there are affiliated undertakings consolidated in the financial statements for the relevant year, broken down for each EU member state plus in each of the countries that are on the EU list of non-cooperative jurisdictions for tax purposes (EU's 'blacklist'), or listed for two consecutive years on the EU's 'grey list'. For all other third-country operations, the information should be given in an aggregate number.

The proposal was adopted by the European Parliament in July 2017, and a formal mandate for Trilogue negotiations with the European Parliament and the European Commission was adopted in March 2021. On 1 June 2021, representatives of the European Parliament and EU Member States agreed a draft directive, although transposition into Member States' domestic law could take another couple of years.

Reaching an internal consensus on your approach to tax transparency

2

Developing voluntary tax disclosures carries risk. Once a public disclosure has been made, it cannot easily be withdrawn. Briefing investor relations, sustainability teams and the Board is a crucial step – a short briefing paper and workshop covering how the tax transparency landscape is changing, what this means for your sector and countries of operation and how you might respond can help to ensure internal support for the approach.

Setting your voluntary standards

3

A number of International organisations, including the UN, OECD, and the World Economic Forum are now pushing the tax transparency agenda. The International Business Council of the World Economic Forum issued its paper **'Measuring Stakeholder Capitalism: Toward Common Metrics and Consistent Reporting of Sustainable Value Creation'** in September 2020. The paper is designed to address the need to harmonise the different ESG reporting frameworks that exist, and converge the various standards.

The Global Reporting Initiative (GRI) is an international organisation responsible for setting sustainability standards globally. The standards are widely accepted as good practice for reporting on a range of ESG topics. In December 2019, the GRI issued the **207 tax standard** which was introduced in order to meet stakeholder demands for greater transparency around tax; especially country-by-country datasets. The standard covers four areas: approach to tax, governance over tax, stakeholder engagement and country-by-country reporting. The main area of focus with the 207 standard is the public CbCR requirement which has data points very similar to the OECD BEPS template. The standard is applicable for reports published from 1 January 2021.

Preparing the data

4

Which data would be helpful to explain your tax affairs? A number of companies are identifying, extracting, analysing and reporting their Total Tax Contribution (TTC) data around the world. TTC provides information to inform the debate about the broader contribution that organisations make in taxes and can be used with a range of stakeholders, particularly in the context of CbC data which is focused on corporation tax. How can your ETR be explained to a non tax expert?

Framing the narrative

5

Tax is a complex topic and narrative can be important to help explain tax data in an accessible way. Who might read your disclosures – consider 'tax transparency to whom and for what purpose? Is there value in preparing a tax transparency report, and if so, which sections should be included? Understand what your peers are doing.

What next?

The scale and scope of the ESG tax challenge should not be underestimated. Tax is a complex topic which can be easily misunderstood or misinterpreted – especially by non-tax experts – without accompanying narrative to explain outlying data points and how tax arises through an organisation's business model.

Many organisations will already have some of the key components of a tax strategy and framework at least partly in place, so the effort level should be incremental. Others will be starting from a significantly lower base so much more will be required. Either way, the dynamic and varied nature of the current ESG agenda means that some level of action should be taken now by all to ensure that this important area is being appropriately addressed. Key to success will be embedding this action in the organisation's wider ESG agenda, with the tax function working in congruence with other key stakeholders.

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