Environmental, social and corporate governance: why tax is pivotal

Large Corporate OMB

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As environmental, social and corporate governance issues play an increasingly significant role in business strategy, we ask why taxation is pivotal in the debate.

Key Points

What is the issue?

ESG – environmental, social and corporate governance – is now definitely a boardroom agenda item as an organisation's ESG policies and activities become ever more important to investors, employees, consumers and the wider communities in which they operate.

What does it mean for me?

Governments around the world are now introducing a range of taxes, levies and other measures as a mechanism to incentivise businesses to adopt improved environmental and sustainability strategies.

What can I take away?

Tax will be a critical tool in the development of global ESG governmental policies. Not keeping abreast of changes in this area is likely to lead to organisations being on the backfoot compared to their competitors.

ESG – environmental, social and corporate governance – is the common banner under which sustainable, ethical and responsible activities are being badged. ESG is now definitely a boardroom agenda item as an organisation's ESG policies and activities become ever more important to investors, employees, consumers and the wider communities in which they operate.

At the same time, organisations are also needing to continually adapt to the current changing world, with increasing inflation, global tensions and shortages of raw materials. Shortages have arisen for a variety of reasons, including international transport logistical issues, semi-conductor/chip manufacturing problems, country lockdowns and extreme weather events.

Ultimately, for many organisations, it is currently a balancing act between pursing their planned ESG agenda and being able to adapt their organisation to be flexible and profitably survive within the current changing environment. Unfortunately, the two may not always easily align.

The worldwide landscape

As companies continue to expand and establish operations in overseas countries, they will need to proactively monitor and adapt their strategy to the ESG related policies and taxes in each overseas territory in which they operate. There is no uniform set of ESG taxes that are being applied across all jurisdictions.

Each country is making its own commitments in relation to meeting its environmental, sustainability and social responsibility obligations for its citizens.

ESG strategy and the link to taxation

Organisations now operate in a world where tax is considered a reputational issue, with frequent news headlines about how an organisation manages its tax affairs. Consequently, many boardrooms and owner managers are focused on ensuring that their tax status is seen positively by their stakeholders, employees and society and that they do not face any negative publicity from their tax affairs.

Tax is pivotal in the ESG debate as the majority of actions which an organisation undertakes will have a tax consequence.

Environmental

Governments around the world are now introducing a range of taxes, levies and other measures as a mechanism to incentivise businesses to adopt improved environmental and sustainability strategies. The measures largely consist of additional taxes and reporting obligations, as well as additional incentives to encourage organisations to adopt greener practices. For many countries, these taxes focus on:

- carbon and emission taxes;
- environmental and ecological taxes;
- natural resources taxes;
- water taxes;
- waste taxes;

- fuel taxes;
- transport and mobility taxes;
- renewable energy taxes; and
- environmental exercise duties.

International organisations and finance functions therefore need to understand how any new taxes will impact their operating profits, pricing, cashflow and forecasting models, as well as be prepared to manage the additional compliance burden these will bring.

Tax incentives

Many governments globally are seeking to provide tax incentives to encourage organisations to innovate through research and development, to use greener sources of fuel (for example, biogas or hydrogen), invest in heat pumps or insulation products, or purchase energy-efficient technologies, electric or low-emission vehicles.

Some governments, such as the UK, are providing tax reliefs and incentives for employers to provide and employees to choose 'green' transportation options, including the installation of charging points at an employee's home with the provision of an electric company car.

Organisations should typically consider areas such as:

- What type of energy do they currently use in their processes and can this be substituted for something more environmentally friendly?
- How can they move their current transport and mobility policy to one which is electric or low emission?
- Can the organisation work with energy efficient technologies or move to a more environmentally friendly building?
- Can the materials used in manufacturing processes and packaging be switched for more environmentally friendly alternatives?
- Can waste be reduced, recyled or used elsewhere to generate energy?
- How do the organisation's activities impact on natural resources such as water? Can alternatives be sourced?
- How can pollution from the organisation's activities be reduced or feed into other processes such as energy production?

Attracting investors

Reducing emissions and achieving Net Zero is crucial to limit global warming to 1.5°C above pre-industrial levels and avoid the most catastrophic impacts of climate change which we are currently seeing.

An increasing number of organisations have now realised the strategic role that Net Zero plays in addressing climate change, and are working to align their organisation's strategy and activities with a Net Zero path. However, with the increased cost of inflation, increased taxes imposed by governments to pay for the Covid pandemic and the other challenges noted above this is not always easily achievable.

Successful organisations will be those that make ESG commitments, set targets to achieve them and are able to adapt, innovate and identify opportunities in a rapidly changing world, so that they can add value to their customers, employees and local communities.

Investor attitudes

Institutional investors, banks and fund managers are now taking a forward-looking approach and seeing ESG as being one of the criteria used to inform their investment decisions. Investors are starting to exclude those organisations which they perceive to be non-compliant from an ESG and tax transparency perspective. Others are publicly divesting of businesses which have weak tax reporting strategies or are perceived to not be paying the right amount of tax globally.

ESG considerations need to be sincere, embedded within an organisation’s strategy, and not be seen as obvious ‘greenwashing’, which can cause more harm than good. Organisations which manage their ESG considerations well are typically seen to be more aligned to consumer preferences, more efficient and have less exposure to regulatory risk.

Reporting and transparency

Many large organisations already have a requirement to consider and provide transparency around their taxation affairs. We are seeing a shift among businesses away from just being compliant and reporting information on their tax affairs and tax strategy, towards seeking to demonstrate why an approach has been adopted and how this interlinks to their wider purpose and ESG strategy.

This approach is also starting to be mirrored by some forward-thinking SME organisations. They may not have an obligation to report, but wish to disclose their approach in order to be able to demonstrate their sustainability and social capital credentials to their customers and the communities in which they operate.

What should organisations do?

The pace of change is increasing as world events impact organisations, and environmental and sustainability matters continue to grow in significance. It will be important for businesses to have robust processes and controls in place to enable their ESG strategy and tax affairs to be integrated.

In the context of taxation, in our experience, the eight actions we recommend organisations take to ensure that the full range of benefits from their ESG initiatives are delivered are:

1. Link their ESG activities to their organisation’s purpose and strategy. Ensure that tax risk is considered as part of the Board’s overall strategy towards risk management.
2. While understanding the relevant tax legislation, drive their ESG and tax agenda from a business perspective, in the knowledge of the constraints in which they operate.
3. Keep their activities practical, with a clear destination in mind. The best firms focus on those areas which they can realistically change and influence, particularly in relation to the environmental and social components of ESG.
4. Have a process for the identification and implementation of new taxes and reliefs which will impact their business.
5. Think about what they have learned from Covid-19, in terms of operational resilience, a greater sense of social good and the need to innovate and develop new products and services in response to global disruptors which are outside their control.
6. Review the organisation’s existing (tax) structures and consider whether the affairs of the organisation can be simplified, with more efficient supply chains and greater transparency.
7. Continue to focus on regular communication and any cultural challenges. These are often the hardest part to get right!
8. Track progress and delivery of the benefits. Be honest about failures and share successes.

Final thoughts

In the short term, there will be a tension between ESG and flexibility/profitability for many organisations as they face inflation and other global challenges outside their control. However, those that succeed will continue with their ESG strategy, recognising change in this area, often at a pace driven by the media.

Tax will be a critical tool in the development of global ESG governmental policies. Forward thinking organisations that are able to embrace ESG for the benefit of their business, their employees and wider communities should be able to prosper, achieve positive reputational benefits and a competitive advantage.