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Tax Strategies and Transparency

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Transfer Pricing and ESG, Part 1: Public Tax Strategies and Tax Transparency

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In this article, the first installment in a three-part series on tax and environmental, social, and corporate governance, the authors focus on the role of transfer pricing in responsible tax practices and suggest what multinational corporations should be doing to improve transparency in transfer pricing.

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Over the last several years, multinational corporations (MNCs) have faced strong encouragement from governments and regional bodies (like the European Commission), nongovernmental organizations, and lobbyist organizations to embrace responsible governance[1] as part of their environmental, social, and governance (ESG) journey. This area will continue to be a focus of internal stakeholders (for example, employees, managers, and owners) and external stakeholders (for example, governments, NGOs, and rating agencies). As part of that focus, stakeholders are increasingly expressing an interest in understanding the MNC's approach to tax and transfer pricing. An MNC can address these pressures by drafting a publicly available, groupwide tax policy that sets forth their approach toward key aspects of taxation, including their approach to transfer pricing. In the next few years, as stakeholders become more engaged on ESG and tax, five critical initial steps for tax departments are:

(1) work with their business to develop a tax strategy that aligns with their overall business strategy;

[1]For example, the World Economic Forum's International Business Council issued a core set of common metrics and disclosures on nonfinancial factors for MNCs' investors and other stakeholders. Ratings agencies are active as well, such as the Dow Jones Sustainability Index including tax transparency in its ESG ratings and S&P Global incorporating tax strategy and governance, tax reporting, and effective tax rates into its governance scores.

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(2) include their approach to transfer pricing in their tax strategy;

(3) make their tax strategy publicly available;

(4) create robust mechanisms to ensure compliance with their tax and transfer pricing policies; and

(5) consider if there are ways to proactively engage with tax authorities to show a commitment to a sustainable approach to tax.

This article will focus on the role of transfer pricing in responsible tax practices and will set forth suggestions of what MNCs should be doing going forward in terms of tax transparency and transfer pricing. It will first set the backdrop for transfer pricing practitioners by discussing the link between ESG and tax, the leading tax transparency standard setters, how the rating agencies calculate their ESG tax score,[2] and what MNCs are doing now in terms of their tax strategy. The authors will publish two additional articles in this series: The next article will focus on ways MNCs can use operational transfer pricing as a mechanism to ensure compliance with their tax policy and transfer pricing approach, and the final article will focus on how MNCs can use advance pricing agreements or multijurisdictional voluntary risk assessments and assurance programs as tools to demonstrate their commitment to responsible governance.

Breaking Down the 'T' (Tax) in ESG

ESG represents the spectrum of environmental, social, and governance factors by which market participants are evaluated for their sustainability and societal impact. When managing their operations, companies are increasingly considering ESG factors in measuring risks, evaluating opportunities, and designing integrated strategies aimed at long-term value creation for all stakeholders. While the concept of ESG is not a new one (many MNCs have published sustainability reports for over a decade), there is a renewed focus on evaluating how an MNC thinks about ESG, largely in response to growing concerns over climate change; diversity, equity, and inclusion; income inequality; transparency; and accountability. The increased scrutiny has reverberated throughout organizations, prompting a reevaluation from all departments — including tax — on their current practices and policies.

Over the last few years, stakeholders have increasingly recognized that tax is a critical component of an MNC's ESG strategy. The following includes examples of how tax is part of the E, S, and G components:

- *Environmental*: Governments often use tax policy to incentivize certain environmentally friendly behaviors such as MNC investment in solar power, wind power, or other green technologies. Conversely, governments use tax policy to disincentivize activities that are harmful to the environment — for example, by instituting a carbon tax or a tax on plastics.
- *Social*: Governments also use tax policy to encourage socially friendly behavior, such as the low-income housing tax credits. Recently, stakeholders are increasingly viewing an MNC's attitudes about tax planning, how much tax an MNC pays, and to which jurisdiction the MNC pays tax as a reflection of its corporate citizenship.
- *Governance*: We are seeing more MNCs improve their governance frameworks and processes, including those related to tax. Tax governance can include an MNC's tax strategy, the tax control framework and tax risk management, and reporting key metrics of tax country-by-country data.

Key Tax Transparency Standard-Setters

Two leading standard-setters are the OECD and the Global Reporting Initiative (GRI) 207. For the ESG tax score, rating agencies such as S&P Global Ratings (S&P) and MSCI often look toward the ESG standard-setter metrics to calculate the tax score.

OECD and the Tax Control Framework

In 2016 the OECD released its "Report on Co-Operative Tax Compliance: Building Better

[2] Many ESG rating agencies use the public disclosure of a global tax and transfer pricing approach as a component to issue a score on how an MNC is performing in terms of ESG and tax — the ESG tax score.

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Tax Control Frameworks." In the report, the OECD provided specific guidance on the importance of a tax control framework (TCF) and set out to define the elements of a robust TCF. The OECD set forth the following six principles for a TCF:

(1) establish a tax strategy;

(2) apply the strategy comprehensively;

(3) assign responsibilities for executing the strategy at all levels of the corporation, as applicable;

(4) document governance to the strategy;

(5) regularly test performance under the strategy; and

(6) provide assurance to stakeholders that the control framework is working.[3]

Many of the OECD's TCF features have been implemented in several countries' adoption of voluntary tax governance programs, as seen in Malaysia's and Singapore's new tax governance programs[4] and incorporated by other tax transparency standard-setters.[5]

The tax strategy should transparently explain the MNC's approach to tax from the strategic level to the operational level, describe the board of directors' oversight of the strategy and frequency of review of tax strategy, risk appetite, and risk management, and explain how the companies comply with the law.[6] Another key element to an effective TCF is to have a well-documented tax governance process. Effective tax governance includes having controls in place to operationalize the tax strategy (which could include transfer pricing practices). The governance guidance should define responsibilities, an approach to the identification of materiality, how tax risks are identified, assessed, monitored, and mitigated, the modes of effective communication to embed tax in the organization, and key performance indicators related to tax. A robust TCF should have controls in place to ensure processes are followed and are subject to routine monitoring, testing, and maintenance. A testing procedure should be in place to monitor compliance with policies and the greater processes of the TCF.

GRI 207

GRI 207, effective from January 2021, is the tax section portion of the larger GRI 200's collection on economic reporting. GRI's reporting framework is one of the most prominent and widely used voluntary standards. GRI 207 is designed to help an organization both understand and communicate its approach to tax, tax governance, tax controls and risk management, stakeholder engagement. GRI 207 additionally guides organizations on how to manage considerations related to its income earned, corporate income tax paid, business activities, and so forth on a CbC level.

GRI 207 contains four components; the first three, 207-1 through 207-3, focus on tax management, and 207-4 focuses on CbC reporting. The following are the key elements for each:

- *GRI 207-1 — Approach to Tax*: This states that the requirements for an MNC's approach to public tax reporting consist of a description of the approach to tax, including: (1) whether the organization has a global tax strategy and, if so, a link to this strategy if publicly available; (2) the governance body or executive-level position within the organization that formally reviews and approves the tax strategy, and the frequency of this review; (3) the approach to regulatory compliance; and (4) how the approach to tax is linked to the business and sustainable development strategies. As part of representing their approach to tax, according to GRI 207-1(a), companies can provide an overview of their transfer pricing policies and practices, which helps demonstrate the MNC's overall tax risk appetite.

[3] OECD, *Co-Operative Tax Compliance: Building Better Tax Control Frameworks*, ch. 2 (2016).

[4] *See* KPMG, "KPMG Report: Tax Governance Frameworks in Singapore and Malaysia, Related Income Tax and GST Benefits" (May 31, 2022).

[5] For example, the B Team (a nonprofit initiative that advocates for business practices that are more centered on humanity and climate change) has emphasized the importance of implementing a transfer pricing policy that follows the OECD's guidance on the arm's-length principle. *See* The B Team, "A New Bar for Responsible Tax," principles 3 and 4.

[6] OECD, *supra* note 3, ch. 2, at "Tax Strategy Established" (2016).

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- *GRI 207-2 — Tax Governance, Control, and Risk Management*: This specifies that the reporting requirements concerning governance include descriptions in three main sections: (1) the tax governance and control framework; (2) the mechanisms for reporting concerns about unethical behavior; and (3) the assurance process for disclosure on tax, and if applicable, a reference to the assurance report, statement, or opinion.
- *GRI 207-3 — Stakeholder Engagement and Management of Concerns Related to Tax*: This includes (1) the approach to engagement with tax authorities; (2) the approach to public policy advocacy on tax; and (3) the process for collecting and considering the views and concerns of stakeholders, including external stakeholders.
- *GRI 207-4 — Country-by-Country Reporting*: This includes disclosures of key CbC data (for example, revenues, number of employees, and corporate income taxes paid) for all MNC jurisdictions.

ESG Tax Scores

Stakeholders are now looking toward the ESG rating agencies to understand how an MNC thinks about and operationalizes ESG. Rating agencies such as S&P Market Intelligence, MSCI, Sustainalytics, and others incorporate tax as a component in an MNC's ESG score and the governance subscore. While the tax component is a relatively small percentage of the total ESG score, tax departments have begun to focus on that element as it is within their department's control. Rating agencies generally perform their appraisal of both qualitative and quantitative factors. The qualitative factors are generally related to the presence of a publicly available tax policy, looking for components of GRI 207-1 and GRI 207-2. The quantitative factors generally include some form of reporting tax data by country and/or a comparison of the MNC's effective tax rate with the tax rate of peers, using GRI 207-4 for reference. Each rating agency has its own interpretation of the value of the various components of the GRI standards and may also consider factors from other standard-setters such as the OECD, the World Economic Forum, and the B Team; or look to other publicly available information like data on tax controversies in the press.

Often the tax policy is a relatively large part of the ESG tax score. The adoption of a formal, publicly available tax policy serves to guide MNC practices and provide investors, regulators, and other stakeholders with an idea of the MNC's tax principles and tax risk profile, against which practices and disclosures can be compared. An effective tax policy generally has board oversight, is created and implemented by senior management, and is regularly reviewed by the MNC to ensure that emerging risks are addressed.

One of the key items the rating agencies look toward is disclosure of how an MNC approaches transfer pricing. While the standard-setter GRI suggests that companies disclose their approach to transfer pricing, we understand that rating agencies like S&P only — at least at present — analyze if an MNC discloses high-level transfer pricing principles, for which the MNC will be given credit if shared. Given the negative publicity on transfer pricing over the last few years and the importance stakeholders now place on transfer pricing as a key MNC tax issue,[7] it seems likely that rating agencies will look for more disclosures on the topic. Other components of a tax strategy include commitments to the following:

- to not use tax structures or engage in transactions without commercial substance;
- to not use secrecy jurisdictions or so-called tax havens for the purpose of aggressive tax avoidance;
- to comply with the spirit of the law as well as the regulations in the jurisdictions in which the MNC operates; and
- to have an approval process of the tax policy by the board of directors.

Recently, the authors have seen three noteworthy trends. First, large asset owners (for example, Norges Bank Investment Management[8] and the Dutch fund Stichting Pensioenfonds

[7] *See* Tim Shaw, "Transfer Pricing Audits Likely to Rise, Tax Expert Says," Thomson-Reuters, Oct. 18, 2022.

[8] *See* Norges Bank Investment Management, "Tax and Transparency Expectations Towards Companies" (last accessed Mar. 7, 2023).

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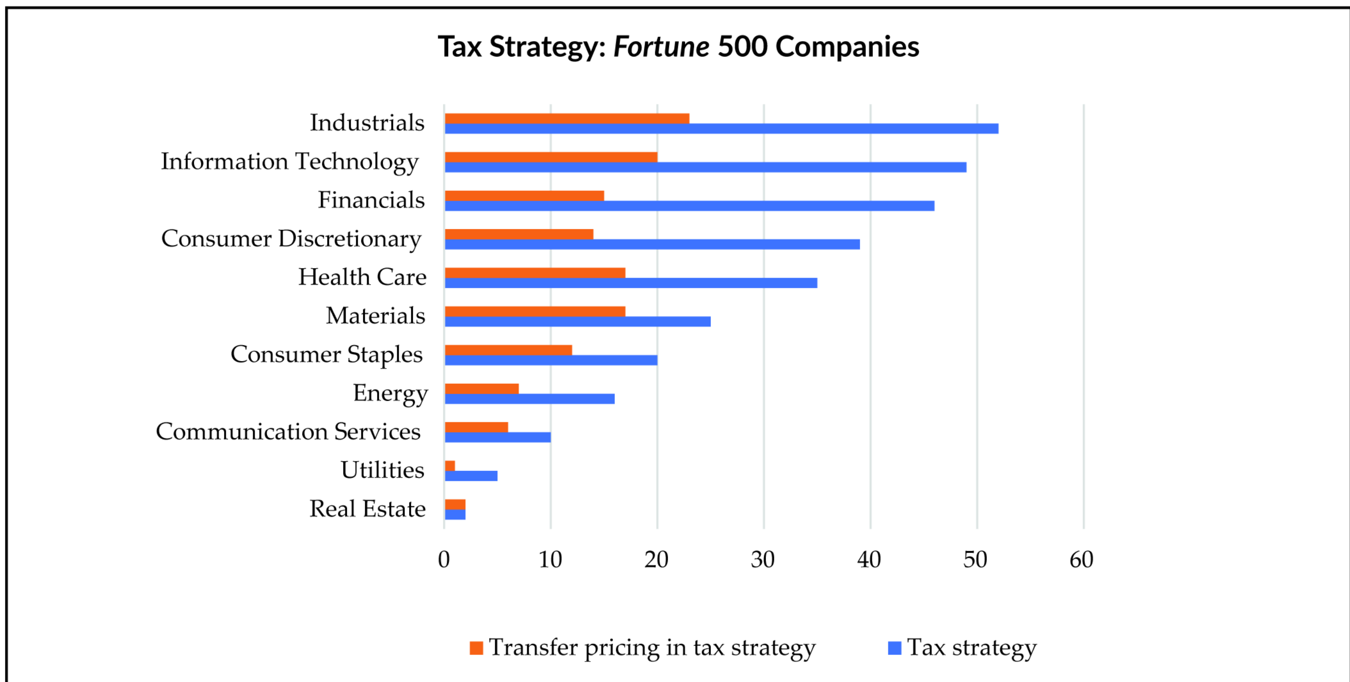

ABP[9]) and investors have expressed increased expectations on tax transparency for their portfolio companies.[10] The second trend is that stakeholders expect MNCs to implement governance measures to ensure implementation and oversight of the tax strategy.[11] The third noteworthy trend is that many tax departments are benchmarking their ESG tax score to understand their rating in the context of industry peers and preparing a gap analysis to understand how to augment tax transparency to improve their ESG tax rating and to guide their ESG journey toward better tax governance.

Data on Tax Strategies: A Long Way to Go

A June 2022 review of the *Fortune* 500 companies revealed that 60 percent currently have a public tax strategy; the industries in which MNCs are most likely to have a tax strategy are industrials, information technology, financials, and consumer discretionary. Interestingly, almost every company with a public tax strategy publishes it using a stand-alone document separate from the company's sustainability or ESG report. Given the increased scrutiny on tax transparency combined with investor demands, we found the percentage of companies with a tax strategy surprisingly low — especially given that almost every *Fortune* 500 company now publishes an overall company sustainability report.[12] It seems clear that tax strategies are lagging behind other forms of ESG reporting.

As the figure shows, about half of the companies with tax strategies currently mention transfer pricing in their strategy. Specifically, these companies discuss that the transactions are consistent with arm's-length pricing and/or that the intercompany pricing is consistent with OECD transfer pricing guidelines. Interestingly, within their tax strategy, two *Fortune* 500 companies noted they obtained APAs that provide for an agreement with the tax authorities to intercompany transactions for future years.

[9] *See* Carlos Tornero, "Dutch Pension Giant ABP Sets Responsible Tax Expectations for Portfolio Companies," Responsible Investor, Jan. 8, 2021.

[10] These requirements include, among other items, that portfolio companies should have policies and commitments outlining their tax approach and a description of the governance and controls around such strategies.

[11] Principles for Responsible Investment, "Advancing Tax Transparency: Outcomes From the PRI Collaborative Engagement" (2020).

[12] The Governance & Accountability Institute Inc.'s "2021 Sustainability Reporting in Focus" reported that in 2020, 92 percent of the S&P 500 companies — over four times as many companies as a decade ago — published a sustainability report detailing how their business addressed ESG issues.

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We understand that most *Fortune* 500 companies intend to adopt a tax strategy in the next few years. Given the concern (whether accurate or not) with using transfer pricing to move tax to low- or no-tax jurisdictions, companies will increasingly incorporate how they address transfer pricing into their tax strategy documents. It seems likely, given the increased stakeholder focus on transfer pricing, MNCs will also include references in their tax strategy to key transfer pricing risk mitigation strategies they employ (such as APAs).

Conclusion

As MNC stakeholders continue to focus on ESG and tax, MNCs would be well served to have a publicly available and groupwide tax policy that sets forth the MNC's approach toward key aspects of taxation, including their approach to transfer pricing. In addition, MNCs should consider incorporating part of their tax strategy in the wider ESG sustainability disclosures to signal to the market that tax is a material consideration in the company's ESG journey. After these first key steps are implemented, MNCs should ensure they have a mechanism to ensure compliance with their tax and transfer pricing policies and consider ways to proactively engage with tax authorities to show ESG commitment.[13] ■

[13] The foregoing information is not intended to be "written advice concerning one or more Federal tax matters" subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230. The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser. This article represents the views of the author(s) only, and does not necessarily represent the views or professional advice of KPMG LLP.

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