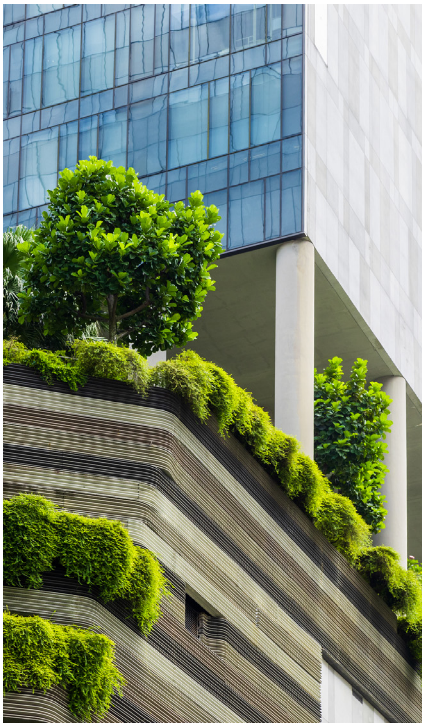
Navigating Tax Sustainability

Aligning Corporate Practices with ESG

In today's business landscape, there is an increasing focus on corporate sustainability, with taxation being a significant part of this agenda. Increasingly, companies are expected to operate in a tax sustainable manner and there is no shortage of guidance on best practice.



However, unlike other facets of environmental, social and governance ("ESG"), there is no universal regulatory framework for tax transparency and governance. There are helpful guidelines but the general steer is that corporates should do better. Moreover, the right approach to governance and transparency required and appropriate for one company might not be suitable or needed by another.

While there is no universally recognised definition for tax governance, it generally encompasses the principles and structures guiding an organisation's approach to tax management. With increased regulation, including from outside the tax world such as the Corporate Sustainability Reporting Directive ("CSRD"), expectations around robust tax governance are rising and the internal tax function can no longer afford to be hidden in the back office.

This article is the first in a series exploring the components of ESG as they relate to tax sustainability and, importantly, the actions and data that are appropriate to meet the increasing expectations of both legacy and new stakeholder groups. Future articles will tackle topics on Stakeholder Engagement (the increasing influence and importance of new stakeholder groups) and Environmental (the importance of horizon planning).

Influencing Factors

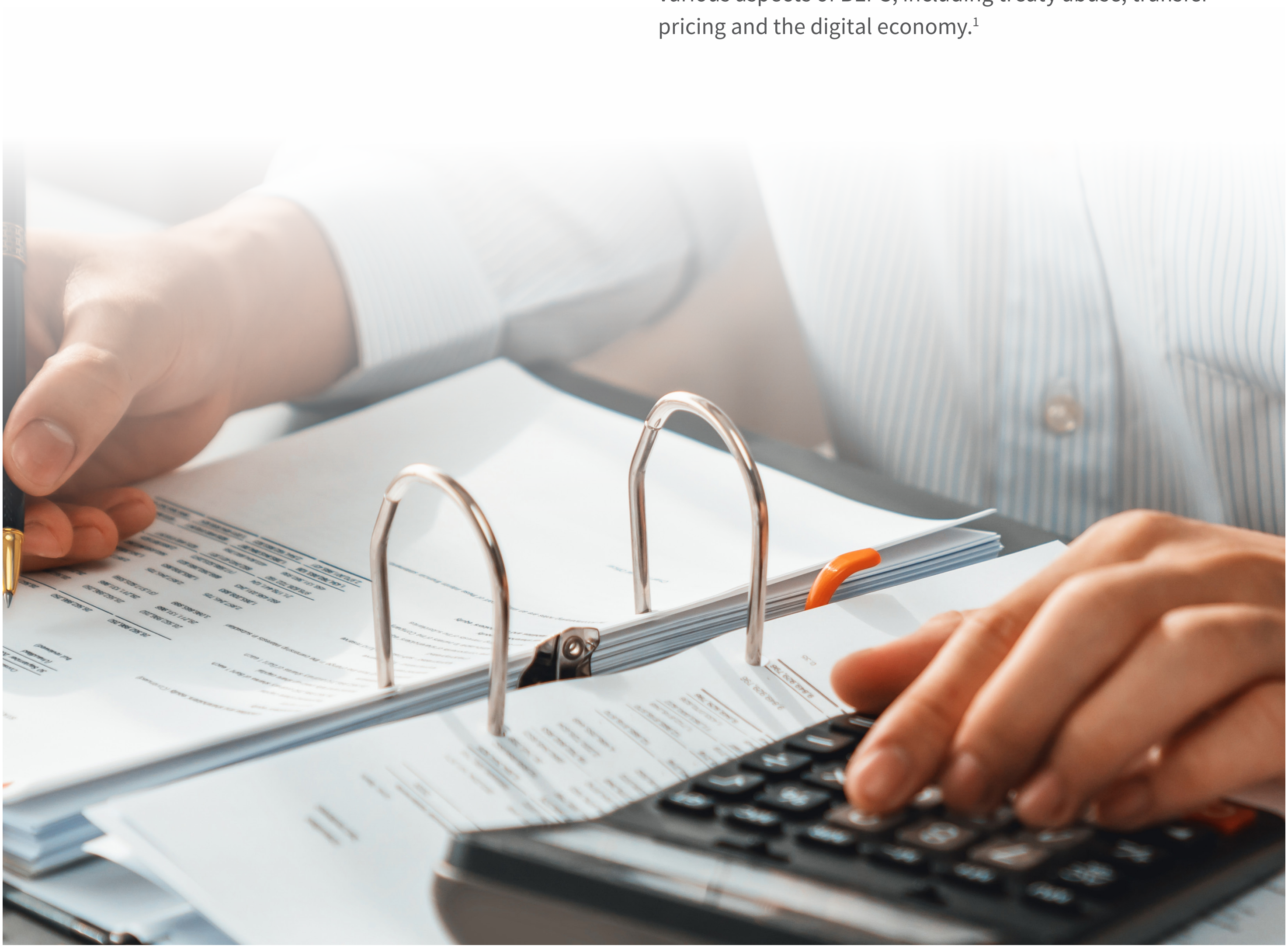
When it comes to tax sustainability, several factors influence how a company should approach its strategy, including:

- **Stakeholder Groups**: The level and nature of engagement with stakeholders can significantly impact the need to demonstrate good tax governance.
- **Company Size**: Larger organisations generally have a greater footprint resulting in more complex tax obligations through their supply chain and/or structure.
- **Sector**: Different industries face varying tax challenges and regulatory environments such as the Extractive Industries Transparency Initiative ("EITI").
- **Geography**: The location of a company's operations affects its tax obligations and reporting requirements with Europe taking the lead most recently with obligations under the Corporate Sustainability Reporting Directive ("CSRD").

Understanding Tax Governance

Less than twenty years ago, tax strategy for multinationals was generally focused on being optimised but compliant: paying the least amount of tax operating within the boundaries of the legislation. Multinationals managed double dips, tax optimised supply chains and the effective navigation of a pathway through tax treaties.

The growing public and political concerns around tax avoidance by multinational corporations, especially in the wake of the global financial crisis of 2008, led to increased scrutiny of international tax practices. According to the OECD, the annual cost of these practices was estimated to be in the region of $100-$240 billion USD in lost revenue for governments and ultimately the communities served. Avoidance had created an unfair playing field, with the more aggressive tax planners gaining a competitive advantage over the voluntarily compliant. Moreover, those on the receiving end feeling the greatest impact of these practices were arguably those in the utmost need of revenue i.e., developing countries. In 2013, the OECD released its Action Plan on Base Erosion and Profit Shifting ("BEPS"), which identified 15 specific actions to address various aspects of BEPS, including treaty abuse, transfer pricing and the digital economy.[1]



We have identified 18 components that form the foundations of corporate tax governance, ranging from the formulation, adherence and articulation of the tax strategy to effective tax compliance and tax data management to tax planning and engagement with tax authorities. These aspects increasingly look to embrace the 'spirit of the law', a paradigm that was rarely genuinely considered by businesses prior to BEPS.

The risks presented by poor tax governance have most commonly been equated to the reputational consequences for multi-national 'business to consumer' organisations such as the media in recent years relating to the tax strategies of the tech giants, but they extend much further. Poor tax transparency and under-reporting can indicate broader business failings and even wider corrupt practices which investors are starting to take notice of. In many cases it will not be sufficient to simply comply with statutory obligations when it comes to disclosure and transparency. Restricting compliance to the essential minimum has the risk of being counter-productive as a business and may be perceived as having a preference not to disclose leaving stakeholders wondering why. Firms need to recognise that it is necessary (as opposed to optional) to ensure that disclosure is applied, dynamic and verifiable.

The impact and requirements of tax governance to stakeholder groups is wide-ranging and leaders in this space acknowledge the importance of recognising, distinguishing and fully addressing the variety of focus and needs of these groups. As an example, an academic study demonstrated that higher degrees of international tax planning can increase a borrower's credit risk.[2]

To put the differing needs and expectations of corporate tax sustainability into context, we will consider three contrasting theoretical corporates here and throughout this series of articles:

- **Vest Global** — a vertically integrated publicly listed global consumer brand
- **Feel Good Group** — a privately owned multinational medical equipment manufacturer
- **Wizz Bang Startup** — an early-stage venture capital backed GreenTech company

The Tax Sustainability Index ("TSi")

Based on our experience with tax leaders driving the sustainable tax agenda, we see a wide-ranging approach, understanding and focus of the requirements for tax sustainability through a business lens driven by a variety of factors that is creating a myriad of challenges and uncertainty.

To support tax leaders in a tailored and structured manner, FTI Consulting and WTS Global have developed the Tax Sustainability Index ("TSi") to help organisations understand their starting position and build a tailored plan of focus on their journey towards tax sustainability. The index provides a confidential indication of an organisation's current performance standing across five pillars: Tax Governance, Tax Risk & Planning, International Compliance, Stakeholder Engagement, and Environmental Impact.

The TSi was designed to help a business consider, understand, and improve its approach to tax sustainability based upon the specific factors driving its business (size and maturity, sector, geographical spread). To put this into context, depending on where it is in the business cycle (i.e., a new small private company operating in a single jurisdiction compared with a long-established global business) it may be more important to focus on stakeholder engagement and benefitting from tax incentives than putting a complex tax governance structure in place that is not warranted or required at that point in time.

The TSi rates the current position of a business across the five pillars through the allocation of a score (between 1 to 100) linked to the five stages of development, from 'beginning', 'emerging' and 'progressing', through to 'strong' and 'leading.' The score helps a business to understand where they are positioned within a particular band (i.e., entry level, securely in the middle or at the higher end pushing towards the next banding level).

The approach and level of tax governance would and should vary between the three example corporates. TSi helps to contextualise this and validate whether a company is appropriately positioned which we illustrate below.

Vest Global — a Vertically Integrated Publicly Listed Global Consumer Brand.

With the risk of reputational damage, Vest Global should rate as ‘strong’ or ‘leading’ across all three governance measures under a framework developed with reference to a recognised standard such as GRI-207. Amongst other things, this will encompass the publication of country-by-country reporting and the disclosure of how tax is aligned to the wider sustainable development practices of the organisation

At the highest standards, and where warranted by the business and its stakeholders, the tax strategy for Vest Global should be dynamic: reviewed and updated periodically, and communicated and understood by all stakeholders including, importantly, employees. Adherence and compliance against the strategy should be monitored and reported each year.

Tax risks should be reported to and fully understood by the Board and tax should not be a primary influencing factor for corporate or transactional structuring. There could also, arguably, be a higher level of expectation around the “fair” allocation of profits and taxes, although with no clear definition of fair outside of BEPS this would be left to the business (and its auditors?) to determine. Compliance with the arm’s length principle still allows a degree of discretion around how prices are set within a benchmarked range. From many different perspectives, the pricing within that range should be set as objectively as possible and with no evident bias in favour of lower relative tax rates.

Feel Good Group — a Privately Owned Multinational Medical Equipment Manufacturer.

As things stand today, the same rigorous levels of governance are not expected of the Feel Good Groups of this world. Feel Good Group, with lower levels of stakeholder engagement, could have a baseline within the emerging banding according to the TSi, but might realistically sit anywhere above that up to the strong banding for a variety of reasons.

For example, it may be less important to have adopted standards and a disclosure framework in line with recognised best practice. A greater degree of pragmatism may be accepted to aspects of compliance and governance and while ultimately Boards should still be accountable for tax risk management in these types of organisations, responsibility is likely to be delegated to the tax or finance department. The likes of Feel Good Group should not, of course, be discouraged from aiming higher but should determine whether the resulting policies, procedures and disclosure would be merited given its profile?

The challenges of meeting the highest levels of tax governance do not come without a cost in terms of time and process, that may ultimately distract the business from the execution of front-line operations. In terms of where Feel Good Group may want to position itself, much will depend on the future plans for the business. If it needs to evidence the importance of tax sustainability or ensure it has a solid platform from which to engage with wider stakeholder groups, for example a public listing, it should aim to achieve a rating within the TSi ‘progressing’ band across all three governance metrics.

Wizz Bang Startup — an Early-Stage Venture Capital Backed GreenTech Company.

A much wider range could be expected for earlier stage companies such as Wizz Bang. Counter-intuitively, it may well achieve higher results in its early years when the operations are more straight forward and when it has a lower headcount and footprint in only one or two countries. As the business grows and becomes more complex, with a greater relative focus on shareholder capitalism over stakeholder capitalism, tax governance may not begin as a primary focus for the finance team, but will rise in importance in line with the business growth.

This period of an organisation's development presents a higher risk from a tax perspective where it may be vulnerable to more uncertain tax positions and intervention from tax authorities that may then hinder growth at a critical time. The challenge which is easily understood but hard to identify is when enhanced tax governance should be considered. At the right time, it could almost always seem excessive or unnecessary. To address this, a score showing a 'beginning' performance should be an amber warning to be investigated at this stage.

The conclusion may be that the risk or beginning nature can be managed. For example, is it necessary to put in place comprehensive documentation for a transfer pricing position that has evidently very low value and risk, or alternatively does the company need to separate the supply of its tax and audit services?

Navigation and Positioning

It is increasingly important that businesses understand what is expected across the 18 components of tax governance and where they currently sit in relation to those compared with where they might expect to be. Outside the largest multinationals for whom tax governance and transparency is paramount, our work has seen that there has been a degree of inertia in ensuring that an organisation's tax sustainability is aligned to and runs alongside the wider business ESG initiatives.

The principal reason for this is that tax governance is so broad and business has only been given a direction of travel rather than an ability to assess a suitable location or destination. This is now changing and there is a far better understanding of what is appropriate at any point in time of a business's evolution. In our experience, we have indicated where we might expect our three companies to be positioned applying the TSi.

	Vest Global	Feel Good Group	Wizz Bang Startup
	A vertically integrated publicly listed global consumer brand	A privately owned European headquartered multinational medical equipment manufacturer	An early-stage venture capital backed GreenTech company
	Indicative TSi Scores		
Tax Governance	Score: 75+ Banding: Strong +	Score: between 47 and 75 Banding: Progressing to Strong	Score: between 24 and 51 Banding: Beginning to Progressing
Tax Risk & Planning	Score: 73+ Banding: Strong +	Score: between 46 and 73 Banding: Progressing to Strong	Score: between 19 and 59 Banding: Beginning to Progressing
International Compliance	Score: 74+ Banding: Strong +	Score: between 50 and 74 Banding: Progressing to Strong	Score: between 19 and 64 Banding: Beginning to Progressing

Tax Sustainability Index

As the demands for sustainability and commitment to ESG principles increase, businesses need to assess their position and be able to communicate this to key stakeholder groups. This priority now stands alongside the multitude of statutory reporting demands. Leaders find themselves at a critical juncture, do they ignore the issue and open themselves up to scrutiny for failing to 'do better', or challenge conventional practices and look forward to the future?

The TSi is a confidential tool that is free and simple to use. It takes no longer than 30 minutes to answer a range of questions and your results are available immediately, providing a structured, objective and measurable basis to assess your tax sustainability. Register here to obtain the TSi ratings for your business and start to build your tailored journey towards tax sustainability.

[1] Organisation for Economic Co-operation and Development (OECD), Base Erosions and Profit Shifting 2013

[2] Tax Notes, Credit Ratings and International Tax Planning, 24 November 2020

RICHARD TURNER
Senior Managing Director
+44 (0) 7717 702162
richard.turner@fticonsulting.com

SUZANNE ALCOCK
Managing Director
+44 (0) 7811 034832
suzanne.alcock@fticonsulting.com

LUCY HEALY
Senior Director
+44 (0) 7971 767797
lucy.healy@fticonsulting.com

TOM SHAW
Senior Director
+44 (0) 7977 752067
tom.shaw@fticonsulting.com

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