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The ESG standards' alphabet soup: a new headache for tax experts?

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The most recent UN Climate Change Conference in Glasgow, or COP26, attracted the attention of long-term investors. The reason for that was the announcement of the International Financial Reporting Standards Foundation Trustees concerning the creation of the International Sustainability Standards Board (ISSB).[1] The initiative aims to address one of the complaints brought up by many long-term investors interested in environmental, social and governance (ESG) matters, i.e. the alphabet soup of ESG reporting standards.[2] For a long time, a patchwork of standard-setting bodies and other entities populating ESG metrics and standards have flourished. This should now come to an end.

The announcement came at an interesting point in time for the ESG reporting. Early in 2021 the European Commission adopted a proposal for a Corporate Sustainability Reporting Directive (CSRD).[3] Among others, CSRD introduces mandatory EU sustainability reporting standards. This shall address the calls for uniform ESG standards within the EU. The first set of standards is expected by October 2022.[4]

The ongoing effort towards ESG unification is a positive development. But can unification be achieved? From an ESG perspective, it seems that we are currently heading toward two sets of standards. One set of standards will be developed by the EU under the framework of the CSRD. The other set of standards will be formulated by the ISSB. It remains to be seen if any alignment between the two institutions is to come. **This may have important implications for corporate taxpayers**.

For a long time, there was no tax standard for ESG reporting. Taxation was at the periphery of ESG discussions. The ESG focus was on various other topics, ranging from natural resource conservation to the company's business relationships. The change was primarily brought by the United Nations Sustainable Development Goals in 2015 when tax was integrated as an essential pillar in achieving sustainable development.[5] It was declared that governments need taxes to make the necessary environmental and social investments. At the same time, it was recognized that corporations and other taxpayers have an impact on how much tax lands in public budgets through their responsible tax practices. The discussion came along with the OECD's tax and transparency agenda and complaints from civil society that called corporations to pay their "fair share" of tax.

Soon after the international community developed **the first ESG standard for tax**, i.e. GRI-207.[6] This was a critical step in the ESG history. ESG rating agencies had tax metrics in their methodologies already before GRI-207 but there was no ESG tax guidance that would support companies in their reporting. As a result, a tax part of sustainability reports was usually rather a short one. In that context, GRI-207 has a chance to bring a sweeping change, since it requires relatively broad disclosure. The standard comprises of four elements: an approach to tax, tax governance, control, and risk management, stakeholder engagement and management of concerns related to tax and Country-by-Country-Reporting (CbCR). These four disclosures being the pillars of GRI-207 were welcomed by ESG investors mainly due to expected increased transparency on tax-related business actions. Reporting in line with GRI-207 should help long-term investors better assess reputational and regulatory risk linked to potential investments.

GRI-207 is certainly the first tax standard for ESG purposes. To what extent it is backed by the investment community is not clear. It suffices to reflect on how the World Economic Forum, or WEF, developed its ESG metrics. In its first draft, GRI-207 was included as the tax standard.[7] The final text deviates from that and instead requires companies to disclose total tax paid, tax remitted, and total and additional tax breakdown by country for significant locations.[8] This may actually indicate that the broad scope of disclosure included in GRI-207, particularly transparency of CbCR was not found as essential as originally expected; at least there was no agreement about its necessity.

It raises the question as to the type of ESG tax related standards that the ISSB and the EU will adopt. Will they follow GRI-207 or will they put forward other, new, tax related standards? In addition, it will be crucial to examine the extent to which the ISSB and the EU will align their approach to tax disclosure. Any differences in the standards developed may lead to a lack of data comparability between sustainability reports issued by EU and non-EU corporations as well as increased compliance burden.

From the perspective of reporting corporations, it will be key to determine whether ESG tax standards developed by the ISSB and the EU will go beyond what is already required for tax compliance purposes. ESG tax standards come on top of already existing “pure” tax regulations. They usually mirror existing tax institutions. GRI-207 is an evident example of that. As such, it does not suggest any new tax requirements. It leverages what corporations may potentially already have in place. Suffice to mention disclosure of CbCR, which is one of the elements of GRI-207 and is also required by the jurisdiction of many corporate taxpayers.

The potential reliance of ESG tax standards on existing tax institutions does not guarantee that corporations will meet the standards. There is a justified fear that ESG standard setters may amend the scope of tax regulations to be reported for ESG purposes and that way increase the compliance burden on corporate taxpayers.

To illustrate that point, let us take CbCR as an example. If CbCR is adopted as a tax standard for ESG reporting (as is the case in GRI-207), the mandatory objective scope of CbCR will be extended. So far, for tax purposes, only taxpayers with consolidated group revenue of at least 750 million euros have to file their country-by-country reports. If the requirement were incorporated by the EU in the CSRD, it would extend the CbCR requirement to all large companies and all companies listed on regulated markets. If the requirement was incorporated by the ISSB, potentially any organization reporting in line with IFRS would have to follow this standard and publish their CbCR.

Besides the personal scope, there is an issue of material scope. The current experience with GRI-207 confirms that a deviating CbCR scope within ESG tax standards may be expected. For example, GRI-207 does not require disclosure of revenue from intra-group transactions within the same tax jurisdiction whereas such disclosure is required by tax regulations.[9]

Although the new ESG reporting requirements for tax may be similar or even almost identical to existing tax regulations, discrepancies are to come. The long-lasting ESG issue concerning the alphabet soup of reporting standards may soon become a headache not only for ESG investors but also for tax experts. It is in everyone's interest to learn from previous ESG experiences and avoid any deviations between tax standards. Despite some efforts taken in this direction, it is still unclear how successful they will be.

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[3] Proposal for a DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL amending Directive 2013/34/EU, Directive 2004/109/EC, Directive 2006/43/EC and Regulation (EU) No 537/2014, as regards corporate sustainability reporting COM/2021/189 final, EUR-Lex – 52021PC0189 – EN – EUR-Lex (europa.eu), access: 20.01.2022.

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