Sustainability regulations and tax: taking a cross-functional approach

Environmental | Management of taxes



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A more cross-functional approach is needed within businesses to ensure that they are fully compliant with sustainability regulations. We ask what operating models can benefit the tax team.

Key Points

What is the issue?

Tax teams need to be aware of the impact of the wave of global regulation that is washing over them right now, organising their response to it and ensuring that they stay compliant.

What does it mean for me?

Tax functions are not adequately aware of the impact of sustainability regulations on tax, while sustainability functions are not adequately aware of the tax elements of sustainability. This needs to change.

What can I take away?

Every organisation is different, so every organisation's approach will be different. Whilst there is no single 'right' approach, there are wrong approaches. Ignoring the issue or adopting siloed responses without cross-functional interaction will not work well in the long term.

This is the third article in a series exploring the connections between tax and sustainability. It highlights what sustainability means in practice for in-house tax functions. In particular, it looks at how tax teams need to be aware of the impact of the wave of global regulation that is washing over them right now, organising their response to it and ensuring that they stay compliant.

The third wave of global regulation and relevance to tax

The world is currently entering the 'third wave' of global regulation.

The first wave came in the late 19th and early 20th centuries in response to rapid industrial growth and urbanisation during the Industrial Revolution. Regulations were introduced, notably in Europe and North America, that included laws on working hours, fair wages, child labour, industrial pollution and so on.

The second wave of regulation occurred in the aftermath of World War II, establishing social welfare systems, health and safety regulations, consumer protections, environmental standards on a global scale, trade and tax treaties, and creating international regulatory bodies such as the United Nations, the World Bank and the International Monetary Fund.

The advent of the digital age and the need for sustainability is now ushering in a third wave of regulations globally: data protection and privacy; frameworks for cybersecurity; the safer development of artificial intelligence; and a significant body

of environmental, social and corporate governance (ESG) regulations, particularly in the EU. As explained below, it is these ESG regulations that tax functions need awareness of.

The mutual regulatory awareness gap

A lack of clarity between tax and other functions often creates a void, where departments are slow to assume accountability. As a result, they are potentially rendering businesses non-compliant with respect to environmental regulations, such as the Carbon Border Adjustment Mechanism (CBAM).

Let’s take a look at a couple of other practical live examples.

Example: double materiality reporting

Are tax functions sufficiently aware of the concept of ‘double materiality’ reporting, which is required by various ESG regulations?

This concept recognises that companies have:

- material impacts on society and the environment (the inside-out view); and
- sustainability developments giving rise to material risks and opportunities to businesses (the outside-in view).

Among those in-house tax professionals who are aware of double materiality, how many are advocating to their chief sustainability officer that tax – typically one of the largest financial items on income statements and one of the largest contributions made by business to society – needs to be considered in that materiality assessment and potentially be included in reporting?

What about the material opportunities for the business of new tax incentives such as under the US Inflation Reduction Act? What about new financial risks from environmental taxes – plastic and packaging taxes, and carbon taxes such as CBAMs? Are these material? This is at least a question that should be posed and answered.

Example: minimum safeguards

Many tax functions and tax advisors will be aware of transparency regimes such as public country-by-country reporting and Global Reporting Initiative 207. However, how many are aware of the minimum safeguards laid out by the EU Taxonomy Regulation? This 2020 regulation ‘is a classification system that defines criteria for economic activities that are aligned with a net zero trajectory by 2050 and the broader environmental goals other than climate’ (see tinyurl.com/3ntzanzr).

The interaction of that regulation with European Sustainability Reporting Standard 2 (ESRS 2) and the EU Corporate Sustainability Reporting Directive (CSRD) requires businesses to implement ‘procedures to ensure alignment with the OECD Guidelines for Multinational Enterprises on Responsible Business Conduct’ (see tinyurl.com/29awajpd).

Those Guidelines state: ‘Enterprises should comply with **both the spirit and the letter of the tax laws and regulations** in the countries in which they operate?’ (emphasis added). This statement rarely appears explicitly in published strategies, and even where it does compliance means keeping the area under review.

A lack of focus

This lack of knowledge of sustainability regulations in tax functions is compounded by the fact that sustainability, HR, legal, risk and other functions are probably focused on trade compliance, climate change, human rights, modern slavery and anti-bribery and corruption regulations. They are not necessarily thinking about tax in those contexts. In short, my experience is that tax functions are not adequately aware of the impact of sustainability regulations on tax, while sustainability functions (and other functions) are not adequately aware of the tax elements of sustainability. This needs to change.

Who is responsible?

The current position is not surprising, given that sustainability is a fast-developing area with new ESG regulations proliferating around the world.

In my view, the mutual ‘regulatory awareness gap’ between sustainability and tax arises in many businesses from a lack of organisational clarity over responsibilities. Without clear internal policies, procedures and allocated responsibilities, there is a clear risk of regulatory compliance falling between functional stools.

Developing a ESG tax operating model

There are many ways for tax functions to address this challenge and to initiate a new ESG tax operating model. The approach advocated below is one that can be adapted to any organisation and follows a roadmap that involves four stages.

Stage 1: Scan the regulatory landscape

First, you should understand what regimes exist that require compliance. There are tools that can help you to understand the scope of environmental taxes or pseudo-taxes, tax transparency and other requirements. Some tools are free to use, such as the EY Green Tax Tracker (see tinyurl.com/33k26hp).

Discuss with other functions what regulations they are complying with. Do any of these overlap with the tax function’s list, or impact on the company’s approach to tax? Are there existing processes and controls already being used to address some of these requirements?

Finally, identify gaps and start to make the case for a holistic future state.

Stage 2: Align stakeholders

Set out and agree principles that are flexible enough to adapt to future developments. For example, if a regulation is administered by a tax authority, should the tax function have the final sign-off? If not administered by a tax authority, should that fall to sustainability, finance or legal teams?

In developing these principles, it is generally preferable to integrate them into existing frameworks that can be modified or extended, rather than introducing new standalone processes.

Stage 3: Design policies, processes and controls in alignment with the principles

Take the time to develop and secure agreement for a cross-functional RACI matrix (allocating Responsibilities and Accountabilities, and determining which functions need to be Consulted or simply Informed).

How will new regulations be monitored and incorporated into the RACI? Consider the resources needed to deliver on the framework: will these be in-house roles or require outsourcing in whole or in part?

Critically, consider the associated technology roadmap. Much of ESG regulatory compliance will become a data challenge. Many data sets will overlap – for example, plastic taxes with extended producer responsibility (EPR) requirements; or Taskforce for Climate-related Financial Disclosures (TCFD) Scope 3 with science based targets (SBTi) and CBAMs.

Typically, it is advisable to use an approach that aligns with the technology function's existing strategy. This will often adopt a holistic approach to data warehousing, gathering and wrangling, rather than working on a point by point solution basis, ensuring fewer inconsistencies and more efficient processes.

Stage 4: Implement the sustainability tax operating model

You should take the following steps:

- roll out the policies and controls;
- ensure that staff are appropriately trained;
- incorporate key performance indicators (KPIs) into your goals and objectives; and
- adopt the technology solutions – will these be bought in or built internally?

Ask internal audit to periodically verify that the processes and controls are effective and refine and iterate the model as necessary over time.

Sustainability tax operating models

As indicated above, there is no ‘one size fits all’ answer. However, a robust response to developing a strong sustainability tax operating model will likely involve a high-degree of cross-functional collaboration. A number of illustrative models that work well in practice are described below.

Illustrative Model 1: Tax led, local responsibility

This model has been applied by a group that adopts a decentralised approach, given its independent divisions. The tax group sets out the RACI matrix (in conjunction with other functions) – preferably, a handshake or even a written ‘contract’ such as a service level agreement with KPIs.

However, the responsibility rests with local tax or finance teams, supported by advisors as needed for compliance. The cross-function business partnering is facilitated by an ESG committee chaired by the sustainability function. Tax plays a role and has a seat at the table together with legal, HR, finance, IT and strategy.

The technology architecture is fragmented as a result of the divisionalised model. This lends itself to a local model, with local teams gathering the required data, supported by advisors.

Illustrative Model 2: Sustainability led, central responsibility

This model adopts a much more centralised approach, which in this case happens to be led by the organisation’s well-resourced sustainability function.

That team tracks new ESG regulations and highlights them to other functions. ESG tax responsibilities are clearly divided between the tax and sustainability functions: sustainability takes accountability for pseudo-taxes; whereas plastic packaging tax and other ESG tax compliance is led by tax.

The sustainability function uses advisors to support it with its pseudo-tax compliance, whereas the tax function uses a shared service centre for compliance, whilst maintaining central oversight and sign-off. Business partnering is led by the sustainability function – in conjunction with a team of cross-functional champions. The sustainability function manages the data gathering for its compliance internally, although the process for CBAM is more fully outsourced.

Illustrative Model 3: Legal/risk led

A legal and risk driven approach is rarer in practice. It is more common in US groups, where the legal function often has wider remit and resources, particularly around cross-border trade compliance and in responding to legal regulations.

The ESG regulatory responsibilities are divided by the risk function in accordance with a global risk-control framework. Multiple functions are involved in supporting the controls and the associated compliance. Risk monitors compliance with agreed functional KPIs through software.

Conclusion

The models described here are simply examples of operating models within a wide spectrum of different approaches. Every organisation is different, so every organisation’s approach will be different.

Whilst there is no single ‘right’ approach, there are wrong approaches. Ignoring the issue or adopting siloed responses without cross-functional interaction will not work well in the long term.

Ensuring our sustainable future will require radical collaboration. It is incumbent on in-house tax teams and the wider tax adviser community to first educate themselves, and then educate their colleagues in other functions of how tax interconnects with sustainability regulations. By collaborating together we can build the sustainable future we need.

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