ESG and asset management: Tax in the picture

Keeping ESG's tax implications in the investment conversation

It's no revelation that environmental, social, and governance-related (ESG) factors are dominating asset management conversations. Nearly every industry representative surveyed for KPMG's 2021 Asset Management Opportunities and Risks report recognizes that ESG-related products are in high demand.

73% are currently offering some form of ESG strategy to investors.[1] Moreover, ESG products rank in the top five focus areas of half of retail investors and a third of institutional investors.

Still, an important but often overlooked aspect of the ESG conversation are the tax implications within its environmental, social, and governance pillars. Identifying these tax implications and assessing their relative importance is key to meeting investors' increasing demands.

For example:

- **Environment.** Tax implications in this pillar may include carbon taxes paid or credits purchased, green tax incentives, and tax policies to influence taxpayer behaviour. For example, Canada's 2021 Federal Budget proposed to enhance capital cost allowance for clean energy equipment and reduce the tax rate on zero-emission technology manufacturing and processing income.[2]
- **Social.** This pillar includes increased public awareness of taxes and public perception of taxpayers' "paying their fair share." These trends predate the COVID-19 pandemic, as demonstrated by the Organisation for Economic Co-operation and Development (OECD) base erosion and profit shifting (BEPS) actions released in 2015. Still, we expect the focus on fairly allocating tax base and combatting tax abuse to continue, as governments seek to raise revenue to offset pandemic deficits.
- **Governance.** The governance pillar includes increased board level responsibility for tax behaviour, greater tax disclosure and transparency, and scrutiny of arrangements put in place solely to minimize taxes. The UK, for example, requires large businesses to publish their tax strategies, including how they manage UK tax risks and their attitude towards tax planning. Responsible tax behaviour is now recognized as a component in investment sustainability.

Investors are increasingly making decisions based on ESG tax issues. Norway's Government Pension Fund Global, for one, is now directly engaging with issuers on tax transparency and disclosure issues and has divested investments due to a lack

1 KPMG, 2021 Asset Management Opportunities and Risks Report, October 2021.
2 KPMG, 2021 Federal Budget Highlights, April 2021

of transparency.[3] Elsewhere, a group of Danish pension funds has adopted a tax code of conduct that outlines how their external asset managers are to act with respect to tax issues and attempts to draw the line between acceptable and aggressive tax planning.[4]

Governments are also increasing demands for tax transparency and reporting. Canada's 2021 Federal Budget includes proposals for additional trust reporting, which is applicable to some investment funds, and for the mandatory disclosure of reportable transactions, notifiable transactions, and uncertain tax treatments. At the same time, international tax initiatives such as the OECD BEPS 2.0 Pillars One and Two are proceeding with tremendous pace, and the scrutiny of entities that avoid tax nexus via digital commerce or take advantage of low-tax jurisdictions is growing.

> In short, the topic of ESG in asset management can no longer be tabled without awareness of the tax issues therein. It's a lot to take in, but the asset management community has a knack for adapting.

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Moving ahead, preparing to address ESG tax considerations will mean:

- **Embedding tax into the screening/investment decision-making and monitoring processes for ESG funds.** This can be cumbersome for funds that actively select or screen particular investments based on ESG factors, rather than passively relying on indexes. This might also be a change of pace for managers who don't typically include tax knowledge as part of their review of potential investments. Still, those who build tax considerations into the screening and investment decision-making portfolio management process will gain a competitive advantage.
- **Including tax in your ESG "story."** Telling a fund's story is one thing, but telling one that demonstrates an awareness of ESG tax issues and related business opportunities will be more attractive for investors. After all, ESG is a complex and evolving topic, and there can be tension between the tax issues in different pillars. For example, a green tax incentive intended to drive environmental outcomes might reduce an issuer's cash taxes paid, giving rise to a lower effective tax rate. As such, an investment manager would need to understand and balance the environmental and social impacts in applying its investment selection criteria. This context is critical to explaining how tax fits into the fund's ESG story.
- **Including tax in discussions with issuers.** Investors and managers should demand increased board accountability for tax governance, enhanced tax policies and risk frameworks, and improved disclosure of tax data.
- **Enhancing and evaluating sources for data on ESG tax issues.** Historically, publicly available tax data wasn't much more extensive than the provision for income taxes and effective tax rate. While some issuers and rating providers are now publishing more detailed tax information, gathering accurate and reliable data on ESG tax remains an ongoing challenge.
- **Monitoring the tax policy landscape.** Canadian and international tax changes are occurring at a rapid pace. Canada's Department of Finance is addressing a significant backlog of proposed tax legislation, while also consulting with stakeholders on a wide variety of issues, and responding to international tax initiatives.

3 Norges Bank, Tax and Transparency Expectations Towards Companies, April 2017; Norges Bank, Introductory statement by CEO Nicolai Tangen before the Standing Committee on Finance and Economic Affairs of the Storting, October 2020.
4 Pension Danmark, Tax Code of Conduct, December 2020.

Meanwhile, international initiatives like BEPS 2.0 are proceeding on pace. Staying competitive and keeping investors content requires asset managers to keep these developments on their radar.

It's clear today that investors, issuers, and regulators alike are sharpening their focus on ESG tax issues.

As we've seen in Europe, ESG tax issues can directly impact investment decisions. Surely, as with any industry evolution, the time for Canadian investors and asset managers to get ahead of change is now, rather than later.

Ready to lead the ESG conversation? KPMG's Asset Management group is ready to help investors and asset managers prepare for the future.

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