Sustainability and the Evolving Value Chain

Tax Considerations for Business

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Sustainability and the impact on tax: Overview

This publication is a follow up to the KPMG article entitled **Getting to Know the Value Chain Analysis**. In that article, we discussed how value chains are evolving to meet the ever-changing needs of the customers, the role of digital transformation across the organization, and the overall impacts of the rapidly changing geopolitical and tax/regulatory framework. Those factors are causing companies to re-examine how they have historically structured their supply chains and, in many cases, to make significant changes from an operational and tax perspective.

This article shines a spotlight on sustainability, the broad framework under which the concepts of environmental, social, and governance (ESG) practices of a company are captured, and how such practices are companies' ability to continue creating value.

ESG issues have long been on the radar of various stakeholders such as business leaders, investors, and regulators. These issues have been highlighted and accelerated through the COVID-19 pandemic. We continue to see a wide range of responses to ESG, with many companies extremely focused on ESG and others less so. Overall, we continue to see increasing interest and focus across industries towards ESG. ESG issues are starting to form the core pillar over which many organizations are increasingly structuring their business, thereby impacting every key function within the organization, right from the front-end to the back-end of the value chain: product/service development, customer engagement, marketing, recruitment, hiring, promotions, and the structuring of day-to-day operations (i.e., performance targets, travel policy, remote work, etc.).

As discussed in more detail in **Getting to know the Value Chain Analysis**, it is very likely that these core, fundamental changes to the way companies are starting to create value for their stakeholders could change the way companies think about their existing tax structures and their underlying transfer pricing models.

In our experience, every tax department is trying to achieve three key objectives as they adapt to these new structures/transfer pricing models:

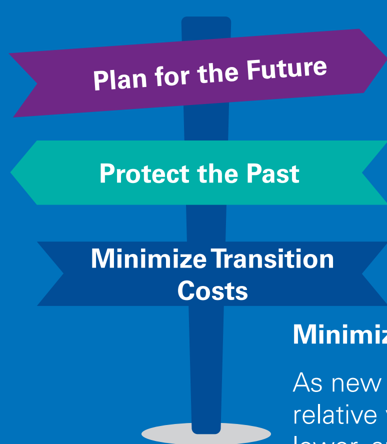
1. **Plan for the Future**: Build a structure(s)/model(s) that works for the evolving value chain.
2. **Protect the Past**: Document how the prior structures/models were appropriate for the value chain that existed prior to the current changes.
3. **Minimize Transition Costs**: Proactively manage the impact of the growing impact of ESG as new value drivers are identified/established, and the likely relative value of older value drivers (i.e., IP/assets) decreases.

Build for Future

Build structures/models that works for the evolving value chain.

Protect the Past

Document how the prior structures/models were appropriate for the value chain that existed prior to the current changes.



Minimize Transition Costs

As new value drivers are established, it is likely the relative value of older value drivers (i.e., IP/assets) is lower, and in some cases, could be non-existent.

For tax departments at companies that are becoming more ESG focused, it is imperative to work closely with the business, corporate leadership, functional and cross-functional leadership, and business unit leadership, among others, to get a full understanding of the changing dynamics of the business environment: how the business is changing, who is driving those changes, where are they being driven from, and how they are changing the concept of value creation from the perspective of all stakeholders (i.e., customers, investors, employees, communities, etc.).

It is only through gaining a deep understanding of these changes throughout the enterprise that a company can not only adequately adapt its tax structures/transfer pricing models accordingly (i.e., Plan for the Future), but also to help reinforce the accuracy of the previous structures/models as it operated prior to the changes being documented in the value chain assessment (i.e., Protect the Past). A properly articulated value chain analysis (VCA) can also help minimize any tax costs of the transition by appropriately assessing the value of any "old" IP/assets that may be transferred to better match the business/tax alignment of any new created tax structures/models (i.e., Minimize Transition Costs).

II Sustainability and the evolving value chain

Changing Role of Business – the Long View is Upon Us

The role of the corporation in society is an abstract, politically polarizing question that has not historically been high on the priority list of most organizations. Yet, embedded in this question are strategic and operational issues critical to not only the long-term sustainability of our current social and economic model, but also to the long-term value creation opportunities of individual organizations operating within those models.

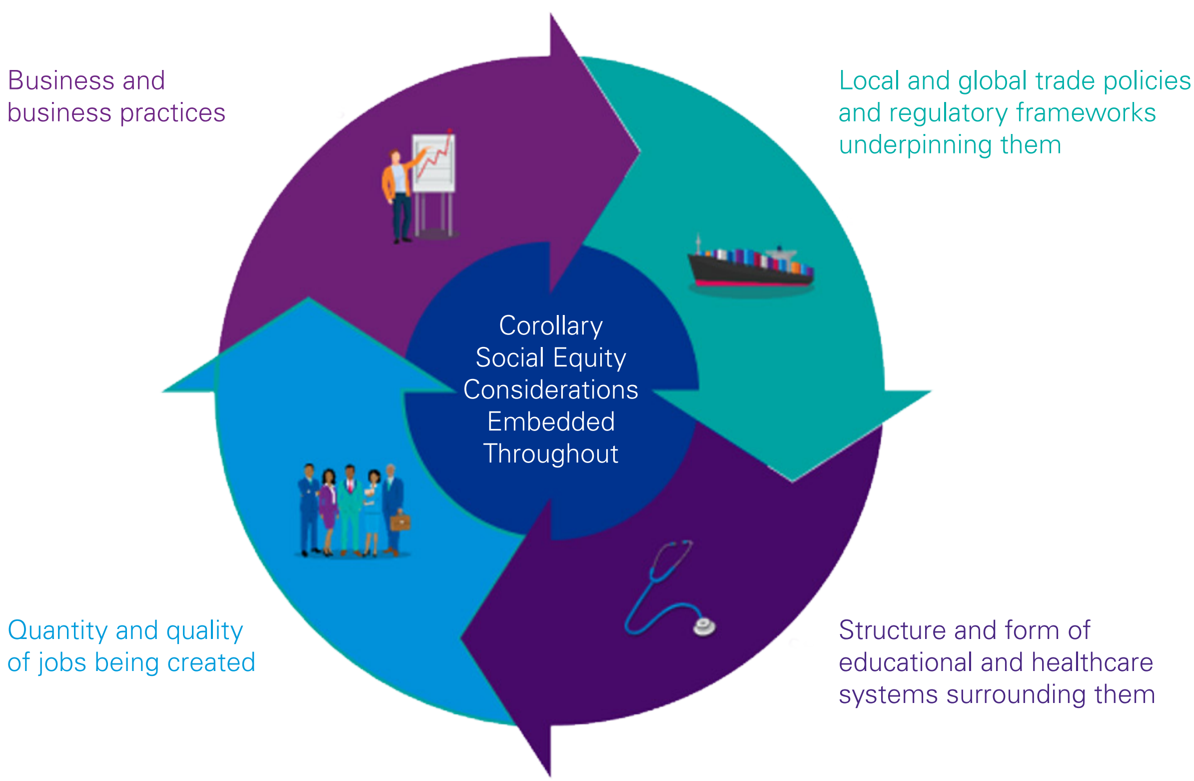
And that's because it's not just business that is being impacted by the outcome of this question. A broad swath of constituents has come to recognize the interdependency between:

— business and business practices,

— the local and global trade policies and regulatory frameworks underpinning them,

— the structure and form of educational and healthcare systems surrounding them,

— the quantity and quality of jobs being created, and the corollary social equity considerations embedded throughout.



More and more of these constituents now recognize the role these interwoven institutions play in the health of the planet. From investors to consumers to employees, communities and other stakeholders that have long been absent from consideration of the legal fiduciary obligations of boards/management teams – there is now a broad consensus arising on the need for business to have solid and actionable plans to not only report on, but to address issues concerning the environment (i.e., climate change), social equity issues (i.e., worker safety, workplace diversity, etc.), and good corporate governance practices (i.e., executive compensation, board composition, etc.) to ensure the proper alignment of corporate priorities.

Many of these issues fall under the now widely accepted label of Sustainability, the framework for a broad set of issues falling under the ESG categories.

The ESG Framework

As noted above, ESG refers to a framework to integrate environmental, social and governance risks and opportunities into a firm's strategy to build long-term financial sustainability and value creation. In other words, ESG strategies can help companies achieve long-term sustainability, drive economic vibrancy, and deliver long-term value through effective engagement with all stakeholders.

ESG critical components

ESG and Company Value

Even before the COVID-19 pandemic, as noted above, a broad coalition of stakeholders were coalescing around the importance of ensuring that organizations embed Sustainability considerations into the way they operate. For some industries, such as energy, natural resources, chemicals, and manufacturers of plastics/other non-bio-degradable materials, the move to more environmentally friendly alternatives may represent an existential threat to their core business. For others, the threat may have been more around their operational footprint compared to peers who are incorporating or have incorporated more sustainable business practices into, for example, their supply chains, the diversity of their workforce, or how well they are executing against their net carbon neutral targets.

A lot of the initial pressure around these issues was driven by a handful of institutional investors/funds and the regulatory bodies looking to improve disclosures. These institutions recognized that poor ESG practices presented environmental, legal, and reputational risks that could damage the company and the bottom line and that positive ESG practices could very well contribute to improved company performance.

The SEC announced its regulatory agenda on June 11, including plans for proposals on disclosures related to climate change, human capital (including workforce and board diversity), and cybersecurity risk governance. Based on recent remarks, proposed rules on these topics are expected by early 2022.

Chair Gensler has asked the SEC staff to explore whether the proposals should require the disclosures to be made in the Form 10-K and to consider including requirements to disclose specific metrics. There appears to be a real focus on consistency and comparability, which would highlight the importance of data integrity. If a decision is made requiring disclosure in the financial statements of one or more of these items, such disclosures could be subject to a company's internal controls over financial reporting (ICFR), which would need to be evaluated by management, and in some cases by a company's financial auditor. There have been no direct public comments on when these potential regulations might ultimately be effective, but it is possible that certain new disclosure requirements could become effective for 2023 calendar-year reporting periods.

The SEC's agenda and various statements that have been made provide an indication that the SEC sees issues related to ESG risks as having the potential to be material information that is important to investors such that they warrant disclosures in a company's public filings.

From an investor/market perspective, Blackrock CEO Larry Fink in his January 2021 CEO letter declared that investors in mutual funds and ETFs invested $288 billion globally in sustainable assets, a 96% increase over the whole of 2019. Broader equity markets are also paying attention. Fink went on to state that the vast majority of sustainable indices outperformed their parent benchmarks, and even more, within industries, companies with better ESG profiles outperform their peers, appearing to benefit from a "sustainability premium."

Whether this "sustainability premium" is sustainable is still an open question, but it has become evident that investors, financial markets, and even financiers are increasingly shifting their investments towards ESG focused companies. This shift can be evidenced by the rapidly expanding green bond markets. According to the Climate Bonds Initiative over $1 trillion in green bonds have been issued since their creation in 2007, and over $269 billion in green bonds were issued in 2020. Just five years prior, the green bonds issued in 2015 only totaled $45 billion.

We are still in early stages of the ESG journey. Nonetheless, we are already seeing a "sustainability premium" being enjoyed by certain ESG leaders. For some this premium appears based on the fact that they have not only recognized the importance of incorporating ESG into the overall core strategy of their businesses, but also have been able to develop a set of actionable targets and investment plans to meet those targets that they've been able to translate into financial performance targets. Others have earned this premium for making such claims around ESG and showing non-financial ESG achievements. And other companies have received a sustainability premium for merely acknowledging the importance of ESG and making claims about their strategy without demonstrating any specifically identifiable impact to date. In the long run, however, like any other set of targets, we do expect that ultimately the question of sustainability (pardon the pun) of the "sustainability premium" will come down to an individual company's ability to execute and earn returns from their ESG investments.

The above view was re-affirmed in a recent KPMG report released at the end of 2020. In a joint report co-published with Eversheds Sutherlands titled **Climate change and corporate value: What companies really think** we found that, of the over 500 directors and executives surveyed, 78 percent believed that managing climate-related risks will be a key factor in keeping their jobs over the next five years, and 74 percent agreed that decarbonizing their organizations requires significant changes to the business.

In a more recent March 2021 KPMG Pulse Survey of over 500 global CEOs, 91 percent of those surveyed indicated that the U.S. re-entering the Paris Climate Agreement would cause their company to have more stringent ESG practices, while 79 percent want to lock-in the sustainability and climate change gains they have made during the pandemic.

How are companies unlocking ESG value

Companies are unlocking ESG across their entire value chain. The change is coming from the top and is being driven through all parts of the business. Investors are making decisions to invest, divest, or choose affirmatively to not invest in companies based on, amongst other factors, whether a company meets whatever ESG criteria the investor adheres to. We are not just talking about one or two individual tree-hugging shareholders. ESG-based investment decisions are increasingly common among some of the largest institutional investors, many of which have been quite vocal about what they are doing and why.

Boards have reacted in kind. For years companies have increasingly begun to issue sustainability reports and such reports have continued to become more and more robust, sometimes solely out of the desires of the company and sometimes driven, at least in part, by the metrics and KPIs set by various investors or by non-government organizations (NGOs) who purport to set standards in the emerging area of ESG. Boards are setting goals and KPIs around ESG from carbon footprint to travel and worker models, from responsible tax to labor practices at vendors. And there are new players within many organizations as a result of this march towards Sustainability. Chief sustainability officer. Chief Diversity Officer. Zero-waste program manager. Social compliance analyst. Solar operations surveyor. LEED (Leadership in Energy and Environmental Design) analyst. These are all job titles that exist today and are increasing in number every day. None of these roles existed five years ago.

Companies are establishing aggressive targets to reduce their environmental footprint across climate, water, and waste which in turn require significant changes to the way companies operate and do business. In order to meet such aggressive environmental targets companies will be required to make changes at every step in their value chains, such as:

- Supply base and supplier locations: With what suppliers do I want to do business? Where are they located? What exposure does that introduce to my operations?
- Manufacturing footprint: Where should my manufacturing assets be located? What should each facilities' mission and purpose be (e.g., complex plants dealing with low volume/high variability versus basic and stable plants dealing with high volume/low variability)?
- Distribution locations and partners: Where should my distribution hubs and centers be located? How is my distribution channel location influenced by my supply base and manufacturing footprint?
- Procurement structure and approach: How centralized or decentralized should my procurement function be? To what degree should exposure be maintained with respect to one or a few prime vendors or key geographic source locations? How do I manage information about, and conduct of, the vendors of my vendor to achieve my ESG goals? Does an international purchasing organization structure make sense?
- Insourcing versus outsourcing approach: Whom should I entrust to manage and execute different portions of my supply chain and operations? Are my internal costs and performance better or worse than an external partner's? Am I doing things that I shouldn't?

From our perspective, these areas of assessment and initiative will be significant levers of cost management, revenue stability and growth, and profitability. Given an uncertain future, they will also form the foundation for long-term supply chain resilience, whatever form disruption takes.

Given the significant opportunities and risks associated with ESG, companies that excel at identifying and incorporating these issues into their strategy will enjoy a competitive advantage in the marketplace.

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From a tax perspective, there is great variance as to when the value from ESG will be evident and, thereby, result in profits. For some companies, there is an almost immediate creation of value. For example, a company that engages in certain ESG changes may qualify to bid on certain projects that otherwise would be closed to them – the revenue created is an immediate benefit. Likewise, a company that reduces operating costs as a result of an ESG-inspired innovation around packaging creates immediate returns. Additional value creation is expected in the form of some "quick hits" and some mid-term horizon investments. But perhaps the biggest components of value, for many companies, is expected to be generated over a longer timeline as ESG initiatives change the shape of the organization, its core IP, its brand image—all of which evolves, sometime synergistically, as a result of ESG activities in the organization. Some value will be created over a few years, and indeed some may take a decade until it is realized. This dramatically increases the complexity associated with transfer pricing for ESG as we see a bundle of activities creating a portfolio of value with wildly different lives.

IV Current state of sustainability in an organization

Every industry has had its own perspective on how to approach ESG priorities. Companies within the same industry group may also have a different emphasis on priorities. It is not uncommon to see certain ESG goals driven by the supply chain organization while other programs directed at employees driven by the human resources organization under the guidance of the Chief Human Resources Officer (CHRO). Separate innovation goals may have been identified and driven by the Chief Innovation Officer (CIO) for the R&D function. The Office of General Counsel (OGC) may be engaged in designing, negotiating, reviewing, and enforcing legal contracts with the suppliers with explicit ESG commitments. Leaders of internal lines of business (LOBs) are devising and implementing their LOB specific goals. Last but not the least, in certain organizations a Chief Sustainability Officer (CSO) may have a role specifically focused on reporting the company's efforts to the external stakeholders. Some companies have started to broaden the coordination between different functions by engaging employees in idea generation and implementation through the "incubator" process to further incremental ESG efforts.

ESG activities are taking place across the entire value chain. Some commonly seen examples include:

- The sourcing team may be developing new vendor selection and certification criteria to meet an ESG goal or to reduce ESG related risk created by over-reliance on climate-risky supplier bases.
- The finance team might be developing and implementing a responsible tax program.
- A research and development (R&D) team may be engaging in a whole host of innovation around testing new materials that could be effective replacements to existing inputs.
- The sales team may be working with customers to understand specifications/requirements for the next generation of products and services that help the company stay competitive with its customer base.
- Health and safety function may have developed key priorities that directly impact the safety of the employees.
- A real estate management team may select a green office building for a new office rental, while a related human capital team might develop alternating work assignment models for use in such new office that reduce necessary space in order to aggregate commute time and total carbon footprint.
- Internal audit function may be engaged in compliance audits of various internal departments of the company as well as external vendors around ESG commitments.

The growing emphasis on ESG is motivating companies to take a holistic look at the entire organization and develop an enterprise-wide program that integrates the efforts across every function with the organization. These programs are organized typically from a governance perspective as follows: (i) oversight board - responsible for guiding and reviewing the entire organization's efforts around ESG and communicating with the external stakeholders; (ii) leadership team - responsible for developing and directing an enterprise-wide strategy; and (iii) execution teams - responsible for day to day execution of the strategy.

V

Ideas on capturing new sources of value from a tax perspective

As mentioned above, as companies mature in their ESG journey we are already seeing the seemingly natural centralization of components of ESG. Not centralization of all the "arms and legs" that are designing and executing at the functional levels, but centralization of teams, often including a CSO or similar lead, and personnel in various roles helping to formulate and drive the ESG strategy. This critical mass of leaders is increasingly responsible for the key decisions around ESG strategy, funding, and measuring outcomes. Some companies are already thinking about ESG as a pillar of who they are, but also as a value driver in the big picture sense – something that is a big part of every dollar they make and everything they do. Such companies are also trending towards thinking of these leaders as a virtual ESG hub, often in different locations and different parts of the business.

ESG Hub

Some astute finance teams are acknowledging this value creation and considering whether and how this creation of new value could create risks around transfer pricing. Some forward thinking companies are already considering whether this ESG leadership team is effectively a virtual value creating hub. Once a company identifies and acknowledges such potential value creation, the appropriate response may be to treat a value hub - where the value is related to sustainability - no differently than a hub within the organization that creates value of other kinds, such as sourcing category management, manufacturing excellence or cyber. Similar to other components of value creation, transfer pricing rules apply under which the ESG Hub would earn an arm's length profit which would vary depending on the facts. The remuneration could be cost plus, or could be something more under the right circumstances. While we often talk about ESG value, as if it is a magical thing, separate and apart from the company's other IP, it is indeed more complex. In a typical organization, the value creation resulting from ESG initiatives and action can create new and distinct intangible assets, but it also adds value to existing assets – brand, workforce in place, supply chain intangibles just to name a few. This does not in any way diminish the efficacy of an ESG Hub but does hint at the complexity involved in delineating where value is created and where profits should be earned under transfer pricing rules.

For companies whose ESG head sits in the U.S., the "good" (for lack of a better term) tax answer is often building around such U.S. value. Growing trends around transparency, reputation, and alignment to business are combining with fast evolving global tax and transfer pricing rules to make the U.S. a fine choice for these models, oftentimes including the tax answer part of the equation.

Innovation Hub

ESG impacts companies in so many different ways. Many of the impacts are really triggers towards innovation. A company offering cloud service declares they will be carbon neutral by year X, even though with current best-in-class technology running server farms drives outsized carbon usage. A shipping company's drive toward zero emissions leads it to acquire an electric vehicle start up to move their development in a direction to support the company's own shipping asset needs. This list is long. Companies trying to achieve ESG goals can only achieve these by innovating. And the innovation is not limited to product R&D. The innovation is across procurement, materials science, human capital, and the rest of an organization.

Before the rise of ESG, it was common for leading companies to leverage one or more Innovation Hubs, global or regional wide hub-based models built around one or more groupings of innovation enhancing value not just in products but in delivery, customer experience, and operations. Innovation Hubs commonly include innovation around products, production process, customer experience, commercial models, sourcing, etc.

In the modern ESG-focused world, the value of innovation is at an all-time high with an increasing quantum of such innovation being driven by ESG related goals. As a result, we expect an increase in the number of companies leveraging models such as the Innovation Hub to operate more effectively in reaching their innovation objectives.

When structured properly, an Innovation Hub, aligned with operations, that delivers innovative products and solutions driving increased revenue or reduced costs may also deliver meaningful tax savings, enhancing the overall impact of the Innovation Hub to the organization.

Digital Center of Excellence

A substantial portion of the innovation driven by ESG is of a digital nature. Companies looking to reduce travel need to be more effective in their technology to stay close to customers. Enhanced CRM and connectivity tools matter, although most of that is adequately handled with off the shelf products. However, often the most high-value components include enhanced **user interface** and **connectivity** to create frictionless sales and deep interactions with vendors while consumers remain in house. Smart factories leverage robotics, internet-of-things (IOT) and artificial intelligence to reduce carbon footprint while increasing effectiveness. Enhanced data and analytics models allow companies to better assess vendors and alignment to ESG standards. All of this and more, triggered by ESG, is delivered through digitalization.

Local Operating Entities

— Use software and other digital assets received from DCOE in their regular business

Developers, Coders, and Scrum Teams

— May sit with the DCOE or anywhere in the world
— Provides development and technology services to the DCOE

Digital Center of Excellence

— Manages strategy, budgets and decision making related to digital assets
— Manages certain functions, assets and risks associated with the development and release of software and other digital assets
— Provides software, algorithams, and other technology to the Local Operating Entities

A common way that companies (especially companies that are not traditional technology companies) have for years managed components of their digitalization is to use a governance model such as a Digital Center of Excellence (Digital COE). A Digital COE typically involves ring fencing components of a digital model to create an operating benefit such as enhanced alignment to a single global strategy, increasing visibility and quality in an agile development model without losing the "agility" of such models, or optimizing your human capital strategy. The flavors of Digital COEs vary with design dictated by business needs from data and analytics hubs to cyber hubs. A Digital COE could operate as a digital service model or could take the form of the now common model focused on locating a "release lab" function in the Digital COE along with key functions that qualify as DEMPE - development, exploitation, maintenance, protection and enhancement, into a model that aligns with business and delivers tax risk mitigation or tax benefits. For example, a U.S. multinational company with significant market jurisdiction profits earned at a high tax rate and expectations that foreign tax will only go up as a result of BEPS 2.0 that has significant digital DEMPE in the U.S. might build the governance around its operations to formalize a U.S. situs Digital COE which would produce vvthe general limitation foreign source income basket for foreign tax credit purposes, which could be advantageous. Alternatively, many U.S. multinational corporations operate today with an offshore Digital COE whose income from managing global (inclusive of U.S.) digital assets results in GILTI income in the hands of the Digital COE, often subject to a lower rate of tax than the operating affiliates that use the created software in the U.S. and higher taxed foreign countries.

Digital COE models have been used successfully for years, and we are already seeing increased application of them in contexts motivated in whole or part by ESG.

VI Considerations for the future

As companies navigate the world post-COVID, the Chief Tax Officers (CTOs) are starting to grapple with at least three major issues that directly impact tax: (i) business transformation, (ii) regulatory changes, and (iii) the global economy. ESG is at the intersection of all the above priorities and has quickly become one of the urgent discussions at the corporate table, including with the Board given the push from investors. It is a topic that cannot be ignored even for tax, as CTOs are discovering. CTOs must give careful consideration on how to present, and exactly what information to include in, the tax narrative which is not all about governance. Tax policy can be used to advance environmental and social goals as well, with opportunities such as environmental tax credits and the low-income housing tax credit. As CTOs are strategizing their approach and formulating philosophy, broad thinking can be beneficial. What's the tax picture when all taxes paid by a company are included, not just income taxes? Is the cash ETR lower because of credits which meet social or environmental goals or other reasons that can twist a low rate into a positive story? Are there compelling stories to tell based on location, activities, and rate of tax? Does the ETR, or tax in any way, affect executive comp/bonus? Did the company forego any COVID-19 tax benefits due to social reasons?

It is important for CTOs to recognize that this is just the beginning of a long journey where the changes occurring within and without their organization around ESG will have profound impacts on the tax function - from managing risks to compliance and report to creating vehicles to capture newly created value. While the journey is long, the key today is to take that first step and begin assessing where the company is today and where it might head tomorrow.

Contact the authors

Anjit Bajwa
Principal, Tax
Economic & Valuation Services
T: 713-319-3759
E: abajwa@kpmg.com

Paul Glunt
Principal, Tax
International Tax - Value Chain Management
T: 949-885-5759
E: gpaulglunt@kpmg.com

Jerry Thompson
Principal, Tax
International Tax - Value Chain Management
T: 949-431-7334
E: jerrythompson@kpmg.com

Daniel Whipple
Manager, Tax
International Tax
T: 949-431-7334
E: dwhipple@kpmg.com

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