

# Tax governance as part of ESG framework 3/45/23



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To embed sustainability aspects in its core business, an organisation should be aware of effects it has on the environment and on its stakeholders, as well as how the environment and stakeholders affect its business. Embedding sustainability aspects in business is a process that encourages the organisation to revise its business model and overall strategy, as well as gathering and analysing data for use in decision-making to identify and mitigate risks affecting it. This article offers a brief overview of the sustainability or ESG framework, focusing on “G” for governance. We are zooming in on tax governance as a sustainability aspect that we encourage organisations to embed in their core business.

## ESG components

The ESG framework rests on three pillars: “E” for the environment, “S” for social factors, and “G” for governance.

The “E” pillar covers various aspects, such as:

- Climate change
- Greenhouse gas emissions
- Biodiversity and ecosystems
- Pollution
- Water consumption
- Waste management
- Circular economy

The “S” pillar focuses on people and on effects an organisation has on people. This covers aspects such as own workforce, workers in the value chain (suppliers and their workers), affected communities, consumers and end users. The “S” pillar not only covers human rights and labour rights but provides a wider perspective – diversity, equity and inclusion is a key component of the “S” pillar.

The “G” pillar covers, for instance, governance structures, remuneration policies, compliance rules, prevention of conflicts of interest, avoidance of corruption risk, and supplier relations. Tax matters are included in the “G” pillar, as well as affecting environmental and social matters. For the purposes of this article, however, we focus on taxation as a component of the “G” pillar affecting sustainability.

## Taxation and sustainability

### *Why is this important?*

According to the State Revenue Service (SRS), the national social insurance gap of EUR 584.2 million in 2022 would have been sufficient to increase maternity, paternity and parent benefits 3.4 times.<sup>1</sup> A tax gap is the difference between (1) the amount of tax that was meant to have been paid had it been properly charged and reported, and (2) the tax actually paid. This is the potential impact from a single tax if that had been reported and paid correctly. This means an organisation can be sustainable only if it has zero

tolerance of the shadow economy and has tax risk management procedures in place.

*What matters should organisations consider to become tax-sustainable?*

The OECD Guidelines for Multinational Enterprises on Responsible Business Conduct state that it's important for organisations to invest in national budgets and meet their tax obligations on time (in particular complying with the laws of countries they operate in).

The guidelines explain that abiding by the law essentially means understanding and following the lawmaker's intention – this does not mean an organisation should be overpaying taxes in excess of statutory amounts.

Organisations are encouraged to perceive tax risk management and tax compliance as a key element of their risk management system. The board should adopt a tax risk management strategy to identify and mitigate tax-related financial and reputational risks.

Other countries, such as the UK, require organisations meeting certain criteria to develop and publish a tax risk management strategy.<sup>2</sup> In Latvia, only a small circle of taxpayers – gold members of the Advanced Cooperation Programme – are required to adopt a tax risk management policy, but they are not required to publish it. It's also unclear whether having a tax risk management policy or a tax governance strategy in place will score an extra point under the SRS's new taxpayer rating scheme.

Whether or not a country makes a formal requirement for organisations to develop a tax governance strategy, we urge organisations to treat paying taxes responsibly and monitor their suppliers for tax compliance.

This article has been prepared following the launch of season 2 of PwC ESG Academy's series of webinars. If you want to learn more about sustainability topics, you can sign up for our webinars via this link.

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<sup>1</sup> Source: "Unreported wages (cash in hand) for workers covered by the general tax regime and the resultant tax gap in 2022", an SRS presentation of 2023

<sup>2</sup> Source: PwC's study "Tax transparency and sustainability reporting in 2023"