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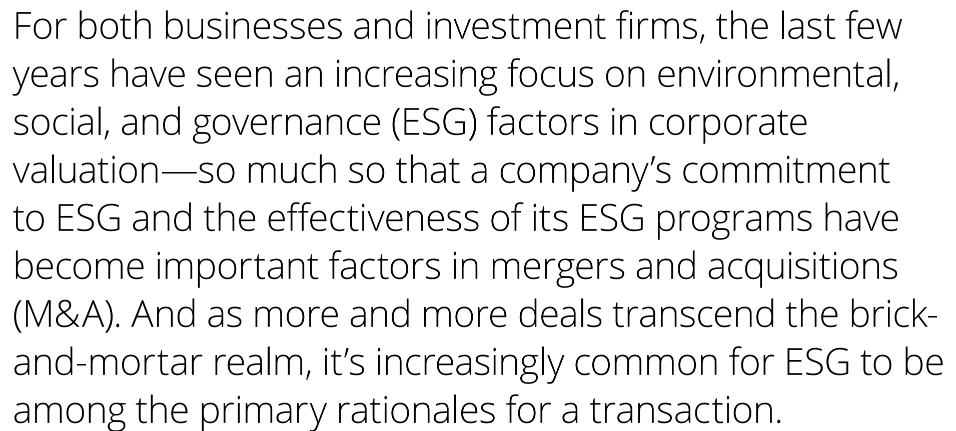
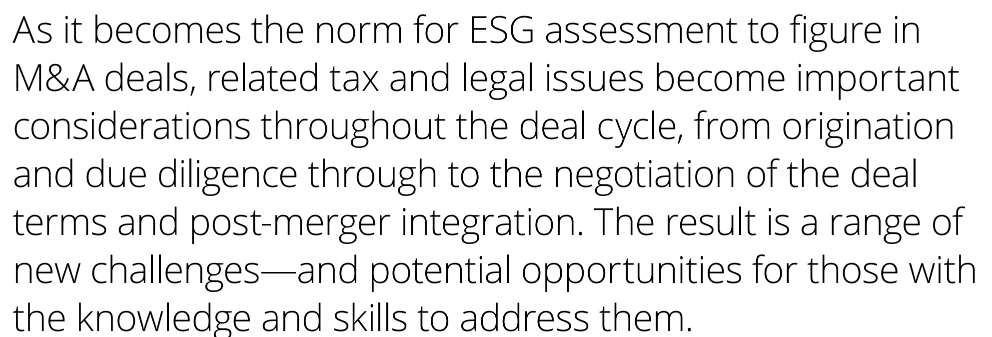
Understanding the tax aspects of ESG in M&A



For both businesses and investment firms, the last few years have seen an increasing focus on environmental, social, and governance (ESG) factors in corporate valuation—so much so that a company's commitment to ESG and the effectiveness of its ESG programs have become important factors in mergers and acquisitions (M&A). And as more and more deals transcend the brick-and-mortar realm, it's increasingly common for ESG to be among the primary rationales for a transaction.

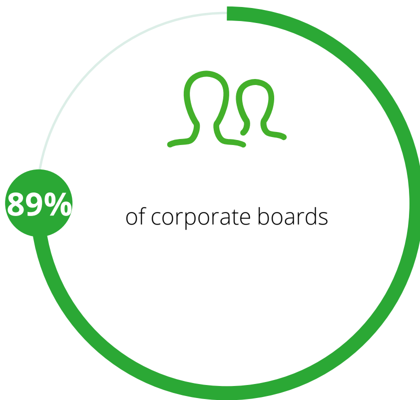


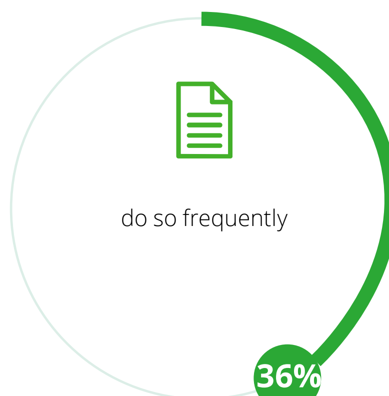
As it becomes the norm for ESG assessment to figure in M&A deals, related tax and legal issues become important considerations throughout the deal cycle, from origination and due diligence through to the negotiation of the deal terms and post-merger integration. The result is a range of new challenges—and potential opportunities for those with the knowledge and skills to address them.

This article explores ESG's impact on the M&A lifecycle, and its growing influence on how deals are done. It then addresses the associated challenges from a tax standpoint, including those which are related to the due diligence process, and the critical role of tax leaders in managing ESG metrics throughout the M&A lifecycle.

ESG's rising importance in M&A

A recent Deloitte client survey[1] exploring the evolution of capital allocation strategies among global businesses underscores the continuing momentum towards ESG:





The reason for this interest is clear: Successful ESG initiatives are increasingly viewed as value drivers. We found that 65% of businesses believe that ESG boosts enterprise value, while 40% see it as a competitive advantage with the potential to create value. And higher M&A premiums aren't far behind. A recent Deloitte analysis[2] found that ESG-focused renewable energy providers averaged valuation to EBITDA multiples of 15.2x in M&A deals between 2019 and 2021, compared to 6.1x–12.8x for traditional oil and gas companies.

With numbers like these, treating ESG as marginal or "nice to have" is no longer an option. A solid track record in this area can improve access to capital while attracting investors, talent, customers, and suppliers. In short, successful ESG can expand strategic opportunities and enhance an organization's ability to weather economic cycles.

ESG in M&A: A range of new challenges

When pricing an M&A deal, both parties must consider how to value ESG commitments, including adding ESG clauses to formal deal frameworks and transaction documents (starting with the letter of intent / heads of terms), identifying how the target business can evidence its ESG commitments and achievements, and scenario planning. This is particularly true of private equity firms, which may specifically target ESG-savvy organizations.

Nonetheless, incorporating ESG into M&A deals also comes with challenges, chief among them:

Evaluation:

Identifying and quantifying a target's ESG-related risks and opportunities. This includes risks relating to non-compliance with "soft laws" such as UN Sustainable Development Goals, OECD Guidelines for Multinational Enterprise, and ISO 14067 standards regarding product carbon footprint measurement, as well as internal ESG policies and procedures.

Reporting:

Assessing whether ESG commitments and their impact and/or achievements have been reported accurately (including credit capture and maintenance of incentives)

Commitment:

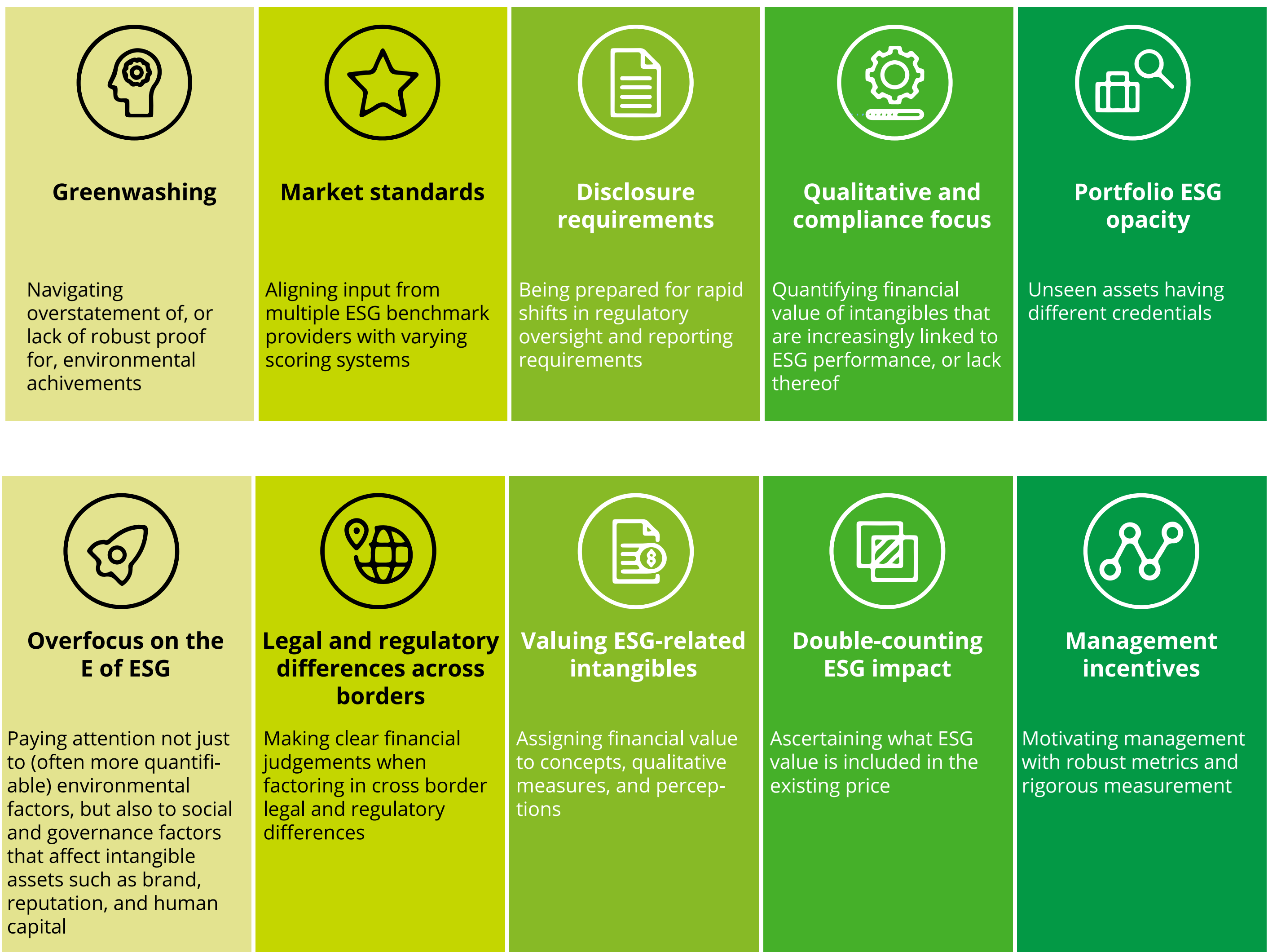
Ensuring that any required changes to ESG commitments identified through due diligence are properly integrated and maintained post-close

In our experience, incorporating ESG into the M&A process can enhance dealmaking. Documenting and evaluating ESG successes early in the process boosts confidence for all involved, and can accelerate time to close. It also requires open, ongoing communication with stakeholders. In the long run, no one benefits from opacity, or from efforts to "greenwash" or overstate environmental achievements.

Of course, ESG evaluation through due diligence is just one part of a comprehensive M&A assessment, and must be viewed in the context of competing corporate objectives. However, as the energy transition accelerates to reach net-zero goals, ESG considerations are likely to grow in prominence. Accordingly, understanding these challenges can help you navigate significant tax, legal and operational implications—areas where expertise is a must—and avoid common complications.

Figure 1 identifies these and other potential challenges when assessing ESG in the context of M&A.

Figure 1. Ten challenges related to ESG in M&A deals



Maximizing value and minimizing tax risks

With ESG, as with many aspects of tax strategy, organizations can benefit from a methodical and replicable approach. Incorporating ESG into M&A requires focus on **strategic alignment, due diligence, execution, and value creation.** Ideally, ESG serves as a guiding light at every step of the deal process, from strategy development to targeting, due diligence, and eventual exit.

To capture the tax benefits associated with ESG, companies should prioritize systematic documentation and recording of ESG policies and commitments as well as the companies' efforts and achievements against these; increase both internal and external transparency; and clearly detail what it will take to secure, maintain, and monetize all applicable tax credits and incentives.

The ESG due diligence process

Unidentified ESG risks can expose a business to, amongst others, unexpected tax liabilities and affect overall deal valuation. To avoid such pitfalls, tax professionals can use evaluation tools and frameworks to assess risk, set baseline performance, and measure impact in each of the three ESG dimensions.

Although there is no global standard for quantifying ESG metrics, efforts to close that gap are underway, including work from the Global Reporting Initiative's[3] Global Sustainability Standards Board (GSSB) and the World Economic Forum[4]. For now, private equity is leading the charge, with multiple firms contributing to a guide to valuations and climate change shepherded by the nonprofit Accounting for Sustainability[5].

Address the E—but don't overweight

Environmental initiatives tend to garner the most ESG attention, in part because they're often more visible and because many jurisdictions offer tax credits and incentives for green operations. To accurately assess a company's environmental profile, evaluators should:

- Assess regulatory compliance.
- Identify voluntary eco-friendly initiatives and estimate the value of each.
- Identify the existence of, and conditions for, environmental tax incentives, including possible clawbacks for noncompliance.
- Quantify any financing terms tied to ESG performance, as well as energy consumption or carbon taxes that could be imposed for high-emission operations.
- Explore the general risk that climate change poses to operations. Be sure to consider supply chain sustainability, which can have tax implications especially in cross-border transactions.
- Ensure that transfer pricing policies align with ESG objectives, to minimize tax risks and ensure regulatory compliance.

Address the S from end to end

In the social and governance realms, due diligence can offer insight into a company's culture and ethics, clarifying whether a prospective merger or acquisition is a good fit.

On the social front, it's crucial to assess a target's positions on diversity, equity, and inclusion (DEI), and its progress toward identified DEI goals. Companies are often rewarded for hiring underrepresented groups, veterans, or other categories of employees, with incentives including tax credits and grants at the federal, state, and local level, or even direct government payments to support the hiring, training, and retention of these workers. Evaluators need to understand any such existing commitments, including reporting requirements.

Address the G, before potential problems emerge

With governance, evaluators may find significant differences in how the acquirer and target view acceptable tax risk, or gaps in tax expertise, reporting, or data collection. Focus on reviewing available information to assess whether the target has been a "responsible taxpayer"—for example, have they taken extreme tax positions, or failed to meet local tax incentive requirements? Less mature businesses and privately held firms may not have the same depth of internal controls, processes, or staffing than an acquiring company does, and may not be as aware of newer requirements such as mandatory US SEC reporting. Due diligence is the right time to surface such disparities and begin discussing how to remediate them.

So what makes a good match?

Similar ESG stances, priorities, and policies can increase the potential for compatibility, including smooth post-merger integration of employees and operations following a merger. To get a clear picture of the role of ESG in each organization, and to provide a holistic view and comprehensive accounting of ESG initiatives in the post-merger company—all while underscoring that ESG is a shared responsibility and commitment across the enterprise—we suggest forming a cross-functional ESG team made up of legal, finance, and operations executives plus your chief sustainability officer.

How tax experts can inform M&A negotiations

In a 2022 Deloitte poll on M&A trends[6], 77% of respondents included ESG metrics in target valuations—and that number is expected to rise. With ESG treated as a quantifiable, valuable asset much like real estate or intellectual property, determining its fair valuation and ROI will require assessing factors including impairment, related revenue streams, and potential costs and fines.

Depending on the maturity of the target, it may be productive to restructure operations to align legal and economic ownership of environmental IP, as well as implement a robust transfer pricing arrangement. The cost of integration of IP is frequently overlooked but if not factored in may produce deadweight tax costs or even negative synergies. Consequently, parties need to understand the history of IP and its tax basis before planning integration.

The sooner you can bring tax expertise into the valuation process, the better. Tax experts can help you:

Facilitate

Structuring a deal efficiently from a tax perspective can yield significant savings, directly contributing to the profitability of a venture. Tax and legal specialists with ESG expertise can facilitate all phases of M&A from due diligence through valuation, negotiation, and post-merger integration.

A good example of the value of expert tax knowledge: Beginning in 2023, under Pillar Two rules, multinational transactions may trigger related compliance and tax costs. While experts can assist in structuring deals that consider and potentially minimize global minimum tax liability, all proposed structural changes should have real business substance behind them.

Educate

Tax and legal specialists can help educate stakeholders, identify synergies, prevent double-counting or omission of assets, and align teams around promising ESG initiatives. In particular, tax specialists can help optimize a company's tax position in the form of tax breaks for renewable energy investment, credits for sustainable practices, and R&D tax relief, and can help decide where any new intellectual property or value from sustainable practices should be based.

However, these actions should integrate into the broader business strategy and not be merely a tax-driven exercise.

Ensure transparency

In the context of reporting requirements that include mandatory detailed disclosure of ESG performance, how a company deals with its tax and legal affairs can be viewed as a proxy for its approach to ESG. Tax and legal teams can use a merger as an opportunity to institute a holistic data strategy spanning ESG, tax, legal, supply chain, and other functions.

That includes establishing a data repository that can function as a single source of truth, rigorous and replicable ESG documentation and reporting, and active management of reputational risk with a focus on building public trust.

An opportunity for growth and competitive advantage

ESG factors are redefining business valuation and risk, becoming a central part of M&A dealmaking and joint-venturing, and significantly influencing deployment of large public and private capital allocations. ESG-focused companies such as Emerson Electric[7] have garnered premium valuations compared to more traditional counterparts, and more and more stakeholders and investors see sustainable growth and responsible practices as core elements of long-term business success. In this environment, the biggest mistake deal teams can make isn't getting ESG wrong—it's overlooking it.

By collaborating with tax and legal professionals to integrate ESG into the M&A and valuation processes, companies can effectively identify, track, and document the value of the full range of their ESG investments—and make sure that value is reflected in deal pricing. The potential payoffs are many: cost savings, improved reputation, regulatory compliance, and long-term sustainability. And perhaps most importantly, taking the lead on ESG can position businesses to seize valuable opportunities.

Contacts

Brian Pinto

Deloitte Global M&A Tax Leader,
Principal, Deloitte Tax LLP
United States
bpinto@deloitte.com

Giorgio Mariani

Partner, Deloitte Legal
Deloitte Italy
giomariani@deloitte.it

Christanna Springs

Tax Principal, Deloitte Tax LLP
United States
csprings@deloitte.com

Endnotes

1. Deloitte publication: Capital allocation and resilient portfolios Insights based on a global survey by Deloitte, 2023
2. Deloitte publication: Four ways ESG is reshaping M&A, June 2023
3. Global Reporting Initiative
4. World Economic Forum article: Embedding ESG metrics: a time for companies to stand up and be counted, May 2022
5. Accounting for Sustainability Framework: Essential guide to valuations and climate change
6. Deloitte publication: The future of M&A 2022 M&A Trends Survey, January, 2022
7. Reuters: Blackstone to take control of Emerson's climate tech in $14 billion deal, October 31, 2022

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