Tax: A crucial component of ESG reporting

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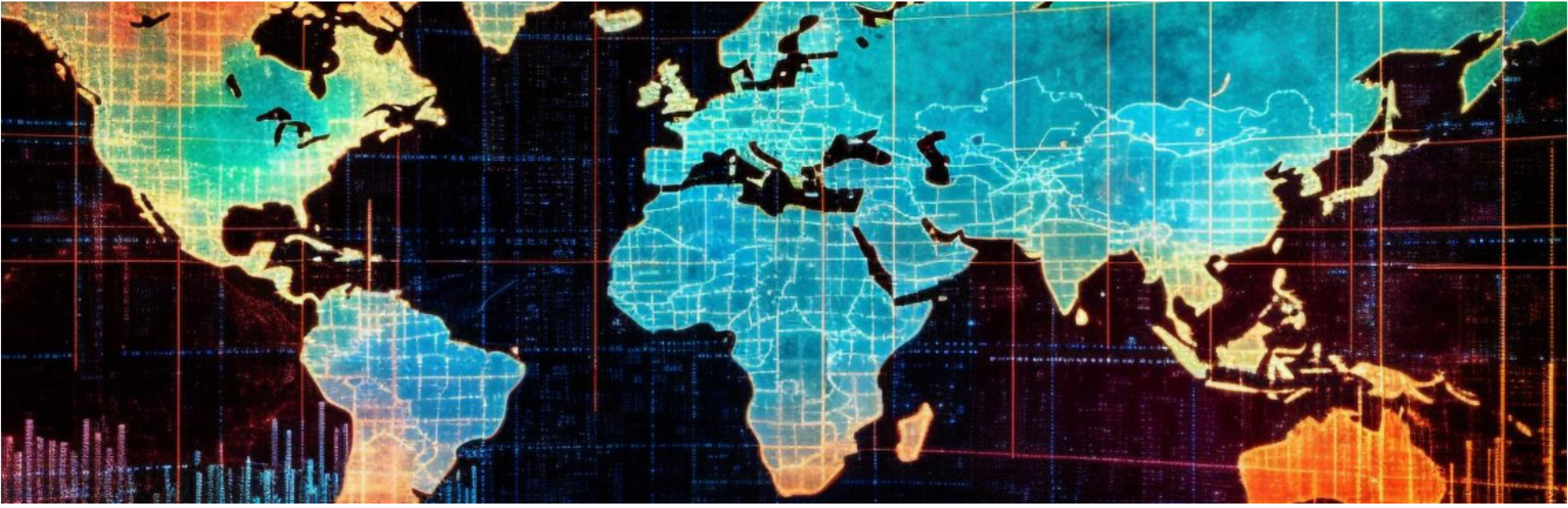


Introduction

In today's global world, the spotlight is on critical issues such as the global economy, peace and stability, and sustainable business practices. The global nature of the discuss has brought businesses under greater scrutiny, compelling them to play a more sustainable societal role. Investors, regulators, and other stakeholders now consider a broader spectrum of factors, known as environmental, social, and governance (ESG), when evaluating business performance. ESG considerations have become essential in funding and investment decisions, transcending traditional profit-oriented perspectives.

Despite the growing ESG awareness, the taxation aspect of ESG appears to be lagging. This is notwithstanding the successes recorded earlier with the Base Erosion and Profit Shifting project (BEPS). While sustainable tax practices rank high on the agenda of most multinational enterprises, we observed that tax is typically not considered a crucial component of ESG by other companies. It is often viewed from a very limited perspective of compliance rather than sustainable best practice.

In light of the foregoing, this article explores the relationship between ESG and tax, and why tax practices and disclosures should be integrated into ESG reporting frameworks in Nigeria.

Nexus between tax and ESG

We have demonstrated below the interplay between tax and the three (3) pillars of ESG:

1 Environmental

Tax can be used to promote environmental sustainability. In Nigeria, the Petroleum Industry Act 2021 (PIA) is a landmark legislation that significantly impacts the ESG landscape of Nigeria's oil and gas industry. As part of decisive steps toward environmental management, the PIA requires every holder of a petroleum exploration license to submit a natural gas flare elimination and monetization plan. This is in addition to the aggressive stance on the non-deductibility of the gas flaring penalty for tax purposes and plans to further increase the penalties for gas flaring.

Similarly, albeit suspended, the 2023 Fiscal Policy Measures introduced green taxes (additional import adjustment taxes) for certain classes of motor vehicles and single-use plastics.

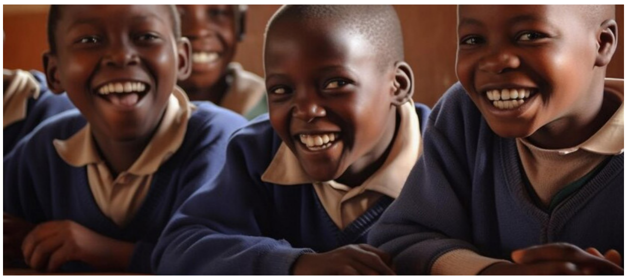
In addition, the enactment of the Climate Change Act which stipulates that the National Council on Climate Change should collaborate with the Federal Inland Revenue Service (FIRS) to 'develop a mechanism for imposing a carbon tax' indicates that plans are underway to introduce a carbon tax policy, under which greenhouse gas emitters will be taxed for their emissions.

These measures aim to reduce environmental pollution, encourage the development and adoption of clean technologies, generate revenue to fund environmental protection programs, and align Nigeria to its 2060 zero emission target.

2 Social

Taxes are an integral part of Governments' fiscal policy and businesses are required to pay taxes as a means of contributing to social development. The taxes paid are used to fund essential services such as education, healthcare, infrastructure, security, and social welfare programs. This benefits everyone in society, including the businesses themselves.

There is a correlation between the tax management approach of an entity and its social responsibility. Entities that have a strong ESG commitment typically also have responsible tax practices. This means that they pay their fair share of taxes in accordance with the law while taking advantage of tax optimisation strategies that help them upscale their businesses and the economy.



3 Governance

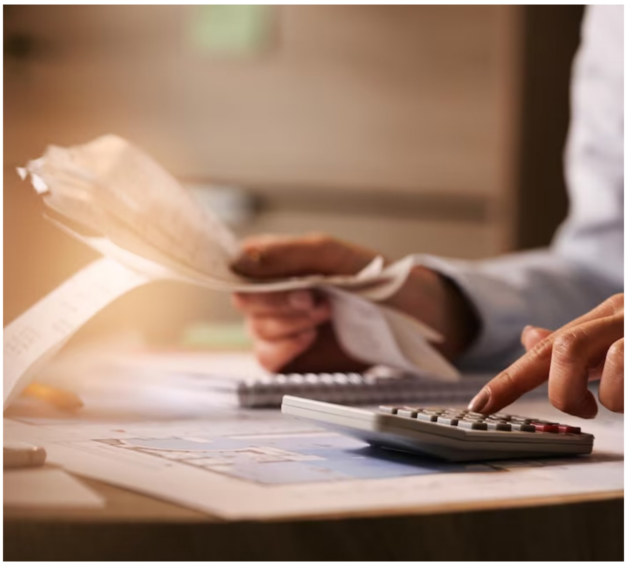
Here, consideration is on the role of tax in promoting good corporate governance (transparency, accountability, and risk management). Tax compliance is a positive indicator of good corporate governance and good tax governance will, amongst others, improve a company's compliance with relevant tax laws/regulations – which is essential for funding public services and supporting economic growth, establishing a transparent relationship with relevant tax authorities, effectively and sustainably manage tax risk for stakeholders. Good tax governance also aids in reputation management.

The need for a tax integrated ESG reporting framework in Nigeria

Based on reports credited to the immediate past Executive Chairman of FIRS, Nigeria's tax-to-GDP ratio is currently 10.86%. While this is an improvement from 6.3% reported by the World Bank in 2021, the current ratio still falls significantly short of the sub-Saharan Africa average (16.4%) and the Organization for Economic Co-Operation and Development (OECD) average (34.1%).

Historically, the slow growth of tax's contribution to Nigeria's GDP has been attributed to several factors, including a low tax base, the prevalence of tax avoidance and evasion, complicated tax systems, and corruption.

As the world advances toward a future characterized by environmental and social consciousness, the Nigerian tax system stands on the brink of potential disruption. Without adequate preparation, this disruption could represent yet another missed opportunity to establish resilient tax culture in the early stages of their adoption.



To bridge this gap, tax integrated ESG reporting may prove useful in the following ways:

- **Increased transparency and accountability:** Public trust and confidence in the tax system are bound to improve with the increased transparency and accountability that comes with the adoption of tax integrated ESG reporting.

  As businesses provide tax practice reports for public consumption, the tax system becomes more transparent and progressive, with the potential for enhanced public involvement in the tax system. This is expected to further encourage voluntary tax compliance and reduce tax evasion.

- **Improved tax policy management:** Tax ESG reporting can be a useful tool for the government to gain insight into companies, industries, and sectors' ESG performances. This information can be leveraged in the development of efficient fiscal policies to promote sustainable development and improve tax revenues.

- **Foreign investment attraction:** ESG practices and compliance are front-burner topics in the boardrooms of investors across the world. Global financiers have substantially integrated ESG considerations into the fundraising and investment process. Tax ESG reporting plays a key role in demonstrating a business' ESG commitment to prospective investors, thus increasing the likelihood of foreign investment in Nigeria.

- **Managed tax avoidance:** ESG reporting can play a key role in the drive to eliminate aggressive tax avoidance schemes through the robustness of mandated disclosures. For example, the Responsible Tax Principles developed by the B Team[1] which is made up of a group of leading companies such as Shell PLC, provides for sustainable guard rails in tax management covering topics such as transparency, compliance, and tax incentives.

  Tax ESG reports typically disclose important information about a company's tax strategy and compliance records in different countries they operate in. These, amongst others, can be a source of useful information for tax authorities to identify and address aggressive tax avoidance schemes.

Consideration for adoption of tax integrated ESG reporting by Nigeria entities

Regulatory requirement:

The Nigerian Stock Exchange (NSE) is considering mandating sustainability reporting for all listed companies. Similarly, the Financial Reporting Council of Nigeria (FRCN) is also considering making ESG reporting compulsory for listed companies, and to this end the FRCN is working with other regulators to develop an ESG reporting standard. These reports are expected to provide information on a company's ESG performance, including its tax practices (tax strategies, policies, and payments).

Investment attraction:

An increasing number of investors are seeking to invest in companies that adhere to ESG principles. Through tax ESG reporting, companies can demonstrate their ESG commitment and appeal to investors who are seeking to invest in ESG-focused companies.

Reputation management:

By reporting on their tax ESG performance, businesses can demonstrate that they are fiscally responsible, ethical, global-minded, and have good corporate governance. This can benefit the business corporate profile and attract new customers/clients and partnerships for the business.

Improved tax governance and management of tax risk and opportunities:

The implementation of tax integrated ESG reporting can assist businesses in enhancing tax governance by ensuring that tax is considered in all decision-making processes.

[1]https://bteam.org/assets/reports/A-New-Bar-for-Responsible-Tax.pdf

In general, this can facilitate the identification and management of tax risks and opportunities. Tax ESG promotes the notion of commercial led projects with tax opportunities and risks, rather than tax led projects with the sole purpose of tax avoidance.

By demonstrating that a taxpayer is financially responsible and ethical, they may be able to negotiate certain tax positions or secure certain concessions from the government.

The implementation of tax ESG reporting by Nigerian companies can be advantageous to companies' financial performance, risk profile, stakeholder relations, and innovation.

Challenges with adopting tax integrated ESG reporting

1 Complexity of tax and ESG reporting:

Tax integrated ESG reporting can be complex and time intensive. This could potentially discourage adoption, as businesses may lack the resources or expertise to implement and produce a tax integrated ESG report.

2 Lack of standardized frameworks:

There is currently no standardized framework for tax integrated ESG reporting. This makes reporting and performance benchmarking challenging for businesses and stakeholders.

3 Cost of implementation:

Companies may consider the cost of implementing tax integrated ESG reporting as high. The cost usually depends on the size and complexity of an organisation, the level of reporting, and the available resources. Some of the costs relate to training, consultancy or external assurances, data collection and analysis.

Conclusion

From our assessment, the major challenge for tax ESG reporting includes lack of awareness and the absence of a standardised framework. To this end, it will be instructive for the regulators including Securities and Exchange Commission (SEC), NSE, FRCN, FIRS, State Board of Internal Revenue Service and other stakeholders such as finance and tax professionals to collaborate in the development of "tax disclosure framework and awareness campaign" for ESG reporting purposes in Nigeria. A starting point may be the adoption of GRI-207: Tax, developed by Global Reporting Initiative (GRI), a leading organisation in the development of sustainability reporting standards.

Further, the recently inaugurated Presidential Fiscal Policy and Tax Reform Committee is advised to consider tax integrated ESG policies, as this could help to create a more equitable, prosperous, and sustainable future for Nigeria.

Overall, the adoption of tax integrated ESG reporting in Nigeria has potential benefits for businesses, investors, and the wider community.

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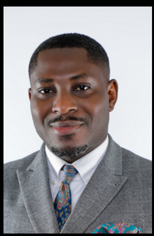

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