The ESG journey in retail

How to position your tax department for success.

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> — Brett Weaver, Partner, International Tax, KPMG

CEOs and CFOs are expanding and clarifying their environmental, social, and governance (ESG) responsibilities, and tax executives should follow suit. This is especially the case in the retail industry where a unique combination of ESG risks and opportunities — including shifting consumer expectations, sustainable distribution, recruiting and retention correlations, packaging decisions, and more — will exert mounting impacts on the bottom line and shareholder value in the coming years.

"We see a lot more data indicating that all types of companies, including retailers, that invest heavily in ESG position themselves very well for success — not only over the long term, but also in the mid-term," notes Brett Weaver, a partner in KPMG LLP's International Tax practice. "Research also shows that there are significant risks for companies continuing to do business without paying attention to their impact on the environment or to sustainable business practices. Tax plays an important role in a company's overall approach to ESG."

In the KPMG 2021 CEO Outlook, 71% of respondents indicated that "CEOs will be increasingly held personally responsible for driving progress in addressing social issues."[1] In the firm's 2020 CEO Outlook, 65% of top executives reported that managing climate-related risks will play a pivotal role in determining how long they retain their jobs. For their part, CFOs will be counted on to translate ESG reporting into financial metrics: "Finance is ideally positioned in the organization to track the information needed for ESG strategies and reporting."[2]

Tax leaders throughout the retail industry are pursuing a related but unique ESG journey, one that centers on developing a sustainable approach to tax amid growing calls for, and emerging regulations on, tax transparency, stronger tax governance, and "responsible tax." Also, as retailers reconfigure their supply chains and related processes in response to ESG strategies and external regulatory requirements, tax departments will need to adjust accordingly.

"If you don't meet your ESG goals, your company likely will eventually be subject to either a tariff or a tax that the tax department will need to address," says Vertex Chief Tax Officer Michael Bernard. "At some point this all comes home to tax."

To advance on their ESG journeys, retail tax leaders should:

- Consider and monitor the drivers behind ESG regulatory mandates as well as organizational ESG investments
- Assess the impacts of ESG matters on strategy and operations
- Prepare the tax department to quickly respond to ESG risks and opportunity by putting in place the right skills, processes, and technologies

ESG translates to sustainable business practices

Weaver distills his definition of ESG to “sustainable business practices” and emphasizes that they are supported by principles that leadership and the workforce embed throughout the organization. These principles require organizations to understand all of their environmental and social impacts.

“And let’s not forget the ‘G,’” Weaver continues. “Stakeholders really want companies to walk the talk. Having the right governance in place ensures that companies are following through on their commitments.”

These commitments are decidedly long-term in nature, given the comprehensive collection of drivers behind the surging adoption and ongoing refinement of organizational ESG strategies and practices. “We’re seeing a lot of retailers making commitments concerning board diversity, working conditions, and environmental impacts across their global supply chains as well,” Weaver reports. “That’s not going to go away.”

The forces driving the adoption and maturation of ESG capabilities include:

- **Employees:** As the “Great Resignation” has led to increased turnover and labor shortages, it’s significant to understand that a company’s ESG practices can serve as a talent magnet — or a substantial recruiting and retention risk. This is especially the case for younger professionals — those in the millennial and Gen Z cohorts — notes KPMG National Transaction Tax Services Practice Leader Mark Rems. “Companies that are invested in ESG are able to attract more and better talent,” Rems explains. “The younger generations care about the environment and they want to make a difference regarding social issues. So, it behooves companies to be branded with ESG.”

- **Consumers:** More customers care about corporate ESG impacts and practices, and many customers are making purchasing decisions based on their perceptions of these impacts and practices. Plus, ESG-related consumer assessments often extend beyond sustainable products into scrutiny of packaging, logistics, sourcing, labor conditions, and other supply chain activities.

- **Investors:** An increasing number of banks, pension funds, asset managers, insurers, and other investment institutions are placing pressure on companies to demonstrate sound ESG practices and to apply the ESG recommendations put forth by global bodies such as the Task Force on Climate-related Financial Disclosures (TCFD). As ESG metrics and reporting practices mature, that data will play a larger role in the investment decisions asset management firms make. “That’s coming,” Rems notes. “There’s also the possibility that the quality of your ESG program could affect your ability to borrow money.”

- **Businesses:** In 2019, the Business Roundtable updated its 22-year-old policy statement on the corporation’s primary purpose. The document replaced the previous core purpose of maximizing shareholder return with a commitment to serving a broader range of stakeholders. This service includes fostering diversity and inclusion, dignity, and respect as well as protecting “the environment by embracing sustainable practices across our businesses.”[3] The statement was signed by more than 180 CEOs of the largest companies in the U.S. “That’s an important document,” Bernard notes. “In many ways, it started a new era of corporate ESG practices.”

- **Regulators:** Global business regulators are rapidly adopting and recalibrating ESG-related requirements. Six years ago, the Financial Stability Board (FSB) — an international body that monitors global financial systems — created the TCFD to recommend how companies should disclose material climate-related risks to financial stakeholders.[4] Since then, the TCFD has published and steadily revised disclosure guidelines concerning greenhouse gas (GHG) emissions; most recently, the TCFD indicated that companies should disclose GHG emissions independently of materiality assessments. In the U.S., the Securities and Exchange Commission (SEC) appears likely to put forth ESG reporting requirements in 2022. And broader ESG rules seem likely to materialize in the next two years. ESG-related regulations are "woven into the fabric of the current administration," notes Bernard. "You see ESG topics in legislation, the labor department, the EPA, and in tax policy-making at the federal level." Each of those drivers affect retail companies and, increasingly, their tax functions.

ESG throughout retail

ESG risks and opportunities exist in nearly every realm of a retailer's operations, starting with sourcing activities and extending to the e-commerce sites and online marketplaces more retailers use to transact with customers.

"From an ESG perspective, retailers tend to focus intensely on their supply chains," Weaver reports. "They look at the ESG impacts of their product designs, packaging, and production. Many retailers have issued commitments to reducing their carbon emissions. Some have pledged to become net-zero on carbon emissions at some point in the future."

More retailers with e-commerce capabilities are also scrutinizing their online channels and supporting systems to determine if ESG risks are lurking there. "Within e-commerce platforms, there are often algorithms and artificial intelligence that gather data about purchasing histories and related behaviors," says Rems, who notes that this data typically needs to be protected from security and data privacy perspectives. "Also, algorithms can be biased. When retailers use and act upon consumer data, they should make sure that no biases based on social factors exist within the algorithms they rely on."

Other retail-specific ESG focal points include:

- **Sustainable distribution:** This concept centers on reducing the negative environmental impacts that arise when goods and materials are transported from suppliers to purchasers. The use of electric vehicles and transport planning are common methods of sustainable distribution. The U.S. Environmental Protection Agency's (EPA) SmartWay program provides a comprehensive system for tracking, documenting, and sharing information about fuel use and freight emissions across supply chains that many retailers use. Since its launch in 2004, this public-private partnership has helped companies save 336 million barrels of oil, which SmartWay reports is equivalent to eliminating annual electricity use in more than 21 million homes.[5]
- **Sourcing:** More grocery stores are reducing the geographic range of their supply base as a way of reducing the carbon emissions generated by transporting food to their shelves. Weaver notes that some grocers have restricted their purchases of dairy, pastries, meats, and other perishables (which require more frequent restocking) to suppliers that are located within a 300-mile radius of their store locations.
- **Packaging:** Weaver also reports that more consumers are requesting retailers to reduce the weight and amount of waste in their packaging materials. Some retailers have responded by offering discounts for slimmer packaging.
- **Talent management:** As Rems notes, talent management and ESG are becoming increasingly connected. That's critical to understand amid a bruising labor crunch. "The more companies talk about ESG and the more policies they put in place," he notes, "the more they will see a net positive when it comes to recruiting, employee retention, and maintaining a productive and engaged workforce."

“The impact of ESG in the retail sector extends throughout the entirety of the supply chain,” Weaver emphasizes. “Second- and third-tier members of the supply chain generally have made limited progress compared to the largest retailers, but that’s changing. Smaller suppliers see the commitments retail leaders are making, and that’s where a ripple effect comes into play.”

A focus on ESG is also rippling throughout organizational functions.

Tax matters

Many tax departments have been addressing ESG matters for decades. “Six to eight different types of ESG-related fees are imposed in roughly 400 different U.S. sales tax jurisdictions now, and have been for years,” Bernard reports. These taxes primarily address environmental impacts and apply to a broad range of products and activities, including plastic bags, rubber tire disposal, electronic waste recycling, and more.

This means current tax management processes and supporting technology are well equipped to manage ESG from a tax determination and calculation standpoint. That’s important, Bernard emphasizes, because failing to comply with environmental taxes and fees not only increases audit risks — it can also subject companies to reputational risks. “Leading tax teams use automation to produce returns accurately and efficiently, which makes it easier for them to file returns in all jurisdictions that have environmental fees and taxes,” Bernard says.

In addition to collecting and remitting ESG-related taxes, tax functions have other ways to contribute to corporate ESG programs, including:

- **Improving the company’s ESG agility:** As is the case for all business leaders, tax executives should monitor ESG rules-making. They should also proactively prepare for new compliance requirements. “Are you going to need additional staffing resources to handle a new requirement?” Bernard asks. “What about additional IT resources? Also, do you as a tax leader need to start communicating anything up the line of command — not just to the head of tax, but also to the CFO?”
- **Recognizing that tax may be in the regulatory crosshairs:** A developing area of social and governance rules-making centers on tax transparency. “The extent to which a company takes aggressive tax positions is getting a lot more attention right now,” Bernard reports, noting that legislative and regulatory proposals concerning mandatory tax disclosures are beginning to take shape in Europe and the U.S. “A group of Danish pension funds have developed and signed a Tax Code of Conduct to help support goals of responsible tax behavior in their investments and through their investment partners,” according to a recent KPMG bulletin.

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"Actions like these underscore the public approach investors are taking in supporting tax as a critical component of ESG." Bernard expects additional EU countries to require multinationals to report more comprehensive tax disclosures within the next two to three years.

- **Assessing and addressing "pandemic pivots":** Many retailers responded to COVID-driven shutdowns with impressive speed and innovations. This work included standing up and/or greatly expanding e-commerce capabilities and systems, adding new sales channels, and adapting to new forms of transactions, like buy online pickup in store (BOPIS). Most of these new capabilities and refinements produced high levels of additional tax management complexity. Retail tax teams, Bernard says, should work with their operations counterparts to ensure that new systems and applications are appropriately integrated with their sales tax engines. That integration will be crucial as new ESG-related taxes and fees come online.

- **Optimizing your tax technology:** Tax technology reduces the risk of major tax determination errors, including those that have social dimensions. Underpaying sales taxes can be perceived as having negative social impacts because tax revenues fund social programs in most states. Overpaying sales taxes and reclaiming large sums from state coffers can also pose reputational risks. "If a business needs to take $20 million back from the state of Pennsylvania, it can generate some really bad press," Rems notes. "The solution to that problem is to implement the right processes and systems up front." For global companies, Rems notes that tax technology increasingly needs to be able to comply with a rising number of new digital requirements related to real-time reporting, electronic invoicing, and the like. "You need a sophisticated solution in place to comply with those types of rules," Rems adds, "and avoid the stiff penalties for not doing so."

As retailers green their supply chains, reassess labor practices throughout the supply chain, and make numerous related ESG strides, many of these changes will bring about additional tax complexities that tax functions will need to manage. Tax leaders should also be prepared to respond to ESG mandates related to tax transparency. Making headway on the retail tax function's unique ESG journey starts with getting the right people, processes, and technologies in place.

End notes

1. KPMG International, 2021 CEO Outlook, 2021:
   https://assets.kpmg/content/dam/kpmg/xx/pdf/2021/09/kpmg-2021-ceo-outlook.pdf

2. KPMG LLP, The Role of Finance in Environmental, Social and Governance Reporting, 2021:
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3. Business Roundtable: **https://opportunity.businessroundtable.org/ourcommitment/**

4. TCFD and Climate Risk Reporting, KPMG:
   https://home.kpmg/be/en/home/services/sustainability-services/tcfd-and-climate-risk-reporting.html

5. **https://www.epa.gov/smartway**

6. ESG and Tax: Increasing importance to Institutional Investors, KPMG:
   https://home.kpmg/xx/en/home/insights/2021/09/esg-and-tax.html

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