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TaxTalk

Simplifying the complexities of Tax

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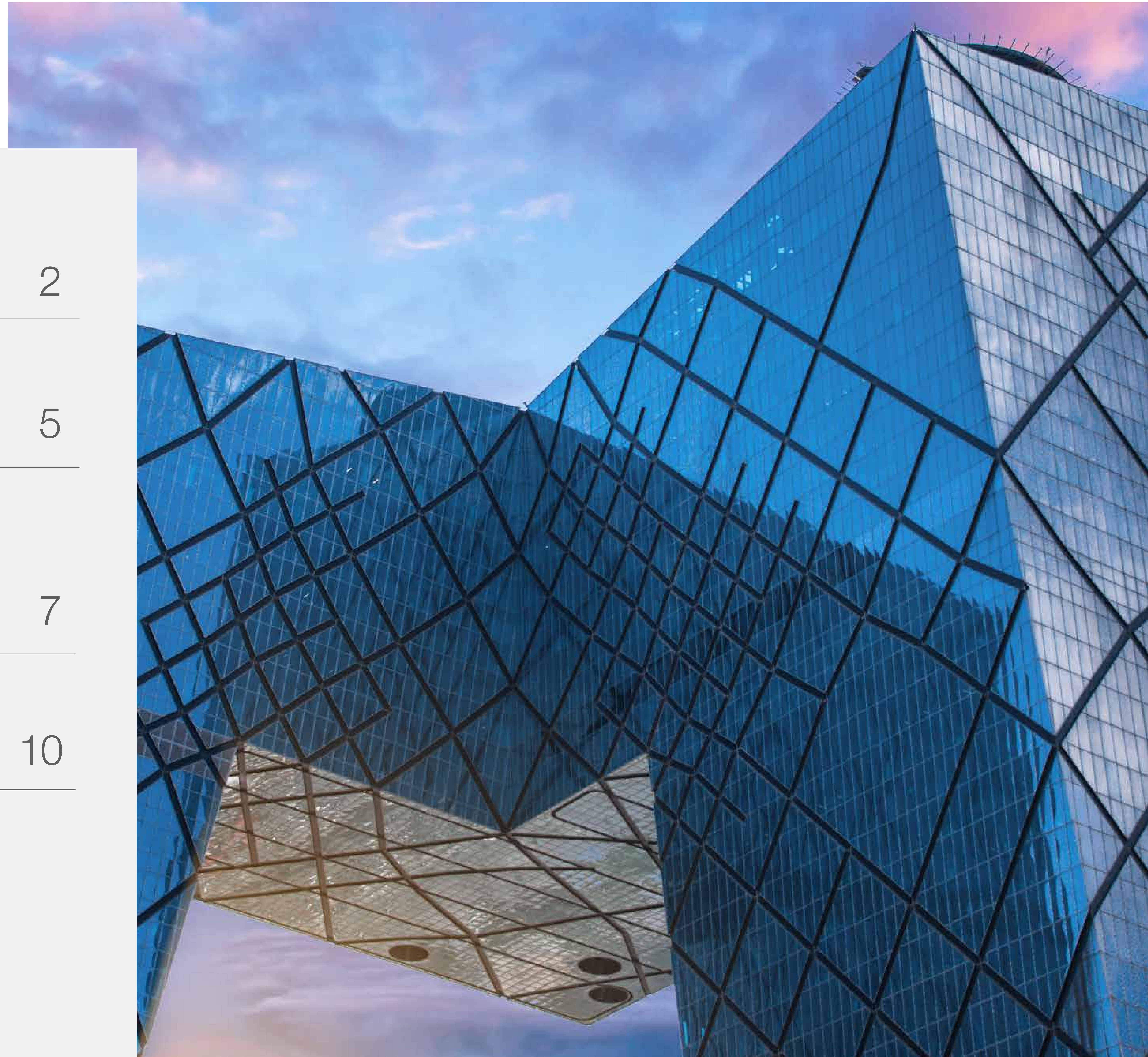

ESG and tax: what you need to know

Recent developments in tax disclosure requirements and environmental tax incentives are shining a new light on ESG. We provide an up-to-date guide on what your company should do and when.

The term ESG was first used in the UN's Global Compact Who Cares Wins white paper in 2004. This led to the 2006 UN Principles for Responsible Investment, which now has more than 3,000 signatories who manage more than US$3tn in assets.

The three components of the ESG framework are:

1. 'Environmental', which concerns our impact on the world we live in and considers climate change, pollution and clean technologies.
2. 'Social', which concerns our contribution to the communities we operate in and considerations like fair labour practices, working conditions and diversity and inclusion.
3. 'Governance', which is our licence to operate and considers matters like responsible tax strategy and transparency.

What is the impact of the ESG framework on tax policy?

Tax plays an important role in the ESG framework. In recent years, there has been increased pressure on businesses to disclose more information about their taxes. This particularly applies to businesses operating in multiple jurisdictions (MNEs).

Governments around the world are using tax policy to motivate a transition to ESG-compliant business models and have launched coordinated efforts to ensure that MNEs pay their 'fair share' of tax (see our Pillar 2 article).

These efforts have led to global tax reforms, including the requirement that large companies report to tax authorities on taxes paid in each jurisdiction where they do business (country-by-country reporting.)

In addition to playing an important role in component 3 of the ESG framework (Governance), tax has also been used to help address environmental concerns in component 1. Governments have introduced tax measures that incentivise businesses to improve their environmental strategies and deter them from continued use of unsustainable practices. Measures introduced by the UK Government include:

- The Climate Change Levy – an environmental tax on a business's electricity and gas use, designed to encourage businesses to be more energy efficient in their operations.
- Capital allowances on energy efficient items – these are available when a business purchases energy efficient or low to zero-carbon technology.

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- The UK Emissions Trading Scheme – the Government sets a total carbon price to incentivise investment in low-carbon electricity generation and technologies and to make sure that polluters pay for their emissions.
- The Plastic Packaging Tax – a tax on finished plastic packaging components that contain less than 30% recycled plastic.

What are the recent developments?

Public country-by-country reporting (CbCR)

In 2015 the OECD and G20 countries formally adopted CbCR as part of the OECD's base erosion and profit shifting (BEPS) initiative which was established to address mismatches between tax systems in different jurisdictions. Under the rules, MNEs with a global turnover of at least €750m must submit an annual return to local tax authorities that shows key elements of the group's financial statements per jurisdiction.

In December 2021, a new EU directive came into effect which requires MNEs with a global turnover of €750m for two consecutive years, whether headquartered in the EU or not, to publicly disclose on their websites information such as profits, number of employees and taxes paid across EU and non-EU countries.

Member countries are required to bring public CbCR legislation into force by mid-2023 and the rules will have effect from 2024. The first report will therefore be due in 2025.

Corporate sustainability reporting

The EU's Corporate Sustainability Reporting Directive (CSRD) was formally adopted by the European Council on 28 November 2022. Almost 50,000 companies will be subject to mandatory sustainability reporting. This includes non-EU companies which have subsidiaries operating within the EU or are listed on EU-regulated markets. The CSRD will include the requirement to report in line with the EU taxonomy (a tool that directs investment to economic activities that are in line with the European Green Deal objectives).

Companies already subject to the Non-financial Reporting Directive (NFRD) will have to report under CSRD reporting from 2024. From 2025, the new reporting rules will also apply to companies not currently subject to NFRD reporting. Listed SMEs, small non-complex credit unions and captive insurance entities will be included from 2026.

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The CSRD will apply to all large companies (listed or non-listed) where two or more of the following thresholds are met:

- Number of employees is 250
- Turnover of €40m
- Total assets of €20m.

What are the current reporting requirements?

In the UK most of the ESG reporting requirements are provided for in Companies Act 2006. But there are additional requirements for listed companies contained in other pieces of legislation.

There are currently no mandatory disclosures for smaller companies. But given the increasing relevance of ESG to consumers and investors alike, these companies often report voluntarily on ESG matters.

Organisations such as the World Economic Forum (WEF), the Global Reporting Initiative (GRI) and the Principles for Responsible Investment (PRI) have developed tax reporting guidelines and standards in this area. Although voluntary, many businesses are adopting them.

More than 10,000 organisations in 100 jurisdictions are using the GRI standards, which include reporting on tax. More and more companies are joining the WEF's International Business Council, which has made tax disclosures a core component of its ESG reporting metrics.

How can we help?

A business's tax department has a pivotal role to play in its transitional strategy, as tax transparency requirements continue to grow. And while additional reporting requirements may increase the administrative burden, they can also offer significant benefits. More and more investors are interested in how businesses manage their tax affairs. It's even becoming a key factor in deciding which businesses they would like to invest with.

In order to prepare for the new tax reporting rules, businesses should take the following actions:

1. Early review. Identify what information is required and start gathering and processing it from each entity. As this process can be timely, it should be done early.
2. Understand the tax position. Many businesses are using tax incentives and reliefs to finance (in whole or in part) the business's transitional strategy. The board of directors and management teams need to understand these measures and be aware of all taxes paid by the business (e.g payroll taxes) and the impact these will have on their tax strategy.
3. Collaboration. Tax departments across the entire business should collaborate to ensure that the overall tax strategy of the business aligns with the tax strategy of each component entity. Almost all business decisions have a tax impact and, with increased tax disclosure requirements in ESG reporting, these impacts will be more visible to stakeholders and the public.
4. Effective communication. Tax disclosures are often read by individuals who are not familiar with the terminology used by tax professionals, so it's important that businesses avoid using overly complex language in their reporting.
5. Future planning. Businesses should consider how their tax strategy and reporting compare with those of their competitors, and correct any deficiencies in their model. It's also important to monitor the changing views of stakeholders and any proposed or upcoming changes to tax reporting requirements.
6. Alignment of ESG and tax. If a business has already implemented a tax strategy for ESG, it should check that its sustainability reporting and tax reporting are aligned. For example, a company may be required to prepare a master file for transfer pricing purposes and this should reflect the information provided under ESG reporting requirements. Inconsistencies between reports may lead to queries from stakeholders and tax authorities.

If you would like further information or support on any of the issues raised in this article, please contact Jacinta Noone, Justine Sacarello, or Catherine Heyes.

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Pillar 2: Less than 6 months until new global minimum tax rules

UK Pillar 2 minimum tax legislation applies to companies/groups with annual consolidated turnover > €750m for accounting periods that begin on or after 31 December this year. So what are the important considerations and reporting requirements that they need to consider?

Pillar 2 has been designed to set a global minimum tax rate for large companies and groups. Here is a reminder of the background:

- In 2021, 136 of the 140 countries in the OECD Inclusion Framework agreed to implement a 15% global minimum Corporation Tax rate for multinationals with consolidated global turnover of €750m or more.
- Where a subsidiary has an effective tax rate of less than 15%, the group will pay additional tax to make up the difference.
- Although the regime framework has been internationally agreed by member countries, each one needs to incorporate the rules into domestic tax legislation.
- The OECD published its model rules and commentary for Pillar 2 in December 2021 and March 2022, respectively.

What updates have there been in the UK in 2023?

On 11 July, UK Pillar 2 legislation received royal assent as part of Finance (No. 2) Act 2023. This legislation included an income inclusion rule (IIR) (multinational top-up tax) and a qualified domestic minimum top-up tax (QDMTT) (domestic top-up tax).

These will be effective for accounting periods beginning on or after 31 December 2023. They are applicable to relevant groups where consolidated revenues are €750m or more in at least two of the last four years.

On 18 July, draft legislation was issued to introduce the Undertaxed Payments rule (UTPR), the second multinational top-up tax after the IIR. A UTPR would work in a similar way to the IIR, being a top-up tax rather than a denial of a deduction. IIR would take precedence over UTPR. It is expected the UTPR would apply for accounting periods beginning on or after 31 December 2024.

What are the OECD Pillar 2 rules?

The IIR in most cases is calculated and paid by the ultimate parent company to its tax authority and applies on a top-down basis. The payment of the top-up tax ensures that the overall tax on profits is brought up to a minimum effective tax rate of 15% in each of the countries in which the group operates.

The UK QDMTT applies to all UK businesses, not just multinationals that meet the Pillar 2 turnover threshold. This will impose a UK top-up tax on low taxed UK profits.

Many other jurisdictions have introduced (or plan to introduce) a domestic minimum tax for companies operating in their jurisdiction, to ensure that they benefit locally from any increased tax rate, rather than the parent jurisdiction.

Transitional safe harbours

Using the information from qualifying country-by-country reports and financial data, there are three transitional safe harbour tests available in the first three years of the regime (until periods beginning on or before 31 December 2026). This allows entities in a jurisdiction to be exempted from Pillar 2 calculations and liabilities if one of the following tests is satisfied:

- The threshold test. This is met where the members in that territory have aggregate revenue below €10m and the aggregate profit before tax is less than €1m.
- The simplified effective tax rate (SER) test. This is met if the SERs of the members of the group in that territory are at least 15% for periods beginning before 1 January 2025, at least 16% for periods beginning in 2025 or at least 17% for periods beginning after 1 January 2026.

Pillar 2: Less than 6 months until new global minimum tax rules

- The routine profits test. This is met if:
  - the qualified substance-based income exclusion amount for that territory is equal to, or greater than, the aggregate profit/loss before tax for that period of the members of the group in that territory, or
  - the aggregate profit/loss before tax for those members is nil or a loss.

If a group is found to not pass any of the tests for a period, it must prepare the full calculations for that period and any subsequent periods. This is the 'once out, always out' feature of the safe harbour provisions. The safe harbour provisions are designed to reduce the compliance obligations when entering the Pillar 2 regime for the first time. But note they do not exempt the group from relevant reporting requirements.

Transitional penalty relief regime

Another measure over the first three-year period is that no penalties or sanctions should apply in connection with non-compliance if it can be demonstrated that "reasonable measures" have been taken.

What are the reporting requirements?

The proposed UK reporting requirements and timeline of filings for the IIR and QDMTT for groups with a year end of 31 December are as follows:

Financial Year End	Filing Deadline
Financial Year Ended 31 December 2024	
One time requirement to register with HMRC when the group first comes into scope of the rules	30 June 2026
An annual UK Self Assessment return to provide HMRC with details of the UK top uo tax liability - in the first year, all returns have an 18-month deadline which is reduced to a 15-month deadline in subsquent periods	30 June 2026
A or B	
A - Ultimate parent company to file Pillar 2 information return with tax calculations made by the group to determine the group's top-up tax liability or justify the absence of such a liability	30 June 2026
B - If Ultimate parent company is overseas, UK entities to notify HMRC annually of the group member filing	30 June 2026
Payment of UK top-up tax	30 June 2026
Financial Year Ended 31 December 2025 and thereafter	
Subsequent information returns, Self Assessment returns and annual notifications have a 15-month deadline	31 March 2027
Payment of UK top-up tax	31 March 2027

What are your next steps?

- With less than six months until the QDMTT and IIR measures come into effect, it's important that businesses are prepared. You should continue monitoring both UK and global developments and ensure the necessary processes are in place to capture the relevant data.
- The new safe harbour provisions require the group's country-by-country report to be "qualifying". Considering this and the expected increased attention from EU public disclosures (please refer to our ESG article in this issue), groups should review existing processes for country-by-country reporting.
- Your business should determine potential exposure to Pillar 2 and assess your eligibility for the safe harbour provisions.
- You'll need to identify the data required for reporting and Pillar 2 calculations and have it readily available.
- It's important to communicate with stakeholders through modelling tax cash flows and effective tax rates, so that increased tax liabilities arising under Pillar 2 do not come as a surprise.

If you would like further advice and support on any issues raised in this article, please contact Mimi Chan.

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International social security rules: where does the UK stand following the new EU framework agreement

New social security legislation for internationally mobile workers applies from 1 July 2023. This is important because in an international environment where an employee spends some time working from their home which is in a different country to their employer there are strict rules around where social security should be paid. The new Framework Agreement extends the amount of time an individual can work in a different country to that of their employer and still maintain their social security contributions in the country of their employer. However, not all countries have signed up to the new Framework Agreement including the UK and to be able to benefit from the new Agreement both countries must be signed up to the agreement, or the old rules will apply.

Social security, or National Insurance as it is referred to in the UK, often gets side-lined when a company operates internationally. Many companies offer employees secondments for a temporary period as part of a career plan, or find themselves looking internationally for the appropriate talent.

The different Income Tax regimes are often considered, and policies drawn up to ensure fair treatment across an employee population but this is not always the case for social security.

Social security rules are completely independent of tax rules and treaties, so it's important to always consider it in its own right.

The general rule is that social security is payable where you work. However, what if you work in a number of different countries throughout the year? What if you go on a short-term secondment overseas for, say, six months? Or a long-term assignment for three years?

It's no surprise that this is where it gets complicated. Pre-Brexit and pre-COVID there was common legislation across Europe. It was possible, given the right circumstances, to apply to remain in your home country social security system, provided the criteria were met. The rest of the world has separate arrangements.

One of the reasons people want to continue paying into the same social security scheme is that most countries require a minimum number of contributions before an individual qualifies for benefits such as a state pension. In the UK this is 35 years.

If a globally mobile person pays into many different social security schemes throughout their career, it may be that there are insufficient contributions to a single scheme to qualify for any benefit. So it is effectively 'money down the drain'. Reciprocal agreements do exist between the UK and some countries which allow contributions made for periods of residence in those countries to be treated as if they were UK national insurance contributions for both state pension and survivor's benefits, but the rules are complex.

International social security rules: where does the UK stand following the new EU framework agreement

What were the EU regulations pre-COVID?

Previously, the EU regulations for social security meant that if an employee lived in a different country to where their employer was located, they could work up to 25% of their total working time in their country of residence and still remain covered by social security in the employer's country of residence.

Following COVID and the various relaxations of the rules during the pandemic, the EU authorities considered the increased amount of cross-border working and the resulting complexities that faced employers, employees and, of course, the social security authorities.

They looked at the existing legislation with a view to making it a better fit with current working practices. The result was a new framework agreement to which countries (including the UK) were invited to sign up.

What has changed in the new framework agreement?

Many of the familiar provisions, such as the ability to remain in the home country social security system for assignments of up to 24 months, as well as provisions for multi-state workers, remain.

The primary change under the new agreement is that 'teleworkers' (see below) can spend up to 50% of their working time working remotely from the EU member state in which they are resident but they will remain subject to social security in the EU member state in which their employer is based. This change represents a doubling of the allowable time. This arrangement only applies between countries that have signed up to the new framework.

What is a teleworker?

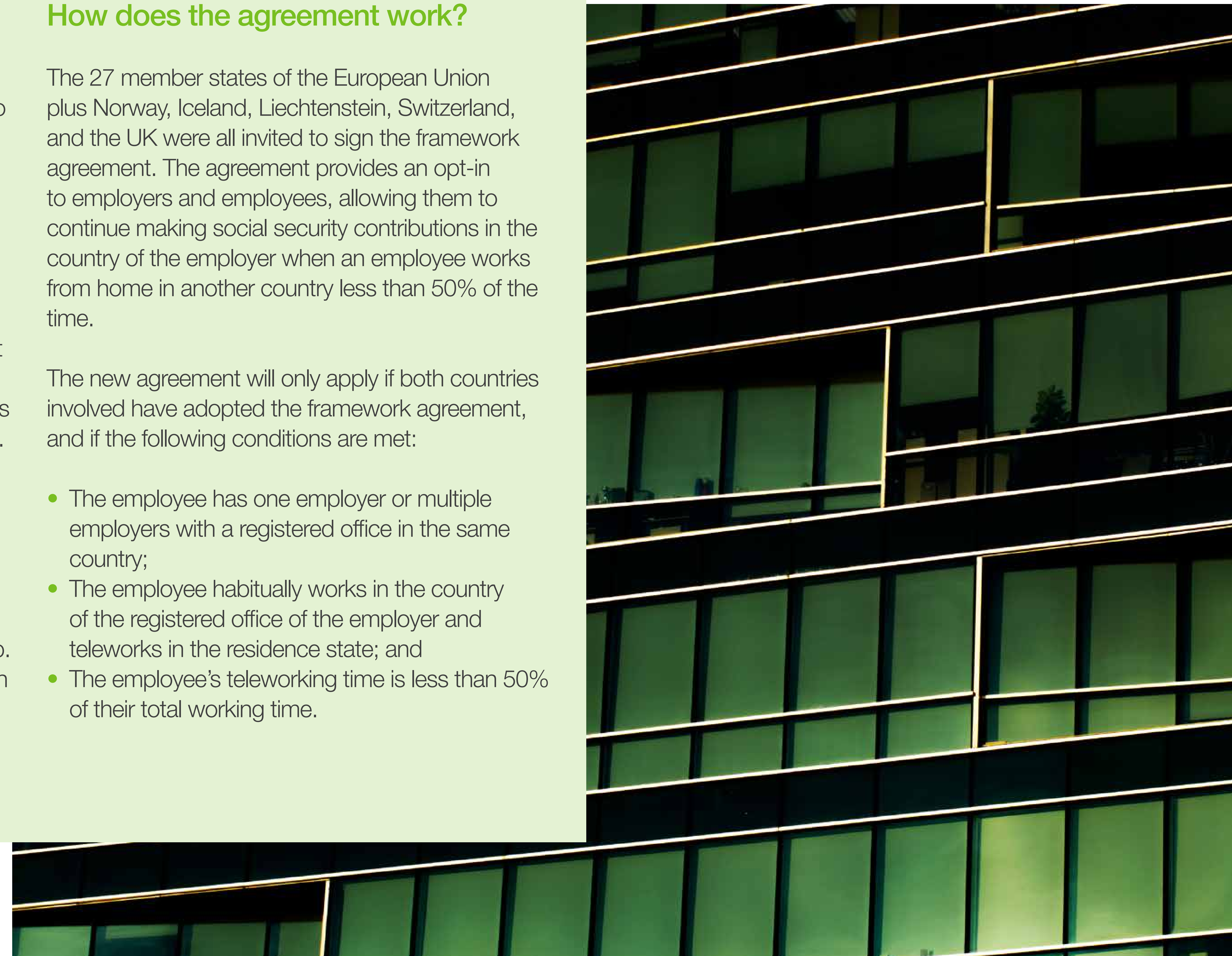
For the purposes of the agreement, a teleworker is someone who uses an IT connection to do their job. Their role can be performed independent of location within a member country other than where their employer is registered.

How does the agreement work?

The 27 member states of the European Union plus Norway, Iceland, Liechtenstein, Switzerland, and the UK were all invited to sign the framework agreement. The agreement provides an opt-in to employers and employees, allowing them to continue making social security contributions in the country of the employer when an employee works from home in another country less than 50% of the time.

The new agreement will only apply if both countries involved have adopted the framework agreement, and if the following conditions are met:

- The employee has one employer or multiple employers with a registered office in the same country;
- The employee habitually works in the country of the registered office of the employer and teleworks in the residence state; and
- The employee's teleworking time is less than 50% of their total working time.



International social security rules: where does the UK stand following the new EU framework agreement

If the conditions are met, the social security legislation of the employer's country of residence will continue to apply.

To opt-in and make use of the facility, an A1 (the document that states the applicable social security legislation) must be requested in the country where the employer is based within three months of the start of activity.

However there is currently a welcome grace period whereby A1 applications filed before 1 July 2024 can have retroactive effect from 1 July 2023. This is to help employers plan and put in place the necessary policies.

Note that the A1 document remains limited in time to a maximum of three years. However a new request can be filed for an extension.

Which countries have signed up so far?

The framework agreement entered into force on 1 July 2023. At that date the following countries had signed up: Austria, Belgium, Croatia, Czech Republic, Finland, France, Germany, Liechtenstein, Luxembourg, Malta, Netherlands, Norway, Poland, Portugal, Slovakia, Spain, Sweden and Switzerland.

Invited countries may still sign the framework agreement but it will run from the time of signature and it will not apply retroactively. Countries that have committed to signing at a later date are Estonia, Hungary, Ireland, and Lithuania.

A number of countries have not currently signed up, including Italy and the UK. This creates additional complexity for employers in creating policies and managing employee requests for hybrid working arrangements.

What about the UK?

So, the UK is not part of this new framework – what does that mean?

The general pre-COVID rules governed by EU regulation apply for the coordination of social security systems and continuous cross-border telework arrangements where the UK is one of the countries involved.

Essentially if an employee spends more than 25% of their total working time in their home country of residence, social security contributions will be required in the resident country of the employee and not the employer.

Whilst the UK has not signed up, HMRC are keeping the position under review.

If you would like further information on issues raised in this article, please contact Louise Fryer.

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