Cadillac health insurance plan. Tax professionals will need to monitor continuing developments in these areas to avoid application of the excise taxes, when possible, and to make proper filings when necessary either to start the statute of limitations running or to pay any excise taxes owed.

Key to Effective Tax Governance: Straight Talk About Tax Risks

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This article provides an update on the top tax issues for shareholders this year. Not surprisingly, straight talk about tax risks was added to the list of investors' demands in today's uncertain tax environment, and Schlank identifies key questions that management should be prepared to address in order to demonstrate the effectiveness of their companies' oversight of tax risks.

The changing world of corporate governance is touching off new storms of controversy over taxes' interaction with familiar investor hot buttons, including risk management, social responsibilities, and executive compensation plans. In the latest message from investors, a handful of major companies recently faced high-profile demands for more information about their tax risks when a leading pension fund sought to place the matter on proxy statements for shareholder votes. Both the spotlight and the demands are likely to continue, and companies are advised to prepare for a full gamut of policy issues, ranging from pointed questions about whether they pay their fair share of taxes to mounting concerns that managerial bonus plans may inadvertently motivate overly aggressive tax positions.

Recent Shareholder Proposals

The leading pension fund that spearheaded the shareholder proposals is the employees' pension plan of the American Federation of State, County, and Municipal Employees (AFSCME). AFSCME is a well-known and respected pioneer in the successful say-on-pay movement. Its tax risk proposals were intended for votes at annual meetings in April, May, and June.[1] The resolution portions of all the proposals are similar and generally worded along these lines:

> Resolved, that shareholders of [Company name] request that [Company's] board of directors annually assess the risks created by the actions [Company] takes to avoid or minimize

[1]The shareholder proposals, no-action letters, and related correspondence are available at http://www.sec.gov/divisions/corpfin/cf-noaction/14a-8.shtml.

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U.S. federal, state, and local taxes and provide a report to shareholders on the assessment, at reasonable cost and omitting proprietary information.

Each proposal also contains a supporting statement loaded with company-specific factors that help make the case for more shareholder involvement at that company. Although the targeted companies were able to omit the initial proposals from their proxy statements in 2011, the resolutions and supporting documents are important trendsetters in two respects. First, they shed new light on current issues of concern to investors. Second, history shows that those actions often lead to regulatory or legislative changes designed to give shareholders more say over the policies at issue, either across the board or through resolutions aimed at specific companies.

Red Flags That Triggered Proposals

To help companies understand which types of events or trends serve as red flags for investors, the following section summarizes the company-specific factors cited in the AFSCME's proposals. The companies targeted by these proposals were Amazon.com Inc., Home Depot Inc., Lazard Ltd., Pfizer Inc., TJX Cos., and Wal-Mart Stores Inc. The following areas were cited as signaling a need for increased scrutiny by shareholders:

- *Sales taxes.* The shareholder proposal for Amazon focuses on risks associated with sales taxes, including potential legislation that might require Internet retailers to collect state sales taxes and the risk of a successful sales tax challenge by one or more states in which the company has not yet collected sales taxes.
- *Open tax audits.* The shareholder proposal for Home Depot focuses on the size of the company's tax reserves and uncertainties associated with the status of its federal, state, and local tax audits for open tax years.
- *Trademarks.* Several proposals focus on potential liability for state taxes on income from intercompany transactions for trademarks. The risk arises when a company has a subsidiary that owns the trademarks and licenses them to stores in other states, and the subsidiary is located in a state that does not tax income from intangible assets.
- *Passthrough entities.* The shareholder proposal for Lazard focuses in part on the company's tax status as a Bermuda company that is treated as a partnership for U.S. federal income tax purposes. The potential risk is that future U.S. tax legislation may adversely affect the company's tax rate.
- *Transfer pricing.* The shareholder proposal for Pfizer focuses mainly on risks associated with transfer pricing practices within the pharmaceutical industry. The types of risks described in the proposal include more frequent IRS audits and sizable payments to settle disputes.
- *Tax shelters.* One shareholder proposal focuses in part on risks associated with a company's use of aggressive tax shelters that the proposal says were recommended by the company's independent auditors.
- *Comparisons with peers.* The shareholder proposal for Wal-Mart focuses on the risk that its favorable tax rate may not be sustainable. It compares the company's state income taxes with those of peer companies using statistics from Compustat. Those statistics indicate Wal-Mart's average state income tax rate for the period 2005-2009 was lower than the comparable rate for its peer companies.

Recurring Themes

The AFSCME documents contain several recurring themes of interest to all companies. In effect, the shareholder proposals build on a central theme that investors should scrutinize a company's tax avoidance activities to ensure that their interests are being properly advanced and that any conflicts of interest are appropriately resolved.

As you might expect, investors are concerned about future earnings and cash flows. As a result, their scrutiny of tax risks is often directed toward future projections and forward-looking risks and uncertainties that might jeopardize the sustainability of current earnings and cash flows. For example, investors may be concerned with whether lower-than-average effective tax rates are sustainable in view of proposed legislation or mega-trends involving shifts in public policies and shortfalls in government financing.

More surprisingly, some of the proposals reflect unusually pejorative connotations for the term ''tax avoidance,'' and they imply that investors should have concerns about whether their interests are best served by tax avoidance techniques.

Traditionally, ''tax avoidance'' has referred to legal and legitimate ways to manage costs and cash outlays that are presumed to be in accordance with shareholders' best interests, while the term ''tax evasion'' has been reserved for more reprehensible techniques. But the shareholder proposals and related correspondence indicate that investors are now thinking about the concepts in nontraditional ways.

Overriding Concerns of Investors

The key concerns identified in the shareholder proposals and related documents can be summarized as follows:

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1. *Tax avoidance has moved front and center as a policy question.* The shareholder proposals maintain that tax avoidance could soon result in changes in public policy. A key precipitating factor is the recently effective requirement for some corporate taxpayers to report their uncertain tax positions on Schedule UTP. The proposals argue that this requirement is likely to result in policy changes, because it focuses greater attention on tax avoidance techniques. That focus is especially propitious in today's environment when governmental budgets are difficult to balance partly because of forgone tax revenue. The proposals argue that companies that rely on tax avoidance may be exposed to greater risk and lower earnings as federal, state, and local governments seek new sources of revenues.

2. *Tax avoidance by a company can lead to stock market losses for its shareholders.* As evidence of the potential losses, the proposals point to an academic study that found a correlation between corporate tax avoidance and subsequent reductions in the stock prices of the companies that used tax avoidance techniques.[2]

3. *Tax avoidance provides opportunities to mislead investors.* The shareholder proposals quote the same study referenced above as concluding that tax avoidance activities can "create opportunities for managers to pursue activities that are designed to hide bad news and mislead investors." The examples in the study refer to a tax shelter used by Enron and tax avoidance techniques once used by Tyco International.

4. *Tax avoidance can benefit managers at shareholders' expense.* As examples of potential conflicts of interest between managers and investors, the proposals explain that some types of executive compensation practices (equity risk incentives) can put a premium on short-term returns and encourage tax avoidance tactics that delay the day of reckoning and thereby conflict with the goals of long-term investors. For example, one study notes that aggressive tax positions may result in bonuses to executives for "hitting their numbers" in the year the positions are taken, while disputes with tax authorities may not be resolved until years later.

5. *Required generally accepted accounting principles and SEC disclosures are not sufficient.* At least one target company indicated in its response to its shareholder proposal that it believed the requested information on tax risks had been provided in its financial statements and in the management's discussion and analysis portion of its annual report on Form 10-K. But AFSCME argued that GAAP and SEC disclosures were not sufficient for several reasons, including the omission of information about lawsuits initiated by states for underpayment of taxes and the use of aggregated information for unrecognized tax benefits. In effect, some disclosures were boilerplate, while others appeared to raise (rather than answer) questions.

All the companies targeted by AFSCME decided to omit the shareholder proposals from their proxy statements, and the SEC issued no-action letters indicating the SEC staff would not recommend enforcement action because of the omission. Interestingly, despite the AFSCME's argument that the policy issues transcend ordinary business, the SEC's no-action letters were granted on the basis that the proposals relate to ordinary business matters.

Questions for Companies to Consider

The shareholder proposals identify evolving investor concerns and set an important precedent. Because these initial proposals could well be a forerunner of additional governance proposals, initiatives, and shareholder questions in the years to come, companies will want to put in place the appropriate policies, governance practices, and communications that will effectively address these kinds of concerns at annual shareholder meetings and year-round.

To address the core issues identified in the shareholder proposals, management should be prepared to answer questions from directors, shareholders, and investors about tax risks, including the following:

- How do the company's taxes and effective tax rates compare with its peers?
- Is the company aware of any trends or developments that might significantly affect the sustainability of its effective tax rate in the future?
- Does the company expect that any changes being discussed in connection with governmental budgets or deficit reduction plans will materially affect its operations or business strategy?
- Does the company have a board-approved policy regarding its tolerance for tax risks that might affect the company's reputation?

[2]Jeong-Bon Kim et al., "Corporate Tax Avoidance and Stock Price Crash Risk: Firm-Level Analysis," 100 *J. Fin. Econ.* 639 (2010), *available at* http://ssrn.com/abstract=1649679.

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- Has the company established appropriate controls over tax risks, including a hierarchy of approval levels for tax risks with low, medium, and high impacts?
- Does the board of directors have direct access to independent advisers with sufficient expertise to identify and review major tax positions?
- Does the company have a mechanism in place to identify and resolve potential conflicts of interest between management and investors?
- How does Schedule UTP affect the company's tax risks, and to what extent is the board of directors involved in any significant issues arising from the disclosures needed for Schedule UTP?

The above list is not meant to be comprehensive, and other questions may arise as well. But the questions on the list may be helpful as a starting point in the rapidly evolving but still nascent field of tax governance.

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