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Developments of Note

♦ FDIC Issues Guidance on Sarbanes-Oxley Application to Insured Banks

The FDIC published a Financial Institution Letter (FIL-17-2003, the "Letter") concerning the effect of the federal Sarbanes-Oxley Act of 2002 (the "S-O Act") on insured banks. The Letter first emphasizes that banks that themselves have registered securities, as well as bank holding companies that are public companies, must comply with the S-O Act, including the provisions governing auditor independence, corporate responsibility and enhanced financial reporting, as implemented by SEC regulations (which the FDIC rules incorporate by reference). Copies of Goodwin Procter's extensive *Client Alerts* on the S-O Act are available on request. For institutions *not* otherwise subject to the S-O Act, the Letter then details the requirements, and the FDIC's recommendations, for two different classes of insured banks: those with less than $500 million in total assets; and those with $500 million or more of total assets.

Less than $500 million in total assets. These banks are not subject to the annual audit and reporting requirements of Section 36 of the Federal Deposit Insurance Act (the "Section 36 Requirements"). Although the Letter assumes that these banks, if not public, are also not subject to the S-O Act, the Letter nonetheless discusses both the major provisions of the S-O Act and how other analogous bank requirements (principally the 1999 Interagency Policy Statement on External Auditing Programs of Banks and Savings Associations) or safe and sound banking practices might compel, or at least encourage, such a bank to adopt similar procedures. In this regard, the S-O Act requires accountants for public companies to be "independent," *i.e.*, not also provide other services (listed in the Letter) in addition to audit services for the bank or bank holding company. The Letter recommends, but does not require, non-public banks with less than $500 million of assets to follow this prohibition. At a minimum, if an auditor for a bank provides audit and other services, the Letter recommends that the bank closely monitor the arrangement to ensure the integrity of the accountant's services. In addition, the Letter recommends that banks rotate lead audit partners as the S-O Act requires, and also recommends that banks adopt the S-O Act's auditor reporting practices and rules on auditor conflicts of interest. As to the S-O Act's requirements regarding corporate responsibility, the Letter also recommends implementing procedures analogous to the S-O Act's requirement that the audit committee establish a procedure for employees to submit confidentially information about questionable audit matters, for certification of financial statements by the bank's CEO or CFO, and to ensure that no management official seeks to influence improperly external auditing work. As to the S-O Act's provisions regarding enhanced financial disclosures, the Letter recommends that banks, among other things, adopt a code of ethics for senior financial officers.

$500 million or more in total assets. These banks are subject to the Section 36 Requirements, and the FDIC is considering possible amendments to its Section 36 regulations to incorporate more provisions of the S-O Act (even if the bank is not otherwise subject to the S-O Act). Moreover, the Section 36 Requirements compel these banks to comply with the SEC's auditor independence requirements, and thus indirectly the provisions governing auditor independence in the S-O Act (*e.g.*, the prohibition on non-audit services, the lead partner rotation requirements, and the conflict of interest rules). As to the CEO and CFO certifications in the S-O Act, the Letter states that the management report mandated by the Section 36 Requirements is sufficiently different from the S-O Act's certification that the S-O Act's certification may *not* be filed in lieu of the Section 36 management report. (Indeed, the Letter notes that many banks are not filing satisfactory management reports). The Letter also highlights that the Section 36 Requirements also mandate that the bank's public accountants attest to management's assertion concerning internal controls. The S-O Act has a similar requirement, and when the SEC issues rules on the S-O Act's provision the FDIC will evaluate whether the S-O Act's filing can be made in lieu of the accountants' report. Finally, the FDIC also recommends that banks with assets of $500 million or more also consider the recommended actions for smaller banks described above.

♦ SEC Results of 2002 Fortune 500 Form 10-K Review

The SEC's Division of Corporation Finance (the "Division") issued a summary of the principal subjects of comment by the Division in its 2002 review of annual reports on Form 10-K of Fortune 500 companies. The comments generally reflect disclosure deficiencies in the areas of financial reporting and management's discussion and analysis of financial condition and results of operations ("MD&A"). In

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connection with its review, the Division sent over 350 comment letters to Fortune 500 companies requesting that they either amend their filings or respond to the SEC's comments in future filings. While the review initially involved Fortune 500 companies, the Division noted that its comments are generally relevant to all companies. Public companies should be reminded that such reviews are likely to increase in the wake of the focus on corporate governance and transparency in financial reporting resulting from the S-O Act and its related rulemaking, as well as the S-O Act's specific mandate that every listed company's Securities Exchange Act of 1934 (the "Exchange Act") periodic reports be reviewed by the SEC every three years.

The SEC's review resulted in comments most frequently in the areas of: MD&A generally (criticizing mechanistic calculations and boilerplate analyses and requiring greater analysis, specificity and year-to-year discussion of trends), critical accounting policies (requiring the presentation or expansion of such disclosure, including the sensitivity analysis discussed in the SEC's December 2001 critical accounting policy guidance release), non-GAAP financial information (the SEC directed many of its comments to financial services companies since they often presented "managed basis" or "normalized" financial information; these comments are largely dealt with in the SEC's recent adoption of new rules governing the use of non-GAAP financial information in Exchange Act filings), revenue recognition (requiring specificity and clarification of how the company's revenue recognition policies comply with Staff Accounting Bulletin 101), restructuring charges (requiring companies to justify and expand their disclosure, including by adding period-by-period disclosure of such charges, greater detail regarding the events giving rise to such charges and greater detail regarding the components of such charges), impairment charges (requiring companies to expand their disclosure to provide greater specificity in the areas of long-lived assets, impairment of securities held for investment and impairment of goodwill), pension plans (requiring greater detail of assumptions and expected trends), securitized financial assets and off-balance sheet arrangements (requiring greater specificity regarding the sale of financial assets through securitizations and compliance with SFAS No. 140), segment reporting and environmental and product liability disclosure.

♦ Massachusetts Enacts Significant Tax Legislation

On March 5, 2003, Governor Romney signed into law significant tax legislation (the "Act") that is substantially similar to the legislation proposed by the Massachusetts House of Representatives and described in the February 11, 2003 *Alert*. Significant provisions in the Act include the following:

1. A nonresident's income relating to employment in Massachusetts or the nonresident's trade or business in Massachusetts, including gain from the sale of an interest in the business, separation pay and deferred compensation and nonqualified pension income not prevented from taxation under federal law and income from a covenant not to compete, is subject to Massachusetts personal income tax regardless of the taxpayer's residence or domicile in the year it is received and regardless of whether the taxpayer has actively engaged in a trade or business or employment in Massachusetts in the year of receipt, effective for tax years beginning on or after January 1, 2003.

2. The Massachusetts Department of Revenue ("DOR") is given enhanced authority to disallow the asserted tax consequences of any transaction by asserting the application of the sham transaction doctrine or any other related doctrine, effective for tax years beginning on or after January 1, 2002. In response to such a challenge, the taxpayer would be required to prove by clear and convincing evidence all of the following: (i) a valid, good-faith business purpose other than tax avoidance, (ii) economic substance, and (iii) that the non-tax business purpose is commensurate with the tax benefit claimed.

3. The exemption from Massachusetts taxation for corporate (business) trusts with an apportionment percentage of less than ten percent is repealed, effective for tax years beginning on or after January 1, 2003.

4. No dividends received deduction is permitted with respect to dividends from a real estate investment trust ("REIT"), effective for tax years ending on or after December 31, 1999. This rule applies both to the financial institutions excise tax and the corporate excise tax. The DOR currently is challenging dividends received deductions claimed by a number of taxpayers for REIT dividends. The legislation purports to be a clarification of existing law and expresses the legislative intent that REIT dividends have never been eligible for the dividends received deduction.

5. A corporation is generally not permitted to deduct interest expense on a note or similar obligation that it has distributed to its shareholders as a dividend, effective for tax years ending on or after December 31, 1999. However, such deductions are allowed if the taxpayer satisfies the conditions in paragraph 7, below.

6. Taxpayers are required to add back to net income intangible expenses (such as royalties and licensing fees) and interest expense arising in connection with intangible property transactions with related parties. Add back is not required if (i) the taxpayer proves by clear and convincing evidence, as determined by the DOR, that the add back is unreasonable, (ii) the taxpayer and the DOR have agreed to an alternative apportionment method, or (iii) the intangible expense or interest expense was passed through by the related party to a non-related party and the transaction giving rise to the expense was not entered into with a principal purpose to avoid tax. These rules, applicable to both the financial institutions excise and corporate excise tax, are effective for tax years beginning on or after January 1, 2002.

7. Similarly, taxpayers are required to add back interest expense unrelated to intangible property transactions that is paid to a related party, unless (i) the taxpayer proves by clear and convincing evidence, as determined by the DOR, that the add back is unreasonable, (ii) the taxpayer and the DOR have agreed to an alternative apportionment method, or (iii) the taxpayer proves by clear and convincing evidence, as determined by the DOR, that (A) a principal purpose of the transaction giving rise to the interest payment is not tax avoidance, (B) the interest is paid pursuant to an arm's length contract, *and* (C) the related party is subject to state or foreign tax on the interest at a rate no less than the Massachusetts rate minus three percentage points. These rules, applicable to both the financial institutions excise and corporate excise tax, are effective for tax years beginning on or after January 1, 2002.

8. A qualified subchapter S subsidiary ("QSUB") is subject to the same entity-level corporate excise tax generally imposed on subchapter S corporations: 3% of net income if receipts are at least $6 million but less than $9 million, and 4.5% of net income if receipts are at least $9 million. (Under prior law, a QSUB's income was treated as the income of the parent and was not subject to this corporate excise tax if the parent was not a corporation for Massachusetts tax purposes (*e.g.*, a business trust)). As passed by the Conference Committee, this provision was effective for tax years beginning on or after March 1, 2003. For most S corporations and QSUBs, this change in effective date would have postponed application of the new provision until the 2004 calendar year. The Governor, however, used his line-item veto to disapprove the provision specifying the effective date of the S corporation amendment. Because the Act is an emergency law, it became effective on March 5, 2003, when signed. Therefore, since the S corporation amendments had no specific effective date after the veto, they were effective March 5, 2003. In his letter accompanying the Act, the Governor stated that he vetoed the effective date provision because "if not vetoed, [it] would cost the Commonwealth millions of dollars by preventing [the S corporation amendments] from becoming effective until tax year 2004." Despite the Governor's intent in vetoing this effective date, the meaning of the S corporation provision becoming effective on March 5, 2003, remains unclear.

9. An ownership interest in a REIT which is a related party will not be considered a "security" for purposes of the security corporation rules, effective July 1, 2003. Financial institutions and corporations qualifying as security corporations (in general, engaged exclusively in buying, selling, and holding securities on its own behalf and not as a broker) are subject to an excise tax of 0.33% in the case of bank holding companies and 1.32% in the case of other corporations, computed on their unapportioned *gross* income.

In addition, separate legislative recommendations of the DOR (House No. 81) pending before the Joint Committee on Taxation include a proposal to treat any corporate (business) trust, partnership, or other unincorporated entity that has elected corporate classification for federal tax purposes as a corporation for state tax purposes, meaning that corporate (business) trust or partnership tax treatment would not apply to such entities. Under current law, LLCs are the only unincorporated entities that are automatically classified as corporations for Massachusetts tax purposes if they so elect for federal tax purposes. Note: This proposal to follow federal classification for business trusts and other entities that have elected corporate classification for federal tax purposes would not cause REITs and regulated investment companies ("RICs") that are organized as business trusts to fail to qualify as REITs or RICs for Massachusetts tax purposes.

Clarification. Although RICs would continue to be exempt from Massachusetts tax (because they are excluded from the definitions of domestic and foreign corporations), REITs do not share that exclusion. Corporations that qualify as REITs are subject to the Massachusetts corporate excise. They are eligible for the dividends paid deduction under Massachusetts law; therefore, the income measure of their excise should be zero. However, under the corporate excise, a REIT is subject to the property measure of the excise, which could be substantial. Using an appropriate structure may minimize the effect of the property measure of the excise.

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