Letter of Comment No: 78
File Reference: 1082-200
Date Received: 08/30/02

Steven K. Hazen, Esq.
Suite 2700
777 South Figueroa Street
Los Angeles, CA 90017
(213) 689-1300
SKHazen@KelleyDrye.com

August 30, 2002

### VIA E-MAIL: director@fasb.org

Financial Accounting Standards Board

401 Merritt 7

Norwalk, CT 06856-5116

Attention: Director of Major Projects and Technical Activities

File Reference No. 1082-200

Re: Comments on the Exposure Draft Relating to

Consolidation of Certain Special-Purpose Entities;

Issues Regarding Not-For-Profit Entities

#### Ladies and Gentlemen:

This letter will provide certain comments on the Exposure Draft issued by the Financial Accounting Standards Board (the "FASB") dated June 28, 2002, setting forth a Proposed Interpretation of Accounting Research Bulletin No. 51 ("ARB No. 51") on "Consolidation Of Certain Special-Purpose Entities" (the "Exposure Draft"). I am grateful for the opportunity afforded by the FASB to comment on the Exposure Draft and hope that this letter will constitute a useful presentation on selected considerations regarding the impact which the Exposure Draft would have on nonprofit organizations and/or entities established by them to facilitate discharging the purposes for which they were established.

The issue to which this letter is addressed is illustrated by a statement in the FASB press release dated July 1, 2002, announcing issuance of the Exposure Draft (the "Initial Announcement"). It stated that the "... proposed guidance would not apply to not-for-profit organizations." Unfortunately, the Exposure Draft does not address details of issues which would make that statement both accurate and useful. Certain of those are addressed in this letter:

## 1. Scope of Exposure Draft: "Business Enterprise"

The statement in the Initial Announcement may simply arise out of the fact that, by its terms, the scope of the Exposure Draft applies only to "business enterprises." There is, no doubt, a substantial amount of lore in popular parlance which might suggest that a nonprofit entity is something other than a "business enterprise." That characterization, however, is not

<sup>1</sup> Accounting parlance itself (with which the undersigned claims no expertise) appears to have similar notions, an example of which would include the "Statement of Financial Accounting Concepts No. 4: Objectives of Financial Reporting by Nonbusiness Organizations" (December 1980) in which what seem to be traditional nonprofit entities are contrasted with "business enterprises."

necessarily supported either by the state laws governing their formation or by the federal tax laws governing their exemption from taxes. Indeed, the key restriction in most such state laws and in the federal tax laws is simply that such entity is prohibited from distributing profits to individuals or to other parties which are not themselves a nonprofit entity. Those laws do not necessarily prohibit the nonprofit entity from being what, in any transparent definition of the term, would constitute an "enterprise" or even one whose permitted activities (or portions thereof) include indicia of "business." Indeed, those laws do not necessarily prohibit that entity from making a "profit" even if they limit the uses to which such profits can be put.

There are, of course, provisions which a nonprofit entity must address if it actually does engage in "business" or in other activities which on their own do make a "profit." Indeed, one reason for nonprofit entities to set up separate legal entities which otherwise would seem to fall into the category of an SPE (as that term is used but not defined in the Exposure Draft) is to facilitate clear record keeping as to various separate permitted activities. Another is to provide a mechanism whereby the more traditional operations and assets of a nonprofit entity are insulated from other activities which fall within the authorized purposes of the nonprofit entity but which may present significantly increased risk and exposure. The Internal Revenue Service recognizes that there are certain entities which can be created by tax-exempt enterprises which are disregarded for tax purposes and instead are deemed to be a part of (and therefore have the tax status of) such tax-exempt entity (a "Disregarded Entity"), e.g., a single-member limited liability company for which the sole member is that tax-exempt entity."

# 2. <u>Consolidation of Nonprofit Entities by Other "Business Enterprises"</u>

Assuming for purposes of analysis that the Exposure Draft does not actually apply to nonprofit entities, that would appear to mean only that such entities are not obligated themselves to consolidate other entities for which the nonprofit entity would otherwise be deemed to be the Primary Beneficiary as that term is used in the Exposure Draft. It leaves open a very tricky and potentially troubling issue: would the Exposure Draft require a "business enterprise" to consolidate an SPE which is a nonprofit entity (or an entity formed by such nonprofit entity to conduct a portion of its operations) if that "business enterprise" is determined to be the Primary Beneficiary with respect to it?

The issue and potential for confusion could be avoided if there actually were a definition in the Exposure Draft as to what an SPE is. Absence thereof is particularly significant in this context due to the manner in which the Exposure Draft introduces the notion of SPE in lieu of defining the category of entities to which it refers: (a) noting that SPEs are "often created for a single specified purpose" the activities of which "may be predetermined by the documents that establish" them, <sup>4</sup> (b) noting that such characteristics do not define SPEs because "some business enterprises that are not SPEs have those same characteristics," <sup>5</sup> and (c) distinguishing

<sup>2</sup> This comment letter does not constitute a legal opinion on federal tax laws or on the laws of any state, much less a survey of state laws as applicable to formation and operation of nonprofit entities.

<sup>3</sup> See, Treas. Reg. § 301.7701-3 (26 CFR 301-7701-3) and Internal Revenue Service Announcement 99-102 set forth in Internal Revenue Bulletin 1999-43 at 545 (October 25, 1999). See also, the Internal Revenue Service "Continuing Professional Education (CPE) Technical Instruction Program" for FY 2001, available at <a href="http://www.irs.gov/exempt/display/0.i1%3D3%26genericId%3D6862.00.html">http://www.irs.gov/exempt/display/0.i1%3D3%26genericId%3D6862.00.html</a>.

<sup>4</sup> See, paragraph 2 of the Exposure Draft. A tax-exempt organizations qualified as such in accordance with the provisions of Section 509(a)(3) of the Internal Revenue Code as a "supporting organization" with respect to another nonprofit entity could be particularly susceptible to falling into a plain-text application of that general description.

<sup>5</sup> See, paragraph 2 of the Exposure Draft.

between the two with the observation that "voting equity interests" of an SPE "do not give the holders a controlling financial interest." Unfortunately, most nonprofit entities would, indeed, fall into the category of (a) but would not be in the excluded category of (b) because there is no "controlling financial interest" specified in category (c) -- be it by virtue of there not being any "voting equity interest" of such nonprofit entity or there not being any party permitted under the applicable laws of formation and tax laws to have such "controlling financial interest."

In addition and as noted above, nonprofit entities are permitted to conduct certain of their operations through Disregarded Entites and those can clearly include one which would otherwise be an SPE but not a "Qualifying SPE" under SFAS 140 or even a "quasi-140 entity" under Paragraphs 22 and 23 of the Exposure Draft. Given the nature and purposes of such Disregarded Entities and the manner in which they facilitate ore even fulfill the permitted purposes of the nonprofit entity, the chances are relatively great that there will be a "business enterprise" deemed to be the "Primary Beneficiary" under the existing provisions of the Exposure Draft with respect to such Disregarded Entity.

The net effect of all of that is at best an analytically indefensible conclusion: a nonprofit entity would itself have to accept being consolidated, or having one of its Disregarded Entities consolidated (potentially even without the knowledge of such nonprofit entity), by some "business enterprise" which is not related to it, not limited in scope of activities and purpose to those permitted to the nonprofit entity, and not tax-exempt. Quite apart from whether that conclusion is analytically defensible, it could well raise problems with the Internal Revenue Service and potentially even jeopardize the tax-exempt status of the nonprofit entity. That would be particularly problematic if such consolidation occurred on a theory that some "business enterprise" was receiving a "private benefit" from such nonprofit entity.

#### **PROPOSALS**

As will no doubt be demonstrated by comment letters addressing issues other than those covered by this one, the problems identified above result from applying consolidation rules aimed at preventing accounting abuses to transactions where their logic does not apply. With that in mind, I respectfully submit that the FASB would do well to consider and adopt the following modifications to the Exposure Draft if that project does go forward and some interpretation of ARB No. 51 is issued with respect to SPEs:

- A. <u>Clarify Scope of "Business Enterprise"</u>. The interpretation should state specifically that, as used therein, the term "business enterprise" does not include a nonprofit entity organized as such under applicable state laws and exempt from federal income taxation under applicable federal laws (a "Nonprofit Entity") or a Disregarded Entity of such Nonprofit Entity, irrespective of whether such state and federal laws otherwise recognize the authority of such Nonprofit Entity to engage in activities (directly or through a Disregarded Entity) which colloquially might be called "business" and/or activities which result in a profit.
- B. <u>Clarify Scope of "SPE"</u>. The interpretation should state that, as used therein, the term "SPE" does not include a Nonprofit Entity or any entity which qualifies as a Disregarded Entity under applicable federal tax laws.

<sup>6</sup> See, paragraph 3 of the Exposure Draft.

Ostensibly, a major thrust of the efforts behind formulation of the Exposure Draft is to provide greater certainty and clarity in accounting for SPEs. Although many of the provisions of it are the responsibility of each "business enterprise" as to interpretation and implementation, in the final analysis it will be auditors reviewing transactions <u>already completed</u> who will have to make the ultimate determination as to whether financial statements are prepared in accordance with GAAP and "present fairly" the subject company's financial condition. In the best of circumstances, that will be a matter of subtlety and will cover new territory if the Exposure Draft is adopted. In the current environment in which there seems to be an "open season" for questioning implementation of existing standards, it would be reasonable to assume that there will be a tendency of auditors to reject an interpretation of such standards unless there is a specific basis for it — even one otherwise carrying significant analytical weight and/or probative relationship to other well-established principles encompassed within GAAP.

Perhaps there is already ample basis for stating that the Exposure Draft does not apply to consolidation requirements for nonprofit entities or to consolidation of such nonprofit entities (including Disregarded Entities) by other "business entities." Even so, the unfortunate silence of the Exposure Draft on the issues addressed in this letter will predictably cause uncertainty, unnecessary tensions, and potentially immobilization. Whatever else the Exposure Draft may represent, those results most certainly would not be an improvement on procedures which had prevailed prior to the relatively recent focus on abuses in connection with special purpose entities.

I hope that the foregoing discussion is helpful to your evaluation of the Exposure Draft and of changes to it which might be appropriate before any variant would ultimately be adopted should the FASB decide to do so. Your office should feel free to contact the undersigned to discuss the content hereof and/or discuss alternate methods for addressing the issues set forth. Please note that, in accordance with the notice given by the FASB on or about July 31, 2002, the undersigned has requested the opportunity to attend and participate in the open public roundtable being held on September 30, 2002, with respect to the Exposure Draft and the potential ultimate adoption by the FASB of an interpretation of ARB No. 51 with respect thereto.

Very truly yours,

Steven K. Hazen

<sup>7</sup> It is beyond the scope of this comment letter to consider the potential implication of implementation of the Exposure Draft as it is currently written which might have the result either of not presenting fairly such condition or otherwise being misleading for purposes of applicable securities laws. Presumably some other comment letter(s) submitted on the Exposure Draft will address that potential outcome or the FASB independently consider that issue prior to final action on the Exposure Draft.

<sup>8</sup> Including the FASB's own wording in the Initial Announcement.