## How the Variable Interest Entity Proposal Could Benefit Businesses

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For years, many Los Angeles and Southern California business leaders have used a simple strategy to save on taxes.

Instead of the operating company owning its owner-occupied real estate, the owners will form a separate entity (usually an LLC) to buy the real estate and then lease it to the operating company. This strategy enables owners to save on taxes by recognizing losses primarily generated by depreciation on their tax returns.

The separate entity is known as a variable interest entity (VIE). VIEs are defined as companies in which the controlling financial interest is not established based on a majority of voting rights.

But there has been one big drawback to this strategy: The operating company, not the VIE, has to guarantee the mortgage, which adds a new asset and liability to the operating company's books. This can result in the operating company running afoul of its bank loan covenants and having to go back to the bank to renegotiate these covenants.

### Some Good News

But there is some good news for operating companies that utilize this strategy. The Private Company Council (PCC), a sister organization of the Financial Accounting Standards Board (FASB), has issued a proposal that would exempt many private companies from applying strict consolidation guidance under U.S. generally accepted accounting principles (GAAP) for VIEs to leasing companies that are under common control. This would eliminate the drawback noted above.

The PCC has been tasked with recommending changes to accounting standards to make them less onerous for privately held companies. This proposal — an exposure draft formally known as *Applying Variable Interest Entity Guidance to Common Control Leasing Arrangements* — is one of the PCC's first, and potentially most beneficial, recommendations.

According to FASB chairman Russell G. Golden, it is "intended to help lenders and other users better align the information used in assessing the financial position of private companies that prepare financial statements."

The exemption can be used only if the lessor entity's liabilities only finance the assets leased to the operating company and are not collateralized by the operating company's assets, the PCC specified in the exposure draft. It applies to all non-public business entities except for non-profits and employee benefit plans.

## Other Exemption Considerations

In addition to *Applying Variable Interest Entity Guidance to Common Control Leasing Arrangements*, the PCC is also considering two other private company exemptions:

- Allowing private companies to choose a simplified hedge accounting approach to their financial reporting when they enter into interest rate swaps to economically convert their variable-rate interest payments to fixed-rate interest payments.
- Giving private companies the ability to amortize goodwill acquired in a business combination.

The PCC is also considering two other proposals regarding:

- The combined instruments approach to accounting for certain receive-variable, pay-fixed interest rate swaps.
- Accounting for identifiable intangible assets in a business combination.

FASB and the PCC are currently reviewing feedback received from stakeholders on the exposure draft *Applying Variable Interest Entity Guidance to Common Control Leasing Arrangements.* After review, they will consider possible changes based on the feedback before issuing a final proposal and announcing effective dates.

## Concluding Thoughts

Many Los Angeles and Southern California business owners and executives save on taxes by forming a VIE to buy owner-occupied real estate and then lease it to the operating company. But the operating company, not the VIE, has to guarantee the mortgage, which adds a new asset and liability to the operating company's books. A proposal from the PCC would exempt many private companies from applying strict consolidation guidance under U.S. GAAP for VIEs to leasing companies that are under common control, which would eliminate this drawback. An outsourced CFO services provider can help you determine how this exposure draft could possibly benefit your company.

## About CFO Edge

CFO Edge, LLC delivers enterprise-class financial and operational performance solutions to executives throughout Southern California. Based in Los Angeles, our formerly-seated chief financial officers engage on demand as part-time CFOs, single-project CFOs, and interim CFOs to help business leaders successfully resolve pressing challenges and realize their financial and operational goals. At CFO Edge, we're passionate about helping our clients create, grow and sustain value. For more information, visit www.cfoedge.com or call 800.276.1750 Ext 101.