

# ARTHUR ANDERSEN

August 19, 1999

Ret. Admiral Robert K.U. Kihune, USN  
Mr. David Paul Coon  
Mr. Francis Keala  
Ms. Constance Lau  
Mr. Ronald Libkuman  
Trustees  
Kamehameha Schools Berrice Pauahi Bishop Estate  
Kawaihao Plaza  
Honolulu, Hawaii

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Arthur Andersen LLP

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Louisville Galleria  
2300 Meidinger Tower  
Louisville KY 40202-3460  
502 589 4160

Dear Trustee Kihune, Trustee Coon, Trustee Keala, Trustee Lau and Trustee Libkuman:

Kamehameha Schools Berrice Pauahi Bishop Estate (KSBE), the tax-exempt trust, has negotiated a proposed closing agreement as of August 18, 1999 with representatives of the Internal Revenue Service (IRS). Pursuant to the agreement, KSBE will retain its tax-exempt status under Section 501(c) (3) of the Internal Revenue Code of 1986, (as amended), for all prior periods and will continue to be recognized as a tax-exempt organization in the future subject to its compliance with the conditions of the agreement and subject to its meeting all continuing requirements imposed by the law. In addition, pursuant to the agreement, KSBE will pay nine million dollars plus applicable interest to settle all federal income, employment and excise tax issues relating to KSBE for the years ended June 30, 1990 through June 30, 1996 with respect to all IRS audit issues, and June 30, 1997 through June 30, 1998 with respect to unrelated business taxable income issues relating to credit enhancements. (Note: the settlement amount does not settle any state income taxes or any tax liabilities resulting from the current tax audit related to the affiliated taxable entities).

Arthur Andersen has reviewed the IRS draft Forms 5701, *Notice of Proposed Adjustment(s)*, regarding the tax-exempt status, unrelated business income tax and other relevant issues. We have reviewed materials submitted to the IRS with respect to these issues and participated in discussions with the IRS regarding the IRS's positions. Further we have discussed the issues and the risks of litigation with internal KSBE responsible personnel, other tax advisors to KSBE and the organization's external litigation counsel. Based on our experience with IRS examination negotiations and settlements involving other clients, the circumstances surrounding this case, and the information obtained from the activities discussed above, we believe the negotiated settlement including the payment amount of nine million dollars (plus interest) to be reasonable in settlement of all outstanding KSBE audit issues raised by the IRS in regard to the tax-exempt trust.

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Furthermore, the IRS continues to explicitly state that absent the approval of the proposed closing agreement, it will begin the process to attempt to revoke KSBE's tax-exempt status retroactive to the year ended June 30, 1990. This will likely result in litigation with the IRS. Based on our understanding of the facts and issues, should such litigation go forward, we believe there is substantial risk that KSBE's tax-exempt status would be lost resulting in significant adverse financial consequences to KSBE and affiliated entities.

If you have any further questions regarding this matter, please contact me.

Very truly yours,

ARTHUR ANDERSEN LLP

By *Diane Cornwell*  
Diane Cornwell

SMH