

# Financial Bulletin

Regulations and developments affecting the financial services industry Nov. 5, 2009

## FIN 48 for investment funds

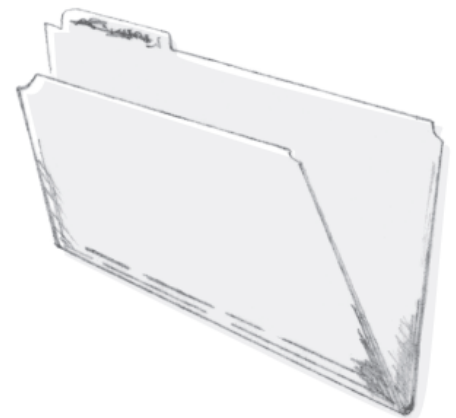
Financial Accounting Standards Board Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, an Interpretation of FASB Statement No. 109 (FIN 48), clarifies accounting for uncertainty in income taxes in an enterprise's financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes* (FAS 109).

FIN 48 creates thresholds for financial statement recognition and measurement of tax positions taken or expected to be taken in a tax return. FIN 48 also provides guidance on de-recognition, classification, interest and penalties, accounting in interim periods, disclosure and transition.

As a result of Accounting Standards Update 2009-6, *Implementation Guidance on Accounting for Uncertainty in Income Taxes and Disclosure Amendments for Nonpublic Entities* (ASU 2009-6), FIN 48 is effective for **private investment funds** that have not yet adopted FIN 48 for years beginning after Dec. 15, 2008. For **nonpublic funds** with Dec. 31 year-ends, FIN 48 should be adopted for the year ended Dec. 31, 2009, with any impact reflected in the first Net Asset Value (NAV) calculation of the year.

FIN 48 applies to uncertain tax positions taken with respect to income-based taxes. For funds, this includes positions taken with respect to federal, state, local and foreign taxes. The term tax position includes positions taken on returns in all open tax years and in all jurisdictions.

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## FIN 48 for investment funds (continued)

FIN 48 needs to be addressed in all U.S. GAAP financial statements for domestic and offshore funds and management companies. FIN 48, as updated by ASC 2009-6, specifically states that the recognition and measurement provisions apply to pass-through entities, such as limited partnerships, even though they are not typically subject to entity-level federal income tax.

FIN 48 applies to all income tax positions accounted for in accordance with FAS 109, whether the positions have been taken on previously filed tax returns or are expected to be taken on a future tax return.

Examples of FIN 48 tax positions include:

- a decision not to file a tax return,
- a decision to exclude potentially taxable income from a tax return,
- a choice made in treating a transaction as “tax free,”
- tax positions acquired or assumed in a business combination, and
- the entity’s status as a tax-exempt or flow through entity.

### Evaluating tax positions

The evaluation of a tax position in accordance with FIN 48 is a two-step process: recognition and measurement.

- 1. Recognition:** The enterprise determines whether it is more likely than not that a tax position will be sustained upon examination, including resolution of any related appeals or litigation processes, based on the technical merits of the position. In evaluating whether a tax position has met the more-likely-than-not recognition threshold, the enterprise should presume that the position will be examined by the appropriate taxing authority that has full knowledge of all relevant information.
- 2. Measurement:** A tax position that meets the more-likely-than-not recognition threshold is measured to determine the amount of benefit to recognize in the financial statements. The tax position is measured at the largest amount of benefit that is greater than 50 percent likely of being realized upon ultimate settlement.

### Pass-through entities

FASB has recently released ASU 2009-6, which clarifies their position with respect to the application of FIN 48 to pass-through entities. While much of the Staff Position paper focuses on “operating” pass-through entities (as opposed to investment companies or investment funds), the interpretation does shed some light on the application to hedge funds. Generally, pass-through entities are subject to the same tax positions encountered by other types of entities. For example, issues that may cause tax uncertainties (exposure to additional income tax expense or reduction of tax attributes) include those that may arise from any of the following (non-inclusive list):

- failure to file income tax returns or to pay income taxes,
- the underreporting of taxable income that may result from underreporting income and/or overstating deductible expenses, and
- challenges to taxpayer status.

Several common tax positions must be documented by pass-through entities, including the entity’s tax status. Management must determine whether the entity is in fact a pass-through entity in the jurisdictions in which it files a return or would otherwise be subject to income taxes. Funds or other pass-through entities must also consider whether the entity has nexus in jurisdictions in which it has income. If the entity has nexus, the filing or not filing of a return is a position.

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Additionally, ASU 2009-6 clarifies whether a tax expense is an obligation of the pass-through entity or its owners. Specifically, the ASU provides examples of when a tax is the obligation of the reporting entity and when the tax should be treated as transactions with the owner or member of the fund. Specifically, they state:

### ***Attribution of Income Taxes to the Entity or Its Owners***

*23. Management must determine whether the laws and regulations of the taxing jurisdiction attribute income taxes to the entity or its owners. That determination is a tax position subject to the requirements of Interpretation 48. If the taxing jurisdiction's laws and regulations attribute income taxes to the entity, amounts due to or from the taxing jurisdiction shall be classified as income taxes and the recognition, measurement, and disclosure provisions of Interpretation 48 must be applied to those income taxes. If the taxing jurisdiction's laws and regulations attribute income taxes to the owners, amounts due to or from the taxing jurisdiction shall be classified as a transaction with owners.<sup>1</sup>*

### **Investment partnership application**

Broadly speaking, many tax positions for investment partnerships flow through to the investors. However, external auditors want to see appropriate documentation surrounding the application of FIN 48 to ensure that the fund or fund group has taken a measured approach towards application.

Also, it is important to note that FIN 48 will be applied by a fund or fund group at the financial statement issuer level. In other words, if a fund group issues GAAP consolidated financial statements that include several entities (and perhaps even different types of entities like blocker corporations, REITs, etc.), the FIN 48 analysis must be performed for each entity included in the consolidated group.

For investment funds, there are a number of issues that should be addressed including (but not necessarily limited to):

- **Tax status and classification of entity (valid partnership).** This can include documenting tax status in other jurisdictions, e.g., check-the-box elections for offshore partnerships.
- **Publicly traded partnership status, which could trigger partnership level transaction.** Evaluate whether partnership interests are readily tradable on secondary markets or established exchanges. However, investment partnerships generally meet safe harbor tests.
- Documentation of valid tax return form disclosures for open years (sufficient Forms 5471, 5472, 8865, 926, 8858, TD F 90-22.1, as well as transactions reportable under the tax shelter regulations - Form 8886).
- State and local tax issues, including tax assessed at the entity level on partnerships (NYC UBT, California, Connecticut, New Jersey, Texas, Illinois).
- Documentation and evaluation of state nexus rules that might require tax returns in various jurisdictions.
- **Loan origination activities that might cause an offshore fund to be engaged in a U.S. trade or business should be documented and evaluated.** This could cause the fund to be subject to U.S. federal and state tax, and/or the federal branch profits tax. If “season and sell” strategy is used, information regarding the validity of the assertion that the fund is not engaged in a trade or business should be obtained.
- Permanent establishments in foreign jurisdiction should be documented and evaluated because funds with foreign offices might be subject to foreign income tax.
- **Blocker entities’ tax status (generally structured as C corporations) should be evaluated and documented.** With regards to international operations, several countries (Australia, Brazil, Germany, Poland, Portugal and Spain) impose capital gains and other income-based taxes on trading and other activities. Funds will need to document and evaluate taxes related to international operations.

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<sup>1</sup> FSP FIN 48-d.

## FIN 48 for investment funds (continued)

### FIN 48 work plan

Hedge funds and investment partnerships need a work plan for FIN 48. A general approach might be:

- **Step 1:** Determine open tax years for all jurisdictions. Generally, this will be three years for federal tax return purposes and most states. However, the statute can be extended if there was a failure to file a necessary tax return, losses in open years that can be carried forward and other limited circumstances.
- **Step 2:** Review the federal, state, local and international tax returns for all open years to establish the inventory of tax positions.
- **Step 3:** Review specific fund tax positions as outlined above and otherwise identified.

- **Step 4:** Review audited financial statements for open years for other applicable information (acquisitions, restructurings, accounting methods).
- **Step 5:** Document all significant tax positions, including entity status.
- **Step 6:** Draft memorandum to document analysis and adoption of FIN 48.

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