

## Important Tax Accounting Pronouncement May Affect Hedge Funds

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A very important pronouncement, FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, has been issued by the Financial Accounting Standards Board (hereinafter “FIN 48”). It is effective for fiscal years beginning after December 15, 2006. FIN 48 may affect hedge funds and other alternative investment vehicles if there is a risk of income tax being assessed at the fund level by the IRS or other taxing authorities. Under FIN 48 such a risk could result in a tax accrual which would be a reduction of the fund’s net asset value.

FIN 48 assures that the benefit of a tax position will not be overstated in the fund’s financial statements. There are many different positions that a fund may take which involve some risk that an additional income tax may be assessed at the fund level. Some examples:

- An offshore fund may engage in lending transactions that could give rise to effectively connected income in the United States.
- In some cases, a domestic fund may fail to file partnership returns in certain states where there is a sufficient nexus to require filing and such failure could result in the imposition of penalties and interest.
- An offshore fund might fail to file a return in a foreign jurisdiction imposing a tax or a domestic fund may fail to file a return in a local jurisdiction imposing an entity level tax (e.g. NYC unincorporated business tax).

FIN 48 applies only to income taxes imposed at the fund level. For example, a decision by a domestic limited partnership to take the position that it is a Trader (as opposed to an Investor) affects the deductibility of management fees and other expenses at the partner level. A challenge to this position by a taxing authority would only affect the income tax liability of the partners, as opposed to the fund; therefore, FIN 48 is inapplicable.

FIN 48 provides a threshold standard of more-likely-than-not to the tax position. More-likely-than-not is defined as the largest amount of the tax benefit that is greater than 50% likely of being sustained upon examination. If 100% of the tax position **is not** more likely than not to be sustained upon examination, an adjustment will be necessary. For example, a fund carefully analyzes a tax position and determines there is at best a 51% chance that only 60% of the tax position will be sustained. The fund would be required to record a liability for the income taxes attributable to 40% percent of the tax position. This will likely be the first such liability in the fund’s history.

Auditors must take FIN 48 into account for audits of fiscal years or short periods beginning after December 15, 2006. Therefore, 2007 is the first calendar year audit to which FIN 48 is applicable. Nonetheless, FIN 48 applies as of the beginning of January 2007. It is most likely that any adjustment proposed under FIN 48 will not occur until early 2008 when the auditors commence the audit of the 2007 calendar year. Any proposed adjustment will affect the net asset value or capital account balances of the fund at each valuation date during the 2007 calendar year. Consequently, it is possible that an investor redeeming during the 2007 calendar year (for example March 31) could be overpaid since the liability for income taxes may not have been recorded on the books of the fund. The first financial statements affected by FIN 48 must take into account the cumulative effect of the adjustment attributable to prior periods.

Fund managers should contact their auditors immediately to discuss the application of FIN 48 to their fund. Discussing the issue with auditors should assist fund managers in avoiding any unpleasant surprises at year end.