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Important Changes in Accounting for Income Taxes – Impact of FIN 48 on Private Equity Funds

In January, 2007, we issued an Eisner Tax Advisory Services Alert describing how a recent interpretation of the Financial Accounting Standards Board Statement 109, referred to as FIN 48, would affect the treatment of uncertain tax positions on GAAP financial statements prepared by both public and private companies. With that Alert, we included a memorandum of how FIN 48 applies in the context of transfer pricing. Both the Alert and the memorandum on transfer pricing can be viewed in the tax section of our online library at www.eisnerllp.com.

The memorandum below describes the impact of FIN 48 on private equity firms, with particular attention to pass-through entities. Future Alerts will describe the impact of FIN 48 on various other tax positions on GAAP reporting entities.

FIN 48 Disclosure Issues for Private Equity Funds

by Lawrence S. Zeff

The Financial Accounting Systems Board ("FASB") has released Interpretation 48 ("FIN 48"), Accounting for Uncertainty in Income Taxes, as an interpretation of FAS Statement 109. The purpose of FIN 48 is to provide consistent guidance on the recognition in financial statements of "uncertain" income tax positions. Since FIN 48 applies to any entity which maintains its books and records in accordance with Generally Accepted Accounting Principles ("GAAP"), it could affect many private equity funds and their portfolio investments even though they may operate as flow-through entities for tax purposes. While the most significant changes will be in the manner in which public and private corporate entities calculate their tax provisions, flow-through entities such as Limited Partnerships and Limited Liability Companies ("LLC's") must now consider whether to establish FIN 48 tax liabilities in their financial statements, and consequently, in their calculation of Net Asset Values ("NAV's"). Since these liabilities may be contingent in nature, the timing of the recording and subsequent release of these contingent liabilities may result in a significant mismatch in investor contribution and withdrawal NAV's. While corporate investors need only disclose uncertain tax positions based upon available information, a related question arises whether, in applying their own FIN 48 application, it is incumbent on such investors to inquire if there are uncertain tax positions at the level of the flow-through entity.

The FIN 48 Rules

FIN 48 provides specific guidelines on recognition, measurement, and other aspects of reporting and disclosing uncertain tax positions. Recognition is permitted on the financial statements for each position if, based on its technical merits, it is "more likely than not" (more than a 50% likelihood) that the position will be upheld under audit. Measurement requires an evaluation of

the potential outcomes that could occur upon an eventual settlement with the taxing authorities and an application of the probabilities. For tax-paying entities, FIN 48 addresses the determination of whether permanent or temporary tax benefits claimed on a tax return should be recorded on the financial statements. The company is required to identify and evaluate all material tax positions taken in all tax returns filed in the past and still open for inspection, as well as tax returns filed currently and in the foreseeable future. For pass-through entities, FIN 48 requires a determination whether to record new tax liabilities on the financial statements.

FIN 48 Exposures for Pass-Through Entities and their Investors

Most private equity funds structure their investor vehicles as tax partnerships which do not directly pay tax, but instead pass through the tax-paying responsibility to their investors. Notwithstanding that structure, the FIN 48 applicability for those vehicles is directed toward the determination whether those entities have identified any exposures which could result in the requirement to book financial statement tax liabilities. Although these pass-through entities do not normally pay tax, there are several potential tax exposures that could cause the establishment of FIN 48 tax liabilities in either the pass-through or corporate investor entities. Some of these exposure items are described below:

1. Exposure to taxation in foreign jurisdictions:
 - a. Whether the pass-through entity is deemed to have established a permanent establishment in a foreign jurisdiction and is subject to foreign tax. This could occur, for example, when a fund opens an office in a foreign jurisdiction and is deemed to be doing business there.
 - b. Whether the pass-through entity may have filed a faulty “check the box election” in the foreign jurisdiction and is consequently taxed at the fund entity level. This might occur if the fund has organized as a “limited liability” entity in the foreign jurisdiction and is consequently taxed as a corporate entity.
 - c. Whether transfer pricing rules will result in apportionment of pass-through entity income to a foreign jurisdiction. This may subject the fund or the investor to taxation in the foreign jurisdiction.
 - d. Whether the pass-through entity has failed to properly collect foreign withholding tax where required. In this case, the foreign jurisdiction may make the determination well after the withdrawal of an investor and cause liability for that share of the withholding tax to be placed at the fund level.
2. U.S. taxation of foreign investors:
 - a. Activities of the pass-through entity that are deemed to create “effectively connected income” for foreign investors, which are subject to U.S. withholding tax. This may arise where a fund with foreign investors is deemed to be conducting a U.S. business. Once again, this determination may be made well after a foreign investor has withdrawn from the fund.
 - b. Failure of the pass-through entity to collect and report withholding tax

“...FIN 48, would affect the treatment of uncertain tax positions on GAAP financial statements prepared by both public and private companies.”

3. State and local tax exposures:
 - a. Whether various states claim nexus to investor entity activities. If these exposures are ignored and are subsequently determined, the resultant tax liability may become an obligatory FIN 48 disclosure of the fund, and/or the corporate investor.
 - b. Whether such state and local tax liability assessed at the pass-through entity level as, for example, the New York City Unincorporated Business Tax, has been properly calculated.
4. Penalty and interest exposures related to tax filings may be included in tax provisions of investor corporations. If so, there may be such exposures as:
 - a. Information reporting
 - b. Tax shelter reportable transaction filing
 - c. Foreign bank account filing
 - d. State and local tax penalties

Effective Date

FIN 48 is effective for fiscal years beginning after December 15, 2006. While the SEC has permitted an extension of FIN 48 implementation for calendar year mutual funds to June 29, 2007, no such extension has been provided to other alternative asset funds. Therefore, any calendar year fund that calculates monthly NAV should have begun compliance with FIN 48 as early as January 2, 2007.

Implementation Issues

The implementation of FIN 48 could result in creation of tax liabilities that are never paid. Establishment of these liabilities will create an immediate effect on NAV. If these exposures eventually expire without actual liability, they will be reversed under FIN 48 in that subsequent period. Therefore, investors may be positively and negatively affected depending upon when they entered and departed the fund.

FIN 48 may cause private equity executives to focus on activities that might create financial statement tax exposure. While great emphasis has been placed on the U.S. taxation of transactions, increased emphasis will be placed on understanding the international and state and local tax implications of these transactions as well.

FIN 48 could have an effect on corporate investors of private equity flow-through entities because these funds, upon request for information by corporate investors, may disclose tax exposure information to such investors, which, in turn, may cause these investors to apply FIN 48 analysis on their own financial statements.

“FIN 48 will cause private equity executives to focus on activities that might create financial statement tax exposure.”

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