

**Client Update: January 12, 2010**

## **FIN 48: Accounting for Uncertainties in Tax Liabilities**

Although public companies have been operating under the Interpretation No. 48, Accounting for Uncertainty in Income Taxes of FASB Statement No. 109 (“FIN 48”) since the beginning of 2007, as of December 2009, US private enterprises and pass-through organizations, such as hedge funds and private equity funds, are now being required to account for uncertainties in their income taxes when presenting their financial conditions in annual financial statements. The new requirements can have particularly distressing effects for investment funds, as much of FIN 48 relates to accounting and reserving for uncertainties in their income taxes—uncertainties that increase substantially with foreign investments and capital gains.

A recent example of the difficulty of accounting for tax liabilities when trading internationally occurred this past November, when Australia's tax office billed a US private equity group, TPG, \$628 million for taxes and penalties regarding the group's recent sale of its stake in an Australian department store in an initial public offering. The dispute appears to center on whether such sales should be taxed as ordinary income as Australian-sourced income and whether TPG had a “permanent establishment” (via controlled agency) in Australia and whether TPG's structure was designed to avoid taxes. The assessment seems to cause a sudden reversal of Australia's trend to attract foreign capital by not imposing capital gains taxes on non-residents.

### **Tax Uncertainties Common to Many Investment Funds**

- A taxing authority in any foreign jurisdiction in which the fund invests may impose a tax on the profits/gains of the fund despite the fund's lack of direct presence in such jurisdiction and its use of prime brokerage agreements, etc.
- The fund's use of a related entity to take title to investments may or may not entitle the fund to the benefits of a “double tax treaty.”
- For a hedge fund taxed as a partnership for US tax purposes that also has tax exempt investors, will the fund's use of leverage and/or other strategies give rise to “unrelated business taxable income”?
- Conversely, for a hedge fund taxed as a corporation for US tax purposes that also has tax exempt investors, will US dividends be subject to withholding taxes?
- Will financing strategies by an offshore fund to obtain US sourced loans (via independent agents) trigger “effectively connected income”?
- Did the hedge fund fail to file returns in states (or local jurisdictions, such as NYC) where there is a sufficient nexus to require filing?

### **Impact of Tax Uncertainties on Investment Funds**

- Calculation of net asset value (NAV)
- Impact of tax reserves in financial statements on loan covenants
- Potential liability if fund liquidates without funding tax reserves

### **Potential FIN 48 Solutions**

- Legal opinions (preferably, “covered” opinions within the meaning of Treas. Circular 230)
- Full indemnification by the fund's general partner/portfolio manager/investment advisor for any tax liabilities (as briefly discussed below, this may impact the calculation of NAV and/or the establishment of tax reserves/charges under FIN 48)
- FIN 48 Insurance or (transactional) Tax Insurance supporting the legal opinion or indemnity obligation

Both FIN 48 Insurance and Tax Insurance policies provide cash certainty with respect to uncertain tax positions, and both cover specified tax positions against claims brought within the policy period. If a covered tax position is disallowed, the additional taxes, penalties, and interest resulting from the disallowance are payable in accordance with the terms and conditions of the policy. Defense costs and “gross-up” costs (the tax on the receipt of insurance proceeds) may also be covered.

Also, both FIN 48 Insurance and Tax Insurance policies provide that once a claim is reported under a policy, the expiration/non-renewal of that policy will not impact coverage for such claim.

FIN 48 Insurance differs from traditional or transactional Tax Insurance in that the FIN 48 Insurance policy:

- Is annual and renewable, allowing for flexibility of limits/premium, covered tax years, covered tax positions, and even covered tax jurisdictions—to fit each firm’s annual budget.
- Generally costs between 1½-3% of limits (depending upon scope of issues, etc.), exclusive of surplus lines taxes and fees.

Transactional Tax Insurance generally covers a discrete tax position (or series of related positions) for a fixed period (up to 6 years) for a rate-on-line of 3-7%, depending upon specific exposures and related issues.

Loss mitigation/due diligence fees are generally charged by underwriters after a preliminary evaluation of the scope of risks and a decision to move forward is made by all parties after the underwriter proposes specific terms. Those fees generally are at least \$10,000 to \$50,000, and can be significantly higher for complex matters involving \$100 million+ programs. The fees offset the initial costs of underwriting the risk and also compensate for the value received in quantifying the tax risk(s) and marshalling the evidence and legal theories in defense of the tax position(s).

### **Potential Benefits**

- Existence of insurance (especially if coupled with legal opinion and/or indemnity obligation) may allow auditor to calculate NAV without liability for covered tax position(s)
- If a “more likely than not” opinion supports the covered tax insurance, existence of insurance may allow auditor to measure settlement discount for FIN 48 reserve/charge purposes at no value (fully recognizing the tax benefits of the covered tax position) since management can demonstrate good reason to not settle the issue at a discount
- Cash when needed for disallowed tax position

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