Valuation: Income Tax Basis vs. US GAAP

November 2017

When reporting for investment values, fund managers should consider two different frameworks: the income tax basis of accounting, as promulgated by the Internal Revenue Service (IRS), and the United States Generally Accepted Accounting Principles (US GAAP), as promulgated by the Financial Accounting Standards Board. Managers need to understand the main differences between these two frameworks in order to make decisions that align with their investment strategy – and from an investment fund's perspective, there is one especially important area of divergence to note.

According to US GAAP, investments are required to be reported at fair value. The Accounting Standards Codification (ASC), the authoritative source of US GAAP, establishes a hierarchy that prioritizes the inputs to valuation techniques used to measure fair value into three broad levels: Level 1 gives preference and the highest priority to quoted prices in active markets for identical assets or liabilities; Level 2 includes inputs other than the quoted market prices in active markets that are observable either directly or indirectly; and Level 3 includes the lowest preference to unobservable inputs. This means a frequently traded public security should not be valued using unobservable inputs, and similarly, an investment in a private entity with no secondary market should not be valued using Level 1 prices. ASC 820, Fair Value Measurement, also clarifies that fair value is market based, as opposed to an entity-specific measure. Therefore, rather than using a subjective approach, investments should be valued at a reasonable current exit price. The difference between the cost of the investment and fair value is known as the unrealized gain or loss, and the change in the unrealized gain or loss is recognized in earnings during the period.

If an investment falls under the Level 3 category, significant additional disclosures are required to comply with US GAAP. Funds have specific disclosure requirements to reconcile beginning and ending balances of these investments, including purchases, sales, issuances and settlement, as well as realized and unrealized gains and losses, the disclosures of unobservable inputs and the numerical range of inputs used, all within the assets and liabilities classes.

From an income tax perspective, fair value may be reported on a fund's Form 1065, where changes in unrealized gains and losses occurring during the period are not considered currently taxable events and instead are referred to as "temporary" differences. When a fund distributes a Schedule K-1 to its partners, none of the change in unrealized gains or losses is passed-through to a partner for inclusion in their tax return. Changes in fair value only become taxable upon exit from a position, when an assessment on the holding period is performed, and tax is levied at either short- or long-term rates, depending on the circumstances. Conversely, US GAAP gives groups all holding periods into a single total "realized gains or losses on securities." Given that the income tax basis of accounting does not recognize the fair value hierarchy, additional Level 3 disclosures are not required.

The example below shows the fair value of "Investment in Private Company X" over a five-year holding period and its associated reporting implications, and assumes no additional investment income or expenses:

Year	Fair Value	US GAAP Income	Tax Income
20XX (acquisition)	$100	$0	$0
20X1	$110	$10	$0
20X2	$160	$50	$0
20X3	$90	$(70)	$0
20X4	$140	$50	$0
20X5 (exit)	$150	$10	$50

One exception to the above rule is when a fund qualifies for special treatment of investments under IRS rules. Known as the "Mark-to-market 475(f) election," when this election is made, changes in unrealized gains and losses are passed through to the partners of the fund and taxed currently as ordinary income rather than capital gains. In the example above, under this election, the Tax Income column would be identical to the current US GAAP Income column. Generally, this election is made at the inception of the fund and should align with the fund's investment strategy. Certain criteria must be met to make this election.

Other areas of accounting that are not as common in the investment industry, but where divergence is notable, are bad debt expenses, depreciation, goodwill, purchase accounting and revenue recognition. Consult your tax professional for important information regarding these topics.

Richey May is dedicated to sharing best practices and trends in the industry to help you stay competitive in the local and national marketplace. For more information on Richey May, please contact **Stephen Vlasak** at **svlasak@richeymay.com** or visit our website at **www.richeymay.com**.

Disclaimer: *The foregoing is a general informational overview and is not intended, and is not to be relied on, as legal, accounting or investment advice. Readers should consult with their own advisors for guidance.*