Tax function of the future for private equity

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Introduction

Each private equity firm's tax function is unique in that it has typically organically grown from a smaller set of tax activities, such as a tax compliance and reporting focus, to a more evolved set of activities meant to address the features that the fund manager's founders and other business leaders perceive as most important for their business — and now, in some instances, to meet the needs of a regulated entity. We have observed that there is no standard, "one size fits all" approach to the tax function across fund managers. Nonetheless, we see commonalities among the tax functions.

Consequently, we believe that the private equity tax function of the future will be a right-sized, cost-effective, value-adding tax group that supports the business objectives of the private equity fund and manages core tax activities, which most often include:

- Identifying opportunities and managing the associated risks
- Structuring investments and restructuring transactions
- Reporting tax and financial results in multiple jurisdictions to varied investors and government authorities
- Efficiently outsourcing non-value-adding tax tasks
- Successfully leveraging processes and technology to access relevant insights from data in a timely manner and to scale and to scale analytics as the business grows
- Timely communicating to key stake-holders vital tax and financial items in a concise and business friendly manner

In our experience, private equity CFOs and heads of tax accordingly view and periodically revisit the tax function with the following questions in mind:

- What tasks are required, value-adding, core activities of the tax function that support the private equity fund's business?
- What core activities should be retained within the organization, and which tasks are not core to the business that should be partially or wholly outsourced?
- Where are these opportunities to reduce risk, maximize value, and create a scalable, cost-effective, value-adding tax function?

This note takes a closer look at the activities of the private equity tax function, with observations of trends and practices related to core and non-core activities, the use of process and technology capabilities (and now even AI) and outsourcing to manage the constantly increasing tax complexity and growth of the business. The discussion proceeds in four parts. **Section 2** reviews the activities and tasks that need to be accomplished by the private equity tax function, with our comments on the primary trends we see in the market. **Section 3** outlines a decision framework for building a tax function of the future. **Appendix A** summarizes common tax function configurations we observe at different-sized managers. **Appendix B** lists "leading practices" and "notable challenges" for the private equity tax function for a variety of common tasks.

What activities and tasks does the private equity tax function need to accomplish?

Common areas of responsibility for private equity tax functions are, broadly: tax policy; fund and manager tax matters (including executive tax); transaction tax; and portfolio company tax matters.

a Tax policy

The primary purpose of the private equity tax function is to support the objectives of the business. Tax policy must provide the objective, governance and measure for every issue managed by the tax function to support the business (we highlight just a few of the key decision areas below). As most of these tax decisions may represent only one element relevant to key business or investment decisions, and they are rarely solely made by the tax function, it remains critical to socialize and communicate necessary tax input for decision-makers. In practice, we often see that they are viewed through a risk-based lens.

Strategy/policy

The threshold issue concerns defining how a particular organization chooses to weigh opportunity and risk in various situations when supporting the business. For example: What risk areas require professional advice? What level of confidence should such advice reflect (e.g., "will," "should," "more likely than not")? Is the tax advice commercial? What is industry practice? For any given tax activity, does the business want to be "best-in-class" (e.g., with respect to investor-related issues), "best-in-cost" (e.g., for certain reporting issues), or somewhere in between? Is the policy well communicated to and understood by the relevant audience? How is the strategy/policy implemented and documented (e.g., formal opinion, informal correspondence, internal file memo)?

Different risks may warrant different approaches. For example, managers must be able to support tax return positions. Other obligations, such as supporting an accounting presentation, or documenting compliance with environmental, social, and governance (ESG) commitments (which often include some tax elements), may require that support to take a particular form. Lastly, we have seen process and technology play a bigger role in risk management, particularly the thoughtful use of integrated document management providing access to useful data from dashboards and analytical reports (without the effort of searching for and sorting through unnecessary details or out-of-date data).

Written tax policies and procedures provide the tax function the opportunity to inform the fund manager (and its advisors) about the "rules of the road" for the organization. A tax function often runs smoothly where the tax function implements formal tax policies and procedures. Failure to do so can lead to inconsistencies in PE fund tax policy (even in small fund managers) and ad hoc decision-making that may result in expensive and unexpected tax costs in the future.

Fund structuring

When raising capital, a fund manager's strategy/policy will determine whether, or to what extent, it can or will cater to investors' tax sensitivities, and whether doing so may merit the creation of structural alternatives (e.g., prevention of US income tax return filings, prevention of taxable income treated by a given investor jurisdiction as derived from a trade or business), which may entail additional structural and administrative liabilities, costs and risks.

Management company activity

As with other categories discussed here, management company activity is almost never solely a tax department decision, but it does have important tax consequences and thus ordinarily should involve tax input. Highlights typically include arrangements for local subsidiaries to employ resident professionals (and often their individual tax issues), and the intercompany agreements and associated transfer pricing embodying the relationship between a parent entity and each local entity.

Carry plan design

Private equity tax functions typically do not make fundamental carry plan decisions but do need to be involved. Typical issues to be addressed include: whether carry plan participation is uniform across the entire fund portfolio, or per investment; funding options for participants' capital commitments (e.g., out of pocket and/or with borrowing); and whether, or to what extent, to protect participants from tax return-filing obligations outside their tax residence jurisdiction. These business issues result in tax issues around the world for both the management company itself, and individual carry plan participants.

Governance

Decisions, decision-making processes, and implementation must preserve the integrity of a strategy and policy by implementing and maintaining consistency and compatibility, while at the same time accommodating and accounting for potentially competing institutional concerns (e.g., tax vs. legal vs. accounting). Well-documented policies and procedures are important to the private equity fund's business, but also increasingly to ESG-conscious investors.

TREND

We are seeing increased reviews of the tax function's connectivity and relevance in supporting the PE fund business that go beyond simply managing risk. We have seen that written tax policies and procedures coupled with the contemporaneous tax involvement with business developments, management company decisions, and investor sensitivities, combined with a robust tax decision-making process that can respond quickly and comprehensively to business developments, are among the most important features of an effective tax function.

b Fund and manager tax matters

Tax compliance and reporting are the most traditionally and universally associated activity with the private equity tax function. The timely and accurate reporting of business activity is critical to the fund and manager. Historically, in tax compliance and reporting, the multiple and varied tax data requests by investors and governmental authorities, in different jurisdictions, in various data formats, with varied tax due dates have consumed an inordinate amount of time and effort of the private equity tax function. Quickly evolving tax process and technology capabilities (and in the future, likely artificial intelligence (AI), as it develops) are a key component of how a private equity fund manages its tax data.

Data development/management

The tax function's ability to access and manage data is fundamental to every element of tax compliance and reporting, as well as planning and transactions. Unfortunately, we often see tax data stored in spreadsheets, which are not easy to access and are prone to error. Equally unfortunate, the required source tax data almost always reside in other enterprise functions, in different formats, and relate to multiple periods. For example, the financial data required for tax return preparation and provisioning reside in the accounting function, which commonly uses financial data differently (e.g., on a consolidated basis, rather than on the entity-by-entity basis needed by the tax function). As another example, investor onboarding information needed for investor demographics, distribution tax withholding and tax reporting compliance is typically located in a subscription-document package ordinarily administered by the legal function. Similarly, details of transactions, and legal entity formation and governance, necessary for tax compliance commonly reside with the legal function, deal teams, and/or outside service providers. Nonetheless, the tax function is "responsible" for the development and management of all tax data required for tax compliance and reporting, as well as for planning and transactions. Increasingly, we see private equity funds (although still a minority) exploring the full potential of process and technology capabilities to manage tax data.

Fund compliance and investor tax reporting

Fund-entity return filings and investor reporting are complex enough in the easiest cases but may be complicated further by difficult questions regarding allocations of taxable income as between investors and the carry plan, global obligations such as FATCA/CRS[1] and investors located in multiple jurisdictions. What is more, investors increasingly have tax reporting questions that need to be answered. Inevitably, the tax function is "responsible" for answering these questions.

Management company compliance and reporting

The management company is of course a complete operating business, often with a global footprint, that is separate from any fund entities and is an operating entity with all the attendant tax obligations, e.g., payroll reporting and withholding, local income tax filings (including transfer pricing where applicable), and VAT registration and filings where applicable. In addition, fund managers provide reporting to owners/founders. Some fund managers also provide family office functions to founders and senior executives.

Fund and management company financial reporting

The tax function generally creates and/or oversees the creation of the tax provision and tax accounts for the financial statements, as well as provides the information for notes required by applicable accounting standards. In a public company environment, the tax function may certify the results on a quarterly/annual basis in cases where the risk profile is significantly higher.

Public company compliance and reporting

Fund managers that are organized as public companies (PubCos) do not typically house all the employees in the PubCo; nevertheless, PubCo may exercise control over the fund manager (and possibly the fund), requiring management of the associated tax matters. In particular, the stakes associated with tax provisions require special care and attention.

Tax audits and controversies

Tax notices and audits come first to the tax compliance function, which generally must respond to the tax notices, oversee the tax audit, and advise management regarding options for addressing any controversy that may arise, many times globally.

TREND

Development of strategies for managing tax data (internal — and often done offshore with a lower cost workforce), tax process and technology (outsourced due to the large investment needed but monitored) and tax personnel (co-sourced and in some cases completely outsourced) are critical to operating the tax function efficiently. High-value tax matters are in-sourced, preserving institutional knowledge within the manager. Low-value matters are outsourced and managed via "dashboarding" and analytical reports in the most cost-efficient manner.

c Transaction tax

Transaction tax is often viewed by the managers of the private equity funds business as the highest value add activity that the tax function provides and often in non-private equity areas of expertise (e.g., credit, real estate). We increasingly see managers hiring "partner-level" in-house tax staff, who assist in transaction structuring and risk management.

To the extent fund deal teams attend to tax issues, the tax function may be involved in deal tax points as well as broader issues affecting the private equity platform. For example, the tax function may be asked to consider items that have a clear and direct relevance to valuation, such as a portfolio company's legacy tax issues/liabilities, and the allocation of tax risks between transaction parties.

[1] Foreign Tax Account and Compliance Act (FATCA) and Common Reporting Standard (CRS).

However, the tax function is responsible for broadening its focus on potentially important fund- and investor-level issues. For example, the investment holding structure and the fund's investor composition may affect a portfolio company's eligibility for such incentives as renewable energy tax credits, accelerated depreciation, or reduced rates of withholding.

More indirectly, but just as importantly, funds generally seek to maintain a consistent approach to managing risks across a wide variety of key tax areas of focus. Examples include the potential for reputational exposure; whether to employ a regional holding company platform, and if so, how it should be implemented; and managing permanent establishment and tax residency risks inherent in board composition, board conduct, and contract execution. We are also increasingly seeing the tax function spend time on transaction matters and tax diligence in preparation for exits of portfolio assets.

TREND

Increasingly, private equity funds are hiring "partner-level" in-house tax talent to manage the risk of complex transactions and assist their advisors with transaction structuring, which fund investors also view as a value-adding activity.

d Portfolio tax matters

Most private equity fund tax functions, historically, for various reasons, have left most portfolio company tax matters to portfolio company management. However, the private equity tax function has always needed high-quality tax information well in advance of the fund's own compliance/reporting deadlines, particularly with respect to portfolio companies structured as fiscally transparent entities. This need for timely and accurate portfolio company tax data has often created tensions with the portfolio company, including consistency of position with the fund on various tax reporting items, information tailored to private equity investor reporting needs (i.e., IRS Schedule K-1/K-3), and the need to develop and disseminate information substantially earlier than the portfolio company may have done prior to acquisition by the fund.

We increasingly see fund managers addressing these issues by engaging the same firm that handles fund compliance and reporting to handle portfolio company compliance and reporting, both to achieve timeliness, consistency, and quality, and to assist portfolio company management with tax positions and incentive arrangements common to private equity investments.

A minority of private equity tax functions have addressed specific portfolio company tax from the fund level by engaging one or two tax advisory firms to work with companies across the portfolio; we see this most often with middle market private equity funds. We increasingly see private equity fund managers, particularly those with operations/value creation groups, focusing on portfolio company tax as a differentiator. They understandably tend to focus on portfolio company cash taxes (such as challenging considerations for interest expense limitations or applying for such benefits as the Work Opportunity Tax Credit (WOTC)), but sometimes they look for possible operational efficiencies within the portfolio company tax function (such as whether or to what extent to outsource tax compliance). We also see more private equity funds perform sale side tax diligence (including so-called "tax books," i.e., a summary of major tax attributes/potential tax issues) to confirm that there are not any value-reducing tax issues when a portfolio company is sold.

At the level of portfolio company holding entities, we see most fund managers outsourcing tax compliance and reporting obligations, often to the same provider(s) that handle fund-level compliance and reporting for the same reasons discussed above.

TREND

An emerging trend noted is the tax function's increasing involvement in tax at the portfolio company level, with tax and operating group team members coordinating, as well as the selection of a single service provider to manage tax matters across all portfolio companies. Many fund managers increasingly view the tax function as providing protection of portfolio company value on exit and increasing value during the investment holding period.

Decision framework for building a tax function of the future

In the private equity business model, the tax function is a non-core but essential operating activity. Like other private equity business functions, tax costs must be managed, and its activities (not necessarily the number of tax professionals) need to scale with the business. In recent years, we have heard founders and CFOs comment: "Who are all these non-investment people and what do they do?" Herein is the tension as the tax function in the face of increasing complexity, regulations and data often needs more headcount, more budget, or both at a minimum for risk management and ideally to support the business. To properly respond, the tax function must present a view on:

1. What are the core tax risk managing and value adding activities and the non-core tax activities of the tax function
2. How all tax activities will be accomplished (i.e., in-sourced (including members of the team in cost effective locations) or outsourced)

In assessing the tax function, we have seen an emerging risk-based framework whereby the tax function reviews and determines which activities and tasks are "core" tax functions, and then combines the strengths of in-house tax professionals, external tax service providers, and tax processes and technology solutions to accomplish all tax activities. The threshold issue is the identification of high value-adding activities. In our experience, the core activities that should be sourced or retained by in-house tax professionals are strategy, risk management (including notably, fund investment transactions), communications, quality control, investor tax sensitivities and issues, data analytics, tax planning, and tax controversy. The non-core activities that should not be sourced in-house are those activities that are routine, not significant, such as data collection, data cleansing, workpaper preparation, reconciliations, direct and indirect tax return filings. Notably, a significant benefit of identifying and sourcing high value-adding activities to in-house tax professionals is the reallocation of in-house resources to more strategic business activities, the augmentation of in-house skills and the likely retention of in-house talent.

Central to the decision on the sourcing of the performance of the activity with or in combination with in-house personnel, the private equity fund must carefully consider its external advisor/service provider outsourcing strategy including the service provider's skill sets, their capabilities in data management and technology, and their ability to scale and grow with the business. We often see middle market funds use a limited number of tax advisors, so the fund is a large enough client for each advisor to merit the proper attention. We often see larger firms use multiple advisors so that they cover the market for the best ideas; competition among advisors often results in better service and pricing. These potential benefits must be weighed against both the benefits of fewer advisors with deeper client knowledge (also higher quality service and consistency that is more proactive), and the potential distractions of spending too much time managing multiple advisors. Most often we see larger fund managers maintain relationships with many firms but designate one or two primary accounting/law firm advisors.

Central to all activity within the framework is a plan for, and the use of, tax data processes and technology. We are seeing more inquiry, more use of data governance, data quality standards, and process and technology solutions to replace historic manual, customized processes and technology configurations previously developed ad hoc as the tax function expanded. We are seeing more tax functions implement solutions, either in response to an urgent need, a strategic multi-year tax plan or as part of an enterprise transformation (where tax has a seat at the table), such as: a common data model for increased automation and reuse of data; automated workflow and tax calendaring; standard reporting and analytics; real-time dashboard capability to view all tax activities; one common portal to view all service provider activity; and integrated document management for version control and access. Often, we see these tax solution improvements developed and implemented in collaboration with the funds' tax compliance service provider due to efficiencies and the cost of software development, which is typically borne by such service provider.

Lastly but importantly, we note that the initial wave of out-sourcing of tax compliance combined with the heavy use of advisors on transactions, has occasionally created the (mis) perception that "tax has been outsourced" and there is no longer a need for an in-house team. While the performance of many activities can and should be outsourced, there is always the need for an internal team that has institutional knowledge of the business and its positions to perform strategic, sensitive work; make material, significant tax decisions; and review the work of its service providers. The need to manage tax costs as well as tax risk requires a thoughtful review of tax activities to be performed and by whom, the use and performance of tax advisor/service providers, the leveraging of process and technology capabilities, and the "right size" and mix of an internal tax talent (i.e., the skills to address and/or manage the activities and service providers as well as qualifications to assess the associated risks).

The following is an emerging view on core and non-core activities, by area, taken by private equity tax functions:

a Tax policy

Tax consideration, tax policy and accountability for tax activities are not outsourced. The tax function strives to have qualified individuals and robust internal processes for identifying and managing tax activities, both as an initial matter and as questions arise in the future. Also, significant investor relations matters (responding to nonroutine, material investor questions) generally are not outsourced and are handled in-house, due to the importance of maintaining investor relationships and a reluctance to insert third parties between investors and the fund manager. Minor or general inquiries are standardized and outsourced.

b Fund and manager tax matters

We most often see tax compliance and reporting either "co-sourced" or "fully" outsourced. The primary considerations for the tax function in outsourcing concern the loss of control, and to some degree the maintenance of "institutional" memory. Heads of tax evaluating whether and to what extent (or how successful) to outsource compliance and reporting typically focus on whether their current processes and technology allow quick and easy access to tax data (e.g., how much time does the tax function spend chasing data?), and whether outsourcing presents an opportunity to improve, with any attendant considerations.

As previously mentioned, tax compliance and reporting have historically relied on highly manual processes centered on spreadsheets and the occasional ad hoc technology solution. The ever-increasing volume of required tax data, additional complexity under changing rules, and the need for scalability drive a centralized, automated, integrated process and technology solution to access and manage the required data. As the private equity business grows, heads of tax see the value of tax compliance and reporting evolving away from spreadsheets and toward databases that serve as an accessible "single source of truth" with data from the various functions primarily responsible for them (e.g., accounting, legal). We have seen how outsourcing tax compliance and reporting can benefit managers in a variety of ways. Service providers are better situated to develop, maintain and continuously improve such expensive and specialized technology as databases and associated tools for developing tax information. As a result, we have seen how fund managers can respond quickly and comprehensively to the tax aspects of new laws and new business without dramatic internal changes. Additionally, service provider fees may constitute a fund expense (which typically must be recouped from investment income before carry entitlements apply), whereas employees commonly are a manager expense.

Notably, outsourcing the fund's tax compliance functions does not mean that there is no internal risk management element to tax compliance. Tax directors should identify the areas that require the most oversight. Consideration should be given to focusing on high-level, big-picture tax issues, while leaving details to the outsourced service providers.

c Transaction tax

Transaction tax almost always is outsourced for reasons of efficiency and/or subject matter, industry, or geographic knowledge. Even so, and as noted above, we increasingly see the tax function staffing in-house (this is especially true of global investing platforms, but also occurs with middle market fund managers) with at least one highly experienced (partner-level) tax person to "own the facts and decision," to manage the outside providers and to provide an appropriate degree of tax structuring assistance. Where managers have multiple asset strategies, we often see multiple experienced (partner-level) tax personnel hired to oversee each strategy (e.g., credit, real estate).

d Portfolio tax matters

Portfolio tax matters primarily remain at the portfolio company level. The analysis of tax activities and the decisioning of outsourcing at the portfolio company level mirrors the framework above. As noted above, we increasingly see the private equity in-house tax function become more active in the assessment of tax skills at the portfolio company level, the communication with the portfolio company tax department and/or service providers of the private equity's expectations, including a proper understanding of the tax effects to the general partner (GP) and limited partner (LP) investors of the fund as a result of operations occurring at the portfolio company level, and assistance in value creation planning.

TREND

We are seeing more focused analysis of tax activities, evaluation of tax service providers, use of process and technology, and review of internal tax talent. Related, an emerging trend is more thoughtful management and monitoring of advisors to establish that the insourcing/outsourcing/co-sourcing strategy supports the business and its plans to grow. As a result, there has been renewed interest of internal talent, with "re-tasking" of responsibilities and/or identification of talent needs.

Appendix A:
Tax function configurations observed

This section summarizes very briefly the trends we see in the tax function of each of three categories of fund manager: publicly traded; large private (e.g., over $50b assets under management (AUM)/often global investing platform) and the middle market.

Public

- In-house tax personnel [20+ people]
  - Law firm/Big Four partner-level professional "Head of Tax"
  - Big Four partner-level transaction professional(s)
  - In-house tax provision team with Big Four advice
  - Small team to work with tax compliance provider/routine tax matters
  - Partner-level tax professionals for strategies (e.g., private equity/credit/real estate/infrastructure/venture capital (VC))
  - Sub-advisor and local country tax advice widely dispersed/localized
- In-house investor relations/tax consideration and legislative developments/transaction risk management and for some structuring. Oversight role on remaining transactions
- Substantial investments in "single source of truth" information systems that afford tax access to relevant data, leveraging Big Four tax compliance technology platforms
- Tax compliance and reporting predominantly outsourced, one or two service providers-leveraging of service providers' tax technology platform/offerings
- Transaction tax run by deal teams (attached to financial due diligence provider), with tax input
- Portfolio company tax serviced by multiple providers, with limited fund-level involvement due to size of portfolios. Emerging trend of fund "Ops Groups" becoming more involved in tax
- Multiple advisors, although often a legacy "house" advisor that has a long-standing institutional relationship (i.e., part of historical fund manager startup, often going back decades)
- Public providers appear to be expanding internally in some areas (e.g., public company reporting) and are beginning to look more like a large regulated financial institution's tax function than their roots in middle market private equity

Large private (often global investing platforms)

- In-house tax personnel [5+ people]
- Law-firm/Big Four partner-level professional tax director typically focuses primarily on transaction tax, often in risk management role, but also in transaction structuring
- Tax manager to facilitate information flow to tax compliance provider(s)
- Tax manager to handle noncompliance tax matters
- No specialization where multiple strategies exist
- Sub-advisor advice and local country tax advice dispersed/localized
- Increasing investment in information systems, but often accounting focused without tax data, some leveraging of Big Four firms technology platforms
- Tax compliance and reporting predominantly outsourced, one or two service providers
- Deal teams drive service provider choice
- Portfolio company tax serviced by multiple service providers with minimal fund-level involvement
- Usually two main advisors; one for each of accounting and law firms

Middle market

- In-house tax personnel [0-2]
- Typically, only CFO/COO, sometimes a manager-level tax reporting person
- Lagging investment in information systems, accounting focus without tax access
- Tax compliance and reporting outsourced -one firm
- Transaction tax outsourced, with "light touch" fund-level risk management
- Deal teams drive tax service provider choice
- Portfolio company tax most often left to portfolio company management
- Usually, a single advisor for each of accounting and law firms

Appendix B:
Leading practices (and notable challenges)

Tax policy

- **Strategy and policy:**
  - Leading practices:
    - Written mission statement for tax function (areas to be served, e.g., risk management, support business, outsourcing, "best-in-class" vs. "best-in-cost")
    - Regular commercial review of structure and resulting tax considerations in supporting the overall business-alignment with and education of key stakeholders
    - Annual staffing review to establish the right skill sets to support business/manage risk
    - Commercial decisions about intended positioning for various tax activities (e.g., best-in-class, best-in-cost, somewhere in between)
    - Annual review of tax positions taken/to be taken — quantifying risk
    - Written policies and procedures to help mitigate risk, verify that tax team understands their responsibilities and wider organization understands the role of tax
    - Multiple-year strategy including areas to be served, staffing, outsourcing strategy and tax technology plan
    - Staffing strategy should include right skill sets (e.g., CPA not cleansing data), cost-effective locations, creating opportunities for staff development/ advancement and appropriate use of outsourcing and occasionally secondees (i.e., fill gaps temporarily, or assignment to hire)
    - Where applicable, developing methodology to charge certain costs to funds
    - Developing internal framework and use of advisors to monitor tax legislation around the world to manage risk and capitalize on opportunities (e.g., implementing a "Global Tax Dashboard/Radar Screen")
    - Development of peer network and strategy for participation in industry groups across the tax team
    - Strategy to manage third-party advisors, including policies and procedures to manage them (e.g., transaction checklist/tax compliance review package)
  - Notable challenges:
    - If policies are not written and or followed, there is a greater risk that regulatory matters are not followed properly, causing fines, penalties and/or reputation risk.
    - If tax is not consulted in a timely manner, a particular internal rate of rate (IRR) on a deal may be adversely affected because of an inefficient tax structure or where appropriate tax considerations were not addressed.
    - If formal policies and procedures are not established, the fund's tax function loses the ability to set the agenda internally and with outside advisors.
- **Fund structuring:**
  - Leading practices:
    - Tax should be consulted and collaborate with external tax counsel early in the fund structuring process and should provide input on legal operating agreements in order to achieve the desired tax consequences, as well as well as comply with complicated partnership tax rules.
    - During fundraising process, there should be constant communication between the tax function and investor relations so that both groups understand the tax characteristics, domicile, sensitives, and reporting needs of the fund's investor base to appropriately structure the fund, including establishing any required blocker vehicles, SPVs, and other holding companies to achieve the highest degree of tax efficiencies for fund investors.
    - Tax must review all investor side letters, which are an integral part of the parties' "partnership agreement" for tax purposes, and catalog and track going forward tax reporting requirements and other tax considerations and investor tax and reporting requirements.
    - There should be appropriate and clear documentation reflecting a common understanding as to the economic deal agreed to between the GPs and LPs and the proper tax allocations (and flexibility to deviate where needed), as the absence of this clearly documented understanding between the parties can have long-term negative effects on the relationship between the GP and fund investors.
    - Defined procedures related to collecting and updating investor data, e.g., IRS Forms W-8 and W-9, FATCA, CRS

Appendix B (continued):
Leading practices (and notable challenges)

- Notable challenges:
  - If the Fund fails to "get it right" from the commencement of the Fund, it may be difficult to amend applicable legal agreements in the future.
- **Management company structuring:**
  - Leading practices
    - Agree upon who will be members/owners of the management company, e.g., only founders, junior GPs.
    - Understand the differences between employee vs. partner tax treatment and implications of each.
    - Determine the tax residency of partners to determine whether a state "Passthrough Entity Tax election" (PTE) is efficient to make.
    - Analyze the various ways to incentivize employees using the management company in addition to carry.
    - Where possible, maintain flexibility in management company documents to accommodate "new joiners" and "leavers."
    - Implement periodic review of transfer pricing (at least every three years).
  - Notable challenges
    - Unwanted or differing tax results and ownership issues may occur between members/partners and employees if not discussed and consulted at the formation of the management company.
- **Carry plan design:**
  - Leading practices
    - Make timely commercial decisions about plan features and scope of participation to determine tax impact.
    - Determine the average hold period of investments as well as potential carry differences between owning investments via partnerships vs. corporations and the type of assets held, and appropriately managing holding period risks of add-on investments.
    - Consider how often new partners will be admitted to the carry vehicle; consider book-up/revaluations, as well as related tax compliance complexities and costs; undertake proper valuations, and appropriate documentation.
    - Identify the differences in tax treatment of carry in different countries/jurisdictions.
    - Assess the commercial and tax consequences to a departing carry partner and remaining partners upon exit or forfeiture by a carry recipient and adopt policies and procedures to provide proper tax attention.
    - Understand the economics of "deal-by-deal" or tracking interest carry plans and the related tax implications and complexities.
    - Determine availability of carry waivers and related leading practices.
  - Notable challenges
    - Failure to evaluate tax issues and consequences for fund managers (as well as carry plan participants) in a timely manner, particularly in jurisdictions where carry plan participants are resident for tax purposes.
    - Deal-by-deal carry point issuances can dramatically increase tax compliance and reporting complexity, as well as create commercial business issues.
- **Governance:**
  - Leading practices
    - Current involvement with all major aspects of business – tax should have a seat at the table.
    - Processes for responding quickly to developments and identifying and resolving potentially competing institutional concerns (e.g., as between tax and accounting).
    - Establishing that there is sufficient flexibility in the decision-making process when approvers are unavailable
  - Notable challenges
    - Without proper governance, people may make the wrong decision (without any intention of doing so) that can lead to unnecessary cost or reputation damage.

Appendix B (continued):
Leading practices (and notable challenges)

Fund and manager tax matters

- **Data development/management:**
  - Leading practices
    - Database technology platform that creates a "single source of truth" and allows easy access to relevant data for users across enterprise functions
    - Investor data
    - Trial balance/transaction data
    - Legal entity data
    - Data must be available for multiple purposes (e.g., tax compliance, FATCA, scenario planning, estimates, carry calculations)
  - Notable challenges
    - Collecting and maintaining financial data on a consolidated basis generally is inadequate for tax compliance and reporting and creates unnecessary work, expense, and delay.
- **Fund compliance and investor tax reporting:**
  - Leading practices
    - Outsourcing/co-sourcing (often relatively small internal team as compared to service providers) of tax compliance
    - Working with service provider to provide review packages where high-quality review can be performed in cost effective manner
    - Periodic review of best-in-class v. best-in-cost for certain tax filings (e.g., investor reporting "best-in-class")
    - Reconciliation of "Book Income" vs. "Tax Income" vs. cash for current investment sales
    - Tax compliance for flow-through investments performed by same service provider as fund to provide timely, consistent, high-quality information
    - If, for various reasons, the service provider is not the same at both the Fund and flow-through investment level, service providers must establish that there is agreement between the parties with respect to timing and tax positions taken
    - Consider state tax filing thresholds
    - Considerations of industry practices impacting tax filing positions
    - Procedures (including cost effective team performing the work) related to tax filing and paying tax due (including withholding taxes)
    - Periodic review of non-US tax information reporting filings obligations (e.g., IRS Forms 8865s, 5471, 8858s) and non-US income and withholding tax filings and parties responsible for preparation (negotiated but often fund is the responsible party) and cost (often investor is the responsible party)
    - GP reporting - quarterly estimates (or at least year-end estimates), annual GP, carry reporting
    - Multi-year tax data plan, including management of data by cost-effective team members in the right location
    - Establish availability and use of data for nontax purposes
  - Notable challenges
    - Generally, a disconnect between the Fund service provider and the service provider at the flow-through investment level can lead to inefficiencies on delivery of fund reporting to investors as well as disagreement with respect to tax issues that may have an effect at the LP & GP level.
- **Fund financial reporting:**
  - Leading practices
    - A qualified internal individual(s) with a tax provision skill set
    - A financial reporting timeline that allows tax sufficient time to analyze data
    - Standardized FIN 48/ASC 740 template
    - Blocker provision outsourced
  - Notable challenges
    - Not having an individual(s) that has the proper income tax provision skill set can lead to financial statement issues, cost overruns, and delayed delivery on financial statements.
    - Not having sufficient time to analyze can lead to errors and/or possibly late delivery of financial statements.

Appendix B (continued):
Leading practices (and notable challenges)

- **Tax audit and controversy:**
  - Leading practices
    - Tracking of tax audit and tax controversy matters
    - Consider impact of financial accounting reserves for tax positions and audits
    - Threshold for paying vs. challenging notices (i.e., cost effective)
    - Division between provider of tax advice vs. managing tax audit
  - Notable challenges
    - Failure to consider impact of financial accounting reserves for tax positions and audits in proper quarter
- **Management company/GP compliance and reporting:**
  - Leading practices
    - Single service tax provider for all tax compliance (including sub-advisors), tax reporting and dashboarding
    - Single service tax provider for internal stakeholders' tax returns to achieve consistency in reporting and reducing internal questions (often funded in full or part by management company)
    - Review of all carry distributions to determine appropriate tax withholding/reserve for tax distributions and withholding tax payments
    - Rigorous review and third-party advice of management fee/carry waivers including detailed calculations to support
    - Dedicated individual or team to manage carry plan including tax reporting, Section 83b tax elections and estimates
    - Regular review of transfer pricing (no more than three years)
  - Notable challenges
    - Internal stakeholder dissatisfaction with tax regarding the quality and/or timing of their tax and carry information
- **Public company compliance and reporting:**
  - Leading practices
    - In-house provisioning with significant Big Four support
  - Notable challenges
    - Errors due to lack of skills and/or time

Transaction tax:

- Leading practices
  - Checklist of fund-level commitments to investors (e.g., no local tax filing obligations, preventing incurrence of certain types of taxable income)
  - Outsourcing
    - *Middle market:* Fully outsourced due to cost of talent
    - *Large private:* Small in-house team, because valued by business and investors
    - *Public:* In-house by investment strategy and/or geography, because valued by business, investors, and risk management
  - Develop controls with respect to activities of deal professionals in connection with the negotiation, execution, and monitoring of investments to minimize tax risk (e.g., relating to establishing a permanent establishment)
  - Establish consistent methodologies for cash tax modeling, including approaches for valuation of tax attributes at entry and exit
  - Standardize tax due diligence process, including communication, written reporting, and integration of findings into deal models and transaction contract negotiations
  - Maximize deductibility of transaction costs through documentation and contracting leading practices while considering the indirect tax consequences
  - Model forms of agreement for management equity awards and terms
  - Standardize approach to funds flow memorandum and documentation of tax impact of structures at entry, during holding period, and at exit (including evaluation of potential exits)

Appendix B (continued):

Leading practices (and notable challenges)

- Develop a "100-day plan" at closing to address documentation, and post-closing action items identified in diligence, document, and action on tax compliance requirements (e.g., short period returns, impact on estimated tax payments requirements, tax payroll compliance, transfer tax filings), including consideration of tax function optimization opportunities for targets, cash tax considerations opportunities, etc.
- Implement a standard approach to maintaining legal entity organizational structure diagrams, including legal/tax monitoring and controls around post-closing changes.
- Coordinate with tax compliance as it pertains to the tax characterization and withholding tax implications of significant transactions, including distributions and exits.
- Periodically reconcile cash tax model to actual results, including review of implications of debt pushdowns and interest deductibility.
- Retain advisor fees until final step plans/documentation received
- Maintain advisor deal checklist that includes points such as (i) identifying investments in non-cooperative jurisdictions for tax purposes, (ii) confirming no LP local net tax payment or filing requirements, (iii) no dry/phantom income tax allocations expected, (iv) no unblocked effectively connected income (ECI) to non-US investors, or Commercial Activities Income (CAI) for Section 892 investors, or unrelated business taxable income (UBTI) to UBTI sensitive US tax exempt investors and (v) identification of material treaty-based positions as it relates to target's cash flows or the taxation of distributions or capital gains.
- Implement standard methodology related to dividend recaps/restructurings/sell side work (i.e., tax review before portfolio company put on market), including engagement of third-party advisors/review of portfolio company tax positions/tax fact books
- Make sure that tax function participates in initial public offering (IPO) transactions

- <u>Notable challenges</u>
  - Deal teams may exclude the tax function and fail to account for fund-level concerns, including risk management (e.g., portfolio consistency, and return preparer and auditor agreement with risk positions), and commitments to investors.
  - Particularly in minority investments, a failure to secure rights to relevant tax information can breach investor commitments and have adverse tax consequences for some investors.

Portfolio company tax:

- <u>Leading practices</u>
  - Engage the same service provider for flow-through investments and fund tax compliance to provide timeliness, consistency and quality of investor tax reporting.
  - Require the portfolio company tax team have the requisite skills needed to handle various tax matters, which are generally different from fund-level tax matters.
  - Verify that portfolio company team understands private equity and the tax effects to the GP and LP investors of the fund resulting from operations and transactions occurring at the portfolio company level.
  - Obtain the appropriate level of portfolio company team support during the acquisition stage, the holding period of the investment, and upon exit.
  - Utilize tax provider at the fund and portfolio company level to provide greater transparency and tax efficiencies at both the fund and portfolio company level.
  - Increase operation group focus:
    - Outsourcing at portfolio companies
    - Tax review before exit to prevent tax "surprises"
- <u>Notable challenges</u>
  - Not having the appropriate service provider or service level agreement at the portfolio company level can lead to tax inefficiencies both during the holding period of the investment (i.e., higher tax leakage) and more importantly, upon exit.
  - If a portfolio company team is not able to provide a tax deal book upon sale to make a buyer's tax due diligence more efficient, then trust in the financial statements may erode and/or tax risk may increase, both of which may lead to lower sale price.

How EY can help

EY professionals are available to facilitate discussion of a PE fund manager's tax function via our EY wavespace™ session, which involves a half-day in-person collaboration workshop utilizing our interactive technology that is customized for each participant on the current state of, and potential opportunities in, a fund manager's tax function.

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