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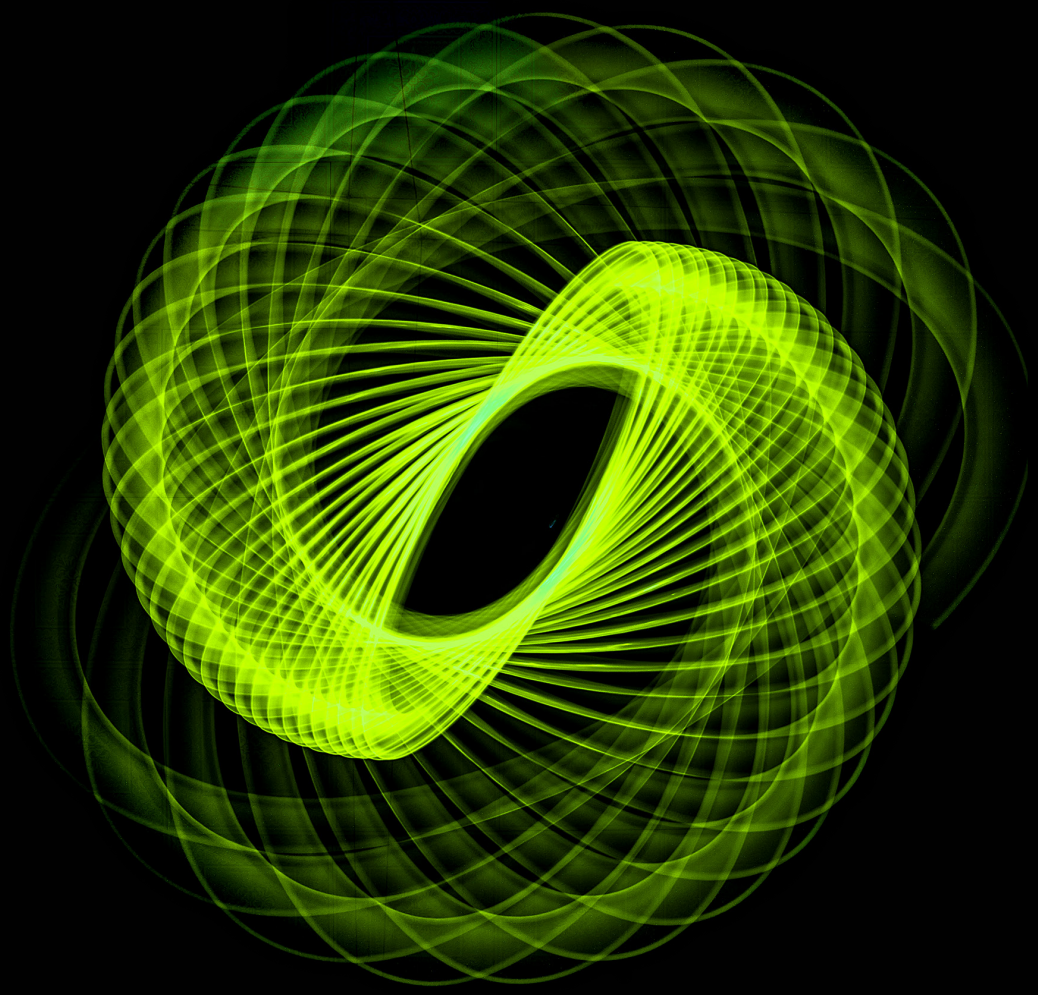

Adding value to private equity tax departments

James Casey, Greg Drudy, and Doug Puckett
Deloitte Tax LLP

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EXPERT COMMENTARY

The transformation of tax functions will be a crucial discussion for investment management firms in a rapidly changing economic landscape, write Deloitte Tax specialists James Casey, Greg Drudy and Doug Puckett



Adding value to private equity tax departments

The private equity industry is evolving to meet the demands of its investor base and the current regulatory, labor, and economic forces at work in the marketplace. The tax function within PE firms isn't immune from these changes and thus there's a transformation underway within PE firm tax departments.

Tax departments need to consider alternative operating models – starting with the question of whether tax should continue to be primarily a compliance function or whether there is more opportunity for it to add value to the firm and its investors.

The need to address the future has caused firm leadership to ask such questions as: What is the future role of our tax team? Does its core focus need to change? How can the tax function add more value as a business partner? How can tax leaders accelerate the transformation journey?

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Skill needs shift

Embedding an appropriate data infrastructure within the tax function and the larger firm (which houses the 'one source of truth' data the firm and tax department need to operate smoothly) and using best in class processes are critical for the future tax vision. Based on a 2021 Deloitte survey, tax leaders are aligned in their view that data skills (45 percent) and technology process experience (43 percent) are "must-have" skills in a tax department of the future, even if more traditional tax specialist knowledge is still noted as important (40 percent). The key to success may be in tax leaders facilitating the way these professionals, with their different backgrounds, can work together collectively to unlock lasting value.

Among the strategic reasons for change is the digitization of tax administrations. Real-time reporting

requirements are an emerging trend that will also necessitate strategic guidance from the tax department. These additional demands on the tax function are compounded by increasingly complicated regulatory and compliance tax reporting requirements such as the new Schedules K-2 and K-3, ongoing Section163(j) (interest expense) limitations, and foreign legislative reform requirements such as Pillar Two.

Big data brings bigger need

As firms continue growing, the amount of data they acquire increases exponentially and may be used differently throughout a PE fund's lifecycle. An example is investor demographic information and withholding forms, both of which require updates and recertification over time. As data is growing, tax departments need not only the human capital to handle these changes, but also the technology and technical ability to synthesize the data so that informed decisions may be made on short notice.

While the volume of data and its complexity are increasing and business partner demands on the tax department are rising, it isn't unusual for tax leaders to say their department's budget is remaining flat. If the tax function is going to redefine itself as a strategic business partner at the pace that is required, leaders will need to evaluate their departmental operations including talent, technology and process, and potentially engage with an external tax provider to assist with certain elements of compliance and reporting.

Due to the impact of the covid-19 pandemic, the last two years have been a watershed for transforming tax compliance and tax team resourcing models. CFOs and tax leaders are taking actions now to create additional capacity and control costs.

Finding the right service provider

One of the biggest pain points that PE firms face is transparency. When clients talk about working with outside firms, they say they're frustrated by the concept of "throw the data over the wall and then let my provider do what they do with it." They have no understanding of where things are in the process, or what challenges the delivery team might be facing. Too much time might be spent on something that's not important to the client, or too many hours poured into an issue that could be easily answered if the client knew their tax advisers were wrestling with it.

Clients can become frustrated when they're unclear on how their data is being used as part of the compliance process. Tax advisers need to share with clients in advance what data is required for the tax compliance process, and why. The days of simply e-mailing spreadsheet files to your tax adviser are long gone.

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Efficiency is another common area of concern – where a provider might make the same mistakes year after year and fail to capture efficiencies through technology. Relying on legacy spreadsheets or other static platforms can result in recreating the wheel every year. For PE firms, this is a pain point in the sense that the data wrangling process could be repetitive and inefficient. Clients are looking to work with service providers that have invested in and leverage technology to deliver efficiencies.

A third pain point is not extracting real-time insights from the process. For example, think of what is commonly referred to as the US 2017 Tax Act and some of the changes it brought, including the need to do interest expense modeling under IRC section 163(j), the qualified business income deduction, or, at the GP level, the excess business loss limitation. PE firms should be working with a firm and platform that can do all the data wrangling work to help develop real-time insights within the tax compliance platform and remove that work from the client's tax team. In-house teams often do this important work via manual processes that are many times inefficient and time consuming.

What's next?

Tax leaders are prioritizing data simplification and lower-cost resourcing as a foundation for their future vision. There's a need to understand the complex implications of adopting new digital product and distribution models, tax credits, grants and incentives, and the impact of government sustainability policies.

CFOs and their tax leaders need to be assessing where the tax department can add the most strategic value to the business and what options are available to increase capabilities and capacity without increasing costs. ■

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